
IMPLICATIONS FOR CHARITABLE INSTITUTIONS UNDER THE INCOME TAX ACT WITH FOCUS ON LANDMARK JUDGEMENTS

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ABSTRACT

This research study examines the implications of the Income Tax Act on charitable institutions, with a particular focus on landmark judgments that have significantly shaped the tax landscape for such organizations. Charitable institutions play a crucial role in providing essential services and contributing to societal welfare. However, the taxation rules and regulations governing these institutions have evolved over time, leading to several landmark judgments that have impacted their tax-exempt status, eligibility criteria, and compliance requirements. The recent landmark judgments of the Hon'ble Supreme Court of India in the cases of Ahmedabad Urban Development Authority (AUDA) and New Noble Educational Society (New Noble) have significant implications for charitable institutions seeking exemptions under the Income Tax Act, 1961. In the AUDA case, the Court clarified that charitable organizations must limit their commercial activities to 20% of total receipts and ensure these activities are incidental to the primary object of general public utility (GPU). The Court emphasized that the critical factor in determining charitable status lies in the intrinsic link between activities and the advancement of the GPU. The nature of charges for services provided is crucial in defining "trade, commerce, or business." In the New Noble case, the Court redefined the interpretation of the term 'solely' for educational institutions seeking tax exemptions. The Court ruled that an institution's primary focus should exclusively be on education, and all its objects must align with the purpose of imparting or facilitating education to qualify for tax exemptions. Compliance with local state laws is also deemed mandatory for registration under the IT Act. These landmark decisions bring clarity to the eligibility and privileges of charitable institutions and emphasize the necessity of compliance with tax regulations and local laws. However, concerns remain about potential litigations and increased scrutiny by the Indian Revenue Authorities, underscoring the need for promoting genuine charitable activities while ensuring adherence to the law.

Recently, the Hon'ble Supreme Court of India made two significant rulings concerning the eligibility and privileges of charitable institutions seeking exemption under the Income Tax Act, 1961. In the case of *Ahmedabad Urban Development Authority¹ (AUDA)*, the Court addressed the provisions and prerequisites for a charitable institution operating in the sphere of advancing an object of general public utility (GPU). On the other hand, the case of *New Noble Educational Society² (New Noble)* centered around the question of whether educational institutions can be involved in other activities alongside their primary educational role. These landmark decisions hold substantial implications for the functioning and entitlements of charitable organizations in the country.

In the case of AUDA, the Supreme Court ruled that charitable organizations cannot engage in trade, commerce, or business activities unless they are incidental to the primary object of general public utility (GPU). These commercial activities must not exceed 20% of the organization's total receipts. The Court clarified the criteria for determining whether an activity qualifies as "trade, commerce, or business," considering the cost of services and the charges imposed. The Court addressed various appeals involving statutory authorities, trade promotional bodies, cricket associations, and private trusts to interpret the proviso to Section 2(15) of the IT Act. The Act includes the advancement of any other object of GPU under the definition of charitable purpose but states that certain commercial activities may not be considered charitable. However, if such activities are carried out while advancing another GPU object and do not exceed 20% of total receipts, they can still be considered charitable. The charitable institutions argued for favourable consideration of minor or incidental commercial involvement, but the Indian Revenue Authorities emphasized the requirement of no profit motive and no significant commercial activities unless in line with core charitable objectives.

Indeed, the Supreme Court did not find these arguments convincing and took a different approach. The Court ruled that instead of focusing solely on the predominant object, a thorough examination of the nature of activities undertaken by the charitable organization is necessary to determine if they are inherently connected to the object of GPU. To qualify as a charitable organization engaged in GPU, these activities must be conducted as part of the process of achieving the overall objectives of the GPU. In essence, the Court emphasized that the critical

¹ *Assistant Commissioner of Income Tax (Exemptions) v. Ahmedabad Urban Development Authority [Civil Appeal No. 21762 of 2017].*

² *M/s New Noble Educational Society Vs. The Chief Commissioner of Income Tax and Anr [Civil Appeal No. 3795 of 2014].*

factor in determining whether an institution qualifies for charitable status lies in the intrinsic link between the activities and the advancement of the GPU.

