IN THE INCOME TAX APPELLATE TRIBUNAL
HYDERABAD BENCHES "A" : HYDERABAD

BEFORE SHRI B. RAMAKOTAIAH, ACCOUNTANT MEMBER
AND
SMT. ASHA VIJAYARAGHAVAN, JUDICIAL MEMBER

ITA.No.1580/Hyd/2013
Assessment Year 2010-2011

The A.P. Mahesh Coop. Urban Bank Ltd., Hyderabad. PAN AABAT4652K (Appellant)	vs.	The DCIT, Circle 2(3) Hyderabad. (Respondent)

For Assessee : Mr. B. Satyanarayana Murthy
For Revenue : Mr. Ramakrishna Bandi

Date of Hearing : 09.10.2014
Date of Pronouncement : 31.12.2014

ORDER

PER B. RAMAKOTAIAH, A.M.

This appeal by assessee is directed against the order of the Ld. CIT(A)-III, Hyderabad dated 24.09.2013. The issue in this appeal is with reference to allowance of an amount of Rs.11,66,894 being contribution to education fund made by assessee and claimed as revenue deduction. The A.O. was of the opinion that this is not an expense out of the profits but has only contributed to the National Cooperative Union of India out of the net profits and therefore, the amount is not allowable as deduction. Ld. CIT(A) confirmed the same. Hence, the present appeal.

2. We have heard the Ld. Counsel and Ld. D.R. and perused the material available on record.

3. Briefly stated, assessee is engaged in the business of banking, corporate agency for insurance and is registered under Multi-State Cooperative Societies Act. In the course of assessment, A.O. noticed that assessee has claimed an amount of Rs 11,66,894 towards education fund in the computation of income as an expenditure. He disallowed the same.

4. Before the Ld. CIT(A) assessee submitted that as per Multi-State Cooperative Societies Act, 2002 assessee has to credit 1% of its net profit to the Cooperative Education Fund maintained by National Cooperative Union, New Delhi. As per Rules, this amount was to be remitted by way of cheque or DD after approval of accounts in the Annual General Body Meeting. As per this procedure, assessee has remitted on 25.11.2009 an amount of Rs.11,68,894 to the said union by way of contribution during the year relevant to A.Y. 2010-2011. Since, this amount is a charge on the net profit and as there is outflow of this amount from the hands of assessee, this amount is allowable as a deduction. It was submitted that simply because this amount was quantified as a percentage on net profits, it does not mean that it is appropriation of profits. It is a charge on the profit, therefore, allowable as deduction. Ld. CIT(A) considered and rejected the same by stating as under :

> *"6.2 I have seen carefully the facts and evidence and I find that the aforementioned amount is by no means a business expense of the appellant. First and foremost, this is a below the line allocation. The relevant section of the multistate co-operative societies act 2002 is quoted below :-*
>
> *" 63. Disposal of net profits.-(i) A multi-State co-*

operative society shall, out of its Profits in any year,

(a) transfer an amount not less than twenty-five per cent. to the reserve fund;

(b) credit one per cent. to co-operative education fund maintained by the National Co-operative Union of India Limited, New Delhi in the manner as a prescribed ;

(c) transfer an amount not less than ten per cent. to a reserve fund for meeting unforeseen losses.

(2) Subject to such conditions as may be prescribed, the balance of the net profits may be utilised for all or any of the following purposes, namely:-

(a) payment of dividend to the members on their paid-up share capital at a rate not exceeding the prescribed limit;

(b) constitution of, or contribution to, such special funds including education funds, as may be specified in the bye-laws;

(c) donation of amounts not exceeding five per cent. of the net profits for any purpose connected with the development of co-operative movement or charitable purpose as defined in section 2 of the Charitable Endowments Act, 1890 (6 of 1890);

(d) payment of ex gratia amount to employees of the multi-State Co-operative society to the extent and in the manner specified in the bye-laws."

(Emphasis provided)

6.3 A plain reading of the above will show that the very opening line of subsection (1) begins by stating that the allocations are to be made out of the "net profits". This clearly implies that after meeting all expenditure and after payment of taxes, the net profits are to be allocated in the manner prescribed in clauses (a), (b) and Cc) of the above subsection. A harmonious reading of the above section would

clearly show that the subsection is concerned with the use of net profits after taxes i.e. it states that the society shall transfer minimum amount of 25% of the net profits to the reserve fund, credit 1% of the net profit to the education fund and transfer a minimum of 10% to the reserve fund for meeting unforeseen losses. These are very clearly in the nature of prudential norms and are applicable only if there is a net profit. During the course of appeal proceedings the Id AR was asked whether the appellant would be required to credit 1% of its turnover even if there was no net profit and if there was loss. The Id AR replied that this could not be the case. It is clear from these facts that the societies act referred to supra and the specific section referred to above does not intend to make 1% as a charge on revenue, rather it is clearly a below the line allocation to be made after payment of taxes.

6.4 The appellant also argued that this 1% was actually an overriding title on the revenue.

6.5 Coming to the argument regarding overriding title, I find that this plea of the appellant is also without any basis.

6.6 In the case of Colaba Central Co-op. Consumers I Wholesale & Retail Stores Ltd. v. CfT 1998 Tax Pub (OT) 0665 ieom-nc) :(1998) 229 ITR 0209 :(1997) 142 CTR 0394 :(1998) 097 TAXMAN 0001, the assessee was obliged to set apart certain amount out of its income for the purpose of redemption of the government share capital and to keep the same in a fund known as "Government share capital redemption fund". Admittedly the amounts standing to the credit of this fund belonged to the assessee. It was kept apart with a view to ensuring the availability of the requisite funds to the assessee for redemption of a part of its share capital. Redeeming shares' means buying back shares from the share holders. That being so, in the instant case, there is no diversion of income from the assessee to anybody.

