Karnataka High Court Commissioner Of Income-Tax vs I.T.I. Employees Death And ... on 24 July, 1998 Equivalent citations: ILR 1998 KAR 3267, 1998 234 ITR 308 KAR, 1998 234 ITR 308 Karn Author: A Bhan Bench: A Bhan, S V Murthy JUDGMENT Ashok Bhan, J. 1. This order shall dispose of ITRC Nos. 30-31 of 1995, ITRC Nos. 32-33 of 1995, ITRC Nos. 34-35 of 1995 and ITRC Nos. 36-37 of 1995, arising from the order of the Income-tax Appellate Tribunal (hereinafter referred to as "the Tribunal"), dated June 15, 1993, relating to the assessment years 1985-86, 1986-87, 1988-89 and 1989-90. The Revenue as well as the assessee have claimed one question each in all the assessment years thereby giving rise to eight reference petitions. The Tribunal has disposed of eight appeals relating to the four assessment years by passing one order as the facts and the questions of law involved are the same. Since common issues arise for consideration arising from the same facts in all these petitions, we also dispose of them by a consolidated order for the sake of convenience. 2. The trust styled "the Indian Telephone Industries Employees' Death and Superannuation Relief Fund" was created by a deed dated December 19, 1983, by the employees of the Indian Telephone Industries called the settlers for the benefit of about 20,000 employees of ITI in various towns in the country. Copy of the trust deed along with its rules were placed on record by counsel for the assessee to which counsel for the Revenue had no objection. As per Clause 2, the trust funds of the assessee consists of the following : "(2) The trust funds being the aforesaid ITI Employees' Death and Superannuation Relief Fund shall consist of the following : (a) Monthly contributions made by the employees through recovery from the pay bill. (b) Contributions, if any, made by the ITI management towards the said fund. (c) Donations received. (d) Interest or other income accrued or earned from the said funds or any investments thereof. (e) All securities and investments made from out of the funds. (f) Money or other assets that may come into or be vested in any manner in the trust to be held as part of the trust assets." 3. Clause 8 provides that all monies contributed to the Indian Telephone Industries Employees Death and Superannuation Relief Fund or received or accrued by way of interest or otherwise, shall be deposited in the bank accounts of the fund and shall be invested as judiciously as possible to see that the fund does not suffer on account of non-investment. Clause 15 made all the provisions of the ITI employees death and superannuation relief fund rules, as detailed in the annexure to the trust, applicable as if the same were contained in the presents of the trust deed. As per Clause 3, the object of the fund is to provide immediate financial assistance to the families of any member of the fund in the case of death of the member or monetary relief to members on superannuation/termination on medical grounds/dismissals/terminations. Clause 4(a) provides that all employees of ITI who subscribe to the aims and objects of the fund shall be eligible to become members. The subscription is Rs. 10 per month recoverable through the pay bills. The board of trustees had the power to change or alter the rate of subscription, as and when it is deemed necessary for fulfilling the objects of the fund. Vide circular resolution dated November 13, 1984, Clause 8 of the annexure was amended and it was provided that the funds may be invested in interest bearing deposits or securities in any scheduled bank, institutions like ITI Employees Union Co-operative Credit Society Ltd., and financially secure co-operative banks, where there is insurance coverage for the deposits made. The secretary with the approval of the chairman is empowered to make such investments. Rules enumerating benefits which could be given to any member of the fund in the case of death of a member or monetary relief to members on superannuation/termination on medical grounds/dismissals/terminations were also framed. 4. The amount was deposited in banks to earn interest. The assessee earned interest income on its deposits from various banks. The assessee claiming itself to be a charitable trust constituted for a charitable purpose claimed exemption of its income from taxation under Section 11 of the Income-tax Act (hereinafter referred to as "the Act"), on the ground that it is a charitable trust. The Assessing Officer denied the exemption to the assessee on the ground that the fund was only an internal arrangement for the benefit of the ITI employees and it was only a mutual benefit fund inasmuch as the subscribers and the beneficiaries being ITI employees and that no outsider is getting any benefit out of the said amount. For all the four years under consideration exemption under Section 11 of the Act was denied to the income of the assessee on the aforesaid grounds. The Assessing Officer brought the following interest income to tax denying exemption under Section 11 of the Act : Assessment year Interest income (Rs.) 1985-86 4,15,815 1987-88 8,56,718 1988-89 9,73,990 1989-90 11,04,997 