

TAX ALERT

LUTHRA & LUTHRA LLP

CHARTERED ACCOUNTANTS



SC RULING ON CHARITABLE INSTITUTIONS

This tax alert provides a comprehensive overview of two recent landmark rulings by the Supreme Court concerning charitable institutions engaged in the advancement of general public utility (GPU) and educational activities. These rulings have significant implications for charitable trusts seeking tax exemptions. Charitable organizations should reevaluate their objectives, operational models, pricing strategies, and compliance practices to align with the new legal requirements and ensure continued eligibility for tax benefits.

1. **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

- In the instant case, the taxpayer was an educational institution and its application for registration under Section 10(23C)(vi) was rejected by the income-tax authority on the ground that inter alia (a) not all its objects mentioned in the charter documents were exclusively for educational purposes, and (b) it was not registered under the applicable state-specific laws regulating charitable institutions.
- SC, taking cognizance of several judgements on this subject, on a literal interpretation, held that the Predominant Test will not apply for Section 10

exemption as the language of the law is unambiguous and that the word 'solely' will have to categorically be interpreted to mean exclusively and not primarily. Hence, if the objects of an educational institution enable it to undertake non-educational activities, such institution will not be eligible for being registered for the purpose of Section 10 exemption. In other words, all objects of such institution must relate to imparting or facilitation of education or be in relation to educational activities.

- The SC also stated that though there is no bar to the generation of surplus by such educational institutions, the key aspect is that such surplus shall be generated while providing educational and related activities only (such as sale of textbooks, providing school bus facilities, hostel facilities etc).
- With respect to the aspect of registration under state laws, though the taxpayer argued that obtaining the registration under state or local laws is not a pre-condition for seeking approval under the IT Act, the SC held that if an educational institution is required under such laws to obtain registration, then such registration should be obtained for the purposes of seeking approval under the IT Act as this would enable the income-tax authorities to not only ascertain the genuineness of the activities of educational institution, but also call for audited financial statements or other such documents for recording satisfaction about this aspect while processing the application.

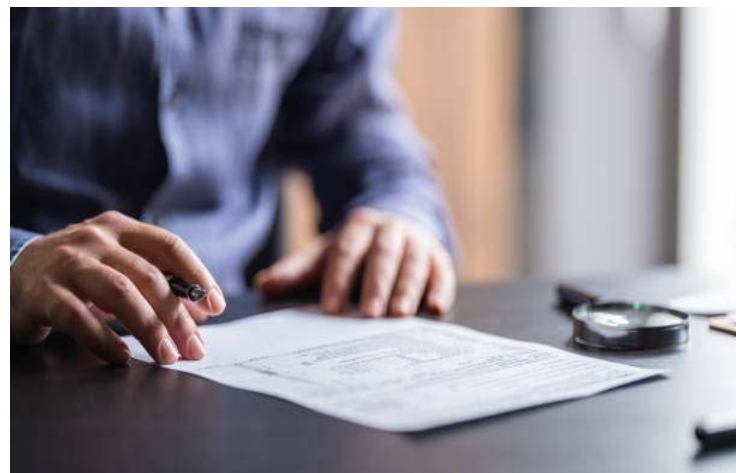
2. ACIT (Exemptions) v. Ahmedabad Urban Development Authority [2022] 143 taxmann.com 278 (SC)

SC analysed and answered the following questions/issues

A. Whether charitable activities should be in the course of "actual carrying on" of the GPU object or it can be the pre-dominant object

The SC overruled the principle of "predominant test" in the case of advancement of any other object of GPU which had been enunciated in its own decision of Addl. CIT v. Surat Art Silk Cloth Manufacturers' Association ('Surat Art Silk') which held that what was important is the predominant object of the activity involved in carrying out the object of GPU is for the charitable purpose or to earn profit and merely because some profit arose from such activity would not lose its charitable character.

The paradigm shift brought forth by Section 2(15) after its amendment in 2008 and as it stands now is that a GPU charity is prohibited from engaging in any action of a trade, commercial, or business nature, or from rendering any service in connection with such activities for any consideration (including a statutory fee etc.).



B. Specific restrictions on GPU on carrying on business activity:

- As per the amended provisions, the GPU test contains the following prohibitions: -
 - Engaging in trade, commerce or business or all activities in nature of or resembling the above.