6.7. Law is well settled that the doctrine of diversion of income by reason of overriding title

applies only in cases where the income never reaches the assessee as his income. The mere fact that the assessee has an obligation to apply certain amount out of its income for a particular purpose cannot make it a case of diversion of income by overriding title. An obligation to apply the income accrued, arisen or received amounts merely to the apportionment of income and the income so applied is not deductible. There is a difference between an amount which a person is obliged to apply out of his income and an amount which, by the nature of the obligation, cannot be said to be a part of his income. Where by the obligation income is diverted before it reaches the assessee, it is deductible; but where the income is required to be applied to discharge an obligation after such income reaches the assessee, the same consequence, in law, does not follow. There is no doubt that the amount appropriated to the Government share capital redemption fund belonged to the assessee. It never got diverted to anybody. The fact that there was a restriction on the use of the amount standing to the credit of the fund in the business of the wholesale stores of the assessee or that there was an obligation on the assessee to deposit the same as fixed deposit with the Central Finance Agency or invest it in the Government loan and securities in consultation with the authority as contemplated under section 70 of the Maharashtra Co-operative Societies Act does not make any difference.

(Observations of the Hon'ble Bombay High Court)

6.8 A reference to the aforementioned ratios will clearly show that the term "overriding title" refers to a legal charge on the revenue which overrides the liability of taxation as enshrined, in the Income Tax Act. Very clearly, the multistate co-operative societies Act, 2002 uses the term "net profit" and not revenue. It does not in anyway state that net profit is to be calculated by denying the liability under the Income Tax Act. Indeed, if that were the case, then the amendment itself would be ultra vires of the Constitution of India because the Constitution of India does not provide for the Cooperative Societies Act to override the Central Legislation. There is not even a hint of diversion through overriding title. The

appellant has fully paid all the state taxes, local taxes, etc. wherever applicable. However, when it comes to the Income Tax Act, suddenly, the interpretation of the appellant changes hue in complete disconsonance with the Constitution of India, the Income tax Act and even the Multistate Co-operative Societies Act, 2002.

6.9 Looking into all the above facts and circumstances and the ratios of the various decisions, it is very clear that the appellant did not make any expenditure in the normal course of its activity. Every allocation of 1 % is akin to the transfer of a certain amount of net profit to the reserves and is clearly a "below the line" allocation. It is not a business expense u/s 37 of the Income Tax Act. The concept of overriding title does not apply, given the facts of the case. Therefore, I have no hesitation in holding that the addition has been correctly made by the Assessing Officer."

5. At the outset, Ld. Counsel submitted that this issue was covered by the decision of the Coordinate Bench of ITAT, Bangalore in the case of Karnataka State Cooperative Apex Bank Ltd., in ITA.No.264/Bang/2001-02 dated 28.02.2013. It was submitted that the provisions of Multi-State Cooperative Bank are similar to Karnataka Cooperative Societies Act, under which, the said decision was rendered and accordingly, the issue is covered.

6. Later on however, it was noticed that there was a contrary judgment to the Karnataka High Court relied on by the Coordinate Bench, from Hon'ble Madras High Court in the case of CIT vs. South Arcat District Cooperative Supply and Marketing Society 127 ITR 467. It was also noticed that the principles laid down by the Hon'ble Karnataka High Court in the case of CIT vs. Pandaripura Sahakara Shakkara Karkhana Ltd., 174 ITR 475; the basis for which Coordinate Bench

decision, was distinguished in the later judgment of Hon'ble Rajasthan High Court in the case of CIT vs. Jodhpur Cooperative Marketing Society 275 ITR 372 (Raj.) specifically stating that judgment relied upon by Hon'ble Karnataka High Court was subsequently reversed by Hon'ble Supreme Court in a later judgment. In view of this, the case was again re-fixed to give an opportunity to assessee to make detailed submissions on this issue.

7. Ld. Counsel has placed detailed written submissions on the issue which are as under :

> *3....."Section 63 of the Multi State Co-operative Societies Act, 2002, which governs this contribution is reproduced below for favour of ready reference :*
>
> *"63. Disposal of net profits - (i) A Multi State Co-operative Society shall, out of its profits in any year,*
>
> *(a) Transfer an amount not less than twenty-five per cent to the Reserve Fund;*
>
> *(b) Credit one per cent to Co-operative Education Fund maintained by the National Co-operative Union of India Ltd., New Delhi, in the manner as a prescribed;*
>
> *(c) Transfer an amount not less than ten per cent to a Reserve Fund for meeting unforeseen losses.*
>
> *(2) Subject to such conditions as may be prescribed, the balance of the net profits may be utilised for all or any of the following purposes, namely:*
>
> *(a) Payment of dividend to the members in their Paid-up Share Capital at a rate not exceeding the prescribed limit;*
>
> *(b) Constitution of, or contribution to, such special funds including Education Funds, as may be specified in the bye-laws;*

(c) Donation of amounts not exceeding five per cent of the net profits for any purpose connected with the development of co-operative movement or charitable purpose as defined in Section 2 of the Charitable Endowments Act, 1890(6 of 1890);

Payment of ex-gratia amount to employees of the Multi State Co-operative Society to the extent and in the manner specified in the bye-laws.

4. Thus, as per Section 63(1)(b) of the Multi State Co-operative Societies Act, 2002, the appellant-bank has to credit 1 % of the net profit to the Co-operative Education Fund maintained by the National Co-operative Union of India (NCUI), New Delhi, in the manner prescribed.

NCUI is an apex body of cooperatives in India. NCUI is registered under Multi-State Cooperative Societies Act, 2002 and all the provisions contained therein have the sanctity and sanction of the concerned authorities/ bodies.

Education and training is one of its prime objectives well recognized by GOI and cooperatives. The role of NCUI has been recognized in the Multi-State Cooperative Societies Act, 2002. As per Section 63 (1) (b) of the Act, "a multi-state cooperative society shall out of its net profits in any year credit one per cent to cooperative education fund 'maintained' by the National Cooperative Union of India, New Delhi in the manner as may be prescribed."

The Cooperative Education Fund shall be administered by a committee constituted by the Central Government for this purpose consisting of following members.

- *The President of National Cooperative Union of India, New Delhi (Chairperson)*
- *The Central Registrar (Member) The financial adviser to the Department of Agriculture and Cooperation in the Ministry of Agriculture (Member)*
- *Two representatives of the multi-State cooperative societies to be nominated by the Central Government for every two years (Member)*

The object of the NCUI is to organise various types of Cooperative Education and Training Programmes by itself or in collaboration with other Cooperative Institutions or as decided by the Cooperative Education Fund Committee from time to time."

