

## Mutuality Principle — A Tax Shelter

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No man can make a profit out of himself. The old adage that a penny saved is a penny earned may be a lesson in household economics, but not for tax purposes, since money saved cannot be treated as taxable income. It is this principle, which is extended to a group of persons in respect of dealings among themselves. This was set out by the *House of Lords in Styles v. New York Life Insurance Co. (1889) 2 TC 460 (HL)*. It was clarified by the *Privy Council in English and Scottish Joint Co-operative Wholesale Society Ltd. v. Commissioner of Agricultural Income-tax (1948) 16 ITR 270 (PC)*, that mutuality principle will have application only if there is identity of interest as between contributors and beneficiaries.

It was the lack of such a substantial identity between the participants, with depositor-shareholders forming a class distinct from the borrowing beneficiaries, that the principle of mutuality was not accepted for tax purposes for a Nidhi Company (a mutual benefit society recognised under section 620A of the Companies Act, 1956) in *CIT v. Kumbakonam Mutual Benefit Fund Ltd. (1964) 53 ITR 241 (SC)*. But then, where the gross surplus was shared both by the shareholder-investors and borrowers, the Tribunal found it to be eligible for non-liability on mutuality principle in *ITO v. Chennai Sri Andal Dhanesekhara Sasvatha Nidhi Ltd. (1990) 33 ITD 86 (Mad)*.

### Incorporation Does Not Destroy Mutuality

Where a group forms itself as a legal entity (say, a company), there was some doubt as to whether the principle of mutuality can still offer a tax shelter from liability. But then the Supreme Court in *CIT v.*

*Royal Western India Turf Club Ltd. (1953) 24 ITR 551 (SC)* found that incorporation itself does not bar mutuality.

The Supreme Court in a later decision in a sales tax case, viz., *Dy. Commercial Tax Officer v. Enfield India Ltd., Co-operative Canteen Ltd. (1968) 21 STC 317 (SC)*, had held that common seal and perpetual succession available for a registered co-operative society would make it ineligible for the benefit of mutuality in respect of canteen sales to its members. But then, this was overruled in a batch of sales tax cases covering a registered society, a company and a trust reported in *Joint Commercial Tax Officer v. Young Men's Association (1970) 26 STC 241 (SC)*, wherein the Supreme Court felt that the earlier understanding, that there could be piercing of corporate veil only in criminal cases and not in tax cases, was incorrect. At any rate, it was found that mutuality is not lost, when an association, company or a trust (including a co-operative society) could act as an agent of its members.

### Can a Co-operative Society Qualify?

Where a co-operative society deals solely with its members, right to recognition for exemption on grounds of mutuality was recognised in *CIT v. Apsara Co-operative Housing Society Ltd. (1993) 204 ITR 662 (Cal)* and *Director of Income-tax (Exemptions) v. Indo Oriental Bank and Commerce Welfare Society (2003) 130 Taxman 575 (Del)*.

### Can a Partnership be a Mutual Association?

Mutuality principle was applied even in respect of a partnership firm, when its activities were confined to its partners in the case of *CIT v. Natraj Finance Corporation (1988) 169 ITR 732 (AP)*, but was dissented in *Wankaner Jain Social Welfare Society v. CIT (2003) 260 ITR 241 (Mad)*, not because a partnership could not be a mutual association, but



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because it was found that there was no identity of interest as between partners, who were depositors and partners, who were borrowers following the rationale of the decision in Kumbakonam Mutual Benefit Fund's case (supra).

### Treatment of Chit Companies

The issue as to whether members forming various groups of subscribers managed by a chit company is the subject matter of conflicting decision of the Courts. In *CIT v. Kovur Textiles Ltd. (1982) 136 ITR 61 (AP)*, it was held that, where a businessman joining a chit group as a subscriber suffers a loss by taking an early bid, such loss as ascertained on termination of the auction chit, was inferable on par with interest on borrowed capital as expenditure. Such loss, it was found, could not be ignored on the ground that it is a loss arising from a mutual activity, because it is a legitimate charge on business income, so as to be not governed by the principle of mutuality. But a different view was taken to the effect, that mutuality principle was applicable in the case of a surplus arising to a chit subscriber, so that the positive income of a member, who made a profit by delaying the bid, was found to be not taxable on the principle of mutuality in *Soda Silicate and Chemical Works v. CIT (1989) 179 ITR 588 (P&H)*. Both the decisions could probably be reconciled, because the latter decision related to an investor, who participated in a chit solely with a view to have the benefit of pooling his interest by being a depositor-subscriber, while being beneficiary, as and when he became a successful bidder, while the former decision related to a businessman, whose object in joining the chit was solely to raise fund constituting a commercial activity, so that his loss was construed as a business loss. For an investor, where there is no "taint of commerciality" to borrow the phrase from the decision of the Supreme Court in *CIT v. Bankipur Club Ltd. (1997) 226 ITR 97 (SC)*, mutuality is not lost.

### Can a Mutual Society also be a Charity?

In any mutual organisation, there is an element of altruism, since the benefit availed by a member may not always be commensurate with his contribution. It was for this reason, that even where there is no return on the contribution, as in the case of an association formed for the purpose of general public utility, mutuality may not be lost. Such association may also be entitled to tax concessions as a charitable institution as was

found in *Addl. CIT v. Surat Silk Cloth Manufacturer's Association (1980) 121 ITR 1 (SC)* and *CIT v. Andhra Chamber of Commerce (1965) 55 ITR 722 (SC)*. In such cases, income from entrance fee, subscription and donations from members may be governed by the principle of mutuality and any other income governed by the exemption for charitable institution. It is likely that both the shelters, whether mutuality principle and concessions meant for charities subject to conditions, may be available for the same entity.

