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Direct Tax Alert

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Supreme Court pronounces landmark rulings impacting Charitable Institutions

Recently, the Supreme Court has delivered two landmark rulings, one in the context of charitable institutions engaged in advancement of general public utility ('GPU decision') and another in the context of educational institutions ('Educational institution decision').

The GPU decision[1] lays down the principle that charitable institutions advancing 'general public utility' cannot engage itself in any trade, commerce or business, unless such trade, commerce or business is undertaken in the course of actual carrying out of the GPU. Further if the taxpayer charges substantial amounts over and above the cost for the GPU related activities, such activities would be considered as 'trade, commerce, or business' and would be subject to restrictions provided in the law.

Similarly, the Educational institution decision[2] holds that the term 'solely' is to be interpreted strictly as 'exclusively' and not 'predominantly'. Generation of surplus or profits *per se* is not a bar for approval, provided such surplus or profits are generated only from activities 'incidental' to education. Also, widens the power of CIT for calling of records for granting of registration and mandates compliance of local/state laws for eligibility of registration under section 10(23C) of the Income-tax Act, 1961 ('the Act').

[1] ACIT (Exemptions) v. Ahmedabad Urban Development Authority [2022] 143 taxmann.com 278 (SC)
[2] New Noble Education Society v. Chief Commissioner of Income-tax (Civil Appeal nos. 6418 & 9108 of 2012 and 3793, 3794 & 3795 of 2014) (SC), order dated 19 October 2022

Backdrop and issues involved (qua the GPU decision)

- A large number of assesses covering statutory corporations, authorities or bodies (like Gujarat Housing Board, Karnataka Water Supply and Drainage Board etc.), statutory regulatory bodies (like Institute of Chartered Accountants of India – ICAI), trade promotion bodies, councils etc (like Rajasthan State Seed and Organic Production Certification Agency, Andhra Pradesh State Seed Certification Agency etc.), non-statutory bodies (like ERNET, NIXI, GSI etc.), sport / cricket associations (like BCCI, Gujarat State Cricket Association etc.) and private trusts were parties to the decision.

- The decision is extremely detailed running into 149 pages and has analysed the entire development of law including various amendments carried out over the years and the jurisprudence including a large number of earlier Supreme Court and High Court decisions.

- Charitable purpose has been defined under section 2(15) of the Act to include relief of poor, education, medical relief and few others (called *per se* charities). It also includes within its purview a residual category '*advancement of any other object of general public utility*' ('GPU'). While engaging in GPU activities it is common for such institutions to carry on any activity in the nature of trade, commerce or business or any activity of rendering services in relation thereto (hereinafter collectively referred as 'commercial activity') for a cess, fee or other consideration.

- Such commercial activities have been subject matter of various restrictions imposed under the law from time to time. A proviso to section 2(15) of the Act was inserted with effect from 1 April 2009 which restricted such GPU institutions from carrying on any commercial activities. Relaxation was provided for GPU institutions to carry on such commercial activities provided they were carried on in the course of carrying out of such GPU activity and aggregate receipts from such activities were within the limits imposed by the law.

- The core issue before the Supreme Court was, what is the correct interpretation of the proviso to section 2(15) of the Act as applicable to such GPU institutions.

- Various High Courts[3] have interpreted the aforesaid proviso to hold that when the activity carried out does not involve any 'motive of profiteering' the said activity cannot be said to be commercial activity and therefore, the proviso to section 2(15) of the Act shall not be applicable. On the other hand[4], certain other High Courts have held that even though activities carried out are in nature of GPU yet accumulation of a huge profit without any explanation for same or without any indication that it was for advancement of GPU object, would not fall within the purview of 'charitable purpose' as mentioned in section 2(15) of the Act read with the proviso thereto.

Supreme Court ruling (qua the GPU decision)

- The Supreme Court held that taxpayer carrying on commercial activity as part of carrying out GPU objects would not entitle the taxpayer to claim the said activity as 'charitable purpose' unless the activities are carried out in the course of advancement of GPU and further the aggregate receipts are within the prescribed limits.

- Whether any activity is a commercial activity, can be gauged from whether the amounts charged by such GPU institutions are on cost

[3] Including decision of Gujarat High Court in Ahmedabad Urban Development Authority v. CIT [2017] 83 taxmann.com 78 (Gujarat)

[4] Including decision of the Punjab & Haryana High Court in Tribune Trust v. CIT [2016] 76 taxmann.com 363 (Punjab & Haryana)

/ nominal mark-up basis or significantly higher. If such activities are charged beyond cost / nominal mark-up then they would be regarded as commercial activities and then the restriction (currently) of the aggregate receipts not exceeding 20% of the gross receipts will become applicable. Where these exceed the said limits then the GPU institution will not be regarded as carrying on charitable activity entitled to exemption.