5. In, CIT Vs. Pandavapura Sahakara Sakkare Karkhane Ltd.(174 ITR 475), the Karnataka High Court was dealing with the deductibility of contribution to the Education Fund under the provisions of the Karnataka Co-operative Societies Act, which are also similar to the provisions of the Multi State Co-operative Societies Act. The wording of Section 57 of the Karnataka Co-operative Societies Act, 1957 and that of Section 63 of the Multi State Co-operative Societies Act, 2002, are similar. The Headnote to the case reads as under.

"An analysis of Section 57 of the Karnataka Co-operative Societies Act, 1957, and Rule 20 of the Societies Rules discloses that the condition for payment to the Co-operative Education Fund is that if the profits of a society exceed RS.5001-, and a declaration of payment of dividend to the members on Paid-up Share Capital at the rate of 2 per cent, is made, then the society is under an obligation to contribute towards the Co-operative Education Fund at a rate not exceeding 1 1h per cent of the net profits. The rate of contribution depends upon the rate of dividend. The language of Section 57(4)(a) of the Societies Act makes it clear that though the contribution is to be made with reference to profits, it is not out of the profits, and the rate is with reference to the rate of dividend. What is provided in the section is an obligation to contribute to the Co-operative Education Fund under certain contingencies and is a statutory liability which is an overriding charge on the income or profits of the society. Hence, the amount paid by the assesse co-operative society to the Co-operative Education Fund is a diversion of profits at source on account of overriding charge created under the Act which is a statutory obligation on the society. Hence, such payment is an allowable deduction."

This case answers the issues raised by the Hon'ble Commissioner of Income Tax (Appeals) in our case It holds that the contribution though determined on the basis of net profits, will not make any difference, that the amount paid by the Society to the account of the Co-operative Education Fund, is covered by the concept of diversion at source, on account of overriding charge created under that Act, which is a statutory obligation on the Society. The Karnataka High Court relied on the decision of the Supreme Court in Puna Electric Supply Co. Ltd. Vs. CIT(57 ITR 521), on the decision of the Madhya Pradesh High Court in the case of Keshkal Marketing Co-operative Societies Ltd. Vs. CIT(165 ITR 437) and distinguished Madras High Court's decision in CIT Vs. South Arcot District Co-operative Supply Vs. Marketing Society Ltd.(127 ITR 467).

6. The Madras High Court in the above case of CIT Vs. South Arcot District Co-operative Supply Vs. Marketing Society Ltd. (127 ITR 467) has also gone on the lines suggested by the Hon'ble Commissioner of Income Tax(Appeals) in our case that the contribution is only after the profits are earned and taxed and that the concept of the diversion of profit by way of overriding title is also not applicable. The Madras High Court equated the provision relates to contribution to Education Fund to the provision relating to declaration of dividends contained in the same section and opined that the contribution to Education Fund is not deductible. This analogy by the Madras High Court is on incorrect lines and therefore cannot be applied in our case as there are contrary cases.

7. The Gujarat High Court in the following three cases :

(a) Mahesana Dist Co-op Milk Producers Union Ltd vs., CIT 258 ITR 780

(b) Mehsana District Co-operative Milk Producers Union Ltd. vs., CIT 203 ITR 601.

(c) CIT vs. Kaira District Co-operative Milk Producers Union Ltd. 209 ITR 898.

dealing with contributions to the Gujarat Co-operative Federal Education Fund, came to a conclusion that the contribution to Education Fund is an allowable deduction.

8. The Madhya Pradesh High Court in the case of Keshkal Co-operative Marketing Society Ltd. vs. CIT 165 ITR 437, dealing with deductibility of transfer to the Reserve Fund u/s. 43(2) of the Madhya Pradesh Co-operative Societies Act, 1960, that it is an allowable deduction as the said amount does not comprise the income of the assessee as the same is divested u/s. 43(2) of the Societies Act and as it should be invested in such manner and on such terms and conditions as may be laid down by the Registrar in that behalf. The Court came to the conclusion that the said amount is not available for use of the Society at its option, as the assessee lose control over the said amount. The Court came to a conclusion that the amount is deductible u/s. 37 of the Income Tax Act.

9 . The Karnataka High Court in the case of CIT Vs. Pandavapura Sahakara Sakkare Karkhane Ltd., 198 ITR 690 was dealing with deductibility of transfer by a sugar factory to a fund called "Molasses Storage Fund". In this

case, the Government has stipulated under the Molasses Control Order that 1/3rd of the price charged should be transferred to a fund called Molasses Storage Fund. This amount could be used only according to the Instructions issued by the Government from time to time. It should be kept separately in a separate bank account and it is not possible to withdrawn without prior approval of the Excise Department. The Karnataka High Court held that the amount transferred to the Molasses Storage Fund is an allowable deduction as the right to the fund got diverted from the hands of the assessee by virtue of the Molasses Control Order.

10. The Karnataka High Court in the case of CIT vs. Hiranyakeshi Sahakari Sakkare Kharkhane 200 ITR 130 followed the above decision(198 ITR 690) while dealing with transfer to Molasses Storage Fund.

11. The Bombay High Court in the case of CIT vs. Bombay State Road Transport Corporation 106 ITR 303, dealing with contribution under Section 44 of the Road Transport Corporations Act. 1950, to "third party liability fund" held that it is an allowable deduction as the contributions are made under legal obligation cast upon the assessee under a statutory rule.

12. The Rajasthan High Court in the case of CIT vs. Jodhpur Co-operative Marketing Society 275 ITR 372 had an occasion to deal with the deductibility of transfer to Reserve Fund u/s.62 of the Rajasthan Co-operative Societies Act, 1965, has held that the transfer to the Reserve Fund under that Act is not an allowable

deduction. It has also explained the concept of diversion of overriding title, came to a conclusion that the transfer to the Reserve Fund is not covered under that concept. The following extracts from the Judgement are very appropriate for the purpose of conclusion of the matter in our appeal :

"The distribution of reserve fund is not in isolation but is a part of the general scheme of the Act dealing with assets and profits of the society in general during the continuance of its business as well as after the society ceases to exist leaving its assets firstly to discharge its own liability towards persons other than share capital, then to repay its members, the share capital contributed by the members with dividends to the extent permissible and the remaining surplus, if any, either to be utilised for any object of public utility or for the purposes of charitable as defined under the Charitable Endowment Act, 1890 or the corpus to be retained for a new society to come into existence in future with the like object as the cancelled society. "

.....

