Charitable nature of educational institutions : View of Uttarakhand High Court

- By S.K.Tyagi

Recently in one of the cases of educational institutions, the Assessing Officer (AO) issued a show-cause letter calling for an explanation from the assessee, as to why it should not be treated as an association of persons (AOP), engaged in a profit making business. In support of the aforesaid allegation, the Assessing Officer excluded the expenditure on land, building, equipment, furniture, etc., from the income applied towards the objects of the trust and thereby worked out surplus, though in reality there was a deficit of income over expenditure, in the case of the educational institution. In support of his aforesaid stand, the AO relied upon two judgements of the Urttarakhand High Court in the following cases :

(i) *CIT Vs. National Institute of Aeronautical Engineering Educational Society [2009] 181 Taxman 205 (Uttarakhand).*

(ii) CIT Vs. Queen's Educational Society and Other [2009] 319 ITR 160 (Uttarakhand) : 177 Taxman 326 (Uttarakhand)

In the aforesaid judgement, in the case of Queen's Educational Society, it has been held that the fixed assets like buildings and furniture might be connected with the imparting of education, but they have been constructed and purchased out of the income obtained from imparting education, with a view to expanding the institution and to earn more income and accordingly, the asessee could not be treated to be an institution, existing solely for the purposes of education. In this case, reliance has been placed on the judgement of the Apex court, in *Municipal Corporation of Delhi Vs. Children Book Trust [1992] 3SCC390*, particularly the following observations quoted on page 164 of the Report in ITR:

In other words, what we want to stress is, where a society or body is making systematic profit, even though that profit is utilized only for charitable purposes, yet it cannot be said that it could claim exemption. If, merely qualitative test is applied to societies, even school which are run on commercial basis making profit would go out of the purview of taxation and would demand exemption.

It is surprising that a judgement dealing with exemption from municipal tax has been made use of, in respect of exemption from income-tax in the case of an educational institution. Similarly, in the case of *National Institute of Aeronautical Engineering Educational Society*, the object of the assessee society was not considered to be of charitable nature and accordingly, the refusal of registration of the society under section 12AA of the Income-Tax Act, 1961 (the Act), by the Commissioner of Income-Tax (CIT) was held to be justified.

It may be emphatically stated here that the aforesaid judgements of the Uttarakhand High Court do not lay down the correct legal position, because the law laid down by them is contrary to the law laid down

by the Apex Court, as regards the exemption of educational institutions, under the relevant provisions of the Income-Tax Act, 1961. Therefore, the aforesaid judgements do not deserve to be followed, in relation to the relevant provisions of the I.T.Act, 1961, regarding educational institutions.

Unfortunately, the IT authorities at several places have been denying the benefit of exemption under section 11 and also under section 10(23C) of the Act, to a number of educational institutions, on the basis of the aforesaid judgements of Uttarakhand High Court. What the IT authorities are doing in such cases, is to disallow the capital expenditure on land, building, furniture, etc., and thereafter work out revenue surplus and wherever a revenue surplus is found, the educational institution is being denied the benefit of exemption under section 11 and / or section 10(23C) of the Act.

In the first place, it may be stated in this regard that in most of the States, the quantum of fees to be charged by various educational institutions, is annually fixed by Shikshan Shulka Samiti appointed by the State Government, in accordance with the judgements of the Apex Court, in this regard. It may be further stated that the very purpose of the appointment of Shikshan Shulka Samiti is to ensure that there is no profiteering involved in the rates of fees to be charged by the unaided private educational institutions. Therefore, it will be totally fallacious to allege that such educational institutions are engaged in a profit making business.

Besides, it is also significant in this context that there is a direct control by the various Government agencies on the activities, including the source of income of such educational institutions, viz. AICTE, MCI, NBA, DTE, etc., as also the concerned Universities.

Therefore, it will be totally incorrect on the part of the IT Department to take a stand that if there is any revenue surplus in case of an educational institution, it will automatically lead to a conclusion that it is not an educational institution, solely for educational purposes or its activities are not charitable.

