

## **Educational and Medical Institutions - Heed the wake-up call !**

**[ Effect of omission of Ss.10(22) and 10(22A) from and amendment of S.10(23C) of, the Income-Tax Act and a brief update of the provisions of Ss.11, 12, 12A, 12AA and 13. ]**

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By : **S. K. Tyagi**

The Finance (No.2) Act 1998 has made far-reaching changes in the provisions of Income-Tax Act 1961 relating to the taxation of educational and medical institutions. The reasons for the same, as stated in the Finance (No.2) Bill 1998, are as follows :

“Under the existing provisions of clauses(22) and (22A) of section 10 of the Income-Tax Act, educational and medical institutions enjoy exemption from income-tax if they do not exist for purposes of profit. However, in the absence of any monitoring mechanism for checking the genuineness of their activities, these provisions are reported to be widely misused.

The Bill, therefore, seeks to omit the aforesaid clauses (22) and (22A) from the statute. The educational and medical institutions which are of charitable nature will, henceforth, have to claim income-tax exemption U/s. 11 and 12 of the Income-Tax Act, subject to fulfilment of necessary conditions. In appropriate cases, the Central Government may also grant exemption by issue of a notification under sub-clause (iv) of clause (23C) of S. 10.”

Ss.10(22) and 10(22A), before their omission, provided exemption to educational and medical institutions if they did not exist for the purposes of profit. To check the genuineness of the activities of such institutions the following monitoring mechanism has been incorporated.

- (i) Ss.10(22) and 10(22A) have been omitted with effect from the Assessment Year ( A.Y.) 1999-2000.
- (ii) S.10(23C) has been amended to provide exemption to any income of such university or other educational institution or hospital or medical institution which is not established for the purposes of profit and -
  - (a) Which is wholly and substantially financed by the Government ; or
  - (b) Whose aggregate annual receipts do not exceed a prescribed amount (Annual receipts have been fixed at Rs One Crore, vide newly inserted Ruled 2 B C ) ; or
  - (c) Which may be approved by the prescribed authority.
- (iii) Other educational and medical institutions which are of charitable nature will, henceforth, have to claim income-tax exemption U/s. 11 and 12 of the Act, subject to fulfilment of necessary conditions.

### **2. Amendments made in S.10(23C), vide Finance (No.2) Act 1998.**

S.10(23C) has been substantially amended / enlarged vide Finance (No.2) Act 1998 in order to provide exemption to any income of such university or other educational institution or hospital or medical institution which is wholly or substantially financed by the Government, or the income of which does not

exceed a prescribed limit or which may be approved by the prescribed authority. The salient changes brought about in S.10(23C) are as follows :

- I. **S.10(23C) (iiiab) and (iiiac)** provide for exemption for the income of educational and medical institutions which are wholly or substantially financed by the Government.
- II. **S.10(23C) (iiiad) and (iiiiae)** provide for exemption for the income of educational and medical institutions, the annual receipts of which do not exceed the prescribed amount (Annual receipts have been fixed at Rs One Crore, vide newly inserted Rule 2 B C )
- III. **S.10(23C) (vi) and (via)** provide for exemption for the income of educational and medical institutions other than those covered under S.10(23C) (iiiab) and (iiiac), (iiiad) and (iiiiae), which may be approved by the prescribed authority.

In the aforesaid provisions the expression “**Educational Institution**” stands for any university or other educational institution existing solely for educational purposes and not for purposes of profit ; whereas the expression “**Medical Institution**” stands for any hospital or other institution for the reception and treatment of persons suffering from illness or mental defectiveness or for the reception and treatment of persons during convalescence or of persons requiring medical attention or rehabilitation, existing solely for philanthropic purposes and not for purposes of profit.

**1<sup>st</sup> proviso to S. 10(23C)** lays down a condition that any educational or medical institution referred to in S.10 (23C) (vi) and (vi a) shall make an application in the prescribed form [ Rule 2C (3) and form No.56 ] and manner to the prescribed authority for the purpose of grant of exemption or continuance thereof. The Guidelines for approval U/s 10 (23 C) (vi) & (vi a) have been prescribed vide newly inserted Rule 2 C A. Such institution may make an application in Form No. 56 D, to the Central Board of Direct Taxes, through Commissioner of Income-tax.