"Sub-rule (4) of rule 55 unfolds the areas in which reserve fund can be put to use. It reads

(i) to meet unforeseen losses incurred by the society

(ii) to meet such claims of the society as cannot otherwise be met; and

(iii) to provide for other financial need in times of special scarcity.

The aforesaid provisions convey in no uncertain terms that the reserve fund remains part of the capital and assets of the society and is to be used only for the purposes of the society in future according to the needs of the society either to be adjusted against its future losses or to payoff its dues which cannot otherwise be paid or to provide for funding needs in the case of financial crisis."

.....

"The diversion of income has multi-facets. Diversion arises where income is applied in a particular manner under statutory or contractual obligation or under the provisions of a document under which the company is constituted, viz., memorandum or articles of association or a firm has come into existence. In these circumstances, the principle that has emerged is that, if a person has alienated or assigned the source of his income so that it no longer remains his income, he cannot be taxed upon the income arising after the assignment of the source. In such event, it is not the income of the assessee at all. On the contrary, if the source is not assigned to, or transferred but passes through the assessee to an ultimate purpose, the case of application of income in a particular manner. Even though he may enter into a legal obligation to apply it in a particular way, still it remains the income of the assessee. Section 61 to section 64 provides an exception to the legislative rule where notwithstanding assignment of the source of income, the income is deemed to be the income of the person who has assigned such source by creating a legal fiction."

"Two features needs be taken into consideration. Firstly, it was a case where diversion of income under overriding title was claimed to be given to a person other than the assessee after receipt of it by the assessee. Secondly, it was held to be an obligation on income of the assessee only after it had accrued and was not a case of diversion of any sum of money before it became the income of the assessee."

.....

"With utmost respect, we notice that learned counsel appearing for the parties did not bring to the notice of the court that the decision of the Madras High Court in Vellore Electric Corporation Ltd.'s case (1977) 109 ITR 454 had since been reversed by the Supreme Court in Vellore Electric Corporation Ltd. v. CIT (1997) 227 ITR 557 referred to above and directly governed the controversy before the court. The decision rests on an over ruled decision and contrary to the Supreme Court decision on the same issue. Keshkal Co-operative Marketing Society Ltd.'s case (1987) 165 ITR 437 (MP), the other

case referred to which had followed Poona Electric Supply Co Ltd.'s case (1965) 57 ITR 521 (SC) was also demonstrably contrary to the principle enunciated by the Supreme Court in the two cases referred to above by us. The Supreme Court drew the distinction obvious in Poona Electric Supply Co. Ltd. (1965) 57 ITR 521 (SC) that there is no parity between the contingency reserve for the benefit of the society itself and the consumer benefit reserve fund, which was intended to be returned to the consumers, the latter never becomes part of the company's business assets.

Since the aforesaid decision of this court is founded on a reversed judgment of the Madras High Court and decision of the other High Court founded on the judgment of the Supreme Court which has been distinguished on the very same principle which has been applied by Poona Electric Supply Co. Ltd.'s case (1965) 57 ITR 521 (SC), the judgment must be deemed to have been rendered per incuriam and not a binding precedent.

As a result of the aforesaid discussion, we allow this appeal and hold that the amount of reserve fund transferred from the net profit under section 62 of the Co-operative Societies Act, 1965 read with rule 68 of the Co-operative Rules, 1966 is not allowable as deduction in computing the taxable income of the society on any of the grounds raised by the assessee. The judgment of the Tribunal is set aside and that of the assessing officer is restored."

13. The Judgement is on the transfer to Reserve Fund whereas the issue in our case is "transferred to the Co-operative Education Fund" maintained by the National Co-operative Union of India. The Rajasthan High Court in the above case came to the conclusion because the amount in the Reserve Fund account does not cease to belong to the Society even after remittance and on the other hand can be used for purposes of the Society. In the present case, the contribution on its remittance to the Co-operative Education Fund ceases to belong to the Society and can be used by the National Co-operative Union of India for purposes mentioned under these rules. This is a very basic difference Our case is more covered by the decision of the Supreme Court in Puna Electric Supply Co Ltd. Vs. CIT 57 ITR

> 521 and is distinguishable from the decision of the Supreme Court In the case of Vellore Electric Corporation Ltd. vs. CIT 227 ITR 557 and in the case of Associated Power Co. Ltd. Vs. CIT 218 ITR 195, because of these basic differences. In the latter cases, the Supreme Court was dealing with Contingency Reserve whereas the Supreme Court was dealing with Consumer Benefit Reserve in the case of Puna Electric Supply Co. Ltd. The basic difference in the two reserves is that the Consumer Benefit Reserve is to be refunded to the consumer whereas the Contingency Reserve is to be utilised by the Electric Company for purpose of set out in the Schedule to the Electricity Supply Act and these purposes cover expenses which the Electric Company has to incur. Thus, in the case of Consumer Benefit Reserve. the benefit goes to the third party whereas the Contingency Reserve is for benefit of the Electric Company itself. In our case, the contribution goes to the third party for utilisation for educational purposes attached to that fund. Therefore. the decision of the Supreme Court in Puna Electric Supply Co. Ltd. and those in the case of Karnataka High Court in 174 ITR 475 and 198 ITR 690, Gujarat High Court in 258 ITR 780 and Bombay High Court in 106 ITR 303 are applicable to our case."

8. Ld. D.R. however, relied on the orders of Ld. CIT(A) to submit that it is only an appropriation of profits but not diversion and relied on relevant principles laid down by various judicial authorities in this regard.

