

## An educational institution is not eligible for tax exemption under Section 10(23C) of the Income-tax Act when it is not engaged 'solely' in educational activities – Supreme Court

### Executive Summary

Section 10(23C) of the Income-tax Act, 1961 (the Act) provides an exemption to any income of university or other educational institutions existing 'solely' for educational purposes and not for profit. There has been considerable litigation on whether educational institutions should exist solely for education. The Supreme Court, in the case of American Hotel and Lodging Association<sup>1</sup> and Queen's Education Society<sup>2</sup> applied the predominant object test and determined whether the 'principal' or 'main' activity was education or not. The Court allowed the exemption to educational institutions where education was the predominant object or activity amongst various other objects, even when it did not exist solely for the purposes of education.

The Supreme Court, in the case of New Noble Educational Society<sup>3</sup> (the taxpayer) overruled its earlier decisions<sup>4</sup> and held that the requirement for the charitable institution, society or trust, etc., is to 'solely' engage itself in education or educational activities and not engage in any activity of profit. Such institutions cannot have objects which are unrelated to education. Where the objective of the institution appears to be profit-oriented, such institutions would not be entitled to approval of the exemption. If incidentally, while carrying on educational objectives, the trust earns profits, it had to maintain separate books of account. It was only in those circumstances that 'business' income could be permitted, provided that the activity was incidental to education or relating to education. Further, wherever registration of trusts or charities is

obligatory under state or local laws, the concerned entity seeking approval under Section 10(23C) should also comply with the provisions of such state laws. Also, the tax authorities are free to call for the audited accounts and other equivalent documents to ascertain the functioning/genuineness of the charitable institution while considering applications for tax exemption.

### Facts of the case

- The taxpayer, an education society, had applied for the registration of trust, which was set up for the charitable purpose of education, and also claimed the benefit of exemption under Section 10(23C)(vi).
- The tax department denied the taxpayer's claim for registration on the ground that it was not created 'solely' for the purpose of education. Further, it was not registered under the Andhra Pradesh Charitable and Hindu Religious Institutions and Endowments Act, 1987 (the A.P. Charities Act) as a condition precedent for the grant of approval.

### Supreme Court's decision

#### Meaning of the term 'Education'

- The Supreme Court, in the case of T.M.A Pai Foundation<sup>5</sup> held that education is scholastic structured learning. Thus, education, i.e., imparting formal scholastic learning, is what the Act provides for under the head of 'charitable' purposes under Section 2(15).

<sup>1</sup> American Hotel & Lodging Association, Educational Institute [2008] 301 ITR 86 (SC)

<sup>2</sup> Queens Educational Society v. CIT [2015] 372 ITR 699 (SC)

<sup>3</sup> New Noble Educational Society v. CCIT (Civil Appeal No. 3795 of 2014) (SC) – Taxsutra.com

<sup>4</sup> Division Bench rulings in Queens Education Society and American Hotels

<sup>5</sup> T.M.A Pai Foundation v State of Karnataka, (2002) (8) SCC 481

### ***'Solely' for the purpose of education***

- The Supreme Court overruled the Division Bench's decision in the case of Queens Education Society<sup>6</sup> and American Hotels<sup>7</sup> on the interpretation of the word 'solely' occurring in Section 10(23C), where the 'predominant object' test laid down in Surat Art Silk<sup>8</sup> was followed.
- The plain and grammatical meaning of the term 'solely' is 'only' or 'exclusively'. The term 'solely' is not the same as 'predominant / mainly'. The term 'solely' means 'exclusion of all others'. Thus, a trust, university, or other institution imparting education should necessarily have all its objects aimed at imparting or facilitating education. The trust or educational institution, which seeks approval or exemption, should solely be concerned with education or education-related activities.
- If the language is unambiguous and capable of one meaning, that alone should be applied and not any other.
- Since the current decision departed from the previous rulings regarding the meaning of the term 'solely', in order to avoid disruption, it would apply prospectively.

### ***Institutions existing for profit***

- Where the objective of the institution appears to be profit-oriented, such institutions would not be entitled to approval of the exemption. At the same time, where surplus accrues in a given year or set of years per se, it is not a bar, provided such surplus was generated in the course of providing education or educational activities.
- The provisions<sup>9</sup> refer to profits that may be 'incidentally' generated or earned by the charitable institution relating to educational activity, i.e., sale of textbooks, school bus facilities, hostel, etc.
- If incidentally, while carrying on educational objectives, the trust earns profits, it has to maintain separate books of account. It was only in those circumstances that 'business' income could be permitted, provided that the activity was incidental to education or relating to education.

- However, if educational institutions provide their premises to other entities for other activities like seminars, workshops, etc., income derived from such activities will not be incidental to imparting education.