### Treatment of Income from Investments

Another question that arises is the case of mutual association is the property and interest income derived from non-members. The law as regards such miscellaneous income is also now settled by the Supreme Court in *CIT v. Bankipur Club Ltd. (1997) 226 ITR 97 (SC)*. The reservation of the Income Tax Department is that the transaction with non-members should not merit exemption because of lack of mutuality. But the Supreme Court in Bankipur Club's case (supra) did not accept this as long as such income is from activity "not

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tainted with commerciality", quoting with approval the head note summarising the decision of the Full Bench of Patna High Court in *CIT v. Ranchi Club Ltd. (1992) 196 ITR 137 (Patna) (FB)* in following words:

*"... that merely because the assessee-company had entered into transactions with non-members and earned profits out of transactions held with them, its right to claim exemption on the principle of mutuality in respect of transactions held by it with its members was not lost. The assessee was a mutual concern. The income derived by it from its house property let to its members and their guests and from the sale of liquor, etc., to its members and their guests was not taxable in its hands."*

Since a number of cases were clubbed for hearing along with Bankipur Club's case (supra) on issues not all concerned with identical categories of income, it was felt that each case has to be decided on facts of the case following the guidelines in Bankipur Club's case (supra), and other cases were accordingly posted for separate disposal. Cawnpore Club Ltd's case was one of the cases left to be decided separately. In Cawnpore Club's case, the issue was precisely that of income from interest on deposits and rent from rooms let out to guests. The Supreme Court, while dealing with the case separately, dismissed the departmental appeal in *CIT. v Cawnpore Club Ltd (2004) 140 Taxman 378 (SC)*. It did not consider it necessary to go into details, while endorsing the decision of the High Court that its income was governed by the principle of mutuality.

The decision by the Allahabad High Court in *CIT v. Wheeler Club Ltd. (1963) 49 ITR 52 (All)* upholding tax on miscellaneous income, has also since been overruled by the Supreme Court in *Chelmsford Club v. CIT (2000) 243 ITR 89 (SC)*. In fact, the decision of the Allahabad High Court had earlier been dissented by the Madras High Court in the *Presidency Club v. CIT (1981) 127 ITR 264 (Mad)*. The Supreme Court in *Chelmsford Club's case (supra)* found that the fact that income of a mutual association is from property does not bar application of the mutuality principle.

After the decisions of the Supreme Court in *Bankipur Club*, *Chelmsford Club* and *Cawnpore Club (supra)*, there need be no controversy as regards receipts from minimal activities with non-members and in the case of bank interest from deposits, if there is no taint of commerciality. More deposit of surplus funds with a bank for custody and interest should not, therefore, attract tax.

To tax such income from interest, revenue sometimes relies wrongly upon the decision of the Gujarat High Court in *Sports Club of Gujarat Ltd v. CIT (1988) 171 ITR 504 (Guj)*. In this case, it was decided after a long discussion that interest income would be taxable for the following reasons:

"However, as pointed out earlier, the objects clause in the memorandum and articles of association empowers those in the management of the assessee-club to invest and deal with moneys of the club not immediately required in such manner as may from time to time be determined by them. Under this clause, the investment need not be confined to investment by way of fixed deposits with banks. It can take any other form or shape, such as investment

in shares, real estate, etc. When income is derived from such investment, whether by way of interest, dividend or rent, it is derived from a third party and is not by way of contribution from the members of the club. We have also noticed that clause (vii) of the memorandum and articles of association provides that in the event of winding-up or dissolution of the club, if there remains any surplus after satisfying all the debts and liabilities, the same shall be paid or distributed amongst the members in equal shares. If the income derived from investments over a period of time is added to the surplus, there can be no doubt that when the surplus is distributed, a component of return on investment would go to the members in equal shares. This component of return which the members will receive will not be by way of plough back of their own contributions by way of fees, etc., to the club." (Emphasis supplied).

It may be seen from the above passage that the High Court has taken the view that interest from mere investments need not come in the way of mutuality principle, but it may, if it involves a commercial activity as was described subsequently by the Supreme Court as "taint of commerciality" in *Bankipurclub (supra)*. Hence, miscellaneous income, even in respect of transactions with third parties being guests of members or interest from deposits from banks or such other incidental income like commission on purchases, should also be eligible for exemption. Only activities that are commercial in nature would attract liability. Probably even in matters of dealings with members, if the objective is solely commercial in character, the mutuality principle may not be applicable, as was found by the Andhra Pradesh High Court in *Kovur Textiles Ltd's case (supra)* in the context of a claim of loss to a member, which was found admissible. It was on the basis of this reasoning that contributions by way of subscriptions and entrance fee paid by a trader to a chamber of commerce, which is a mutual association, has been found deductible.

## Conclusion

Mutuality principle offers a tax shelter, as long as its character of a mutual association is retained, with its income not tainted by commerciality. A formal organisation indicating mutuality as between members with bye-laws spelling out mutuality may, however, be necessary as proof of claim to mutuality either as a society or a company registered under Section 25 of the Companies Act, 1956, or even as managed by a public trust, with such activities primarily intended to be confined to its members. □