5. Aggrieved by the order of the Assessing Officer, the assessee preferred an appeal before the Commissioner of Income-tax (Appeals) contending, inter alia, that the assessee is a charitable trust entitled to the benefits of Section 11 of the Act and that even if it is held to be a mutual benefit fund or mutual concern still its income is exempt from taxation. The first appellate authority rejected all the contentions of the assessee. It upheld the view taken by the Assessing Officer. It was held that the assessee was not a charitable trust and as such it is not entitled to claim any exemption under Section 11 of the Act. The assessee's claim based on the principle of mutuality was rejected holding that the bank interest income accrued not on account of lending by the appellant fund to its members but on account of the fixed deposits kept by the appellant fund in various banks and that the income from bank interest is not covered by the principle of mutuality for claiming exemption. The assessee being aggrieved filed further appeals before the Tribunal. 6. The Tribunal accepted the assessee's plea that it was constituted for charitable purposes and, therefore, its income is exempted under Section 11 of the Act. The alternative plea raised by the assessee that the assessee is a mutual benefit fund and, therefore, interest income derived by it is not chargeable to tax was rejected. 7. The assessee as well as the Revenue filed petitions under Section 256(1), before the Tribunal, claiming a question each on the findings which had been recorded against each of them. The Tribunal being of the opinion that the question of law'claimed by the Revenue as well as by the assessee arise from the order of the Tribunal referred the following two questions to this court for its opinion : "1. Whether, on the facts and in the circumstances of the case, the Tribunal is right in law in holding that the objects of the assessee-society fall within the purview of Section 2(15) of the Income-tax

Act, and as such its income is exempt under Section 11 of the Income-tax Act, even though the assessee has not fulfilled the conditions laid down in Section 12A of the Act ? 2. Whether, on the facts and in the circumstances of the case, the interest income earned by the fund was exempt on the principle of mutuality ?" Question No. 1 has been referred at the instance of the Revenue and question No. 2 has been referred at the instance of the assessee. 8. Counsel for the Revenue and the assessee are agreed that so far as the question claimed by the Revenue is concerned the same is concluded by a judgment of this court in CIT v. BEL Employees Death Relief Fund and Service Benefit and Association [1997] 225 ITR 270 in favour of the Revenue and against the assessee. On similar facts it was held that the objects of the society do not fall within the purview of Section 2(15) of the Act and its income was not exempted under Sections 11 and 12 of the Act. The relevant observations made by the Bench are (headnote) : "That the rules unambiguously indicated that the benefit of the scheme or the alleged charitable purpose could be utilised only by specified persons who were required to be the subscribers or their dependants. Contributories to the fund allegedly collected for this personal benefits, could not be held to be forming an association for charitable purpose and thus being entitled to the benefit of exemption under Section 11 of the Act. The objects of the society did not fall within the purview of Section 2(15) of the Act and its income was not exempt under Sections 11 and 12 of the Act." 9. In view of the aforesaid judgment on question No. 1 referred to us, it is held that the Tribunal was not right in law in holding that the objects of the assessee-society fell within the purview of Section 2(15) and as such its income is exempted under Sections 11 and 12 of the Act. The same is answered in favour of the Revenue and against the assessee. 10. In the alternative the case of the assessee is that the income of the assessee is not liable to tax on the principle of mutuality. According to him, it is a well established principle of law under the Income-tax Act that no taxable profit is said to emerge from mutual activity of its members on the ground that no man can trade with himself. Counsel submits that the employees of the Indian Telephone Industries, who are the members of the assessee contribute to the assessee's fund and that they participate in the surplus and, therefore, the test of mutuality is satisfied. Counsel for the Department supported the view taken by the Tribunal and argued that the principle of mutuality would not apply to the interest income earned by the assessee on its deposits kept in the various banks. The bank interest was earned on the deposits made by the assessee and was not an income generated from principal by giving loans to the members themselves and the principle of mutuality has no application to the bank interest derived on the deposits made by the assessee. 11. Before we proceed to consider as to whether the principle of mutuality would apply on these facts, we would examine the judgments which were cited at the Bar by counsel for the parties which have culled out the principles of mutuality. 12. In terms of time, perhaps the first judgment of mutuality was rendered by the House of Lords in Styles (Surveyor of Taxes) v. New York Life Insurance Company [1889] 2 Tax Cases 460. Shortly stated the facts were that the New York Life Insurance Company was incorporated by special Act of the Legislature dated April

