

# NEW ERA FOR INCIDENTAL BUSINESS

◆ Legal Series Vol. XV ◆ Issue 7

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## SUPREME COURT JUDGEMENT ON EDUCATIONAL INSTITUTIONS



**Standards & Norms**

Resource support on NGO Governance, Accounting and Regulations



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## INTRODUCTION

**1.01** The Supreme Court of India in the case of *M/s New Noble Education Society vs. The CCIT 1 and Anr.*, Civil Appeal No. 3795 of 2014 dated 19th October 2022 has given a landmark judgement which will have far reaching impact on educational institutions subject to exemption u/s 10(23C)(vi). This ruling will also have impact on other charitable institutions as far as incidental business activities are concerned.

**1.02** The major conclusions from the judgement are summarized as under:

- a. It is held that the requirement of the charitable institution, society or trust etc., to 'solely' engage itself in education or educational activities, and not engage in any activity of profit, means that such institutions cannot have objects which are unrelated to education. In other words, all objects of the society, trust etc., must relate to imparting education or be in relation to educational activities.
- b. Where the objective of the institution appears to be profit-oriented, such institutions would not be entitled to approval under Section 10(23C)(vi) of the IT Act. At the same time, where surplus accrues in a given year or set of years *per se*, it is not a bar, provided such surplus is generated in the course of providing education or educational activities.
- c. The seventh proviso to Section 10(23C), as well as Section 11(4A) refer to profits which may be 'incidentally' generated or earned by the charitable institution. In the present case, the same is applicable only to those institutions which impart education or are engaged in activities connected to education.
- d. The reference to 'business' and 'profits' in the seventh proviso to Section 10(23C) and Section 11(4A) merely means that the profits of business which is 'incidental' to educational activity – as explained in the earlier part of the judgment i.e., relating to education such as sale of text books, providing school bus facilities, hostel facilities, etc.
- e. The reasoning and conclusions in *American Hotel and Lodging Association v Central Board of Direct Taxes*, (2008) 10 SCC 509 and *Queen's Education Society v*

*Commissioner of Income Tax*, (2015) 8 SCC 47 so far as they pertain to the interpretation of expression 'solely' are hereby disapproved. The judgments are accordingly overruled to that extent.

- f. While considering applications for approval under Section 10(23C), the Commissioner or the concerned authority as the case may be under the second proviso is not bound to examine only the objects of the institution. To ascertain the genuineness of the institution and the manner of its functioning, the Commissioner or other authority is free to call for the audited accounts or other such documents for recording satisfaction where the society, trust or institution genuinely seeks to achieve the objects which it professes. The observations made in *American Hotel* (supra) suggest that the Commissioner could not call for the records and that the examination of such accounts would be at the stage of assessment. Whilst that reasoning undoubtedly applies to newly set up charities, trusts etc. the proviso under Section 10(23C) is not confined to newly set up trusts – it also applies to existing ones. The Commissioner or other authority is not in any manner constrained from examining accounts and other related documents to see the pattern of income and expenditure.
- g. It is held that wherever registration of trust or charities is obligatory under state or local laws, the concerned trust, society, other institution etc. seeking approval under Section 10(23C) should also comply with provisions of such state laws. This would enable the Commissioner or concerned authority to ascertain the genuineness of the trust, society etc. This reasoning is reinforced by the recent insertion of another proviso of Section 10(23C) with effect from 01.04.2021.

## **CAN A “SOLELY” EDUCATIONAL INSTITUTION HAVE OTHER CHARITABLE ACTIVITY**

- 2.01** The basic provision granting exemption u/s 10(23C)(vi) requires that the educational institution should exist 'solely for educational purposes and not for any other charitable object.

- 2.02** The Supreme Court in this respect has discussed and clarified the meaning of the word 'solely' in the phrase 'solely for educational purposes and not for purposes of profit'. It has been held that the plain and grammatical meaning of the term 'sole' or 'solely' is 'only' or 'exclusively'.

Reference has been made to *P. Ramanath Aiyar's Advanced Law Lexicon* which explains the term 'solely' as exclusively and not primarily".

The Cambridge Dictionary has also been referred which defines 'solely' to be, "only and not involving anyone or anything else".

The synonyms for 'solely' are "alone, independently, single-handed, single-handedly, singly, unaided, unassisted" and its antonyms are "inclusively, collectively, cooperatively, conjointly etc." **It is, therefore, clear that term 'solely' is not the same as 'predominant /mainly'. The term 'solely' means to the exclusion of all others.** The following para from the judgement will provide greater clarity in this regard:

***"Para 51** The ruling further states that a trust, university or other institution imparting education, as the case may be, should necessarily have all its objects aimed at imparting or facilitating education. Having regard to the plain and unambiguous terms of the statute and the substantive provisions which deal with exemption, there cannot be any other interpretation."*

- 2.03** The Supreme Court overruled its own judgement in *American Hotel and Lodging Association v Central Board of Direct Taxes*, (2008) 10 SCC 509 and *Queen's Education Society v Commissioner of Income Tax*, (2015) 8 SCC 47 with regard to the interpretation of expression 'solely'. It may be noted that in these judgements it was held that if the organisation was dominantly engaged in educational activity, then some other activity will not have any effect on the 'solely' educational character.

