Development of Income Tax Law w.r.t Mutual Associations

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The Proposition that no man can make a profit out of himself as recognized by House of Lords (1889) is now well accepted. The principle of mutuality has been tasted at different judicial levels and as of now enough guidelines are available as to its application and tax treatment.

Although a mutual association (Ma) is not defined in income tax law, however it may be defined as a tool for a section /group of members where the members themselves are the contributors and participants and where it is stipulated that in case of dissolution, the funds available would be distributed amongst themselves. Where the clause as to distribution of surplus to members upon dissolution is absent, such association would entail dual character of Ma as well as a charitable form. The Ma may be in the form of a society, co-operative society, trade/merchant associations, chambers, resident's welfare society, employees association etc and they can also function as a charitable company u/s 8 of The Cos Act, 2013.

It is a well settled law that where the contributors and participants (Beneficiaries) are the same, the principle of mutuality survives and hence income like membership fees, Subscription fees, entrance fees, charges for welfare funds etc qualify for exemption on principle of mutuality, provided that the same are spent/ applied for the benefit of such members only. Even the room rents, rent of premises in the property of association taken from members would not vitiate mutuality. Similarly mutuality condition is not vitiated if a club has different classes of membership- their rights, enjoyments, subscriptions- may be different but in no way it affects mutuality. Even the existing members may go out and new members come in. However where the receipts of fees/charges from members sounds of a taint of commerciality, tax liability may arise such as collection of transfer fees for transfer of flats was held to be taxable in the case of *ITO v. Jai Hind Co-operative Housing Society Limited.*[*1]

In the case *CIT v. Bankipur Club Limited* it was held that overcharging for refreshments and beverages from members cannot be considered as tainting of commerciality. The fact that there is some diversion to non-members where some of the rooms were let out to non-members not necessarily vitiate the principle of mutuality as long as there is substantial compliance with the principle.

A persisting contraversory in the mind of tax professionals is whether the income of mutual association from interest on bank deposits is covered by mutuality principle or not?

In view of the writer of this article, this controversy had been settled long back by the Apex Court while delivering the judgments in the cases of *CIT v. BANKIPUR CLUB LIMITED*[*2], *CHELMSFORD CLUB*[*3] *AND CAWNPORE CLUB*[*4] *JUDGEMENTS.*

In case of BANKIPUR CLUB (1997, AND 2004) the SC quoting with approval the head note and summarizing the decision of the full bench of Patna High Court(in the case of Ranchi Club Ltd), held that the rent of rooms from non-members as well as interest from bank deposit qualify for mutual principle. Similarly while dealing with the case of Chelmsford Club (2000),the SC overruled the decision of *CIT v. Wheelers Club Ltd*[*5] (taxing on misc. income). Here it would be pertinent to mention that the Wheelers case was earlier dissented by Madras High Court also in the case of *Presidency Club(1981)*[*6].

The Dept. generally insists, amongst others on the judgment of Gujarat High Court in the case of *Sports Club of Gujarat*[*7] for taxing income such as bank interest, charges from non-members etc. but the thin line of distinction needs to be well understood. In fact in this case, the Court discussed the language of the objectives mentioned in the memorandum & articles of the Club which had authorized and allowed large discretion to its management to invest surplus not only in bank deposits but also shares, real estate or any other form or shape ,which sounded a taint of commerciality in the sense that when the income derived from such investments over a period of time is added to the surplus and when such surplus is distributed to the members, a component of income so distributed would be a plough back not from their own fees but also from out of income generated through transactions entered into with taint of commerciality, hence not qualified for mutuality principle. However the High Court further observed that all such income if tainted with commerciality, then only may be disqualified from mutuality otherwise not. From the above, it can be inferred that misc. income of a club like interest from bank deposits, income from third parties being guests of members or even the incidental income from charges of Mela, commission on purchases, certification fees, or fees charged for conducting seminars/conferences with participation of non-members also against a fee, rent of rooms/ premises from guests of members or the members should also be eligible for exemption on principle of mutuality. Only commercial activities transacted with any outsiders or for that matter even with members would attract tax liability.

Incidentally the decision of *Madras Gymkhana club v. CIT*[*8] had gone against the 'a', however with due regards, it was passed without considering the apex court ruling passed in the case of Ranchi club Ltd. The High Court in this case was influenced by the fact that the club had abnormal funds which could not be treated as necessary for running the club and therefore such interest income was not considered to be covered by the mutuality principle. High Court in this case made an incidental reference to the judgment of Gujarat High court in *Sports Club of Gujarat*[*7],where interest income was taxable only because the management had large discretion in the matter of investment like in shares, real estate etc. However the conception would be clear in the minds of the tax professionals when the rider put by the HC in the judgement is read with utmost care. The rider is—

"therefore what is relevant is to see as to how the funds generated by way of contribution, donation etc from the members as well as the outsiders are expended and utilized for the objects of providing various recreational and other facilities to the members and then alone it can be held that the principle of identity between the contributors and the participants is fulfilled which is the basic requirement in the concept of mutuality."

