

EY Tax Alert

Supreme Court interprets 'solely' restrictively to deny tax exemption to educational institutions with multiple objects

Executive summary

Tax Alerts cover significant tax news, developments and changes in legislation that affect Indian businesses. They act as technical summaries to keep you on top of the latest tax issues. For more information, please contact your EY advisor.

This Tax Alert summarizes a recent Supreme Court (SC) ruling in a batch of appeals with New Noble Educational Society vs CIT¹ as the lead case (Taxpayers). The issue involved before the SC was on rejection of taxpayer's application for approval for tax exemption under Income Tax Law (ITL) on the grounds that (i) educational institution did not solely exist for the purpose of education as required under the relevant provisions of ITL and (ii) it was not registered under applicable state legislations. The SC held that tax exemption cannot be availed by educational institutions having objects other than imparting education/educational activities having regard to the language- "*...educational institution existing solely for educational purposes...*". The SC further held that it was mandatory for charitable institutions availing tax exemption to register/comply with mandatory provisions of applicable state legislations.

In addition, the SC also explains meaning and scope of the term 'education' as also 'business incidental to the object' and provides restrictive meanings thereof.

¹ TS-809-SC-2022

Background

The ITL provides exemption to charitable trusts and institution engaged in charitable purposes subject to fulfilment of conditions. Education is one of the defined charitable purposes under the ITL. Income of university or other educational institution (Educational Institution) existing solely for the purposes of the education and not for the purposes of profits enjoys exemption under provision of section (s.) 10(23C)(vi) of ITL. Exemption is conditional upon spending of at least 85% of its income on the objects of the trust or institution or accumulates it for being spent on the objects over a period of five years.

Further, exemption is subject to the approval by the Prescribed Authority under the ITL² (PA) and such approval requires periodical renewal. The ITL also confers powers on PA to call for documents or information to ascertain the genuineness of activities of the charitable institutions at the stage of renewal of approval.

Besides approval under the ITL, such charitable institutions are required to get registered for regulatory and other compliances under applicable state laws.

Under the Indian jurisprudence, various Courts including the Supreme Court (SC)³ permitted educational institutions to avail the tax exemptions under the ITL even when it was not existing solely for the purposes of education, but education was the predominant object or activity amongst various other objects. The term 'solely' thus was interpreted by applying the 'predominant test' which was outlined by the SC for the first time in the case of Surat Art Silk Cloth Manufacturers Association⁴ (Surat Art).

Further, in view of the ratio laid down in the case of American Hotel and Lodging Association (*supra*), it was the general understanding that the nature of enquiry for grant of approval under s. 10(23C) was restricted to examining the objects of the institution. Thus, usually the PA was prevented from going beyond examination of the objects for grant of approval.

Another aspect which lacked clarity was whether charitable institutions which were registered under the ITL were required to comply with registration and other provisions under other applicable state laws.

Issues before the SC

In a batch of appeals filed before the SC, it was concerned with issue of rejection of claim for approval under the ITL as educational institutions on primarily two grounds - educational institutions not existing solely for the educational purposes, and where educational institutions were not registered under applicable state laws.

Taxpayers' contentions before SC

- ▶ Taxpayers contended that the term 'solely' maybe interpreted liberally to construe education as being a predominant object. The support was drawn from certain earlier SC rulings⁵ on the subject wherein such construction was favored by the Court.
- ▶ Further, where taxpayer was engaged in objects other than education, but such other objects were charitable in nature, it fulfilled the condition of solely for educational purposes. The emphasis of the word 'solely' was in relation to the institution's motive not to operate for the purposes of making profit and it was not to be interpreted in relation to the objects of the institution.
- ▶ Also, if more than one object did exist and all the objects were essentially charitable in nature, what was required to be seen was the actual functioning of the institution. The mere possibility that the trustees possessed the discretion to apply the surplus or earnings in respect of any object, and education was not sufficient.
- ▶ The emphasis in ITL was not on the absence or existence of objects other than education, rather, the negative mandate against profit is that profit cannot motivate a charitable institution's functioning.
- ▶ Taxpayers referred to the SC ruling in the case of Queens Educational Society (*supra*) in support of the proposition that income earned incidentally, or profits incidental to the main activity, per se would not debar a trust's application for approval or registration, as a tax-exempt organization.
- ▶ The enquiry by PA at the stage of grant of approval be restricted to examining the objects of the institutions, and not beyond that. The threshold conditions were actual existence of educational institution and approval of the PA. Once condition of actual existence was met, compliance with requirements of other related provisions was not relevant at the stage of grant of approval. The manner of utilization of surplus or profits, question on application of income, audited books of account could arise only at the stage of assessment where the tax authority examined the functioning of the institutions and compliance with law.
- ▶ The provisions of the ITL relating to charitable institutions operate as a complete code in itself. There is no requirement under ITL to be registered under other applicable state laws as a pre-requisite and registration under ITL cannot be denied merely on the fact that the institution was not registered under state laws applicable to it.