In the light of the above 'solely' educational institution under section 10(23)(vi) have to exclusively be engaged only in educational activity and not dominantly.

## MEANING OF THE TERM 'EDUCATION' REAFFIRMED

**3.01** With regard to the scope of the term 'education' while delivering this judgement the Supreme Court has also observed that it is not the broad meaning of the expression which is involved in this case. As was held in *T.M.A Pai Foundation vs. State of Karnataka*, (2002) 8 SCC 481: AIR 2003 SC 355 education in the narrower meaning of the term as scholastic structured learning is what is meant in Article 21-A, Articles 29-30 and Articles 45- 46 of the Constitution. As to what is 'education' in the context of the IT Act, was explained in *Loka Shikshana Trust v. Commissioner of Income Tax* [1975] 101 ITR 234 (SC) in the following terms:

*"5. The sense in which the word "education" has been used in section 2(15) is the instruction, schooling or training given to the young in preparation for the work of life. It also connotes the whole course of scholastic instruction which a person has received. The word "education" has not been used in that wide and extended sense, according to which every acquisition of further knowledge constitutes education. According to this wide and extended sense, travelling is education, because as a result of travelling you acquire fresh knowledge. Likewise, if you read newspapers and magazines, see pictures, visit art galleries, museums and zoos, you thereby add to your knowledge....All this in a way is education in the great school of life. But that is not the sense in which the word "education" is used in clause (15) of section 2. What education connotes in that clause is the process of training and developing the knowledge, skill, mind and character of students by formal schooling."*

Thus, education i.e., imparting formal scholastic learning, is what the IT Act provides for under the head of "charitable" purposes, under Section 2(15). In other words the Supreme Court reaffirmed that education will continue to have a narrow scope covering only formal education.

## CAN A “SOLELY” EDUCATIONAL INSTITUTION HAVE PROFIT MAKING ACTIVITY

- 4.01** The Supreme Court in this ruling has held that a “solely” educational institution should engage only in educational activity it cannot engage in any other charitable or profit making activity. In other words, all objects of the society, trust etc., must relate to imparting education or be in relation to educational activities. If the educational institution seems to be working with a profit motive i.e., the fees collected from the student is substantially more than the cost of services then such organisation will not be eligible for exemptions. The effect of the ruling will apply to all charitable organisations who charge their beneficiaries.
- 4.02** The ruling further states that there is no bar in having surplus provided such surplus is generated in the course of providing education or educational activities. In other words a educational institution can generate profit from its beneficiaries provided it is reasonable and there is no dominant profit motive. It is pertinent to quote another Supreme Court ruling where the reasonableness of permissible surplus was decided. The Hon’ble Supreme Court in the case of *Islamic Academy of Education v. State of Karnataka* on 14 August, 2003, WP (Civil) 350 of 1993 held that an educational institution can have reasonable surplus upto 6% to 15% every year without affecting its charitable character.
- 4.03** It is also held that any other activity such as non-recognised courses, Management Development Programmes etc., which do not result in recognised degree, will not be treated as advancement of educational objective. Further, such activities cannot be treated as incidental business activity unless they have a direct nexus with the main activity or the beneficiaries under the main activity. It is important to note that the Apex Court has held that the various incidental business activities which are not related to the main object or to the beneficiaries then such activity will neither be treated as a

charitable activity nor as a incidental business activity. The relevant para 72 and 73 is reproduced as under:

*“.....It was held that if an institution facilitated learning of its pupils by sourcing and providing text books, such activity would be ‘incidental’ to education. Similarly, if a school or other educational institution ran its own buses and provided bus facilities to transport children, that too would be an activity incidental to education. There can be similar instances such as providing summer camps for pupils’ special educational courses, such as relating to computers etc., which may benefit its pupils in their pursuit of learning.”*

*73. However, where institutions provide their premises or infrastructure to other entities, trusts, societies etc., for the purposes of conducting workshops, seminars or even educational courses (which the concerned trust is not actually imparting) and outsiders are permitted to enrol in such seminars, workshops, courses etc., then the income derived from such activity cannot be characterised as part of education or ‘incidental’ to the imparting education. Such income can properly fall under the other heads of income.”*

*“74. It is unclear from the record whether R.R.M Educational Society was providing hostel facility only to its students or to others as well. If the institution provided hostel and allied facilities (such as catering etc.) only to its students, that activity would clearly be ‘incidental’ to the objective of imparting education.”*

In the light of the above the impact on incidental business activity will be as under:

- (i) Any income from use of property and infrastructure for any activity including workshop, seminar or even educational courses will not be treated as incidental business income.
- (ii) The business activity must be actually linked with the advancement of the primary charitable objective.