9. We have given a considerable thought to the issue and perused the submissions made by rival parties. Section 63 of the Act was extracted above as part of Ld. CIT(A) order. As far as section 63 of Multi-State Cooperative Societies Act, 2002 is concerned, it provides that payment of various amounts out of its profits in any year - (a) transfer of amount not less than 25% to the reserve fund. This amount has not been claimed as deduction at all as is only an appropriation of profit. (c) transfer of amount not less than 10% to reserve fund for

meeting unforeseen losses, this amount also is not claimed as deduction as it is also appropriation of income. The issue is only with reference to item (b) i.e., credit 1% to Cooperative Educational Fund maintained by National Cooperative Union of India, New Delhi in the manner as prescribed. We are also not concerned with the other amounts which are subject to utilisation of funds as per section 63(2). It is the contention of assessee that amount paid u/s 63(1)(b) is an amount paid to third party out of the profits of the year. Therefore, it is a charge on the profit and so, diversion of income at source. The submissions in this regard are also summarized on the same principles that if the funds are for the benefit of the society, then, it is only an appropriation of income and if the funds are utilized for third party, then, it is an outgo from assessee's profits, therefore, an allowable deduction.

10. Before adverting to the legal principles, what is to be noted here is that assessee is not claiming deduction of the amount paid out of profits of the financial year which is under consideration. Even though, it is calculated on the net profits as per section 63(1)(b), assessee is paying the amount of 1% on the profits quantified as on March, 2009. This is admitted before us that the amount claimed in each year was in fact, 1% credit of the profits of the previous year as approved by General Body Meeting of that year, paid during the year and charged in P&L account. Thus, the amount of Rs.11,68,894 paid during the year is not out of profits of the year which were subjected to tax in this year, but out of profits of earlier year but paid during the year. This is the fundamental point to be considered that assessee is not claiming amount in the year of accruing the liability but is claiming in the year in which it is

paid to the said society. Therefore, on fundamental principles the amount of claim made during the year does not pertain to the year itself as it is a liability, if at all chargeable to P & L account, of income of earlier year i.e., for the year ending March, 2009 and not for the year ending March, 2010 relevant to A.Y. 2010-2011. Therefore, on first principle itself, the amount cannot be allowed as deduction of this year as assessee is not claiming the amount on accrual basis but on payment basis in a later year. Thus the claim cannot be allowed in this assessment year as the liability does not belong to the profits of the year.

11. It is the assessee's contention that this amount is diverted out of profits and therefore, is allowable as revenue expenditure. The Hon'ble Rajasthan High Court in the case of CIT vs. Jodhpur Cooperative Marketing Society (supra) has considered the principles governing diversion or appropriation of income and has summarized law as under :

> *"31. The first issue which arises for consideration is whether in the circumstances stated above, carrying forward a part of net profit of the society amounts to diversion or income by overriding title.*
>
> *32. The diversion of income has multi-facets. Diversion arises where income is applied in a particular manner under statutory or contractual obligation or under the provisions of a document under which the company is constituted viz., memorandum of article of association or a firm has come into existence. In these circumstances, the principle that has emerged is that if a person has alienated or assigned the source of his income so that it is no longer remains his income, he cannot be taxed upon the income arising after the assignment of the source. In such event, it is not income of the assessee at all. On the contrary, if the source is not assigned to, or transferred but passes through the assessee to an ultimate purpose,*

the case of application of income in a particular manner. Even though he may enter into a legal obligation to apply it in a particular way, still it remains the income of the assessee. Sec. 61 to s. 62 provides an exception to legislative rule where notwithstanding assignment of source of income, the income is deemed to be the income of the person who has assigned such source by creating a legal fiction.

33. Another shade of such controversy is where the income is not applied but diverted by an overriding title from the assessee, which he would otherwise have received. Such diverted income cannot be considered the income of the assessee at all. Reference may be made to Raja Bejoy Singh Dudhuria vs. CIT (1933) 1 ITR 135 (PC) where the assessee has succeeded to the family ancestral estate on the demise of his father. Subsequent to such succession, his step-mother who had legal right to maintenance out of the estate of her husband brought a suit of maintenance against him and the assessee suffered a decree of the Court to pay a fixed monthly sum to the step-mother and it was declared that the maintenance was a charge on the ancestral estate in the hands of the assessee. The question that arose before the Privy Council was that the assessee was liable to be assessed as an individual in respect of the amount of maintenance which was payable to step-mother; to that extent what he received for her was not his income. It was not a case of the application by the appellant of part of his income in a particular way. Lord Macmillan delivering the opinion of the board stated:

> *"In the present case, the decree of the Court by charging the appellant's whole resources with a specific payment to his step-mother has to that extent diverted his income from him and has directed it to his step-mother; to that extent what he receives for her is not his income. It is not a case of the application by the appellant of part of his income in a particular way, it is rather the allocation of a sum out of his revenue before it becomes income in his hands."*

34. It may be noticed that the title to receive the income in the aforesaid case vested with assessee but the assessee has received it for someone else than himself

and the income at no stage become part of the assesse's capital block which could be used by him in future for his own purpose. In fact, it was made a charge on assessee's income which if the assessee failed to pay, could be directly recovered before it reached the assessee. This case is more akin to Poona Electric Supply case (supra) to which we shall shortly advert to.

35. In Provat Kumar Mitter vs. CIT (1961) 41 ITR 624 (SC), the assessee who was a registered dealer of 500 ordinary shares in a limited company, assigned to his wife, by a deed of settlement, the right, title and interest to all dividends and sums of money which might be declared or which may be due and payable in respect of those shares for the term of her natural life and covenanted to deliver and endorse over to her any dividend warrant or other document of title to such dividends or sums of money and to instruct the company to pay such dividends and sums of money to her.

36. The assessee claimed exclusion of dividends on the aforesaid 500 ordinary shares on the ground of transfer of diversion of income by overriding title. The Supreme Court repelled the contention by holding that the deed of assignment was, it its true nature, only a contract by the assessee to transfer, or make over, to his wife in future all dividends that may be declared in respect of the shares; as a company can pay dividend only to the registered holder of the shares, neither s. 16(1)(c) nor its third proviso was applicable to the case; the income continued to accrue to the assessee and was assessable in the hands of the assessee as his income, even though it was ultimately payable to his wife under the terms of the deed. It was a case of application of income after it had accrued and not a case of diversion of any sum of money before it had become the income of the assessee nor was a case where the assessee has received the income for someone else.

