

SC settles the issue regarding applicability of ‘Principle of Mutuality’ on interest earned by social clubs from investments

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The 'Principle of Mutuality' is based on the concept that 'No man can make profits out of himself'. The essence of this principle lies in the commonality of contributors and participants who are also beneficiaries.

The Act¹ does not make any direct reference to the Principle of Mutuality. However, the definition of the term 'income' in the Act² contains specific references of certain mutual businesses such as mutual insurance companies. As there is no reference to other mutual organisations (e.g. clubs), such mutual organisations claim that their receipts are not taxable on account of the general principle of mutuality.

In various judicial precedents, the Supreme Court (SC) has explained the doctrine of mutuality. However, there are divergent SC rulings regarding the applicability of the 'principle of mutuality' to certain income earned by clubs.

The SC, in its recent decision³, has settled this controversy and affirmed its earlier decision in the case of Bangalore Club⁴. Further, the SC observed that interest earned by the clubs from its member bank on deposits or other investments cannot be regarded as not taxable based on the 'Principle of Mutuality.'

Background

- The taxpayers⁵ earned interest income from fixed deposits maintained with various banks (including member banks). Such deposits were made out of surplus funds generated through various activities of the club.
- In this case, various High Courts (HCs)⁶ uniformly held that the interest earned by the taxpayers is liable to be taxed in their hands.

- The HCs held that taxpayers cannot claim exemption basis the Principle of Mutuality.
- Aggrieved by the decision of the HCs, the taxpayers filed an appeal before the SC.

Controversy before the SC

- The HCs relied on the SC's ruling in the case of Bangalore Club. However, the taxpayers relied on the SC's decision in the case of Cawnpore Club⁷. Both these SC decisions were based on similar facts. However, the SC, in the case of Bangalore Club, did not refer to its earlier ruling in the case of Cawnpore Club.

¹ The Income Tax Act, 1961 (the 'Act')

² Section 2(24) of the Act

³ Secunderabad Club ETC v CIT-V ETC (2023) (Civil Appeal no. 5195-5201 of 2012)

⁴ Bangalore Clubs v CIT [(2013) 5 SCC 509] ('Bangalore Club')

⁵ Secunderabad Club, Madras Gymkhana Club, Madras Cricket Club, The Coimbatore Cosmopolitan Club, Madras Club, M/s. Wellington Gymkhana Club and M/s. the Coonoor Club (the 'taxpayers').

⁶ In the given case, the decisions were pronounced by High Court of Andhra Pradesh and Madras High Court

⁷ CIT v M/s. Cawnpore Club Ltd (2004) [140 Taxman 378 (SC)] ('Cawnpore Club')

- In light of the above, the issues involved in the present appeal are as under:
 1. Whether the decision in the case of Cawnpore Club is a binding precedent?
 2. Whether the decision in the case of Bangalore Club require reconsideration in view of the SC's decision in the case of Cawnpore Club?
 3. Whether the Karnataka HC decision in the case of Canara Bank⁸, similar to Cawnpore Club, is applicable to the present case even if the SC has dismissed the Special Leave Petition (SLP)?
 4. Whether Principle of Mutuality is applicable to the interest on deposit of surplus funds by the clubs?

Brief summary of key rulings the SC discussed in this case:

- **Cawnpore Club** - The taxpayer earned income from letting out of rooms, interest from fixed deposit receipts (FDR), National Savings Certificate (NSC), etc.

In this case, the Allahabad HC observed that the income earned from letting out of rooms to its members cannot be subject to tax based on principle of mutuality. The Revenue did not challenge this issue.

The Revenue filed an appeal before the SC for other issues (i.e., interest on FDR, NS, etc.). The SC, in this case, observed that there is no purpose in proceeding with the other questions, as the taxpayer cannot be taxed because of the Principle of Mutuality.

- **Bangalore Club** – In this case, the taxpayer earned interest on fixed deposits kept with various member and non-member banks. Interest earned from non-members was duly offered to tax under the Act. Whereas, with respect to the interest earned from member banks, the Karnataka HC held that the Principle of Mutuality would not be available since the relationship in this case was that of a banker and its customer.