The key aspects of the Supreme Court ruling are enlisted below:

(i) Transition and effect of amendment to section 2(15) of the Act vide the Finance Act, 2008 (w.e.f. 1 April 2009)

- The principle enunciated by Supreme Court in its earlier decisions[5] was that so long as the predominant object of GPU institution is charitable, its engagement in a commercial activity resulting in profits that are incidental, is permissible as such profits were deployed or "fed" back to achieve the dominant charitable object.

- By inserting the proviso to section 2(15) of the Act, a paradigm transition is envisaged by the legislature. The change is that firstly a GPU category taxpayer cannot engage in any commercial activity for any consideration (including a statutory fee etc.). Therefore, the test of the charity being driven by a predominant object (as laid down by the Supreme Court in its earlier decisions), is discarded and is no longer good law.

- Secondly the aforesaid prohibition is relieved by the legislature to a limited extent by permitting the GPU institutions from carrying on commercial activity in the course of actual carrying on the GPU activities within the prescribed limits.

(ii) Connotation of the term 'trade, commerce or business'

- The Supreme Court has taken cognizance of the fact that pure charity (in the sense that the performance of an activity without any consideration) is not envisioned under the provisions of the Act.

- Generally, the charging of any amount towards consideration for such a GPU activity, which is on cost-basis or nominally above cost (and thereby deriving nominal profit / surplus), cannot be considered to be "trade, commerce, or business". The Supreme Court also remarked that if the charges are markedly or significantly above the cost incurred, the same would fall within the mischief of "cess, or fee, or any other consideration" towards "trade, commerce or business" and the limits prescribed in the proviso to section 2(15) of the Act will be applicable. Consequently, the revenue was directed to discern the aforesaid fact from the records of the taxpayer on a year-on-year basis.

(iii) Interpretation of the term 'incidental' appearing under section 11(4A) of the Act

- Section 11(4A) of the Act inter alia provides that profits and gains of business earned by charitable trusts may be exempt, if such business is incidental to the attainment of its objects and separate books of accounts are maintained.
- The Supreme Court held that the proper way to interpret the word 'incidental' as referred to in section 11(4A) of the Act is to interpret the same in light of clause (i) of the proviso to section 2(15) of the Act i.e., that the activity in the nature of business, trade, commerce or service in relation to such activities should be conducted actually in the course of achieving the GPU object, and the income, profit or

[5] ACIT v. Surat Art Silk Cloth Manufacturers Association [1979] 2 Taxman 501 (SC)

surplus or gains can then, be logically incidental. Only when the activity in the nature of business, trade or commerce is intrinsically pursued to achieve the GPU object, then they could be regarded as incidental.

(iv) Application of the aforesaid principles to the following categories of taxpayer

- Authorities, corporations, or bodies established by statute:

  The Supreme Court held that recovery of charges or fees as per the rates fixed by the statute itself, cannot be characterized as *"fee, cess, or other consideration"*.

  Further, such activities are essential for advancement of public purposes / functions, such activities are prima facie to be excluded from the mischief of 'commercial activities'.

- Statutory Regulators (such as ICAI, ICSI etc.):

  The Supreme Court observed that such regulators perform statutory functions in the larger public interest and therefore do not *ipso facto* carry commercial activities. The income and receipts of statutory regulatory bodies which are for instance, tasked with exclusive duties of prescribing curriculum, disciplining professionals and prescribing standards of professional conduct, are prima facie not commercial receipts.

- Trade promotion bodies:

  Trade promotion bodies which are set up with the object of purely advocating for, coordinating and assisting trading organizations, can be said to be involved in advancement of objects of general public utility.

  However, where additional services such as courses meant to skill personnel, providing private rental spaces in fairs or trade shows, consulting services, etc. are rendered, then income or receipts from such activities, would be commercial in nature and consequently, the proviso to section 2(15) of the Act would be applicable.

- Non-statutory bodies:

  Non-statutory bodies performing public functions are engaged in important public purposes and if the consideration charged by them for the purposes provided are nominal, the same may not be in nature of commercial activity.

- State cricket associations:

  The Supreme Court rejected the claim of the sports associations that 'sports promotion' is 'education' and held that such activities would fall within the GPU category.

  It was observed that the functioning of state cricket associations is on business lines, wherein such associations own physical and other infrastructure, maintain them, have arrangements for permanent manpower, have well-organized supply chains to cater to the several matches they host, earn media rights, broadcasting rights sponsorship fees etc.

  Accordingly, the Supreme Court directed the revenue to factually determine the pattern of revenue and expenses and the extent of sports promotion activities undertaken by them and therefore the matters are remanded back for further adjudication.

