
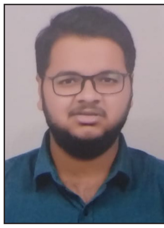

Mutuality under The Income Tax Act – Origin & Development

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What is taxable under the Income Tax Act is "income" or "profits" or "gains" as they accrue to a person in his dealings with other party or parties that do not share the same identity with the assessee. For income, there is an underlying exchange of a commercial nature between two different entities.[1]

The principle that no one can make profit of himself is true enough but may in its application, easily lead to confusion.[2]

Taxes on income are taxes on moneys or profits generated by a person in their transactions with others. No assessee can generate real income out of himself, which can be taxed. The doctrine of mutuality postulates that when transactions are carried out between people in mutual association with each other, i.e. where they contribute to a common fund for the betterment of the contributors and generate returns there-from, such returns are not taxable. The exemption granted to a mutual concern is premised on the assumption that the concern is being run for the mutual benefit of the contributors and the contributions made by the members ought to be directed in that direction.[3] The contributions to the mutual concern are held in trust for the benefit of the contributors, and required to be spent accordingly.

It may be noted that the doctrine of mutuality bestows a special status that enables the concern to qualify for exemption from tax. In tandem with the recent trend of interpreting tax exemptions very strictly[4], the Supreme Court in Yum! Restaurants (Marketing) (P) Ltd.[5] has cast the burden on the assessee to prove that it meets the conditions for applicability of the doctrine. Resultantly, the importance of appreciating the contours of the doctrine, the various circumstances in which it can be used and the various factors that prevent the assessee from seeking exemption under the doctrine, cannot be understated.

The quotes in the beginning of the paper, one from a most recent Supreme Court judgment, and the other from one of the earliest cases on the principle of mutuality, express the basic foundations of taxation of income and also the difficulties in applying the principle to the facts of the case. This paper seeks to explore the

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1. *Yum! Restaurants (Marketing) (P) Ltd. v. CIT Delhi [2020] 116 Taxmann.com 374 (SC) para 14.*
2. *Dublin Corporation v. M'Adam (1887) 2 Tax Cas 387.*
3. Supra note 1, para 30.
4. *Commissioner of Customs (Import) v. Dilip Kumar & Co. (2018) 9 SCC 1 (5j).*
5. [2020] 116 Taxmann.com 374 (SC).

various constituents of the doctrine of mutuality in the context of income tax law.[6]

A) Principle of Mutuality – A Historical Backdrop

Amongst the first cases to have applied the principle of mutuality is the House of Lords decision in *New York Life Insurance Co. v. Styles (Surveyor of Taxes)*[7]. In Styles, the assessee company issued life insurance policies of two kinds namely, participating and non-participating policies. There were no shareholders of the company in the ordinary sense of term, but each holder of a participating policy, ipso facto became a member of the company; each holder of a participating policy was entitled to a share in the assets and liable for a share in the losses. The company calculated the probable death rate amongst its members along with the probable expenses liability and thereafter required its members to contribute premia. At the end of the year, accounts were drawn up. Greater part of the surplus of premia over the expenditure referable to the policies was returned to the members while the balance was carried forward as a fund to the credit of the general body of members. While considering the question whether the surplus returned was liable to be taxed, the majority of the Law Lords held that the members of the assessee company had merely associated themselves together for insuring each other's life on the principal of the mutual assurance and the returns were, therefore, not liable to tax.

