IMPLICATION OF TDS AGAINST GRANTS

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ANALYSIS OF VARIOUS TYPES OF GRANT CONTRACT

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INTRODUCTION

1.01 Charitable societies often receive grants from government and private parties, with some donors deducting TDS under Sections 194C and 194J of the Income Tax Act, 1961. The key question is whether these grants should be treated as incidental business receipts solely due to the TDS deduction, in light of restrictions under Section 2(15) on commercial activities.

1.02 The proviso to Section 2(15) restricts incidental business activities for General Public Utility (GPU) organisations to 20% of their total receipts, and other charitable organisations must operate without profit motives.

1.03 The Supreme Court's ruling in the case of *ACIT v. Ahmedabad Urban Development Authority* [2022] 143 taxmann.com 278/[2023] 291 Taxmann 11 clarified that charitable entities may engage in business activities if they are incidental to their objects and do not exceed 20% of total receipts.

1.04 The audit report in Form 10B requires auditors to report any business income or income from commercial activities, including TDS deductions under Sections 194C, 194J, and others. Clause 19 of Form 10B specifically focuses on TDS reporting, necessitating the classification of these incomes to determine their nature and adherence to Section 2(15).

1.05 The mere deduction of TDS does not automatically classify the grants as business receipts. Grants subject to 100% utilisation or those where the unspent balance must be returned to the donor are not considered commercial receipts.

1.06 If donors wrongly deduct TDS, the charitable organisation can still claim exemptions under Sections 11 and 12, as clarified in the case of *Aroh Foundation v. CIT, Exemption,* [2024] 159 taxmann.com 608 (Delhi).

1.07 Grants should not be treated as commercial receipts or income from services just because of TDS deductions, provided the grants are subject to proper utilisation, align with the donee's objects, and do not involve any profit element to the implementor.

ISSUE AND BACKGROUND

2.01 A charitable society receives grants from the government and private parties. However, many of these donors deduct TDS under Sections 194C and 194J while disbursing the grants. The question arises whether the grants received should be treated as receipts from incidental business activities solely because of such tax deductions under Sections 194C/194J, especially considering the restrictions on commercial activities or contractual income as per the first proviso to Section 2(15).

SECTION 2(15) AND RESTRICTION ON BUSINESS-LIKE ACTIVITY

3.01 The proviso to Section 2(15) of the Income Tax Act, 1961 limits business activities for General Public Utility (GPU) organizations to 20% of their total receipts. Additionally, other charitable organizations are expected to primarily operate without a profit motive, even though they are not subject to the same 20% restriction on business activities.

3.02 The Supreme Court of India in the case of *ACIT* v. *Ahmedabad Urban Development Authority* [2022] 143 taxmann.com 278/[2023] 291 Taxmann 11 has clarified that:

- An assessee in GPU category cannot engage itself in any trade, commerce or business, or provide service in relation thereto for any consideration ("cess, fee or any other consideration");
- However, in the course of achieving the object of general public utility, the concerned trust, society, or such other organization, can carry on trade, commerce or business or provide services in relation thereto for consideration, provided that

(i) the activities of trade, commerce or business are connected ("actual carrying out…" inserted w.e.f. 01-04-2016) to the achievement of its objects of GPU; and

(ii) the receipt from such business or commercial activity or service in relation thereto, does not exceed 20% of total receipts of the previous year, w.e.f. 01-04-2016);

IMPLICATIONS OF VIOLATING THE PROVISO TO SECTION 2(15)

4.01 Section 13(8) outlines the consequences of violating the proviso to Section 2(15), stating that exemptions under Sections 11 and 12 will not be available if a trust violates these provisos. In other words, the exemption will be withdrawn if the trust engages in business activities and the aggregate receipts from such activities exceed 20% of the total receipts during the previous year. The institution would then be subject to penal consequences under Section 13(8), read with Sections 13(10) and 13(11). Furthermore, repeated violations, i.e., year-on-year breaches of the proviso to Section 2(15), may jeopardize the trust's charitable status and lead to cancellation proceedings under Section 12AB(4)

TYPES OF GRANT CONTRACTS WHICH MAY OR MAY NOT BE TREATED AS COMMERCIAL

5.01 Grants from government and private entities may be subject to various conditions and deliverables. Therefore, it is important to understand the different types of contractual obligations in order to properly analyse the tax implications. For the purposes of this query, the grant contracts and related issues are categorised as follows

(a) **Grant agreements subject to 100% actual utilization**, where any unspent balance belongs to the donor. Such grants, as explained below, cannot be treated as commercial receipts, even if TDS is deducted.

(b) **Delivery/milestone-based grant agreements** that are not subject to

100% utilization, where the donor has no claim on the unspent balance. These grants, as explained below, shall be treated as commercial receipts, even if TDS is not deducted.

(c) **Cases where the donor incorrectly deducts TDS** from the grant amount. Such grants, as explained below, cannot be treated as commercial receipts, even if TDS is deducted.