### ***Role of tax authority (Commissioner or any other designated authority)***

- The tax authorities are not bound to examine only the objects of the institution. To ascertain the genuineness of the institution and the manner of its functioning, they are free to call for audited accounts or other such documents.
- However, while considering an application for approval and the further material called for (including audited statements), tax authorities should confine the inquiry ordinarily to the nature of the income earned and whether it is for education or education-related objects of the society (or trust). At the stage of registration or approval therefore focus is on the activity and not the proportion of income.

### ***Applicability of Other Law***

- Local laws provide the regulatory framework by which annual accounts, the manner of choosing the governing body acquisition and disposal of properties, etc., are constantly monitored.
- It provides a statutory regulatory framework in regard to the activities of charitable institutions in the state. It also contains provisions to protect the interests of the institution, especially funds and properties.
- Thus, charitable institutions and societies, which may be regulated by other state laws, have to comply with them. Compliance with or registration under those laws was a relevant consideration that can legitimately weigh with the tax authorities while deciding applications for approval<sup>10</sup>.

### ***Our Comments***

The Supreme Court has held that the principle of 'predominant object' as laid down in the case of Surat Art Silk Cloth Manufacturers' Association is not applicable in the context of Section 10(23C). Hence, charitable organisations claiming Section 10(23C) exemption basis this landmark decision will be impacted.

<sup>6</sup> Queens Educational Society v. CIT [2015] 372 ITR 699 (SC)

<sup>7</sup> American Hotel & Lodging Association, Educational Institute [2008] 301 ITR 86 (SC)

<sup>8</sup> ACIT v. Surat Art Silk Cloth Manufacturers' Association [1980] 2 SCC 31 (SC)

<sup>9</sup> Seventh proviso to Section 10(23C), as well as Section 11(4A) of the Act

<sup>10</sup> Under Section 10(23C) of the Act

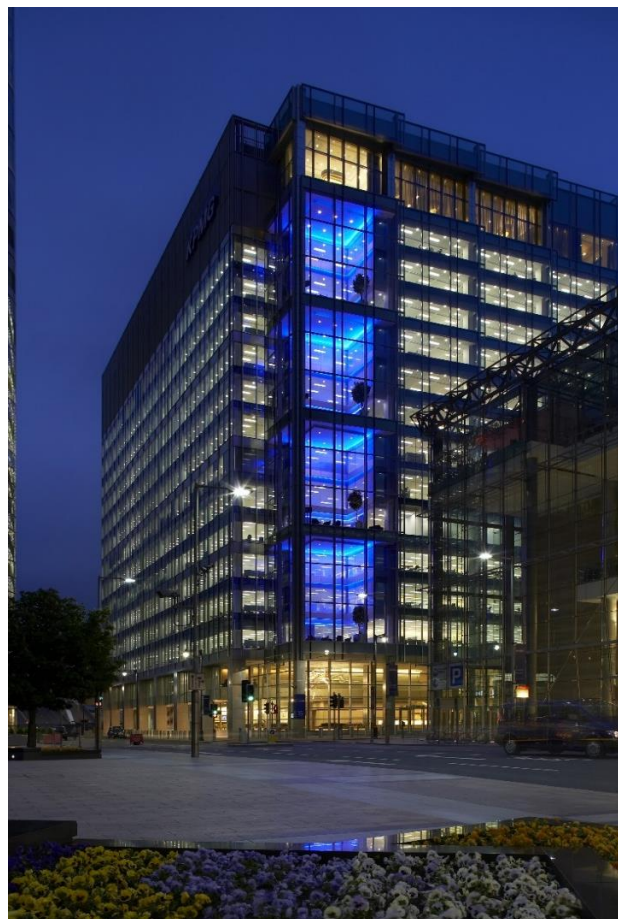
Many courts have dealt with the term 'education' in a wider sense to keep in sync with changing times. However, the Supreme Court has reiterated the principles laid down in the case of Lok Shikshana Trust, i.e., the term "education" is restricted to "imparting formal scholastic learning" only and not in a wider sense. In view of the above, this decision may further challenge the eligibility of several organisations who are imparting non scholastic / non classroom education eg. trainings, capacity building workshops, etc. to claim an exemption under the Act.

Further, the Supreme Court has put limitations on the nature of incidental activities that may be undertaken by Section 10(23C) registered institutions. Few examples are provided to indicate the incidental business activities that an institute can undertake, provided separate books are maintained for such activities. The decision will impact several educational institutions that are currently carrying out other unrelated activities which are not 'solely' for the purpose of education.

Apart from education institutions, even hospitals registered under Section 10(23C) and carrying out unrelated activities will need to relook at their operations.

The observations on the meaning of 'incidental' activities could also have a bearing on the activities carried out by charitable organisations registered under Section 12AB. The charitable organisations had little to choose between Section 10(23C) and Section 12AB, as the Finance Act, 2022, had introduced several amendments to bring parity between these two sections. However, with this decision, several institutions may now look at claiming exemption under Section 12AB, considering how widely the section is worded.

Some of the positive aspects of this decision are that generating a surplus in the course of providing core activities of education/healthcare is not prohibited. Further, the decision will only have a prospective impact.



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