## THE MEANING OF THE WORD 'INCIDENTAL' TO DETERMINE PERMISSIBLE BUSINESS ACTIVITY

**5.01** The Supreme Court has taken a very narrow view of the term incidental in context of incidental business activities. In the past the Supreme Court has been taking a very liberal interpretation of the term 'incidental'. For instance Supreme Court in the case of *Asstt. CIT v. Thanthi Trust* [2001] 115 Taxman 126, had held that if the income generated from a business of publishing newspaper is totally used for charitable purposes then such business should be considered as incidental.

**5.02** In this *New Noble Educational Society* case (supra) the Supreme Court observed that incidental has to be something related with the main activity of the society. A business cannot be said to be incidental only because the surplus from it is applied for charitable purposes. The Supreme Court cited its own judgment in *Delhi Cloth & General Mills Co. Ltd. v Workmen & Ors.* 1967 (1) SCR 882 where the meaning of 'incidental' was explained in the following manner:

*"21. [T]he word 'incidental' means according to Webster's New World Dictionary:*

*"happening or likely to happen as a result of or in connection with something more important; being an incident; casual; hence, secondary or minor, but usually associated:"*

*"Something incidental to a dispute" must therefore mean something happening as a result of or; in connection with the dispute or associated with the dispute. The dispute is the fundamental thing while something incidental thereto is an adjunct to it. **Something incidental, therefore, cannot cut at the root of the main thing to which it is an adjunct.**"*

**5.03** The seventh proviso to Section 10(23C) and Section 11(4A) provide that a charitable or religious organisation can engage in incidental business activities. Prior to the Supreme Court ruling virtually any kind of business was allowed to be undertaken as incidental business activity provided the entire surplus was used for charitable or religious purposes. However, in this case Supreme Court has taken a very strict view of the term "incidental", it has held that 'incidental' business activity has to be incidental to educational activity

for example activities such as sale of text books, providing school bus facilities, hostel facilities, etc.

- 5.04** After this Supreme Court ruling educational institutions shall not be permitted to undertake income generation activity with anybody who is not the primary beneficiary. For example, even providing infrastructure to non students for training for seminar purposes will not be treated as “incidental” activity as discussed earlier.
- 5.05** This Supreme Court ruling will have very far reaching implication on the incidental and other business activity of educational as well as other charitable or religious institutions. An incidental business activity should have a direct relationship with the advancement of the main objective. For example, selling books to students can be incidental business activity but the same activity for non student will not be treated as an incidental business activity.

## **WILL THE JUDGEMENT AFFECT INCIDENTAL BUSINESS ACTIVITIES OF ALL OTHER INSTITUTIONS REGISTERED UNDER SECTION 12AB ALSO**

- 6.01** The judgement will have an far reaching affect on the incidental and other business activity of all category of charitable or religious institutions. This judgement is not confined only to educational institutions as far as business activities are concerned. It may be noted that the provisions pertaining to incidental business activity of organisation approved under 10(23C) are covered under seventh proviso to that section. However, the Supreme Court has also analysed section 11(4A) which applies to the incidental business activities of all category of charitable or religious institutions. The Supreme Court has even specifically stated that these two provisions are identical and therefore the law shall apply equally to all types of charitable or religious institutions. The relevant extract from the decision is as under:

*“Thus, the underlying objective of seventh proviso to Section 10(23C) and of Section 11(4A) are identical. These have to be read in the light of the main provision which spells out the conditions for exemption under Section*

10(23C) - the same conditions would apply equally to the other sub-clauses of Section 10(23C) that deal with education, medical institution, hospitals etc.”

## POWER OF CIT TO EXAMINE BOOKS OF ACCOUNTS AT THE TIME OF GRANTING APPROVAL

**7.01** The court has given crucial directions with regard to the power of the Commissioner or any other designated authority at the stage when it approaches the authority for approval under Section 10(23C). The Court modified its earlier decision in *American Hotel and Lodging Association vs. CBDT* (2008) 10 SCC 509 where it was held that the Commissioner of Income Tax cannot call for records at the time of granting registration. The Court held that records may not be called for new charities but can be called in case of existing charities. The Commissioner or other authority is not in any manner constrained from examining accounts and other related documents to see the pattern of income and expenditure.