The House of Lords further explained the principle in *Municipal Mutual Insurance Ltd. v. Hills*[8]. In this case, the assessee was established to extend fire insurance to its members, who alone were entitled to participate in the surplus assets on winding up of the company. With the passage of time, the assessee expanded its business to offer employers liability and miscellaneous insurance, both to its members as also non-members. With respect to the fire insurance business, the revenue admitted that it was carried out for mutual benefit and was not taxable. In so far as employers' liability and miscellaneous insurance business done with the non-members was concerned, the assessee admitted it to be taxable. The dispute was in respect of the employers' liability and miscellaneous insurance business done with holders of insurance policy against fire who were also members of the assessee. Lord Macmillan laid down the test that has been universally applied by Courts in the last century:

> *"The cardinal requirement is that all contributors to the common fund must be entitled to participate in the surplus and that all the participators in the surplus must be contributors to the common fund; in other words, there must be complete identity between the contributors and the participators. If this requirement is satisfied, the particular form which the association takes is immaterial."*[9]

Styles' (supra) was examined and explained in *English and Scottish Joint Co-operative Wholesale Societies Ltd. v. Commissioner of Agricultural Income-tax, Assam*[10], in which the Privy Council, speaking through Lord Norman, summarized the grounds of the decision in Style as follows:

6. Doctrine of mutuality also applies in indirect tax law. Applying the principle that no person can sell goods to himself, the turnover of sales of clubs, societies etc. has been held exempt from the purview of indirect tax laws. See the judgments in *State of West Bengal v. Calcutta Club Ltd., Civil Appeal No. 4184 of 2009 decided on October 3, 2019 and CTO v. Young Men's Indian Association (1970) 1 SCC 462 (5j).*
7. (1889) 2 Tax Cas 460.
8. (1932) 16 Tax Cas 430.
9. Ibid., p. 447.
10. [1948] AC 405; 16 ITR 270.

"…it appears that the exemption was based on (1) identity of the contributors to the fund and the recipients from the fund, (2) the treatment of the company, though incorporated as a mere entity for the convenience of the members and policy holders in other words, as an instrument obedient to their mandate and (3) the impossibility that contributors should derive profits from contributions made by themselves to a fund which could only be expended or returned to themselves."

The Supreme Court elaborated on the doctrine of mutuality in *Royal Western India Turf Club India Ltd. v. Commissioner of Income Tax*[11], observing:

"Thus a railway company which earns profits by carrying passengers may also make a profit by carrying its shareholders or a trading company may make a profit out of its trading with its members besides the profit it makes from the general public which deals with it but that profit belongs to the members as shareholders and does not come back to them as persons who had contributed them. Where a company collects money from its members and applies it for their benefit not as shareholders but as persons who put the fund, the company makes no profit. In such cases where there is identity in the character of those who contribute and of those who participate in the surplus, the fact of incorporation may be immaterial and the incorporated company may well be regarded as a mere instrument, a convenient agent for carrying out what the members might more laboriously do for themselves."

The Supreme Court, while explaining the doctrine of mutuality in *CIT v. Bankipur Club Ltd.*[12] relied upon *Simon's Taxes*[13] to observe as under:

"……it is settled law that if the persons carrying on a trade so in such a way that they and the customers are the same persons, no profits or gains are yielded by the trade for tax purposes and therefore, no assessment in respect of the trade can be made. Any surplus resulting from this form of trading represents only the extent to which the contributions of the participators have proved to be in excess of requirements. Such a surplus is regarded as their own money and returnable to them. In order that this exempting element of mutuality should exist it is essential that the profits should be capable of coming back at some time and in some form to the persons to whom the goods were sold or the services rendered….."

A conspectus of these judgments make it abundantly clear that for the doctrine of mutuality to apply, the assessee has to demonstrate complete identity between the contributors to a fund and the participants in the surplus of that fund, and that business is not being conducted from a commercial perspective but to benefit its members.[14]

B. Dissecting Mutuality - Yum! Restaurants (Marketing) (P) Ltd.

The above mentioned tests were recently exhaustively considered and explained by the Supreme Court in *Yum! Restaurants (Marketing) (P) Ltd. (supra)*. In *Yum! Restaurants (Marketing) (P) Ltd.*, the assessee was a wholly owned subsidiary of Yum Restaurants India Pvt. Ltd (parent company). It entered into a tripartite agreement with its parent company and the franchisees of its parent company where-

