

Supreme Court interprets the term ‘solely’ and settles the controversy regarding the eligibility of tax exemption to profit-oriented educational institutions

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Summary

Section 10(23C) of the Income tax Act, 1961 (Act) deals with the tax exemption scheme for certain approved institutions engaged in charitable activities, including institutions established 'solely' for education¹. To be eligible for the said tax exemption, such an institution must obtain approval from the prescribed authority (PA)².

The Hon'ble Supreme Court (SC), while dealing with a batch of appeals³ in the context of denial of the registration of educational institutions for tax exemption, has laid down the following key principles:

- Institutions existing with the "sole object" of imparting or facilitating education are only entitled to tax exemption and cannot have objectives unrelated to education.
- Profit-oriented institutions are not entitled to the benefit of tax exemption.
- Generation of surplus or profits incidental to the educational and/or related activities would not bar the institution from seeking approval for tax exemption.
- While granting registration, tax authorities are required to examine the objects of the institution, and ascertain the genuineness of the institution, and the manner of its functioning.
- Such institutions must adhere to registration and other compliance-related requirements under the respective state or local laws. The PA may call for information/documents to check if such compliance requirements are fulfilled⁴.

While dealing with the issues involved, the SC also dealt with the scope of certain terms such as "education", "business incidental to the object", etc.

¹ Section 10(23C)(vi) of the Act

² Commissioner or any other designated authority

³ M/s New Noble Educational Society v The Chief Commissioner of Income Tax (C.A. No. 3795/2014); M/s St. Augustine Educational Society v The Chief Commissioner of Income Tax (C.A. No.3793/2014); M/s St. Patrick Educational Society v The Chief Commissioner of Income Tax (C.A. No. 3794/2014); M/s R.R.M Educational Society Hyderabad v The Chief Commissioner of Income Tax (C.A. No. 6418/2012) and M/s Sri Koundinya Educational Society v The Chief Commissioner of Income Tax (C.A. No. 9108/2012).

⁴ This reasoning is reinforced by the insertion of second proviso to Section 10(23C) which has been in effect from 1 April 2021.

Facts of the case:

- The PA rejected the taxpayer's application for registration under Section 10(23C) of the Act to avail tax exemption as an educational institution. The High Court⁵ confirmed the said action of the tax authorities because the respective institutions were:
 - Not created solely for education; and
 - Not registered under the applicable state laws⁶ governing such institutions, which is a pre-requisite for the grant of approval.
- The taxpayer filed an appeal against the order of the HC and raised the following issues before the SC:
 - What is the meaning of the term 'solely' in the context of educational institutions under Section 10(23C) of the Act.
 - For the purpose of tax exemption, what is the correct manner to consider surplus/profits generated by an educational institution.
 - Whether the PA is required to satisfy himself of compliance with any other conditions, such as registration of charitable institutions under local or state laws, when the taxpayer is seeking approval.

Taxpayer's contentions

- The term 'solely' ought to be interpreted liberally and should not be construed in the literal sense. To decide if an institution exists solely for educational purposes, the test is whether the 'principal' or 'main' activity was education or not ('predominant test') rather than whether some profits were incidentally earned.
- The taxpayers do not cease to exist 'solely for educational purposes' where

they had other/secondary objects. The existence of more than one object, alongwith education, could not hinder or bar an institution's claim to exemption. The determinative factor is that charitable institutions' functions are not motivated by profits. The emphasis of the word 'solely' concerns the institution's motive not to operate to make profits and should not be interpreted in relation to the object of the institution.

- Relying on an earlier ruling of SC in the case of Queen's Education⁷, the taxpayer argued that the income earned incidentally or profits incidental to the main object *per se* would not debar the trust's application for approval or registration as a tax-exempt organisation.
- It relied on the SC ruling in the case of American Hotel⁸, wherein it was held that to discern whether the applicant's claim for exemption can be allowed, the 'predominant object' must be considered. Additionally, it was held that examining whether and to what extent profits were generated and how they were utilised was not essential at the time of grant of approval but rather formed part of the monitoring mechanism.
- At the stage of registration (i.e. vetting stage), the PA may only examine the actual existence of the educational institution. Enquiry into the institution's functioning and compliance with other related provisions would be relevant post-grant of approval (i.e., at the assessment stage).

⁵ High Court (HC) of Andhra Pradesh

⁶ Andhra Pradesh Charitable and Hindu Religious Institutions and Endowments Act, 1987

⁷ Queen's Education Society vs Commissioner of Income Tax [2015] (372 ITR 699)

⁸ American Hotel and Lodging Association vs Central Board of Direct Taxes (2008) (10 SCC 509)

- The Act does not stipulate registration of the institutions under other applicable state laws as a pre-requisite for the grant of approval. If the trust/ institution is registered under some law or duly incorporated as a not-for-profit, no other requirement under the Act compelled further registration or endorsement under any state laws. The taxpayer emphasised that the Act by itself is a complete code and should not be linked to any other enactments.