The nature of charges for services provided by charitable institutions is critical in determining whether their activities fall under "trade, commerce, or business." If the charges cover costs or have a nominal mark-up, the activities are permissible and do not affect the charitable status. However, if the institution charges significantly more than costs, the activities may be classified as "trade, commerce, or business." In such cases, the income generated might be considered commercial, impacting the institution's charitable status if aggregate receipts exceed 20% of total receipts. The Supreme Court applied this criterion uniformly to various institution types. To ensure compliance with the Income Tax Act, the Indian Revenue Authorities must thoroughly analyse records and compare charges to costs. If the statutory corporation's charges greatly exceed costs, such activities may be categorized as "trade, commerce, or business." To maintain charitable status, such activities must not exceed 20% of total receipts. Compliance with these limits is essential for tax exemptions under the IT Act.

The Supreme Court has ruled that a comprehensive analysis of the income and expenditure of charitable institutions engaged in advancing objects of GPU should be conducted annually. This assessment is crucial to ascertain the nature of their activities and determine whether the amounts charged for the services provided are nominal or significantly higher. Based on this evaluation, it can be established if such activities fall under the category of "trade, commerce, or business." By examining the financial records on an annual basis, it becomes possible to gauge whether the charges imposed by the charitable institution for its services merely cover costs or consist of a nominal mark-up. Alternatively, it can help identify cases where the consideration received is substantially higher than the costs incurred, potentially leading to the classification of such activities as "trade, commerce, or business." Continuous monitoring and thorough analysis of income and expenses serve as integral factors in ensuring strict adherence to the guidelines outlined in the Income Tax Act. Additionally, these practices are instrumental in evaluating the charitable status of institutions, with a primary focus on their activities. By adopting such a diligent approach, these organizations can maintain compliance with the Act's stipulations and demonstrate their eligibility for tax exemptions as recognized charitable entities.

In the *New Noble* case, the Supreme Court addressed appeals related to the interpretation of

the term 'solely' in Section 10(23C)(vi) of the Income Tax Act. The focus was on understanding whether educational institutions must exist exclusively for educational purposes and not for making profits to qualify for tax exemptions. The Court also examined the significance of complying with state laws as a condition for obtaining approval under the IT Act. The outcome of this case holds importance for the taxation treatment of income earned by educational institutions and their adherence to the prescribed conditions for tax exemptions under the IT Act.

In the case of *New Noble*, the institutions based their arguments on previous judgments of the Supreme Court in the cases of *American Hotel*³ and *Queens Education Society*⁴. They contended that the term 'solely' had been interpreted by the Court in those cases to imply the dominant, main, or principal object of the institution. The institutions argued that having more than one object does not automatically disqualify them from being considered as existing 'solely' for educational purposes. As long as their primary focus is on education and education-related activities, and they predominantly engage in such activities, they meet the 'solely' condition. They emphasized that the term 'solely' should be understood in the context of their motive to operate non-profitably and not strictly interpreted based on the number of objectives pursued. According to them, the key criterion for availing tax exemption under section 10(23C)(vi) of the IT Act is the institution's primary intention to function for educational purposes and not to generate profits. By relying on earlier judgments and interpreting 'solely' in this manner, the institutions sought to strengthen their claim for tax exemption on the income derived from their educational activities.

The IRA put forth a contrary view, arguing that the statute explicitly requires the institution to exist 'solely' for the purpose of education. They pointed out that the predominant object test used in the cases of *American Hotel* and *Queens Education Society* was established in the *Surat Art Case*⁵, which dealt with charitable organizations involved in advancing objects of GPU, and not in the context of educational institutions. According to the Indian Revenue Authorities, the reasoning applied in previous cases like *American Hotel* and *Queens Education Society*, which used the predominant object test to determine charitable status, may not be applicable to the case of educational institutions seeking tax exemption under section 10(23C)(vi) of the IT

³ *American Hotel and Lodging Association v. CBDT* (2008) 10 SCC 509.

⁴ *Queens's Educational Society v. CIT* 2015 (8) SCC 47.