The reasons in support of the stand that the law laid down in the aforesaid judgements of Uttarakhand High Court is not correct, the same being contrary to the law laid down by the Apex Court; are as follows :

1. **A reasonable revenue surplus generated by the educational institution for the purposes of development of education and expansion of the institution, does not, militate against the charitable character of such institution.**

   The crux of the issue in point is whether a reasonable surplus, which may be generated by an educational institution for the purposes of the development of education and expansion of the institution, can lead to an inference that such an institution is not a charitable institution. The answer to the above query is an emphatic NO. In support of the aforesaid stand, reliance is placed on the following legal precedents :

(i) *The judgement of the Supreme Court, in the case of TMA Pai Foundation and Others Vs. State of Karnataka and Others,(2002)8SCC481.*

In this case, one of the issues before the Hon. Supreme Court was regarding the fee structure in case of private unaided educational institutions. For our purpose, certain part of para (53) and full para (57) of the judgement are relevant. For the sake of ready reference, the aforesaid observations are reproduced as follows :

(a) Part of para (53)

Furthermore, in setting up a reasonable fee structure, the element of profiteering is not yet accepted in Indian conditions. ***The fee structure must take into consideration the need to generate funds to be utilized for the betterment and growth of the educational institution,*** *the betterment of education in that institution and to provide facility necessary for the benefit of the students* (Emphasis added)

(b) Para (57)

We, however, wish to emphasize one point, and that is that inasmuch as the occupation of education is, in a sense, regarded as ***charitable****, the government can provide regulations that will ensure excellence in education,* ***while forbidding the charging of capitation fee and profiteering by the institution.*** *Since the object of setting up an educational institution is by definition "****charitable****", it is clear that an educational institution cannot charge such a fee as is not required for the purpose of fulfilling that object. To put it differently, in the establishment of an educational institution, the object should not be to make a profit, inasmuch as education is essentially charitable in nature.* ***There can, however, be a reasonable revenue surplus****,* ***which may be generated by the educational institution for the purpose of development of education and expansion of the institution****.* (Emphasis added)

From the aforesaid observations of the Apex Court, it is clearly established that a reasonable revenue surplus, which may be generated by an educational institution for the purpose of development of education and expansion of the institution, cannot lead to a conclusion that such educational institution does not exist for the purposes of education but exists for the purposes of profit. In other words, such an educational institution will have to be treated to be existing solely for educational purposes and not for purposes of profit.

It has also been held in this case that such an institution will be essentially of charitable nature.

In the light of the aforesaid observations of the Apex Court, the aforesaid judgements of Uttarakhand High Court do not lay down the correct legal position and therefore, the same should not and can not be followed.

(ii) *The judgement by the Supreme Court, in the case of Islamic Academy of Education and Another Vs. State of Karnataka and Others (2003) 6SCC697*

In this case also, one of the issues before the Hon. Supreme Court was regarding the fee structure in respect of private unaided educational institutions. The aforesaid issue has been dealt with by way of Question No.1, of the aforesaid judgement. For the sake of ready reference, the relevant part of the aforesaid observations is reproduced as follows :

Question No. 1

So far as the first question is concerned, in our view the majority judgement is very clear. There can be no fixing of a rigid fee structure by the Government. ***Each institute must have the freedom to fix its own fee structure taking into consideration the need to generate funds to run the institution and to provide facilities necessary for the benefit of the students. They must also be able to generate surplus which must be used for the betterment and growth of that educational institution.*** *In paragraph 56 of the judgement it has been categorically laid down that the decision on the fees to be charged must necessarily be left to the private educational institutions that do not seek and which are not dependent upon any funds from the Government. Each institute will be entitled to have its own fee structure.* ***The fee structure for each institute must be fixed keeping in mind the infrastructure and facilities available, the investments made, salaries paid to the teachers and staff, future plans for expansion and / or betterment of the institutions etc. Of course there can be no profiteering and capitation fees cannot be charged. It thus needs to be emphasized that as per the majority judgement imparting of education is essentially charitable in nature.*** *Thus the surplus profit that can be generated must be only for the benefit / use of that educational institutions. Profits surplus cannot be diverted for any other use or purpose and cannot be used for personal gain or for any other business or enterprise.* ***As at present there are statutes / regulations which govern the fixation of fees and as this Court has not yet considered the validity of those statutes / regulations, we direct that in order to give effect to the judgement in TMA Pai case the respective State Governments concerned authority shall set up, in each State, a committee headed by a retired High Court Judge who shall be nominated by the Chief Justice of that State.*** *The other member, who shall be nominated by*

the judge, should be a Chartered Accountant of repute. A representative of the Medical Council of India (In short 'MCI') or the All India Council for Technical Education (in short 'AICTE') depending on the type of institution, shall also be a member. The Secretary of the State Government in charge of Medical Education or Technical Education, as the case may be, shall be a member and Secretary of the Committee.

From the aforesaid observations, it is clearly established that the fee structure for each institution must be fixed, keeping in mind the infrastructure and facilities available, the investments made, salaries paid to the teachers and staff, future plans for expansion and / or betterment of the institutions, etc.