- Providing any service in relation to trade, commerce or business.
 - The above two activities are undertaken “for a fee, cess or any other consideration”.
 - Prohibition apply even where the application of the income from such “prohibited activities” is applied for on charitable purposes.
- The amended provisions proceed on the basis that income received as fee, cess or any other consideration derived from “prohibited activities” is necessarily motivated by profits and, thus shall not be considered as charitable.
 - the taxpayer can carry on trade, commerce or business etc., provided that such activities are connected to the achievement of the objects of GPU and the receipt from such business or commercial activity or service in relation thereto, does not exceed the quantified limit provided in the Income Tax Act.

C. Consideration significantly above the cost incurred (with mark-up)

- The consideration for advancement of an object of GPU charity on a cost basis or nominally above cost, cannot be considered "trade, commerce, or business" or any services in relation thereto.
- When the charges are markedly or significantly above the cost incurred that they would fall within the mischief of “cess, or fee, or any other consideration” towards “trade, commerce or business” and such receipts should not exceed the limit i.e. 20% of the total receipts as of now



D. Distinction between business held under the trust and trust carrying on the business:

- Income tax provisions provides exemption from tax to income derived from property held under the trust wholly for charitable or religious purposes, subject to the condition that income therefrom is applied to such purposes in India. This tax exemption benefit would extend to business held under the trust.
- If, however, business is not held under the trust, income would qualify for exemption only if such business is incidental to the attainment of objects of the trust and separate books of account are maintained.
- There is a distinction between business held under the trust and trust carrying on the business. In the former, property in the form of business may be settled by a settlor in the trust, whereas in the latter, the trust carries on business as a source of income for applying it on the object of the trust. In the latter, business is not held under the trust and, hence, it has to meet with the requirement of it being incidental to attainment of the objects of the trust and

separate books of account are to be maintained.

- the term “incidental” has to be interpreted in the light of carrying out the activity in the nature of trade, commerce or business (or services in relation thereto) in the context of GPU, which is actually conducted in the course of achieving the GPU object, and therefore, any income or profit or surplus is incidental. Furthermore, the requirement of maintaining separate books of account is also in line with the necessity of demonstrating that quantitative limit prescribed is not breached.



Conclusion and way forward

- Although the aforementioned SC decision initially seems to be limited to charitable institutions falling under the GPU category, ***in our considered view and practical experience, they may also apply to other category of charities, such as those related to education, medical, and relief to the poor seeking exemption under Section 11 of the Act.***
- Further to **SC rulings above, ITAT (Hyderabad) in case of Fernandez Foundation (earlier ‘Fernandez Hospital’)** placed reliance on the decision of New Noble Educational Society (supra) resultant to which exemption u/s 11 was denied on basis that the assessee has failed to

demonstrate that the charges/fee charged by it from outdoor/ indoor patients was a reasonable markup on the cost.

- This development is likely to empower the Revenue authorities to scrutinize charitable activities and assess whether they have been conducted with a profit motive. **Factors such as providing services at cost or a nominal markup over cost will be considered, potentially leading to detailed examinations of the activities undertaken by such charitable trusts. The surplus generated in certain years and the extent of markup over costs have not been explicitly defined, making these aspects highly subjective and prone to potential litigation.**
- However, profits derived from activities incidental to the main objective will still be eligible for exemption within specified threshold limits. The determination of which activities are considered incidental to the primary objective will also require careful attention and action. The discretionary power of the Revenue to determine what constitutes a "nominal markup" without any legislative approvals hangs as a potential threat to taxpayers.
- These Supreme Court decisions have far-reaching implications for charitable institutions seeking tax exemptions. Charitable trusts must reassess their objectives, operating models, and structures to ensure compliance with the new legal requirements. Key actions to consider include:
 - Conduct an annual review of business activities to determine their classification as trade, business, or commerce

- Align pricing strategies with the requirement of "nominal mark up" as set by the Supreme Court.
 - Maintain proper records and books of accounts to justify the costing of commercial activities and avoid disproportionately higher price/charges.
 - Regularly review profitability analysis to ensure the financial viability of revenue-generating activities and fixation of appropriate prices.
- Comply with state-specific laws by obtaining registration where required, facilitating scrutiny by income-tax authorities.
 - Failure to align with these requirements may result in the denial of exemptions, cancellation of registration, penalties, and the applicability of Section 115TD of the Income Tax Act.

Charitable institutions should seek professional advice to navigate these complex changes and ensure compliance with the law. For further guidance and assistance, please reach out to our tax experts at taxhelpdesk@llca.net

Disclaimer: This tax alert is for general informational purposes only and does not constitute legal or tax advice. Seek professional advice before making any decisions based on the information provided.

GET IN TOUCH

DELHI

A-16/9 & A16-4, Vasant Vihar, New Delhi – 110057

+91-11-42591800, 42591818

delhi@llca.net

www.llca.net