**2<sup>nd</sup> proviso**, further lays down that the Central Government may, before notifying the educational or medical institution, call for such documents or information as it thinks necessary, in order to satisfy itself about the genuineness of the activities of such institution and that Government may also make such enquiries as it may deem necessary in this behalf.

**3<sup>rd</sup> proviso** lays down that such educational or medical institution covered U/s.10 ( 23C ) (vi) and (vi a) -

- (a) applies its income or accumulates it for application, wholly and exclusively to its objects and
- (b) does not invest or deposit its funds otherwise than in anyone or more of the forms or modes specified in S.11(5). There are, however, certain transitional concessions given in this respect

**7<sup>th</sup> proviso** lays down that nothing contained in Ss. 10 ( 23C ) (vi) and (vi a) shall apply in relation to any income of such educational or medical institution, **being profits and gains of business**, unless the business is incidental to the attainment of its objectives and separate books of account are maintained by it in respect of such business.

**Meaning of the expression “Incidental to the attainment of its objectives.”**

As already pointed out, as per 7<sup>th</sup> proviso to S.10(23C), if the income of an educational or medical institution includes income from profits ad gains of business then such business must be incidental to the attainment of its objectives. There is a similar provision in S.11(4A), which provides that

exemption will not be available to any income of a charitable or religious trust / institution from profits and gains of business, unless the business is incidental to the attainment of the main objects of such trust or institution. In order to clarify the aforesaid concept the following decisions of the Apex Court are quite relevant.

(i) **C.I.T. Vs A. P. State Road Transport Corpn., 159 I.T.R. p.1 ( S.C.)**

The relevant part of the Report on p.10 is as follows :

If the predominant object is to carry out a charitable purpose and not to earn profit, the purpose would not lose its charitable character merely because some profit arises from the activity.

(ii) **Aditanar Educational Institution Vs Addl. C.I.T., 224 I.T.R. p.310 ( S.C.)**

It was held by the Apex Court in this case that if after meeting the expenditure any surplus results incidentally from the activity lawfully carried on by the educational institution, it will not cease to be one existing solely for educational purposes, since the object is not one to make profit. It was further held that the decisive or acid test is whether, on an overall view of the matter the object is to make profit and in evaluating or appraising the above, one should also bear in mind the distinction / difference between the corpus, the objects and the powers of the concerned entity.(p.318 of the Report)

(iii) **Thiagrajar Charities Vs Addl. C.I.T., 225 I.T.R. p.1010 ( S.C.)**

The relevant part of the Report on p.1025 is as follows :

“It is clear that the business of purchasing and selling cotton, cotton yarn, cloth and other fibres, etc., was held under trust ; the said business was started in exercise of the powers vested in the trustees under clause 7(e) read with clause 32 of the resolution dated June 6, 1962, and in view of clause 3 of the deed it is the “corpus” of the trust in reality. It is not an object of the trust. So, it cannot be said that the trust is carrying on (business)- an activity for profit. The business-corporus-property held under trust-produces or results in income, like any other property. That is all. The business is only a “means” of achieving the “object” of the trust ; it is a medium through which the “objects” are accomplished. In this view, the entire approach made by the Appellate Tribunal as also by the High Court fails to give due effect to the trust deed as a whole and is palpably erroneous and the resultant conclusion is vitiated, in denying the exemption to the appellant-trust. We hold accordingly.”

(iv) **Addl. C.I.T. Vs Surat Art. Silk Cloth Mfrs. Asson., 121 I.T.R. p.1.**

The relevant parts of the Report on pp. 25 & 26 are, as follows :

“But where the predominant object of the activity is to carry out the charitable purpose and not to earn profit, it would not lose its character of charitable purpose merely because some profit arises from the activity. The exclusionary clause does not require that the activity must be carried on in such a manner that it does not result in any profit.

If the profits must necessarily feed a charitable purpose under the terms of the trust, the mere fact that the activities of the trust yield profit will not alter the charitable character of the trust. The test now is, more clearly than in the past, the genuineness of the purpose tested by the obligation created to spend the money exclusively or essentially on charity.”

(v) **Sole Trustee, Lok Shikshana Trust Vs C.I.T., 101 I.T.R. p.234 ( S.C.)**

The relevant observations of Their Lordships are to be found on p.256, which are reproduced as follows :

“If the profits must necessarily feed a charitable purpose, under the terms of the trust, the mere fact that the activities of the trust yield profit will not alter the charitable character of the trust. The test

now is, more clearly than in the past, the genuineness of the purpose tested by the obligation created to spend the money exclusively or essentially on “charity”. If that obligation is there, the income becomes entitled to exemption. That, in our opinion, is the most reliable test.”