It has also been held in this case that such an institution will be essentially of charitable nature.

In the light of the aforesaid judgement of the Apex Court also, it is clearly established that the aforesaid judgements of Uttarakhand High Court do not lay down the correct legal position, as the same are contrary to the law laid down by the Apex Court.

(iii) *American Hotel and Lodging Association Educational Institute Vs. CBDT [2008] 301 ITR 86 (SC).*

It has been, *inter alia*, held in this case by the Apex Court that excess / deficit of income over expenditure, will not decide whether the assessee exists for profit or not.

Besides, on page 105 of the Report, the Hon High Court has referred to the judgement of the Apex Court, in the case of *Addl.CIT Vs. Surat Art Silk Cloth Manufacturer Association [1980] 121 ITR 1 (SC).* The relevant observations of the Apex Court on page 105 of the Report, are reproduced as follows :

In Addl. CIT v. Surat Art Silk Cloth Manufacturers Association reported in [1980] 121 ITR 1, it has been held by this court that the test of predominant object of the activity is to be seen whether it exists solely for education and not to earn profit. ***However, the purpose would not lose its character merely because some profit arises from the activity****. That, it is not possible to carry on educational activity in such a way that the expenditure exactly balances the income and there is no resultant profit, for, to achieve this, would not only be difficult of practical realization but would reflect unsound principles of management.* ***In order to ascertain whether the institute is carried on with the object of making profit or not it is duty of the prescribed authority to ascertain whether the balance of income is applied wholly and exclusively to the objects for which the applicant is established.***

In deciding the character of the recipient, it is not necessary to look at the profits of each year, but to consider the nature of the activities undertaken in India. If the Indian activity has no co-relation to education, exemption has to be denied. [see the judgement of this court in Oxford University Press [2001] 247 ITR 658 (supra)]. Therefore, the character of the recipient of income must have character of educational institution in India to be ascertained from the nature of the activities. If after meeting expenditure, surplus remains incidentally from the activity carried on by the educational institution, it will not cease to be one existing solely for educational purposes. ***In other words, existence of surplus from the activity will not mean absence of educational purpose*** *(see the judgement of this court in Aditanar Educational Institution v. Addl. CIT [1997] 224 ITR 310). The test is - the nature of activity.*
(Emphasis added)

From the aforesaid observations of the Apex Court, it is clearly established that the predominant object of the educational activity is to see whether it exists solely for education and not to earn profit. **It is also clearly established that an educational institution would not lose its charitable character merely because some profit arises from its activity**. Besides, in order to ascertain whether the institute is carried on with the object of making profit or not, it is the duty of the prescribed authority to ascertain whether the balance of income is applied wholly and exclusively to the objects for which the assessee is established.

It has been further held that if after meeting expenditure, surplus remains from the activity carried on by the educational institutions, it will not cease to be one existing solely for educational purposes. In other words, existence over surplus from the activity will not mean absence of educational purposes.

In the light of the aforesaid judgement of the Apex Court, it is absolutely clear that a reasonable surplus cannot lead to a conclusion that an educational institution does not exist solely for educational purposes and on the other hand, it exists for the purposes of profit. In this context, what is relevant is to ascertain whether the aforesaid surplus has been applied wholly and exclusively for the objects of the trust.

In the first place, there is no surplus in the case of the assessee trust. On the other hand, even if the method adopted by the AO is taken into consideration, the so-called surplus has been applied wholly and exclusively towards the objects of the trust, viz. on the construction of building, purchase of equipments and furniture, books, etc.

In view of the aforesaid judgements of the Apex Court also, the law laid in the aforesaid judgements of Uttarakhand High Court is not a good law, as these judgements are contrary to the law laid down by the Apex Court.

(iv) *Aditnar Educational Institution Vs. Addl.CIT [1997] 224 ITR 310 (SC).*

In this case, the relevant observations of the Apex Court are to be found on page 318 of the Report, which are reproduced as follows :

We may state that the language of section 10(22) of the Act is plain and clear and the availability of the exemption should be evaluated each year to find out whether the institution existed during the relevant year solely for educational purposes and not for purposes of profit. After meeting the expenditure, if 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. The decisive or acid test is whether on an overall view of the matter, the object is to make profit. 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.

From the aforesaid observations, it is clearly established that in the case of an educational institution, if after meeting the expenditure, any surplus results from the activity lawfully carried on by such institution, it will not cease to be one existing solely for educational purposes, since the object is not to make profit. The decisive or acid test is whether on an overall view of the matter, the object is to make profit.