² Commissioner or any other designated authority

³ Illustratively, Queens Educational Society Vs Commissioner of Income Tax (2015) 372 ITR 699, American Hotel & Lodging Association, Educational Institute (2008) 301 ITR 86

⁴ Additional Commissioner of Income Tax vs Surat Art Silk Cloth Manufacturers Association (1979) 121 ITR 1

⁵ Queens Educational Society Vs Commissioner of Income Tax (2015) 372 ITR 699, American Hotel & Lodging Association, Educational Institute (2008) 301 ITR 86

Tax authority's contentions

- ▶ Tracing the legislative history surrounding the relevant ITL provisions and referring to the SC ruling in the case of T.M.A Pai Foundation⁶, it was contended that as per the ratio in the said ruling, education under the Constitution meant and included education at all levels from primary school up to post-graduation, and also included professional education. The expression 'educational institution' meant institutions which imparted education as understood in the formal sense of schooling. In other words, education meant mainstream curriculum-based education and it cannot be understood in a broader sense.
- ▶ The term education was covered by the term 'occupation'. The term 'occupation' would be an activity of a person undertaken as a means of livelihood or as a mission in life. Thus, education was an occupation and can be regarded as a charitable activity. It could not be regarded as trade or business with profit motive driving it. In other words, education could not, either under the Constitution or under the ITL, be regarded as a business activity. Thus, any commercialization of education would result in loss of the benefit of tax exemption which an institution would otherwise be entitled.
- ▶ The predominant object test applied by various courts was erroneous since the provision expressly stipulated that the institution exists solely for education purposes. Further, the distinction drawn between making a 'surplus' and carrying on an activity for profit, where institutions making a surplus were not debarred from tax exemption, as held in Queens Educational Society (*supra*) was incorrect.
- ▶ Further, the Taxpayers' proposition that the manner of utilization of surplus or profits, question on application of income etc. viz, the monitoring provisions are to be considered only at the assessment stage by relying on the American Hotel ruling is erroneous.

SC's ruling

SC has upheld the tax authority's order rejecting the grant of approval to the Taxpayers and held as under:

Meaning and scope of 'education' as charitable purpose

- ▶ Though subject of education is vast, for ascertaining the charitable purpose the broad meaning of the expression is not warranted. Referring to SC decision in the case of T.M.A. Pai Foundation, SC reiterated to adopt

narrower meaning of the term 'education' as scholastic structured learning or imparting formal scholastic learning. In other words, education for charitable purpose is the process of training and developing the knowledge, skill, mind and character of students by formal schooling.

Institutions existing 'solely' for education

- ▶ The plain and grammatical meaning of the term 'sole' or 'solely' is 'only' or 'exclusively'. The term 'solely' means to the exclusion of others, and it cannot be 'predominant or mainly'.
- ▶ The SC rulings in Queens Educational Society and American Hotel, where SC adopted the predominant object test in the context of educational institution for the expression 'solely', did not explore the true meaning of the expression 'solely'. Also, the SC erroneously extended the test of predominant object as expounded by it in the case of Surat Art which was decided in the context of the society set up to advance objects of general public utility. In Surat Art, SC picked up the first among the several objects as the 'predominant' object which it had to consider while judging the association's claim for exemption. The SC in Queens Educational Society and American Hotel when applied the 'predominant object' test, it was clearly inapt in the context of charities set up for advancing education. These decisions not laying down the law correctly are overruled to that extent.
- ▶ With a view to further buttress the proposition, SC observed that the exemption provision entails the positive condition of solely for educational purposes and negative injunction of 'and not for the purposes of profits'. Reiterating the requirement of 'solely', SC concluded that a trust, university or other institution imparting education should necessarily have all its objects aimed at imparting or facilitating education.
- ▶ SC referred to the principles of interpretation of statutes pertaining to tax laws, discussed in various rulings including the Constitution Bench ruling in Dilip Kumar and Company & Ors⁷ and stated that language of the provisions being plain and unambiguous, the words may be construed in their natural and ordinary sense.
- ▶ Basis above, SC in present ruling concluded as under:
 - ▶ The educational institution will qualify for exemption only if all objects of the institution relate to imparting of education or educational activities and does not have objects unrelated to education.

⁶ T.M.A Pai Foundation v State of Karnataka, (2002) (8) SCC 481.

⁷ Commissioner of Customs (Import), Mumbai v. Dilip Kumar and Company & Ors., (2018) 9 SCC 1.