37. Two features need be taken into consideration. Firstly, it was a case where diversion of income under overriding title was claimed to be given to a person other than the assessee after receipt of it by the assessee. Secondly, it was held to be an obligation on income of the assessee only after it had accrued and was not a case of diversion of any sum of money before it became the income of the

assessee. This brings out another essential feature of application of principle of diversion of income by overriding title, viz., that income not only payable should reach other than the assessee but income should be reachable to the third party before it becomes the income of the assessee.

38. In the present case, it may be noticed that neither the reserve fund goes to any party other than the assessee itself, nor there is any obligation to provide for such reserve before it becomes the part of net income earned by the society.

39. In the like way is the case of K.A. Ramachar & Anr. vs. CIT (1961) 42 ITR 25 (SC), where though under the deed of settlement which was irrevocable, each of the beneficiaries of the settlement was entitled to receive 1/4 of the share of the settlement in the profits of the firm during a period of 8 years from the date of settlement, the beneficiaries were entitled to directly receive and collect from the firm their shares under the settlements. The assessee's claim that those amounts were payable to the wife and children of settlor under the obligation arising under the irrevocable deed of settlement was negatived on the ground that on the facts, the effect of deeds of settlement was that profits were first to be accrued to the assessee and then to be applied for determination of share payable to the beneficiaries and under the law of partnership, it was the partner and the partner alone who was entitled to the profits. A stranger, even if he were an assignee, did not have and could not have any direct claim to the profits. The dispositions were, in law and in fact of portions of the assessee's income after it had accrued to him and tax was payable by him at the point of accrual.

40. On these principles, the decision in Raja Bejoy Singh Dudhuria's case (supra) was distinguished by the Court.

41. In P.C. Mullick & Anr. (Executors) vs. CIT (1938) 6 ITR 206 (PC) for the aforesaid reasons, the Privy Council too distinguished its earlier decision in Raja Bejoy Singh Dudhuria's case (supra). It was a case in which a testator had by his will appointed the appellants his executors and had directed them to pay Rs. 10,000 out of the

income of his property on the occasion of his 'addya sradh' for expenses in connection therewith to the person who was entitled to perform the sradh. He had also directed them to pay out of the income of his property, the costs of taking out probate of his will. The board opined that these are the income of the estate coming to the hands of the appellants as executors and in pursuance of obligation imposed by the testator. It was not a case in which a portion of the income was by an overriding title diverted from the person who would otherwise have received it as in Bejoy Singh Dudhuria's case (supra), but a case in which the executors having received the whole income apply a portion of it in a particular way.

42. In other words, rights to receive income should exist independent of the accrual and receipt of income by the assessee in some third party who could lay claim before it reaches the assessee.

43. The difference between "obligation of income after it reaches the assessee" and "diversion of income by overriding title before it reaches the assessee" was explained by the Supreme Court in CIT vs. Sitaldas Tirathdas (1961) 41 ITR 367 (SC).

> *"In our opinion, the true test is whether the amount sought to be deducted, in truth, never reached the assessee as his income. Obligations, no doubt, there are in every case, but it is the nature of the obligation which is the decisive fact. There is a difference between an amount which a person is obliged to apply out of his income and an amount which by the nature of the obligation cannot be said to be a part of the income of the assessee. Where, by the obligation, income is diverted before it, reaches the assessee, it is deductible; but where the income is required to be applied to discharge an obligation after such income reaches the assessee, the same consequence, in law, does not follow. It is the first kind of payment which can truly be excused and not the second. The second payment is merely an obligation to pay another a portion of one's own income which has been received and is since applied. The first is a case in which the income never reaches the assessee who even if he were to collect it, does so, not as part of his income,*

but for and on behalf of person to whom it is payable."

44. In CIT vs. Imperial Chemical Industries (India) (P) Ltd. (1969) 74 ITR 17 (SC) the Court held that :

"the payment of amounts by the respondent to the outgoing agents was not by an overriding title created either by act of parties or by operation of law, and it could not be said that the amount of compensation paid to the outgoing agents did not form part of the respondent's income. Applying the principles in Raja Bejoy Singh Dudhuria's case (supra) and Sitaldas Tirathdas's case (supra), the Court opined that an obligation to apply the income in a particular way before it is received by the assessee or before it has accrued or arisen to the assessee results in the diversion of income. An obligation to apply income which has accrued or arisen or has been received amounts merely to the apportionment of income and the income so applied is not deductible. The true test for the application of rule of diversion of income by an overriding title is whether the amount sought to be deducted in truth never reached the assessee as his income."

45. In a recent decision, the Supreme Court in Motilal Chhadami Lal Jain vs. CIT (1991) 94 CTR (SC) 195 : (1991) 190 ITR 1 (SC) explained the connotation of the expressions "reaches the assessee" and "has been received" as has been used by the Court earlier in Sitaldas Tirathdas's case (supra). The Court said :

"The expressions "reaches the assessee" and "has been received" have been used not in the sense of the income being received in cash by one person or another. What the Court emphasised is the nature of the obligation by reason of which the income becomes payable to a person other than the one entitled to it. Where the obligation flows out of an antecedent and independent title in the former (such as, for example, the rights of the dependants to maintenance or of coparceners on partition, or rights under a statutory provision or an obligation by a third party and the like), it effectively slices away a part of the corpus of the right of the latter to

> *receive the entire income and so it would be a case of diversion."*
>
> *46. Significantly, the nature of diversion of income by overriding title is that income reaches to a party other than the assessee by reason of a pre-existing title to it.*

11.1. Thus, on the basis of principles as down by Hon'ble Supreme Court what is to be considered is, whether the amount is diversion of income by overriding title or appropriation of income.

12. Coming to the facts of the present case, apparently, the liability to pay the amount is after quantification of profits by the society under the Societies Act. It is only after the net profit reaches the co-operative society that the question of its disposal in terms of the provisions arise of the Act of 1965 and not earlier thereto, net profit is to be apportioned by transferring part of it as may be prescribed by Rules to the reserve fund or to other funds. Part of the profits has to be carried to the co-operative deduction fund constituted under the Rules and the balance is available for utilisation for payment of dividends to the members, bonus to the members and contribution to such other special funds as may be specified in the Rules as per Sec.63(2).As already stated earlier, assessee is not charging the amount of 1% on the profits of the year, in the year of accrual but is claiming the amount paid during the year on the profits of earlier year. This certainly indicates that the amounts have been received by assessee and utilized by assessee, then only amount was remitted to the said National Union under the Act. This indicates, there is no diversion at source but is only appropriation of profits as per principles laid down. It is also

an admitted fact that there is no charge in the year in which assessee incurs losses. It is only when there are profits the amount has to be paid. This also distinguishes the issue that it is only an appropriation of profits earned but not diversion of income. If it is to be considered as diversion at source by overriding title, whether assessee incurs profits or loss, the said amount has to be paid. This is not the case here. The amount at 1% is payable only when assessee has profits in any year. This supports the view that this is not a diversion at source but an appropriation of amounts.