Background and issues involved (qua the Educational institution decision)

- Section 10(23C)(vi) of the Act inter alia provides certain exemption to charitable trusts that '*solely*' exist for education purpose and '*not for profit*'. Seventh proviso to section 10(23C)(vi) of the Act inter alia provides that profits and gains of business earned by such trusts may be exempt, if such business is incidental to the attainment of its objects and

separate books of accounts are maintained. The exemption under section 10(23C)(vi) of the Act is available subject to approval by the prescribed authority.

- Various courts including the Supreme Court[6] have interpreted the term 'solely' appearing in section 10(23C)(vi) of the Act to mean 'predominantly'. Also, in view of the ratio laid down by the Supreme Court in its earlier decision[7], it was understood that at the time granting approval for registration under section 10(23C)(vi) of the Act, only the objects of the Trust ought to be examined by the prescribed authorities and that the detailed scrutiny of records to verify the genuineness of actual activities carried out by the Trust was possible only at the time of assessment as part of monitoring mechanism.

- The issue before the Supreme Court was, what is the correct interpretation of the term 'solely' appearing in section 10(23C)(vi) of the Act and the extent of enquiry to be carried out at the time of granting registration under section 10(23C)(vi) of the Act.

- The taxpayer in the present decision had applied for registration under section 10(23C)(vi) of the Act as an educational institution. The memorandum of association of the trust inter alia included other objects which were not exclusively for education such as publishing journals, magazines, or other media for diffusion of useful knowledge, invite experts from India and abroad to improve quality of education etc.

- The Revenue rejected the application for registration by observing that –

  - the objects of the trust included, other objects unrelated to education and is therefore not incorporated *'solely'* for the purpose of education.
  - the assessee was not registered under the state law i.e., Andhra Pradesh Charitable and Hindu Religious Institutions and Endowments Act, 1987.

Supreme Court ruling (qua the Educational institution decision)

- The term 'solely' is to be interpreted strictly as 'exclusively' and not 'predominantly' and that all the objects of the trust, must relate to imparting education or be in relation to educational activities. The Supreme Court has also explained the other requirement that such an institution should not be for profit except where the profit is incidental to the attainment of the educational objective.

- Further, the Supreme Court also remarked that the requirement to register with state laws is a prerequisite for obtaining approval under the Act. While the decision pertained to an institution engaged in education and had applied for exemption under section 10(23C)(vi) of the Act, it is clarified the principles enunciated by the Supreme Court would also apply to medical institutions seeking exemption under other clauses of section 10(23C) of the Act.

The key aspects of the Supreme Court ruling are enlisted below:

(i) Meaning of the term 'education'

- The Supreme Court observed that the term 'education' means imparting formal scholastic learning in the sense of structured learning rather than the wider meaning of the expression.

- Further, though the trust may not by itself carry on educational activities, however if it sets up and governs such other educational

[6] Queens Educational Society v. CIT (2015) 372 ITR 699 (SC), American Hotel and Lodging Association Educational Institute v. CBDT [2008] 301 ITR 86 (SC)

[7] American Hotel and Lodging Association Educational Institute v. CBDT [2008] 301 ITR 86 (SC)

institution, then it would be regarded as a charitable trust established *'solely'* for educational purpose.

(ii) Meaning of the term 'solely' in section 10(23C)(vi) of the Act and interpretation of the seventh proviso thereto

- The term *'solely'* means *'exclusively' and not 'predominantly' or 'mainly'.* The term needs to be interpreted in a strict sense and not liberally. While holding the above, the Supreme Court have overruled its earlier decisions[8] which in turn relied on the decision of Supreme Court in *ACIT v. Surat Art Silk Cloth Manufacturers Association [1979] 2 Taxman 501 (SC)*.

- The trust imparting education should necessarily have all its objects aimed at imparting or facilitating education. Objects unrelated to the main object of education will disentitle the institutions to exemption under the law.

- Having said the above, the Supreme Court observed that on reading section 10(23C) of the Act with the seventh proviso thereto, it is evident that the trust must solely exist for educational purposes and not for profit. However, as an exception, the seventh proviso permits such trust to earn profits from business, provided such business activities are incidental to the attainment of its objective of providing education (connected with the activity of education like sale of textbooks, school bus facility, hostel facilities etc.).

- However, where institutions provide their premises or infrastructure to other entities, for the purpose of conducting seminars, workshops etc. and outsiders are permitted to enrol in such seminars, workshops etc., the income derived therefrom cannot be characterised as education or incidental to the imparting of education.

- In case surplus is generated in the course of providing education activities in a given year or set of years, the same shall not be a bar for registration under section 10(23C) of the Act. However, the pursuit of education should not be with the intention of earning profit.

(iii) Nature of inquiry for grant of registration

- Hitherto, based on the principle enunciated by Supreme Court in its earlier decision[9], at the time of registration, at the stage of considering the application for approval or registration under section 10(23C) of the Act, the Revenue was confined to examine only the objects of the Trust. Thereafter, the detailed scrutiny of records to verify the genuineness of actual activities carried out by the Trust, could arise only at the stage of assessment.