Revenue's contention

- It relied on the decision in the case of T.M.A. Pai Foundation⁹ wherein it was held that 'education' under the Constitution meant and included education at all levels, from primary school up to postgraduation, including professional education.
- Further, it highlighted that the intention behind the tax exemption under the Act was to promote education as mentioned in the Constitution. Thus, in the Constitutional sense as well as under the Act, education has to be understood as curriculum-based schooling. The term 'education' could not be comprehended to have an enlarged meaning for tax exemption purposes.
- It was argued that the entity is claiming exemption should be imparting education itself and may generate surplus during such activity. As per the ratio laid down in T.M.A. Pai Foundation (*supra*), education *per se* is to be regarded as a charitable activity. It could not be considered as trade or business with a profit motive driving it. Thus, the commercialisation of education would result in the loss of the benefit of tax exemption, which otherwise may be available.
- It contended that the Act expressly stipulates that the institution must exist 'solely' for education purposes and that the expression 'solely' must be given its plain and grammatical meaning. Hence, the application of the 'predominant test' for determining eligibility for tax exemption by various courts¹⁰ is erroneous in the context of charities set up for advancing education.
- It also argued that the taxpayer's contention that monitoring provisions are to be considered only at the assessment stage is misplaced.

SC ruling

- The SC upheld the decision of the HC rejecting the taxpayer's application for approval as an educational institution for the purpose of tax exemption.
- The SC affirmed that in the context of 'charitable activity' under the Act, 'education' means imparting formal scholastic learning.
- SC held that an institution shall be eligible for tax exemption only if its objects are solely concerned with education or education-related activities. All objects of the society, trust, etc., must relate to imparting education or be in relation to educational activities, and not engage in any activity of profit.
- Further, it clarified that the term 'solely' is not the same as 'predominant /mainly'. The term 'solely' means to the exclusion of all others.

⁹ T.M.A. Pai Foundation vs State of Karnataka (2002) (8 SCC 481)

¹⁰ Queen's Education Society vs Commissioner of Income Tax [2015] (372 ITR 699) (SC); American Hotel and Lodging Association vs Central Board of Direct Taxes (2008) (10 SCC 509)

(SC); Pinegrove International Charitable Trust Vs. Union of India, (2010) (327 ITR 73) (Punjab and Haryana HC).

- It was observed that SC's ruling in Surat Art¹¹ propounding the 'predominant object' test was in a different context (i.e. entity engaged in the advancement of general public utility). Further, the Court noted that the application of a 'predominant test' in the context of charities set up for advancing education is inapt. Thus, SC overruled its earlier decisions in the case of the American Hotel (*supra*) and Queen's Educational Society (*supra*), which were adjudicated considering the principle of 'predominant object' as laid down in Surat Art (*supra*).
- The seventh proviso to Section 10(23C) as well as Section 11(4A) of the Act refers to profits that may be 'incidentally' generated or earned by the charitable institution. In the present case, the same applies to those institutions which only impart education or are engaged in activities connected to education.
- Where the objective of the institution appears to be profit-oriented, such institution would not be entitled to be approved under Section 10(23C) of the Act. At the same time, accrual of surplus in any given year or set of years, per se, is not a bar, provided such surplus is inextricably linked to the providing education or educational activities. Further, if profits are generated incidentally, while carrying on the educational or related objectives, such 'business income' may also be tax exempt subject to maintenance of separate books of accounts for such business¹².
- On the powers of PA, SC held that the enquiry may not be restricted only to objects of the institution at the vetting stage. PA is free to call for audited accounts or other such records/ documents to determine the genuineness of the institution. However, the SC also explained that such enquiry should be confined to understanding the nature of income earned and whether it is from education or education-related objects. It observed that disproportionate weight ought not to be given to incidental profits/surplus generated.
- PA should not reject the application merely because of surplus, where the income generating activity is intrinsically a part of the educational objective.
- The SC further observed that registration of the institutions under relevant state laws concerning charitable institutions enables the state to ensure that they are managed efficiently without misfeasance. Thus, compliance with other state laws also legitimately weighs with the PA while deciding on the application and genuineness of the institution.
- Since the present judgement has departed from the previous rulings regarding the meaning of the term 'solely', laws/interpretations declared in the present judgement shall operate prospectively, thereby providing time to other institutions likely to be affected to make appropriate changes and avoid disruptions.

¹¹ Additional Commissioner of Income Tax v Surat Art Silk Cloth Manufacturers' Association (1980) 2 SCC 31

¹² Illustration cited by SC for incidental business activity – sale of textbooks, school bus facilities for transportation of its students,

hostel facilities, summer camps for pupils' special educational courses. Excludes – rental of premises to other trusts or institutions for conducting workshops, seminars, etc. not exclusively for its pupils

Our comments

This Apex Court ruling addresses many interpretational issues relevant to educational institutions. This includes clarity in the scope and meaning of education for claiming tax exemption, permissible activities for educational institutions, incidental business activity, etc. Further, it has been clarified that mere accumulation of surplus by the charitable institutions shall not automatically debar them from seeking exemption under the Act. Due consideration needs to be given to the source of the profits.

The SC has also cleared the ambiguities surrounding the powers of PA and the scope of enquiry as regards the examination of annual accounts at the vetting stage. The ruling emphasised the significance and requirement of registration with the relevant state laws for approval. Thus, compliance with other state laws is a must now for being eligible for tax exemption.

Due to the departure from its earlier rulings where a liberal interpretation of the term 'solely' as the predominant objective was adopted, SC has allowed the prospective application of the law settled by this judgement. This would allow taxpayers to align their objectives and conduct in line with the ratio laid down in this ruling and evaluate the way forward.

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