13. As briefly stated above, there are conflicting judgments from the Hon'ble Madras High Court and Hon'ble Karnataka High Court given on interpretation of respective Cooperative Societies Act of the State. This being a National Act, and as assessee is operating under Multi-State Cooperative Societies Act in a way those decisions may not apply fully. However, the latest judgment by Hon'ble Rajasthan High Court interpreted all the judgments and came to conclusion that the amount earmarked for reserve fund is not a diversion of income but an appropriation of income. The facts in the said case are with reference to payments made under section 63(1)(a) and 63(1)(c) but not 63(1)(b) of the Act. However, since the amounts earmarked for various payments are of part of section 63 of Multi-State Cooperative Societies Act, we are of the opinion that the principles will apply equally. In the above said case, Hon'ble Rajsthan High Court clearly distinguished the law on the subject considering the principles laid down by Hon'ble Supreme Court, as under :

> *"31. The said principle was reiterated with reinforced vigour in Vellore Electric Corpn. Ltd. vs. CIT (1997) 141*

CTR (SC) 398 : (1997) 227 ITR 557 (SC) distinguishing the Poona Electric Co. Ltd.'s case (supra) and following the Associated Power Company's case (supra), when the Court said:

"The contingencies reserve is to be created from existing reserves or from the Revenues of the undertaking which indicates that the monies which have to be put into the contingencies reserve reach the electricity company and it is the electricity company which has to invest the sums appropriated to the contingencies reserve. The contingencies reserves differs from the consumers benefit since the amount appropriated in the consumers' benefit has to be returned to the consumers and it is as if the electricity company had not received that amount which it is obliged to return. The position is altogether different in the case of monies standing to the credit of the contingencies reserve, which are set apart to be utilised by the electricity company for the purpose set out in Para V of the Sch. VI to the Electricity (Supply) Act, which are the expenses which the electricity company has to incur and the reservation is made so that money is always available for meeting these expenses and the supply of electricity is not interrupted."

32. We have already examined the scheme of the co-operative societies governing the creation of reserve fund in question which clearly indicates that under s. 61 no part of funds other than the net profits of a co-operative society shall be utilised by way of bonus or dividend or otherwise distributed amongst its members and s. 62 has unequivocally provided for disposal or appropriation of net profit. It is only after the net profit reaches the co-operative society that the question of its disposal in terms of the provisions arise of the Act of 1965 and not earlier thereto net profit is to be apportioned by transferring part of it as may be prescribed by Rules to the reserve fund. Part of the profits has to be carried to the co-operative deduction fund constituted under the Rules and the balance is available for utilisation for payment of dividends to the members, bonus to the members and contribution to such other special funds as may be specified in the Rules. Donations not exceeding 10 per cent of net profits of any charitable purposes and payment of bonus to the employees of the society to the extent required by the bye-laws.

The reserve funds' object has been set out in r. 55 by declaring that it shall belong to the society and is intended to meet unforeseen losses. That is to say for societies own purpose in future and ordinarily is not to meet any existing liabilities or obligations. The unforeseen losses and other purposes to which such fund can be used have also been spelt out as noticed by us that, apart from meeting unforeseen losses in the society, it can also be used to meet such other purposes, viz., to pay off its debts and to use the same during the financial stringencies in the society by declaring that it shall belong to the society and has intended to meet unforeseen losses. That is to say, not to meet any existing liabilities or obligations. Unforeseen losses and other purpose for which the reserve fund is to be applied, also forms part of the need of the society and none else. The fund is always available for the society and forms the part of its assets for paying off its dues and to pay off the share capital on its dissolution. Therefore, there is no overriding title vesting in any other person or obligation to which such profit is diverted before it reaches the society. The requirement of surplus, if any, on dissolution of the society after appropriation of assets to discharge its liabilities towards creditors and shareholders to be used for an object of public utility is also an obligation of the net surplus of the society and not merely of the remainder of reserve fund, if any, towards object of public utility or charitable purposes as may be ordained by the members of the society. That also clearly amounts to appropriation of the funds of the society as per the decision of the general body of the society. At the end of the day, it may be appropriation of remainder as per the requirement of law, but it does not, at the time of creation of a reserve fund becomes a certain obligation which it is obliged to discharge but rest in domains of uncertain contingency. It remains a contingent obligation of the assets of the society in future dependent upon the surplus remaining after discharge of its liability and that too as per the resolution of the members of the society only.

Thus, in our opinion, the principle governing dealing with the reserve fund in question, which is created under the Co-operative Societies Act, 1965, is fully governed by the ratio of the decision in Associated Power Co.'s case (supra), Vellore India Co. Ltd.'s case (supra) and not by

the ratio laid down in Poona Electric Supply Ltd. Co.'s case (supra).

33. The decision of the M.P. High Court in Keshkal Co-operative Marketing Society Ltd. (supra) undoubtedly supports the contention of the assessee-respondent.

We have already noticed that the decision of M.P. High Court in Keshkal Co-operative Marketing Society Ltd. (supra) is founded on the principle enunciated in Poona Electric Supply Co. Ltd.'s case (supra).

With utmost respect, we regret our inability to fall in line with the decision in Keshkal Co-operative Marketing Society Ltd.'s case (supra) in this regard. Apparently, the distinction which existed between the reserve fund for the benefit of consumers required to be created under the Electricity Supplies Act, 1948 with object to return to the consumers the excess profit charged by the supply company and the fund created to meet the future requirement of the supply company or the co-operative society had not been noticed. We may also notice that perhaps the attention of the Court was not drawn to detailed scheme of the M.P. Co-operative Society Act, as we do not find any mention thereof in the decision.