In the light of the aforesaid judgements of the Apex Court, it is clearly established that the charitable character of an educational institution will not be affected, if the fee structure of the educational institution generates reasonable surplus for the purpose of infrastructure and facilities available, the investments made, salaries paid to the teachers and staff, future plans for expansion and / or betterment of the institution, etc. Therefore, the aforesaid judgements of Uttarakhand High Court do not lay down the correct legal precedent and accordingly, they need not be followed in the cases of educational institutions claiming exemption under sections 11 or 10(23C)(vi) of the Act.

2. Even capital expenditure on buildings, etc., is an application of income towards the objects of the educational institution.

It is a well-settled position in law that in the case of a charitable trust, including an educational institution, any expenditure of capital nature for the furtherance of the objects of the trust / institution, is an application of income on the objects of the trust and the same is, therefore, exempt from income-tax, as per the provisions of section 11(1) of the Act.

In this connection, a reference may be made to section 11(1)(a) of the Act, according to which income derived from property held under trust wholly for charitable or religious purposes, to the extent to which such income is **applied** to such purposes in India, shall not be included in the total income of the trust.

Similarly, any part of income applied towards the objects of the institution is exempt from tax, as per clause (a) of third proviso to section 10(23C) of the Act.

In the light of the aforesaid reasons, any income applied on the objects of the institution, which includes capital expenditure on buildings, equipment, etc., will not be included in the total income of the institution.

3. Once registration is granted by the CIT under section 12A, the AO cannot make further probe into the objects of the institution.

It may also be stated in this context that once registration is granted by the CIT under section 12A of the Act, the AO is precluded from making any further probe regarding the objects of the institution. In support of this stand, reliance is placed on the following legal precedents:

(i) *ACIT Vs. Surat City Gymkhana [2008] 300 ITR 214 (SC).*

It was held in this case that the registration of an institution under section 12A of the Income-Tax Act, 1961, once done, is a *fait accompli* and the Assessing Officer cannot thereafter, make further probe into the objects of the institution.

(ii) *M.P.Madhyam Vs. CIT [2002] 256 ITR 277 (MP)*

It was held in this case that proceedings for registration and cancellation of registration of charitable institutions are different from assessment proceedings. The income-tax authorities are bound by registration and once they have registered an institution as charitable, they cannot go behind the registration in the assessment proceedings. They are *prima facie* bound by such a registration.

(iii) *Hiralal Bhagwati Vs. CIT [2000] 246 ITR 188 (Guj.)*

It was, *inter alia*, held in this case that once the registration under section 12A(a) of the Act is granted, the ITO was not justified in refusing the benefits which would otherwise accrue under registration, on the ground that it was not for the benefit of the public at large.

Besides, on analogical grounds, the aforesaid legal precedent will equally apply to the exemption granted to an educational institution under section 10(23C)(vi) of the Act, by the CBDT.

In the light of the aforesaid reasons, the AO is totally precluded from making any further probe into the objects of the institution, during the course of the assessment proceedings.

4. Conclusion

In the light of the reasons brought out in the preceding paragraphs, it is clearly established that –

(i) When the fees being charged by the educational institutions are as per the guidelines of the Shikshan Shulka Samiti, there cannot be any element of profiteering embedded therein.

(ii) A reasonable revenue surplus generated by the educational institution for the purposes of development of education and expansion of the institution, does not militate against the charitable character of such institution.

(iii) Even capital expenditure on land, building, equipment, furniture, etc., is an application of income towards the objects of the institution.

(iv) If the institution has already been granted registration by the CIT, under section 12A, then the AO cannot make further probe into the objects of the institution.

In the light of the discussion in the aforesaid paragraphs, particularly the law laid down by the Apex Court in the aforesaid judgements, the law laid down in the aforesaid judgements of Uttarakhand High court, is not legally correct, because the same is contrary to the law laid down by the Apex Court. Therefore, the aforesaid judgements of Uttarakhand High Court, do not deserve to be followed at all.

In view of the aforesaid reasons, it is clearly established that the educational institutions cannot be denied the benefit of exemption under section 11 or section 10(23C) of the Act, just because there is any revenue surplus for the relevant previous year.

Besides, it must be clearly understood in the present context that if the law laid down in the aforesaid judgements of Uttarakhand High Court is accepted as correct, then it will be the death knell for any private initiative in the field of education, which the Central Government, as also the State Governments, desire to encourage and expand.

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