GRANT AGREEMENT SUBJECT TO 100% ACTUAL UTILISATION

6.01 Grant agreements are normally not be hit by proviso to Section 2(15) even if the donor deducts TDS, if it satisfies the following conditions:

(a) ***Grant agreement is in the nature of trusteeship contracts:*** We understand that a grant agreement cannot be treated as a service agreement only because TDS is deducted from the amount received as a grant. In our opinion, if the Grant contract is based on contribution to be utilized entirely without any possibility of profit or loss or any element of adventure, then such contract are essentially trusteeship contracts in the nature of legal obligation, therefore the question of such a contract being treated as service agreement (with or without profit motive) does not arise. Generally, in case of specific tied up grants and grants from Government or private parties, grant is received for specific purposes which are covered within the object clause of the Donee organization and are subject to utilization. Therefore, these are in the nature of legal obligation and technically should not be considered as income at all. Whether specific or restricted grants can be considered income or not, has been settled by the Supreme Court in the cases of *CIT v. Tollygunge Club Ltd.* [1977] 107 ITR 776 and *CIT v. Bijli Cotton Mills (P.) Ltd.* [1979] 116 ITR 60 where it was held that legal obligation should not be considered as income.

(b) ***No benefit /reward to the implementing organisation:*** For a commercial contract,

it is necessary to create Client – Service Provider Relationship, which implies that the client must not only pay the expenses of the service but also the consideration or reward for the service to the service provider. Grant agreements are subject to utilisation and any unspent balance is required to be refunded back to the Donor and therefore, there is no room for any reward to the donee organization. The Hon'ble Supreme Court in *the case Apitco Ltd. v. Commissioner of Service Tax, Hyderabad [2012] 26 taxmann.com 213 (SC)* held that if grants-in-aid received from Central and State Governments for implementation of welfare schemes for various sections of society are totally utilized for such purpose, there is no service provider-client relationship between assessee and Government. Only utilization of money for agreed purposes will not result in service provider-client relationship; a client must not only pay the expenses of the service but also the consideration or reward for the service to the service provider.

6.02 In this context, it may be noted that the actual utilisation should not include internal transfers and intra-organisations cost recoveries. In other words, the application should be based on actual payment and transfer of funds between two parties.

a) The interest or any other income shall be a part of project fund.

b) The unspent balance shall belong to the donor or utilized as per the mandate of Donor.

DELIVERY BASED GRANT AGREEMENTS WHICH ARE NOT SUBJECT TO ACTUAL UTILISATION

7.01 **Delivery-based grants** are those provided or reimbursed by the donor upon the completion of specified activities or milestones. The amount of the grant or reimbursement is fixed at the time of entering into the agreement for each milestone achieved and is not dependent on the actual expenses incurred. For example, in a

grant agreement where the donor agrees to pay Rs. 5,000 per trainee regardless of the actual amount spent, such a delivery-based grant may be considered a service contract. This could be subject to the proviso to Section 2(15) if the total receipts from such business or commercial activity, or related services, exceed 20% of the total receipts for the previous year. In such cases, whether TDS was deducted or not is irrelevant. Additionally, grant contracts where internal transfers are claimed as expenses for the use of staff or infrastructure may also be treated as commercial contracts.

7.02 The Hon'ble Supreme Court in the case *ACIT v. Ahmedabad Urban Development Authority [2022] 143 taxmann.com 278/[2023] 291 Taxmann 11* explained that generally, the charging of any amount towards consideration for such an activity (advancing general public utility), which is on cost-basis or nominally above cost, cannot be considered to be "trade, commerce, or business" or any services in relation thereto. It is only when the charges are markedly or significantly above the cost incurred by the assessee in question, that they would fall within the mischief of "cess, or fee, or any other consideration" towards "trade, commerce or business". In this regard, the Court has clarified through illustrations what kind of services or goods provided on cost or nominal basis would normally be excluded from the mischief of trade, commerce, or business, in the body of the judgment.

7.03 In our opinion, the Supreme Court's judgment primarily addresses the impact on a charitable organisation's status when beneficiaries are charged as part of a charitable activity. Therefore, we believe that the ruling does not apply to cases where a recipient organisation generates a surplus from a grant contract, even if the surplus is reasonable. In a trusteeship grant agreement, there is no scope for generating a surplus or retaining an unspent balance.

WHERE THE DONOR WRONGLY DEDUCTS TDS

8.01 If the donor erroneously deducts TDS from the grant amount and the donor acknowledges this error, such a grant cannot be classified as receipts from professional or technical services, or as contractual income, according to the first proviso to Section 2(15).

8.02 In the case of *Aroh Foundation v. Commissioner of Income-tax, Exemption [2024] 159 taxmann.com 608 (Delhi)*, the Court held as under:

> *"If the deductor in its Income-tax Return, under misconception, deducts TDS under sections 194C and194J, the same would not disentitle the assessee to claim benefit under sections 11 and 12 unless the case of assessee is specifically hit by the Proviso of section 2(15), which is not the case here. The Proviso to section 2(15) would not get attracted merely on the basis of deduction of TDS by the donor under a particular head. [Para 21]"*

CONCLUDING REMARKS

9.01 To summarize, grants received should not be treated as receipts from professional or technical services, or as contractual income under the proviso to Section 2(15), merely because donors deduct TDS under Sections 194C and 194J, if the following conditions are met:

(a) The grant is for a purpose or objective that the donee organization is entitled to pursue according to its approved objects.

(b) The grant is subject to 100% utilization for implementing the specified program, without any cost recoveries in the form of internal transfers.

(c) The donee does not receive any benefit or reward beyond the grants-in-aid.

(d) The unspent balance, as per the agreed terms, must either be refunded to the donor or utilized only with the donor's approval.

(e) Any interest or other income earned from the project or project funds must be added back to the project.

9.02 If all these conditions are met, then the grant agreement cannot be considered an adventure in the nature of a business activity. Consequently, the contract essentially becomes a trusteeship contract with a legal obligation, and the grants received would not be classified as receipts from professional or technical services, or as contractual income under the first proviso to Section 2(15).

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