From the above discussion, it may be inferred that where there is no taint of commerciality in transactions held with members as well as non-members or outsiders and the mutual association functions well within its authorized field, then income earned from surplus funds or all other misc. income earned are exempt applying the mutuality principle. In such cases, even section 28(iii) won't apply.

Likewise emphasis may be laid down in favour of Ma, that a bank where the deposits are placed, is neither a contributor nor a participant but mere a custodian or constructive trustee for the association/members and in no way it is a transaction with any outsider/non-member, hence mutuality is not lost.

The recent judgment of Delhi High Court in *CIT v. Delhi Gymkhana Club*[*9] which can be considered to be the last word in favour of the Ma. The HC while passing this judgment referred to number of earlier judgments latest amongst them was - *CIT v. Standing conference of public Enterprises(SCOPE)*[*10].

A feeling prevails that there is a set back after the decision in Bangalore Club*11 as regards the transactions with non-members and even income from bank deposits being taxable. However the facts are not so. The observation of the SC in this case was prompted by the theory that there could be trading transactions with both members and non-members as in this case the club had deposited

its funds with some banks who were corporate members of the club and also with some other banks who were not corporate members of the club and while filing return of income, voluntarily offered interest income from bank deposits held with non-corporate members(banks) and in the given facts and circumstances of the case, the principle of mutuality was dealt in by SC verdicting that entire interest income would be taxed for taint of commerciality.

However The writer of this article is of the opinion that the case of Bangalore club should be seen as dealt within the given situation and cannot be straightly applied to other cases because such an inference would go against the law well settled in *CIT v. Bankipur Club* as well as *CIT v. Cawnpore Club* where it is clearly laid down that interest income from bank deposits and rent income from premises of the club do not vitiate the mutuality principle.

Similarly it should be clear to our minds that income which is not liable to be taxed on mutuality principle, can not be brought to tax by treating a mutual association as *AOP (ITO v. Sarvodaya mutual benefits trust)*[12]

MUTUAL ASSOCIATION CAN ALSO BE A CHARITABLE INSTITUTION

It is well appreciated that any mutual organization generally, do have an element of altruism(spirit of charity), since the benefit availed by a member is not always commensurate with his contribution ,he may enjoy less or more as compared with others members. It was for this reason that even when there is no return on the contribution made by a member, as happens to be the case where association is formed with the purpose of general public utility as well; mutuality is not lost. Such association may also be entiltled to tax concessions as a charitable institution as was found in *Addl.CIT v. Surat silk cloth manufacturer's Association*[13]. In such cases ,income from entrance fees, subscription and donations etc. 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 concessions , whether on mutuality principle or as a charitable institution, may be available. However it would be imperative for such MI to take registration u/s 12AA. It would be noteworthy that every receipt like advertisement receipts for souvenirs and journals which is not open for sale shall not be commercial income attracting proviso to section 2(15). In *PHD Chamber of commerce & industry v. DIT(exem.)*[14], it was held that any activity in the nature of rendering assistance to trade should not be considered as business.

The doctrine of mutuality, as the law so far developed, may be understood in the way that the surplus funds so invested in bank deposits and the interest earned on such deposits have resulted out of the transactions held amongst the members then also income would be exempt applying the mutuality principle and if generated from non-members then taxable. It may be advised that a Ma may account for separately the income earned out of the transactions with members and non-members. However the writer of this article is of the opinion that all income of a Ma would be exempt if there is no taint of commerciality regardless of separate accounting.

Surprisingly there is no section in Income Tax Act which straightly allows Ma to claim exemption. A new clause in section 10 can be inserted in line with section 10(23AAA) and 10(23C) for Ma. In the absence of the same, it becomes very difficult to choose the correct return Form and appropriate columns to claim exemption. This flaw needs to be looked into by the law makers.

Case laws referred in this article-

1. (2009)318 ITR (AT) 407 MUM.
2. (1981)129 ITR 787(PAT.),(1997)226 ITR 97(SC)
3. (2000) 243 ITR 89(SC)
4. (1984) 146 ITR 181(ALL.)
5. (1963) 49 ITR 52(ALL.
6. (1981) 127 ITR 264(MAD)
7. (1988) 171 ITR 504 (GUJ.)
8. (2010)328 ITR 348 (MAD)
9. (2011) 339 ITR 525 (DEL.)
10. (2009) 319 ITR 179(DEL.)
11. (2013) 350 ITR 509(SC)
12. (2013) 22 ITR (TRIBUNAL) 277 CHENNAI
13. (1980) 121 ITR1 (SC)
14. (2013)357 ITR 296(Del.)

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