As a summation it can be safely stated that, institutions with philanthropic purposes having an incidental or ancillary business activity that generates profits necessary for achieving the main objects of the institutions, will be entitled to the exemption from income-tax in respect of profits and gains derived from such business activity. In other words an educational institution will not lose its exemption U/s. 10 (23C) if incidentally it makes some profit in carrying on its main object of promoting education and such profits are applied for such educational objects. Similarly exemption will not be denied to a hospital or a similar medical institution just because some surplus results while providing medical relief. **Thus if the surplus resulting from an activity while pursuing the object of promotion of education or medical relief, is utilised on the aforesaid objects, the institution would be entitled to exemption from income-tax U/s.10(23C) of the I. T. Act.**

3. **Brief Update of the provisions of Ss. 11 to 13.**

As already pointed out if certain educational and medical institutions, so far claiming exemption U/Ss.10(22) and 10(22A) respectively ; are not covered under the provisions of S.10(23C), then they will have to claim income-tax exemption U/s.11 and 12 of the Act, subject to the fulfilment of conditions laid down U/s.12A, 12AA and 13. For the benefit educational and medical institutions a brief update of the provisions of Ss. 11, 12, 12A, 12AA and 13 ; is provided hereinafter. The relevant provisions, case law and circulars etc. are as follows :

I. **Registration U/s. 12A**

S.12A provides that exemption U/Ss.11 and 12 shall not be available in relation to income of any trust or institution unless the same is registered by the C.I.T. or the C.C.I.T. U/s.12AA of the Act.

In this respect a decision of Calcutta High Court in the case of Anand Marg Pracharak Sangha Vs C.I.T., 218 I.T.R. p.254 ( Cal.), is very relevant. In this case the Calcutta High Court has held that registration of a trust U/s.12A, granted subsequently, operates retrospectively from the date of formation of the trust.

II. **Procedure for registration U/s. 12AA**

S.12AA has been incorporated in the I.T. Act 1961, by Finance Act 1996 w.e.f. 1.4.1997. This section lays down a procedure to be followed for grant of registration to a trust or institution,

according to which the C.I.T. or the C.C.I.T. shall call for relevant documents and information and hold enquiries regarding the genuineness of the trust or institution. If the C.I.T. / C.C.I.T. is satisfied about the charitable or religious nature of the objects and genuineness of the activities of the trust or institution, he will pass an order granting registration. If, however, the C.I.T. / C.C.I.T. is not so satisfied, he will pass an order refusing registration, subject to the condition that an opportunity of being heard shall be provided to the applicant before an order of refusal to grant registration is passed and the reasons for refusal of registration shall be mentioned in such order. The order granting or refusing registration has

to be passed within 6 months from the end of the month in which the application for registration is received by the C.I.T. or the C.C.I.T. and a copy of such order has to be sent to the applicant. In metropolitan cities these powers are vested with the D.G.(Exemption) and D.I.T.(Exemption).

### III. **Audit of accounts – S.12A (b).**

This section provides that if the total income of a trust or institution exceeds Rs.50,000 /-, the accounts of the trust or institution have to be audited by a qualified accountant, as per the requirements prescribed in form No.10B. Donations received, out of which charitable or religious expenses are incurred will not be taken into account for calculation of the aforesaid amount of Rs.50,000 /-

### IV. **Investment in specified modes.**

This section prescribes the forms and modes of investing and depositing the money referred to in S.11(2)(b). The various forms and modes of investing and depositing the accumulated income of the trust / institution, have been prescribed U/s.11(5) of the Income-Tax Act. Besides, the trust funds are required to be invested and deposited in any one or more of the modes specified in S.11(5). If at any time the funds remain invested in any mode other than those specified in S.11(5), the exemption granted to it, shall stand forfeited.

### V. **Conditions for exemption of income U/s.11 and 12.**

#### (i) **Utilisation of income for charitable or religious purposes.**

The basic philosophy underlying the grant of exemption to the income of a trust or institution is that such income should be applied or utilised for “charitable purposes” as defined U/s.2(15) of the Act. It, therefore, follows that even if only one of the objects of the trust / institution is non-charitable, the entire trust would lose the benefit of such exemption.