11. [1953] 24 ITR 551 (SC).
12. [1997] 92 Taxmann.com 278 (SC).
13. Vol. B Third Edition, paragraphs B 1.218 and B 1.222.
14. The underlying foundation of the principle of mutuality, and its essential characteristics, were also noted by the Andhra Pradesh High Court in *CIT. v. Merchant Navy Club [1974] 96 ITR 261(AP) paras 9-11*, where the exposition of origin and development of the law in paragraph 79 of Gunn's Commonwealth Income Tax Law and Practice, and paragraph 1-417 of Wheat-croft's Law of Income Tax was extracted.

under, it received 5% of the gross sales of each franchisee as contribution for undertaking advertising, marketing and promotional activities for the mutual benefit of the parent company and its franchisees. The parent company was under no obligation to contribute any money to the assessee. Pepsi Foods Ltd., whose products were sold by the franchisees but was not itself a franchisee, also contributed to the assessee's funds. The assessee claimed exemption from payment of income tax on the ground of mutuality.

The assessing authority rejected the plea by observing that the parent company of the assessee was under no obligation to contribute any funds to the assessee. The Commissioner (Appeals) upheld the denial of exemption, but on the ground that the activities of the assessee were tainted by commerciality. The Income Tax Appellate Tribunal observed that the parent company and Pepsi Foods Ltd. had also contributed to the assessee despite the parent company being under no obligation to contribute to the common fund and Pepsi Foods Ltd. was neither a franchisee nor a beneficiary. The Tribunal held that the essential requirement of the principle of mutuality that the contributors to the common fund also participate in the surplus was missing. The High Court also denied the exemption, leading to an appeal before the Supreme Court.

The Court expounded the following three conditions to prove the existence of mutuality:[15]

(i) Identity of the contributors to the fund and the recipients from the fund;

(ii) Treatment of the company, though incorporated as a mere entity for the convenience of the members and policy holders, as an instrument obedient to their mandate; and

(iii) Impossibility that contributors should derive profits from contributions made by themselves to a fund which could only be expended or returned to themselves.

i) Common/Completeness of Identity

Succintly put, and as held earlier by *Lord Macmillan in Hills (supra)*, this test implies that those who contribute to the fund should be the same as those who eventually benefit from its surplus. In *Yum Marketing (supra)*, the Supreme Court explained the test as follows:[16]

a) no person ought to contribute to the common fund without having the entitlement to participate as a beneficiary in the surplus thereof. Conversely, no person ought to participate as a beneficiary without being a contributor or a member of the class of contributors to the common fund.

b) the class of *members* should stay intact as the transaction progresses from the stage of contributions to that of returns/surplus. It must manifest uniformity in the class of participants in the transaction.

c) the inclusion or exclusion of new members is not prohibited. However, the infusion of a participant in the transaction who does not become a 'member' of the common fund, at par with other members, and yet participates in either the contribution or the surplus without subjecting itself to mutual rights and obligations, is prohibited.

d) Any one-dimensional alteration in the nature of participation in the common

15. The Court, in para 16, relied upon The English and Scottish Joint Co-operative Wholesale Society Ltd. (supra) and the Royal Western India Turf Club Ltd. (supra) to expound these tests.
16. Supra note 1, para 17.

fund as the transaction fructifies is prohibited.

e) The moment such a transaction opens itself to non-members, either in the contribution or the surplus, the uniformity of identity is impaired and the transaction gets tainted by commerciality.

The importance of the completeness of the identity between the contributors and participators was emphasized as follows:[17]

> *"The theory of completeness of identity presupposes the contributors and participators to be two separate classes, but there is oneness or equality in the matter of sharing of surplus/ profits. This is to ensure that there is no interference of any alien commercial entity in the transaction. With the interference of any alien entity, the idea of conducting business with oneself is defeated and any profits or gains accruing therefrom become subject to tax liability."*

The Supreme Court thus equated the inclusion of a non-member in the affairs of the mutual concern as introducing the taint of commerciality in its dealings, thereby knocking off the foundations of the principle of mutuality. This is so because non-members have no concern with the affairs of a mutual concern and derive benefit or make contributions in a capacity different from that of the members.[18]