⁵ *Assistant Commissioner v. Surat Art Silk Cloth Manufacturers' Association* (1980) 2 SCC 31.

Act. The IRA contended that since the IT Act explicitly mentions 'solely' for educational purposes, the focus should be on whether the institution's primary and exclusive purpose is educational, as stated in the statute.

The Supreme Court, in the case of *New Noble*, made a significant observation that previous decisions had not thoroughly explored the true meaning of the term 'solely.' The Court clarified that 'solely' should be interpreted as 'only' or 'exclusively,' not 'primarily.' Moreover, the Court emphasized that the approach and reasoning used for charitable organizations advancing objects of general public utility (GPU) are different from those applicable to educational institutions. Based on its analysis, the Court ruled that for an educational institution to be eligible for tax exemption under section 10(23C)(vi) of the IT Act, all its objects should be aligned with the purpose of imparting or facilitating education. The institution's primary focus should exclusively be on education, without significant objectives diverting its attention from this core purpose. The Court overruled the judgments of *American Hotel and Queens Education Society*, as their interpretation of 'solely' was found incorrect when applied to educational institutions. This ruling sets a new precedent for determining the eligibility of educational institutions for tax exemption under the IT Act, emphasizing the necessity for their primary and exclusive commitment to educational purposes without substantial divergent objectives.

In addition to analysing the expression 'solely,' the Supreme Court also examined the 7th proviso to Section 10(23C)(vi) of the IT Act, which allows educational institutions to record profits and gains from business activities that are incidental to the attainment of their educational objectives. The Court clarified that since the institution's sole purpose is education, the term 'business' should be interpreted in the context of activities related to education and educational endeavours. The Court provided examples of activities that could be considered incidental to providing education, such as offering textbooks, hostel or bus facilities for students, and organizing educational camps. However, it pointed out that activities like renting out premises for external events would not qualify as activities incidental to education. Regarding registration with state laws, the Supreme Court acknowledged that compliance with applicable local state laws is a relevant factor for the Indian Revenue Authorities (IRA) to grant registration to charitable institutions under Section 10(23C) of the IT Act. The Court held that such compliance helps the relevant authorities in assessing the genuineness of the charitable institution. Therefore, adherence to local laws is deemed mandatory and is a prerequisite for the approval of tax exemption under the IT Act.

The Court's analysis in these areas provides essential clarity on the interpretation of relevant provisions and conditions for educational institutions seeking tax exemptions and registration under the IT Act. It establishes the importance of ensuring that activities are genuinely incidental to educational purposes and emphasizes the significance of compliance with local state laws to determine the authenticity of charitable institutions.

Major Implications

The landmark judgments in the New Noble case are expected to have significant implications for charitable institutions seeking exemptions under the Income Tax Act. The introduction of a novel test for claiming exemptions based on cost plus nominal mark-ups may lead to potential litigation as entities claiming charitable status while earning substantial income and profits could come under scrutiny. The definition of what constitutes a nominal mark-up might become a point of contention between assesses and the Indian Revenue Authorities. The judgments necessitate charitable institutions to review their objectives and activities. With the predominant object test discarded, educational institutions must ensure their activities solely focus on education and are directly connected to their educational objectives. For GPU charities, their activities must be intrinsically linked to the purpose of the charity to be excluded from the category of "trade, commerce or business." The decisions also highlight the importance of complying with conditions mandated by other laws to claim exemptions under the IT Act. Non-compliance with other laws, even if unrelated to charitable activities, could lead to increased scrutiny and complications for charitable organizations, potentially causing disputes between the IRA and the institutions. There is a concern that the IRA might become more aggressive in enforcing compliance, but it is hoped that the decisions will be applied judiciously and without unnecessary vindictiveness or litigations. The focus should be on promoting genuine charitable activities while ensuring adherence to laws and regulations. While these judgments bring clarity and stricter requirements for charitable institutions, there is also a concern that the IRA might become more aggressive in enforcing compliance. It is hoped that the IRA would apply the rationale of these decisions judiciously and avoid any vindictive or unnecessary litigations. The focus should remain on promoting genuine charitable activities while ensuring adherence to the laws and regulations.