#### (ii) **Application of income S.11(1)(a).**

As per S.11(1)(a), if a wholly charitable trust / institution holds any property wholly for charitable or religious purposes, the income of such a trust would be exempted to the extent to which income is applied to such purposes and application of the income during the year is not less than 75% of such income.

In this context the following points are worth-noting :

#### (a) **Excess expenditure is adjustable in a subsequent year.**

Excess of the expenditure in an earlier year can be adjusted against the income of the subsequent year and such adjustment is to be treated as an application of income for charitable purposes, in such subsequent year – C.I.T. Vs Shri P.S.M.P. Jain Mandal, 211 I.T.R.p.293(Guj.)

(b) **S.11(2) does not restrict the operation of S.11(1)(a) in respect of accumulation of income to the extent of 25%.**

S.11(2) does not restrict the operation of S.11(1)(a). Accumulated income to the extent of 25% thereof, exempt U/s.11(1)(a), need not be invested in Government securities. Additional accumulated income beyond 25% of the total income, can also get exemption if invested as laid down U/s.11(2)- Addl. C.I.T. Vs A.L.N. Rao Charitable Trust, 216 I.T.R.p.697( S.C.)

(c) **Donation is also an application of income.**

When a charitable trust donates its income to another charitable trust, the provisions of

S.11(1)(a) can be said to have been met by such donor-trust and donor-trust can be said to have applied its income for religious and charitable purposes.- C.I.T. Vs Saraladevi Sarabhai Trust No.2, 172 I.T.R.p.698( Guj.) and instruction No.1132 of the C.B.D.T., dt: 5.1.'81.

In the case of Alarippu Vs I.T.O., 60 I.T.D.p.478( Del-Trib.) ; the assessee had given certain amount to another charitable trust with similar objects and the amount was recovered in subsequent year. It was held that,

- The amount did not constitute either a deposit or investment,
- The payment constituted application of income on the objects of the trust.

Similar was the view taken by the Delhi Bench of the I.T.A.T. in the case of Indian National Theatre Trust Vs I.T.O., 13 I.T.D.p.588.

(d) **Repayment of debt or advance of loans to students is also an application of income.**

As per circular No.100, dt: 24 January 1973, -

- Where a trust incurs a debt for the purposes of the trust, the repayment of such a debt would amount to an application of income for the purposes of the trust ; and
- The loans advanced by an educational trust to students for higher studies would be treated as an application of income for charitable purposes.

(e) **Application of income may be for revenue or capital purposes.**

The application of the income of the trust may be either on revenue account or on capital assets. So long as the expenditure has to be incurred out of the income earned by the trust, even if such expenditure is for capital purposes on the objects of the trust, the income would be exempt.

It is thus clear that a trust can utilise its income for the purchase of house property or other assets and such an expenditure will be treated as an application of the income on the objects of the trust.

(f) **Option to spend income in the following year.**

As per explanation (2) to S.11(1) , if a trust is not able to spend 75% of its income during an accounting year, it can avail of an **option** to spend the amount, to be exercised before the date prescribed for submission of return of income. Such option can also be exercised if the income accrued has not been actually received during the year. The amount for which option has been exercised has to be spent in the year of receipt or the following year.

(iii) **Voluntary donations earmarked to the corpus of the trust are exempt from tax - S.11(1)(d).**

Under S.11(1)(d) of the Income-Tax Act 1961, corpus donations made to a trust are not considered as income of the trust. Thus charitable or religious trusts may receive corpus donations as far as possible, as they are not required to spend corpus donations.

(iv) **Accumulation of income for corpus or future application - S.11(2).**

Where 75% of the income is not applied to charitable or religious purposes, the charitable trust or institution, may accumulate or set apart either the whole or part of its income for future application for such purposes in India. Such income so accumulated or set apart will not be included in the total income of the trust or institution in the year of the receipt of income provided such trust or

institution has specified by means of a notice to the Assessing Officer (AO) in form No.10, the purpose and period for which the income is accumulated or set apart. For exercising an option for accumulation of income U/s.11(2), the following conditions have to be fulfilled, :

- The option has to be exercised in writing and filed before the AO along with the return of income.
- The purposes for which such income needs to be accumulated have to be clearly stated.
- The period for which such income to be accumulated also needs to be mentioned. **In any case, the period of accumulation cannot exceed 10 years.**
- The income so accumulated has to be invested or deposited in the forms and modes as prescribed in S.11(5) of the Act.