On appeal before the SC, it was observed that to claim the benefit of the Principle of Mutuality, three cardinal conditions must be fulfilled. These conditions were not fulfilled in the case of the Bangalore Club. A gist of the SC's reasoning in the context of the above conditions is as under:

1. **Complete identity between participators and contributors:** In this case, depositing funds with the banks suffered from deflections due to exposure to commercial banking operations. The banks could use such funds to advance loans to their clients. This ruptured the 'privity of mutuality' and, thus, violated the one-to-one identity between the contributors and participators as mandated by this condition.
2. **Actions of the participators and contributors must be in furtherance of the mandate of the association or club:** When the member banks placed the funds at the disposal of third parties, an independent contract was initiated between the banks and its clients (i.e., third parties) that were not privity to mutuality. This activity cannot be categorised as an activity of the

⁸Canara Bank Golden Jubilee Staff Welfare Fund v DCIT [(2009) 308 ITR 202 (KAR)] ('Canara Bank')

club in pursuit of its objectives. Accordingly, the second condition, which postulates direct step resulting in direct benefit to the club's functioning, was violated.

3. **The funds must be returned and expended solely on the contributors:** Though funds are returned to the club, it is after being expended on the non-members, i.e., the bank's clients. The loaning of funds of the club by the banks to outsiders for commercial reasons breached the third condition.

Considering the above, the SC, in the case of the Bangalore Club, upheld the Karnataka HC's order and observed that the aforesaid arrangement was not between a club and its members but between a bank and its clients.

- **Canara Bank** - The Karnataka HC held that the interest on investment and dividend received on shares are governed by the principle of mutuality⁹. In this case, the source of funds was wholly contributed by the club members during the relevant years, hence, such income was not taxable. Further, the SC dismissed the SLP filed by the Revenue against the Karnataka HC's decision.

Taxpayer's contentions

- Relying on the SC's decision in the case of Bangalore Club (pronounced in 2013), various HCs denied exemption on interest income earned by the clubs on bank deposits claimed on account of the Principle of Mutuality. Also, HCs had

disregarded the SC's earlier decision in the case of Cawnpore Club (pronounced in 2004).

- The taxpayers contended that the decision of Bangalore Club is not a binding precedent. They claimed that there are flaws in the reasoning of the decision in Bangalore Club, which are summarised below:
 - The decision failed to note that if there is no profit motive in the activities of a club, despite the fact that surplus income is generated, its activities and income cannot be tainted with commerciality. Hence, this ruling was contrary to the SC's earlier ruling in the case of the Cawnpore Club.
 - It did not consider the definition of income, the fact that the income was utilised for the benefit of members, and the nuances of the Principle of Mutuality.
 - No distinction was made between two kinds of transactions, i.e., a transaction between the clubs and banks and the other between banks and their borrowers (i.e., clients). It did not appreciate that these two transactions are totally distinct.
 - The SC ruling of Cawnpore Club is a binding precedent under the Constitution of India¹⁰. However, the decision in the case of the Bangalore Club has not referred to the ruling of the Cawnpore Club, and hence, taxpayer argued that the decision in the case of the Bangalore Club needs to be reconsidered.

⁹ Placing reliance on Natraj Finance Corporation, [(1988) 169 ITR 732] and Chelmsford Club [(2000) 243 ITR 89]

¹⁰ Article 141 of the Constitution of India

- There are two decisions, i.e., Bangalore Club and Cawnpore Club, which have taken diametrically opposite views. Accordingly, taxpayers contended that it is necessary to revisit the SC's position and the ratio laid down in the former decision (i.e., Cawnpore Club). Taxpayers argued that the matter needs to be referred to a larger bench for laying down the correct law.
- Taxpayers contended that the 'Principle of Mutuality' is applicable in the present case, as:
 - Interest earned on deposits is from the surplus generated by the clubs from its members through the club's activities. There is a complete identity between the source of funds deposited with the bank and the beneficiaries of the interest earned.
 - Interest earned is ultimately used for the benefit of its members. There is no diversion of funds by the clubs to any non-members.
 - The profit motive cannot be attributed to the clubs since the prudence was the sole intent of depositing the money in the bank.
- There is an express inclusion of income earned by the mutual insurance company or co-operative societies under the scope of 'income'.¹¹ Other entities, such as social clubs, are not covered by this provision, and hence, the income earned by such clubs would not be taxed based on the principle of mutuality.
- Further, taxpayers argued that the SC had also dismissed the SLP filed against

the Karnataka HC's decision in the case of Canara Bank (which was in line with the decision in the case of the Cawnpore Club).