- ▶ Where the objective of institution is profit oriented, (except where such profit is derived from business which is incidental to educational activity) such institution would not qualify for exemption. However, generating surplus in a given year or set of years in itself will not debar the institution from exemption if such surplus is generated in the course of providing education or educational activities incidental thereto.
- ▶ SC having departed from the earlier rulings on the meaning of the term 'solely', declared the instant ruling to operate prospectively in order to avoid any disruption and to give time to the institutions likely to be affected by the present ruling to enable them to make appropriate changes and adjustments.

Scope of business profits incidental to objects⁸

- ▶ SC noted one of the proviso's⁹ to the exemption provision which provides that profits of the business will not be exempt unless the business is incidental to the attainment of its objectives, and separate books of account are maintained in respect of such business.
- ▶ SC read this provision as carving out an exception to the principal requirement of educational institution existing solely for education and not for profits. The said proviso permits the educational institution to record/earn profits provided the 'business' which in the context is restricted to education or educational activities incidental thereto.
- ▶ While explaining the meaning incidental business activity in relation to education, SC cited examples of activities such as sale of textbooks, provision of school bus facilities, hostel facilities, providing summer camps for pupils' special educational courses, such as relating to computers etc. considered as incidental to providing education. However, where educational institutions provide their premises to other entities for conduct of workshops, seminars or even educational courses (which the concerned institution is not actually imparting), income derived from such activity cannot be characterized as incidental to imparting education.
- ▶ Where educational institution is also engaged in providing hostel and allied facilities (such as catering), the hostel activity will constitute incidental activity only if these facilities are provided to its students.

Scope of examination by PA at stage of approval

- ▶ On scope of PA's nature of enquiry where a charitable organisation approaches the authority for approval under relevant provisions¹⁰ of ITL, SC noted that such examination by PA may not be only restricted to the objects of the institution. In order to ascertain the genuineness of the institution or manner of its functioning, the PA is free to call for audited accounts or other such documents for recording satisfaction where the society, trust or institution genuinely seeks to achieve the objects which it professes.
- ▶ The observations in American Hotel ruling on this issue are contrary to the clear provisions and are non-cognizant of the discretion vested with the PA and are on the assumption that only newly set up societies or institutions may apply for approval.
- ▶ SC, however held that the PA at the stage of approval should confine the enquiry to the nature of income earned and whether such income is from education or education related objects. SC also held that if the surplus or profits are generated in the imparting of education or related activities, no disproportionate weight should be given to such fact if such activities are incidental. In other words, the focus of enquiry should be on the activity and not the proportion of income.

Requirement of registration under other applicable state laws:

- ▶ SC observed that the state legislations applicable to the public charitable institutions provide a statutory regulatory framework in regard to their activities in the state. Such legislations enable the state for the proper administration of charitable institutions, to ensure that they are managed efficiently without misfeasance. They also contain provisions to protect the interests of trusts, especially funds and properties.
- ▶ Basis above, SC held that charitable institutions and societies as well to comply with the mandatory provisions of state laws. Such compliance will enable the PA under ITL to ascertain the genuineness of the trust/society.

⁸ SC specifically observed that the discussion around incidental business will equally apply to cases covered by S. 11(4A) and other sub-clauses of Section 10(23C) that deal with education, medical institution, hospitals etc.

⁹ Seventh proviso to S. 10(23C)
¹⁰ S.10(23C)

Comments

The SC ruling is an important development in relation to exemption enjoyed by educational institutions covered by S. 10(23C) of the ITL. It unfolds many interpretational issues concerning applicability of exemption provisions to educational institutions and may also extend to other charitable institutions claiming exemption under different provisions (S.11) of ITL. This includes scope and meaning of incidental business, difference between surplus and profits, compliance with applicable state legislations and scope of enquiry by tax authority at stage of application of approval.

In the context of educational institutions covered by S.10(23C) of ITL, the SC departing from its earlier position, held that the educational institution will enjoy exemption only if it exists for the purpose of education and no other purpose. SC expressly overruled its earlier rulings in *Queens Educational Society* and *American Hotel* which have adopted liberal meaning of the term 'solely' as predominant object.

However, interpretation of 'solely' as indicated in the SC ruling will be restricted to educational institutions registered under S.10(23C) where the language of the provision provides such restriction. Consequently, charitable trusts and institutions not governed by such specific restriction can pursue multiple charitable purposes as their objects.

As a good gesture, SC declared the instant ruling to operate prospectively in order to avoid any disruption and to give time to institutions likely to be affected by the present ruling to enable them to make appropriate changes and adjustments. Accordingly, taxpayers affected by the ratio of this ruling may endeavor at the earliest to take suitable steps to align its objects with the SC ruling.

The ruling also highlights that it is mandatory for charitable trusts and institutions to ensure compliance with other state laws as applicable to them. Such is also now the implied requirement of specific provision in ITL mandating compliance of material provisions of other laws.

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