VI. **Exemption of business income of certain charitable or religious trust - S.11(4A).**

As per S.11(4A) exemption will not be available to the income of a trust by way of profits and gains of business, unless the business is incidental to the attainment of the main objects of the trust or institution and separate books of account are maintained by such trust or institution in respect of such business.

Before the amendment of the Act by Finance Act 1991, a trust carrying on business was entitled to income-tax exemption in specified circumstances only. This exemption was available if the business was of publication of books or where the work in connection with the business was mainly carried on by the beneficiaries of the institution, in respect of such income.

In the case of public charitable and religious trust, if it derives any income, being profits and gains of business, the exemption U/s.11 or 12 will now be available w.e.f. 1.4.1992, subject to the condition that **the business carried on is incidental to the attainment of the objectives of the trust or institution and separate books of account are maintained in respect of such business.**

A trust running a hospital may also run a medical store as the same is incidental to the attainment of the main objectives i.e. medical relief. Similarly a trust running educational institution may run the business of publication and printing of books.

The scope of the expression “**Incidental to the attainment of its objectives**” is not, however, so limited or restricted, as could be seen from the various decisions of the Apex Court in respect thereof, already quoted in earlier para (2).

#### VII. **Denial of exemption U/s.13.**

**S.13(1)(c)** provides that exemption will not be available U/s.11 and 12 if a trust diverts its income or funds for the benefit of interested persons listed in S.13(3).

As per **S.13(1)(c)(i)**, the entire income of a trust or an institution created after 1.4.1962, will be liable to tax even if a part of its income directly or indirectly results in a benefit to any interested person.

As per **S.13(1)(c)(ii)**, the entire income of a trust or an institution will be liable to tax even if a part of its income or property is directly or indirectly applied or used for the benefit of the interested persons during the relevant previous year.

It is provided in **Ss.13(1)(a) and 13(1)(b)** that a private religious trust or trust created after 1.4.1962 for the benefit of any particular religious community or caste will not be eligible for exemption under

S.11 and 12. It has, however, been provided that a trust for the benefit of Scheduled caste, Backward Classes, Scheduled Tribes, Women and Children, will not be considered as a trust set up for the benefit of any particular religious community or caste.

If a trust violates the provisions of S.13(1)(c), it automatically loses exemption U/s.11 and 12. The income of such trust would be liable to tax at the maximum marginal rate. The trust would also lose

exemption under the Wealth-Tax Act. For and upto the A.Y.1992-93 the Wealth-Tax in such cases, would be levied at the maximum marginal rate. From the A.Y.1993-94 only specified assets are liable to Wealth-Tax @ 1% of the value of such asset exceeding Rs.15,00,000/-.

**S.13(2) provides that the following situations are deemed to constitute application or use of the income or property of a trust for the benefit of the interested persons and will result in forfeiture of exemption of income of the defaulting trust :-**

- (i) If a trust lends money to the interested persons without adequate securities and / or interest.
- (ii) If it lets out property to the interested persons without adequate rent or compensation.
- (iii) If it pays unreasonably excessive salary or other perquisite for service rendered by them.
- (iv) If it receives inadequate payment from interested persons for services rendered by the trust.

- (v) If the trust pays excessive price for any purchase made from interested persons.
- (vi) If it receives inadequate price for sales to the interested persons.
- (vii) If it diverts its income or property exceeding Rs.1,000/- in value to the interested persons as referred in S.11(3).
- (viii) If it makes investment with an interested person or a concern in which any interested person is substantially interested. However, it has been provided by S.13(4) that if the investment by the trust does not exceed 5% of the capital of the concern mentioned in S.13(2)(h), forfeiture of the exemption will be confined to the income from the investment.

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| <b>S.K.Tyagi</b> , M.Sc., LLB. | ☎ | Office    | : (020) - 6133012  | Flat No.2, (First floor) |
| Ex-Indian Revenue Service      |   | Fax       | : (020) – 6121131  | Gurudatta Avenue         |
| <b>Income-Tax Advisor</b>      |   | Residence | : (020) - 6682032  | Popular Heights Rd       |
|                                |   | Residence | : (020) - 6682444  | Koregaon Park            |
|                                |   | email     | sktyagidt@vsnl.com | Pune - 411001.           |

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