**7.02** However the court has defined the limitation in the nature of enquiry regarding books of accounts and held as follows :

“63. .... The Commissioner or the concerned authority, while considering an application for approval and the further material called for (including audited statements), should confine the inquiry ordinarily to the nature of the income earned and whether it is for education or education related objects of the society (or trust).

If the surplus or profits are generated in the hands of the assessee applicant in the imparting of education or related activities, disproportionate weight ought not be given to surpluses or profits, provided they are incidental. At the state of registration or approval therefore focus is on the activity and not the proportion of income. If the income generating activity is intrinsically part of education, the Commissioner or other authority may not on that basis alone reject the application.”

**7.03** The ITAT Hyderabad in the case of *Fernandez Foundation vs. CIT(E)* ITA No.1884 & 1885/Hyd/2019 and ITA No.299/Hyd/2020 dated 08.12.2022 has held that the CIT(E) is well within his rights to scrutinize and analyse document and information in the light of the Supreme Court judgement in *New Noble Educational Society (supra)*. The relevant extract is as under:

“Further from the reading of ratio laid down by the Hon’ble Supreme Court in the case of *New Noble Educational Society* [2022] 143 taxmann.com 276 (SC) (supra), it is abundantly clear that the Id.CIT(E) was well within his right to examine the audited records / other financial statements with a view to deciphering the nature of the activities. Undoubtedly, in the present case, the Id.CIT(E) has brought on record that the activities of the assessee are commercial in nature. In our view, the argument of the learned counsel for the assessee that only the data for the period 03.08.2018 to 25.02.2019 can only be considered is without any basis and is contrary to Form 56 / Form 10A and the judgment of the Hon’ble Supreme Court, in the case of *New Noble Education Society (supra)*. In our view, the above said proposition of the assessee cannot be accepted, in case of the assessee, as the assessee was not a beginner or new starter. Rather the present case is a case of conversion of a profit making company into a section 8 Company. In fact, the assessee was earning huge profit as a private company, which was later on converted into section 8 company w.e.f. 03.08.2018. As mentioned hereinabove, the assessee was having surplus of Rs.15,96,02,014/- in the financial year 2018-19 and Rs.34,82,52,005/- for financial year 2019-20, which only shows that the assessee has been charging cost plus unreasonable mark up on its services. Further, if we accept the argument of the learned counsel for the assessee that only the subsequent document should be taken into consideration, despite the fact that the assessee, being a profit earning private company prior thereto, then it will be a handy tool for an otherwise profit-making company to conveniently convert into a so-called charitable company and avoid payment of due taxes to a welfare state.”

## WHETHER AT THE TIME OF GRANTING APPROVAL THE COMPLIANCE WITH STATE LAW IS REQUIRED

- 8.01** It is held that wherever registration of trust or a charity is obligatory under a state or local laws, then the concerned trust, society, other institution etc. seeking approval under Section 10(23C) should also comply with provisions of such state laws. This would enable the Commissioner or concerned authority to ascertain the genuineness of the trust, society etc. This reasoning is reinforced by the recent insertion of another proviso of Section 10(23C) with effect from 01.04.2021. The following para from the judgement will provide greater clarity in this regard:

*“70. In view of the above discussion, it is held that charitable institutions and societies, which may be regulated by other state laws, have to comply with them- just as in the case of laws regulating education (at all levels). Compliance with or registration under those laws, are also a relevant consideration which can legitimately weigh with the Commissioner or other concerned authority, while deciding applications for approval under Section 10 (23C).”*

## THE JUDGEMENT WILL APPLY PROSPECTIVELY

- 9.01** The Supreme Court has clarified that the judgement will apply prospectively, in other words the Apex Court has provided transition time to the existing organisations to make the necessary changes. The relevant para 78 of judgment reads as follows:

*“This court is further of the opinion that since the present judgment has departed from the previous rulings regarding the meaning of the term ‘solely’, in order to avoid disruption, and to give time to institutions likely to be affected to make appropriate changes and adjustments, it would be in the larger interests of society that the present judgment operates hereafter. As a result, it is hereby directed that the law declared in the present judgment shall operate prospectively.”*

## WAY FORWARD FOR INSTITUTIONS HAVING CONSIDERABLE INCOME GENERATION ACTIVITY

**10.01** The institutions which are having incidental business activity which do not have a direct nexus with advancement of their main object will have to discontinue such activities or create separate institutions to undertake such activities. From the court ruling it seems that following activities may not be undertaken by section 10(23C)(vi) approved educational institution :

- Income from consultancy, research, training etc. from non beneficiaries
- Use of infrastructure by persons and organisations not related with the advancement of education of the beneficiary .
- Any activity where the organisation fails to establish an nexus with advancement of the main activity.

Further, the same ratio of law shall apply to all kinds of charitable and religious institutions as far as incidental business activities under section 11(4A) is concerned.

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