In the backdrop of later Supreme Court decision in which we have adverted to the case of consumer benefit fund, which arose for consideration in Poona Electric Supply Co. case was for the benefit of consumers exclusively, could not have been equated with the reserve fund created under the Co-operative Societies Act and Rules framed thereunder, which never went out of the societies' capital asset block. It always remains the assets of the society to be used for its own purpose, albeit under the regulatory power of the Registrar. As noticed by the apex Court, there existed a clear distinction between a reserve fund created for the benefit of the consumers which was to be returned to the consumes by way of rebate and the reserve fund created under the statute for meeting out of contingent liability in future. Undoubtedly, in the latter case, it always remained capital of the company and notwithstanding its use could only be with the approval of the State Government, it did not make any difference so far as the nature of the contingency reserve fund is concerned. Apparently, the M.P. High Court has not

noticed this distinction and has not adverted to the provisions of the M.P. Co-operative Societies Act which concerned creation of reserve fund, its object and the Government Rules about obligation to apply the reserve fund for the purposes of the society. Had the same been brought to the notice of the Court, perhaps the M.P. High Court would have reached the same conclusion to which we have reached.

Be that as it may, in view of the direct decision of the Supreme Court in Associated Power Co. Ltd.'s case (supra) and Vellore India Co. Ltd.'s case (supra) making out a distinction between reserve fund created for the benefit of consumers and reserve fund to be used for the assessee's own income to meet any contingencies occurring in future cannot be excluded from the computation of total income either on principle of diversion of income by overriding title or on the principle of income not forming part of the real income or as the part of deductible expenses under s. 37; the decision in M.P. High Court cannot be considered as an authority laying down the proposition in respect of reserve fund created by co-operative societies for its own purposes as the law laid down correctly and is impliedly overruled.

34. The other decisions referred to and relied on by the learned counsel for the Revenue in Pandavapura Sahakara Sakkare Karkhane Ltd. (supra), Hiranyakeshi Sahakara Sakkare Karkhane (supra) all from Karnataka High Court proceed on the principle laid in the Poona Electric Supply's case, without noticing the aforesaid distinction as noticed by the apex Court in Associated Power Supply's case and Vellore India Co. Ltd.'s case (supra). For the reason stated above while considering decision of M.P. High Court in Keshkal Co-operative Societies' case, we express our inability to agree with the aforesaid decision also.

35. Lastly, reliance was placed on a Bench decision of this Court in CIT vs. Kotputli Rural Electric Co-operative Society Ltd. (2002) 175 CTR (Raj) 282 : (2002) 255 ITR 563 (Raj). Firstly, it was not a case relating to reserve fund to be created under co-operative society. Hence, the question of examining the reserve fund in the light of provisions of the co-operative society was not before the Court. Secondly, it was a case of creating a contingency

reserve fund at 1.5 per cent under cl. VI of Sch. VI to the Electric Supply Act. Relying on the decision in Keshkal Co-operative Marketing Society Ltd.'s case (supra) and decision of Madras High Court in Vellore India Co. Ltd. (supra) reserve fund was held as deductible while computing the income of the assessee-co-operative society.

With utmost respect, we notice that the learned counsel appearing for the parties did not bring to the notice of the Court that decision of the Madras High Court in Vellore India Co. Ltd.'s case had since been reversed by the Supreme Court in Vellore India Co. Ltd. referred to above and directly governed the controversy before the Court. The decision rests on an overruled decision and contrary to the Supreme Court decision on the same issue. Keshkal Co-operative Marketing Society Ltd.'s case (supra), the other case referred which had followed the Poona Electric Supply Co. Ltd.'s case (supra) was also demonstrably contrary to the principle enunciated by the Supreme Court in the two cases referred to above by us. The Supreme Court drew the distinction obvious in Poona Electric Supply case that there is no parity between the contingency reserve for the benefit of the society itself and the consumer benefit reserve fund, which was intended to be returned to the consumers, the latter never becomes part of the companies business assets.

Since the aforesaid decision of this Court is founded on a reversed judgment of the Madras High Court and decision of the other High Court founded on the judgment of the Supreme Court which has been distinguished on the very same principle which has been applied by the Poona Electric Supply Co. Ltd.'s case (supra), the judgment must be deemed to have been rendered per incuriam and not a binding precedent.

36. As a result of aforesaid discussion, we allow this appeal and hold that the amount of reserve fund (sic–net profit) transferred to the net profit (sic–reserve fund) under s. 62 of the Co-operative Societies Act, 1965 r/w r. 68 of the Co-operative Rules, 1966 is not allowable as deduction in computing the taxable income of the society on any of the grounds raised by the assessee. The judgment of the Tribunal is set aside and that of the AO is restored."

13.1. Thus, respectfully following the principles laid down by the above Judgment, we are of the opinion that the amount contributed by assessee to the National Cooperative Union, New Delhi is appropriation from the net profits. There is a right to receive the income independent of accrual and receipt of income by the assessee before third party could lay claim to any part of it. Since income reached assessee before it reached to a third party, there is no diversion. As already stated, there is no payment in the year of losses. Therefore, payment under section 63(1)(b) is only an appropriation of profit. Moreover, this amount paid during the year is also not out of the profits of this year but profits of earlier year. Therefore, on that count also amount cannot be allowed as deduction during the year. For these reasons, we uphold the order of the authorities and reject assessee's grounds on the issue.

14. In the result, appeal of the assessee is dismissed.

Order pronounced in the open Court on 31.12.2014.

Sd/-	**Sd/-**
(ASHA VIJAYARAGHAVAN)	**(B.RAMAKOTAIAH)**
JUDICIAL MEMBER	**ACCOUNTANT MEMBER**

Hyderabad, Dated 31st December, 2014
VBP/-
Copy to

1.	The A.P. Mahesh Cooperative Urban Bank Ltd., Hyderabad. C/o. Venugopal & Chenoy, Chartered Accountants, Door No.4-1-889/16/2, Tilak Road, Hyderabad – 500 001.
2.	The DCIT, Circle 2(3), Hyderabad.
3.	CIT(A)-III, Hyderabad.
5.	CIT-II, Hyderabad.
6.	D.R. ITAT "A" Bench, Hyderabad.