- However, the Supreme Court having regard to the provisions of section 10(23C) of the Act, which inter alia refers to the procedure for approval of application, observed that there exist no restrictions on the nature of documents to be called for at the stage of considering the application for approval or registration.

- Accordingly, the Supreme Court overruled its earlier decisions and held that the Revenue while granting registration under section 10(23C) of the Act is not restricted to examine only the objects of the trust but may is also free to call for the audited accounts or other such documents for recording satisfaction as to whether the Trust is incorporated for education or education related objects. The Supreme Court also

[8] American Hotel and Lodging Association Educational Institute v. CBDT [2008] 301 ITR 86 (SC) and Queens Educational Society v. CIT (2015) 372 ITR 699 (SC)

[9] American Hotel and Lodging Association Educational Institute v. CBDT [2008] 301 ITR 86 (SC)

remarked that if the surplus or profits are generated while imparting education or related activities, disproportionate weight ought not be given to surplus or profits, provided they are incidental.

(iv) Obligation to comply with State Laws

- The Supreme Court held that where, the trust is obliged to register under the state or local laws, the said trust seeking approval u/s 10(23C) should also comply with provisions of such state / local laws. This would enable the Revenue to ascertain the genuineness of the trust, society etc.

(v) Prospective application of the present judgement

- The present decision has departed from its previous rulings regarding the meaning of the term *'solely'*, and therefore, in order to avoid disruption, and to give time to institutions, to make appropriate changes and adjustments, the Supreme Court held that the present decision would be applied sly.

Dhruva Comments

Charitable trusts have existed in one form or the other, tracing their roots to the instinct of benevolence and eleemosynary, which is part of human evolution. The law, while granting exemption to income from religious and charitable trusts has taken effective measures to minimize misuse of trust funds. As a result, the legislature has placed various checks and balances in the Act, to monitor and penalize taxpayers from misuse of the exemption provided therein.

Taxation of charitable trusts engaged in carrying on activities of GPU have faced myriad interpretational issues drawing attention of various judicial forums including the Apex Court on several times. Given the desire of the Revenue to ensure that trade, commerce or business is not carried on in the garb of charity as would lead to exemption from taxability of income which is otherwise taxable, various legislative amendments been made from time to time, to curtail the magnitude of business or commercial income that such charitable trust can earn during the course of carrying out activities under GPU category.

The aforesaid GPU decision, though at an initial blush appears to only apply to charitable institution under the GPU category, the interpretational process adopted, the elaborate discussion on legislative amendments, jurisprudence developed over the years and the observations made by the Supreme Court, seemingly may also apply to the so called '*per se*' category of 'charity' (i.e., education, medical, relief to poor etc.).

The Supreme Court in the case of GPU decision was dealing with the GPU activities and to what extent profit motive would impact the eligibility for tax exemption. In the other decision the Supreme Court was dealing with an educational institution. A reading of both the decisions suggest that the principles enunciated could equally apply to the *per se* charities (education, medial relief etc.) seeking exemption under section 11 of the Act.

It seems that the decision would add feathers to the wings of the Revenue to question activities of charities from the lens as to whether the same have been carried out with motive of profit judged from whether the services have been provided at cost / nominal mark up over cost or not and to initiate detailed scrutiny on the activities carried by such charitable trusts. The surplus generated in a few years, the extent of mark up over costs have not been explicitly spelt out and would therefore become extremely subjective aspects, potentially inviting a fresh round of litigation. Profit from

activities which are 'incidental' to attainment of the main objective would be eligible for exemption subject to some restrictions. What activities will be regarded as incidental in relation to the frontline activity will also be invite lot of attention and action.

The aforesaid decisions have far-reaching ramifications which may lead to denial of exemption provisions where activities are perceived to be carried on with a profit motive beyond what is permissible under the law, possible withdrawal of registration granted under the Act and penal consequences. One may also have to be mindful of the provisions of section 115TD of the Act, which inter alia levies tax on the accreted income (excess of market value of assets over liabilities) of the charitable trusts where registrations are cancelled.

The determination of what constitutes a 'nominal markup' at the sole discretion of the Revenue (without any legislative approvals) seems like a hanging sword on the taxpayers.

On a conjoint reading of both the aforesaid decisions, the same may have huge ramifications, it may be imperative for charitable trusts to revisit their objects, operating model / structure and the other operating mechanics. Further, charitable institutions would also be required to carry out fresh renewal, compliances etc. (wherever required)

The Supreme Court has comprehensively looked at the provisions governing exemption for charities and in the process have explained, clarified and overruled many Supreme Court and High Court decisions. While providing certainty to many existing litigations, it appears decisions may also start a new round of litigation.

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