Applying these principles, the Court found that as Pepsi Foods did not become a part of the tripartite mutual agreement and there being no franchisee agreement with Pepsi Foods, the amounts received from Pepsi Foods could not be viewed as contributions from a member of the mutual undertaking. The Court thus held that the assessee was realizing money both from members and non-members. It also noted that Pepsi Foods, while becoming a contributor to the common pool of funds, did not participate in the surplus as a beneficiary. This singular feature was sufficient to negate the principle of mutuality.[19] The Court further observed that even if any remote of indirect benefit was being reaped by Pepsi Foods, the same could not be said to be in lieu of it being a member of the purported mutual concern. Non-members like Pepsi Foods Ltd., stood on a different footing as they have no proximate connection with the affairs of the mutual concern.

ii) Treatment of the company as an instrument obedient to the mandate of members

For appreciating whether the company/society/ firm is only being used as an instrument to further the objects of the mutual concern and does not have a commercial character, the actual working of the company/society/firm is to be examined. The form of the structure – whether it is a company/society/firm is immaterial. The authorities will go behind the formal structure of the organization, and closely examine its actual functioning to determine its mutual character, even undertaking an examination akin to the lifting of the veil in order to discern the real nature of the organization.[20]

While examining the functional framework of the assessee, the Court found that its parent company (Yum Restaurant India Pvt Ltd.) had no mandatory obligation to contribute to the funds of the assessee. The parent company reaped the benefits of the arrangement, without any corresponding obligation to contribute, thus putting it at a higher pedestal than the other franchisees who were obliged to contribute 5% of their revenues. This feature was against mutuality, which pre-supposes that all members of the undertaking are bestowed with similar

17. Ibid., para 18.
18. Ibid., para 22.
19. Ibid., para 19.
20. Ibid., para 18.

obligations and reap similar advantages. The Supreme Court observed:[21]

> *"That members of a financial concern exercise mutual control over its management without the scope of prejudicial exercise of power by one class of members over the others is the quintessence for the existence of mutual concern. The word "mutual" offers guidance to this effect. Literally understood the word "mutual" points towards reciprocity and a mutual arrangement is one in which the members/parties have reciprocal rights or understanding or arrangement. An arrangement wherein one member is subjected to the absolute discretion of another, in such a manner that the entire liability may fall upon one whereas benefits are reaped by all is antithesis to the mutual character in the eyes of law."*

While dealing with the submission that it is not mandatory for every member of the mutual concern to contribute to the common pool, the Court distinguished between non-contribution by some members in certain situations with the complete non-contribution by a member or a class of members at all times and in all circumstances. Complete non-contribution by a member or a class of members would give an all-pervasive overriding position to that member or class of members and negate mutuality. The Court emphasized the fine line of distinction between the absence of obligation and presence of overriding discretion, and emphasized that the real essence of mutuality is whether members contribute for the mutual benefit of all and not of one at the cost of others.[22]

iii) Refund of Surplus & Impossibility of Profits

The third test requires that the mutual operations must be marked by an impossibility of profits. That, however, does not mean that there cannot be any surplus with the assessee at the end of the year. However, there is no absolute right of the members to get a share in the surplus and insist on its distribution. Additionally, in case of distribution of surplus of a mutual concern, the reason is not a redistribution of profits as in the case of a company or firm (as no profits arise in a mutual concern). The *raison d'etre* behind refunding the surplus to the contributors or mandatory utilization of the same in the subsequent assessment year is to reduce their burden or contribution proportionately in the next year.[23]