- The taxpayers also pleaded that they are not-for-profit entities and that tax on interest income would be prejudicial to the very existence of such social clubs.

Revenue's contentions

- Revenue authorities argued that in the case of the Bangalore Club, the SC correctly analysed the nature of transactions involved (i.e., the club's investment of surplus income in banks, post offices, etc., to earn interest.)
- It further argued that the above judgement squarely covered the facts and issues involved and does not require reconsideration.
- The Revenue relied on the SC's reasoning in the Bangalore Club case. It contended that the Principle of Mutuality would apply to the surplus income generated by the clubs from members. However, when the surplus is invested in the form of fixed deposits with the banks, post office, NSC, etc., it is exposed to commercial banking operations. Hence, the Principle of Mutuality would not apply.
- It also highlighted that the Bombay and Madras HCs followed the decision of the Bangalore Club and distinguished the Karnataka HC's ruling in the case of Canara Bank on the premise that the Canara Bank ruling should be restricted to the facts of the said case alone. Thus, this decision (i.e., Canara Bank) was

¹¹ Section 2(24)(vii) of the Act

implicitly overruled by the decision of Bangalore Club.

Key observations by SC

Ratio decidendi

- It is a settled principle that only ***Ratio decidendi*** of a judgement is binding as a precedent.
- Legal principles guiding the decision in a case is binding precedent for subsequent cases.
- The law declared by the SC is binding on all the courts in India¹². However, a decision that is not express, which is neither founded on any reason nor proceeds on a consideration of issue cannot be deemed to be law declared.
- It can be said that a law is declared by the SC only when it is contained in a speaking order, either expressly or by necessary implications, and not by dismissal *in limine*.
- In the case of the Cawnpore Club, the SC order does not spell out or even indicate what '*the other questions*' were. Also, it did not spell out that the Principle of Mutuality was applied to which aspect or activities of the said club and its transaction.
- The above case was disposed with a brief order, without any reasoning or discernible *ratio decidendi*. Accordingly, it cannot be a binding precedent that has been ignored while deciding the case of the Bangalore Club. It only binds the parties involved in that case.

- The SC held that the Cawnpore Club did not answer the issue involved in the present case. On the other hand, the Bangalore Club had answered the same with a detailed judgement.
- Thus, there is no flaw in decision of Bangalore Club in not considering the judgement of Cawnpore Club. In view of this, it is not required to refer the case of the Bangalore Club to a larger bench on this ground.
- In relation to the decision of Canara Bank, the SC observed that the said judgement is specific to the facts of that case. Accordingly, it cannot be considered as a binding precedent.

Principle of Mutuality

- The SC discussed the evolution of the Principle of Mutuality in India in light of the decisions by Indian as well as foreign courts.
- The SC agreed with the decision of the Bangalore Club. It held that the mutuality applies till the stage of deposit of funds and would lose its application once the funds are deposited as fixed deposits in the banks. Exposure to banks' commercial operations would completely rupture the 'privity of mutuality'. The element of complete identity between the contributors and participators is lost in such cases.
- If the same facility of the club as offered to members is also offered to public / non-members for the purpose of earning and additional income, then, it is in nature of a commercial transaction. Thus, it becomes a profitable venture and mutuality would not apply.

¹² As per Article 141 of the Constitution of India

- While applying the triple test for mutuality, it is necessary to lift the veil and discern the nature of each transaction, i.e., whether there is a third-party intervention or it is an income generated between the members and the club.
- It was also held that the mode of application of surplus generated has no bearing on the satisfaction of the triple test of mutuality. Thus, the fact that the funds so deposited would be ultimately used for the benefit of members is irrelevant.
- Accordingly, the SC held that the Principle of Mutuality would not apply to interest income earned by the taxpayers on the fixed deposits. This is irrespective of the fact that whether such deposits are made with members or non-members.
- The SC also clarified that any income earned by clubs through its assets and resources from non-members would be liable to tax under the Act.

Our comments

The SC explained and reiterated the triple test to be fulfilled for applying the Principle of Mutuality based on various Indian and foreign judicial precedents. The ratio pronounced by the SC would assist taxpayers in assessing whether their income can be exempt basis the principle of mutuality.

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