In *Yum Marketing (supra)*, the Supreme Court held that the nature of the agreement may result in a situation where the parent company would not contribute even a single penny to the common pool and yet be able to derive profits in the form of royalties, created by the fixed 5 percent contribution made by the franchisees. This would be nothing short of derivation of gains out of inputs supplied by others. This, the Court found to violate the basic essence of mutuality, which entails that there should not be any profit earning motive, directly or indirectly. The Court also found that under the agreement, the assessee had no specific obligation to spend the amounts received from the franchisees for their benefit. The net result was that the assessee company did not hold the contributed amount under any implied trust for the franchisees, which itself was anti-thetical to mutuality.[24]

C. Statutory Erosion of the Doctrine of Mutuality

The general principles regarding non-taxability of mutual income are however, subject to statutory carve-outs. Nothing prevents the legislature from taxing incomes of certain mutual concerns by specifically amending the Income Tax Act. With effect from 01.04.1993, the Income Tax Act introduced Section 2(24)(vii), which specifically provides that the profits and gains of any insurance business carried out by a

21. Ibid., para 25.
22. Ibid., para 26.
23. Ibid., para 28.
24. Ibid., para 30.

mutual insurance company or by a co-operative society to be taxable. Section 2(24)(viia), with effect from 01.04.2007, made taxable the profits and gains of any business of banking carried out by a co-operative society. Furthermore, Section 28(3) of the Income Tax Act provides that income derived by a trader, profession or similar association from specific services performed by its members is income chargeable to tax under the head profits and gains or business or profession.

D. Concluding Thoughts

The essence of mutuality lies in the return for what one has contributed to a common fund. In order to claim exemption based on the doctrine, the fund has to fulfill the foremost requirement that all its contributors must be entitled to participate in the surplus and that all the participants in the surplus should be contributors to the common fund. There has to be complete identity between the contributors to the fund and the participators in the surplus.

In the case of clubs, their profits are exempted from tax liability because of the underlying notion that they operate for the common benefit of the members wishing to enter into a social exchange with no commercial intent. Furthermore, all the members of the club generally not only have a common identity in the concern but also stand on an equal footing in terms of their rights. However, such parity of rights was missing in *Yum Marketing (supra)*. The Court found that the purported mutual concern was a commercial venture wherein contributions were accepted from members as well as non-members, and one member (the parent company) had been vested with a myriad set of powers to control the functioning and interests of other members (the franchisees).

Even in the case of a mutual association, it is not necessary that every activity of the association is exempted from tax. An association may engage in activities which can be described as mutual those that are not.[25] As noticed in *Styles (supra) and Municipal Mutual Insurance Ltd. (supra)*, mutuality is not destroyed by the presence of transactions which are non-mutual in character and mutuality can be confined in such cases to transactions with members. The two activities in appropriate cases can be separated and the profits derived from non-members, can be taxed.[26]

The decision of the Supreme Court in *Royal Western India Turf Club India Ltd. (supra)*[27] laid down the broad proposition that if the object of the assessee is to carry on a particular business and funds are realized both from the members and from non-members, for the same consideration by giving the same or similar facilities to all alike in respect of the same business, and the dealings as a whole disclose the same profit-earning motive, the activities of the asseessee are tainted with commerciality and cannot claim exemption by relying upon mutuality. The Supreme Court, in Yum Marketing (supra), does opine by relying upon *Royal Western India Turf Club Ltd. (supra) and The English and Scottish Joint Co-operative Wholesale Society Ltd. (supra),* that inclusion of non-members in the affairs of the mutual concern introduces an element of commerciality.[28] However, a careful reading of the judgment would indicate that it is the context where there is no activity of the assessee from which the non-member parent company can be excluded, and the bifurcation of mutual and non-mutual activities of the assessee is not possible.

25. *CIT v. Common Effluent Treatment Plant, (Thane-Belapur) Association [2010] 328 ITR 362 (Bom).*
26. *CIT v. I.T.I. Employees Death & Superannuation Relief Fund [1998] 234 ITR 308, 318 (Karn.).*
27. See also *CIT v. Kumbakonam Mutual Benefit Fund Ltd. [1964] 53 ITR 241 (SC) and Fletcher v. ITC (1971) 3 All ER 1185 (PC).*
28. Supra note 18.