18, 1843. A branch or department of the said company for Great Britain and Ireland, under the management of a general manager appointed by the trustees and responsible to them, was established in the city of London. The company had no shareholders and there were no shares. The company was organised for and did business solely under the plan of mutual insurance. Each policy-holder was a member of the company and liable for all losses and expenses incurred by the company. At the close of each year an actuarial valuation was made, and if the aggregate receipts of the company were more than sufficient to cover the expenses and estimated liabilities, the surplus was divided between the participating policyholders, who received their dividends in the shape either of a cash reduction from future premiums, or of a reversionary addition to the amount of their policies. The surplus divided consisted partly of excess of the premiums paid by the participating policyholders, over and above the cost of their insurances, and partly of profits arising from non-participating policies, the sale of life annuities, and other business conducted by the society with non-members. It was held that so much of the surplus as arises from the excess contributions of the participating policyholders is not profit assessable to the income-tax, on the principle that a person could not trade with himself and the surplus arising from the excess contribution from the policyholder was not profit assessable to the income-tax. But in so far as the company dealt with those outside its own body, it does carry on the business of insurance, and in respect of the profits made in this business was liable to income-tax. 13. In another judgment of the House of Lords in Thomas v. Richard Evans and Co. Ltd., [1927] 11 Tax Cases 790, it was held that the surplus of the association's income from the calls from its members and the income from its investments, over its outgoings by way of indemnity payments and re-insuring its risk did not constitute profits arising from the trade carried on by the association and it was therefore not liable to income-tax in respect thereof. Styles' case [1889] 2 TC 460 (HL) was followed. 14. The Andhra Pradesh High Court considered the principle of mutuality in CIT v. Nataraj Finance Corporation [1988] 169 ITR 732. In that case (somewhat unusual as observed by the Bench) the assessee carried on business in lending money to its partners. The assessee had been carrying on the said business for quite some time. For the assessment year 1977-78 some changes occurred in the constitution of the firm with the result that a deed of partnership was executed on April 15, 1976, among 19 partners. The firm filed a return declaring an income of Rs. 48,310. It was said to represent interest received on loans advanced by the firm to its partners except some interest amount received from a former partner and also on moneys deposited in a savings account with the Canara Bank which monies were kept in deposits for safe keeping. Rs. 48,310 did not include the interest from any person other than the above. The asses-see set up a claim that it was a mutual benefit association and its income was derived wholly from members and, consequently, the principle of mutuality was applicable and the income cannot be taxed. The plea of the assessee was rejected by the Income-tax Officer. The assessee filed an appeal before the Appellate Assistant Commissioner of Income-tax which was accepted and the claim of the assessee was upheld. The appeal carried by the Revenue before the Tribunal was rejected. In other words the claim regarding mutuality was accepted by the appellate authorities. The Revenue went up in reference before the High Court seeking opinion of the High Court as to whether, on the facts and in the circumstances of the case, the Appellate Tribunal was right in holding that the principle of mutuality was satisfied and consequently the income of Rs. 48,310 was not taxable. The question referred was answered in the affirmative, i.e., in favour of the assessee and against the Revenue and it was held (page 735) : "We have already referred to the relevant facts. There is nothing on record to show that the assessee has been carrying on the business activity of lending moneys to any persons other than its 19 members. The two other persons referred to, from whom interest was received, are not really persons to whom moneys were advanced. One person is a former partner who is paying interest on the moneys owed by him at the time of his retirement and the other person is the Canara Bank with which moneys are kept in safe deposit. It is not possible to say that any business transactions are carried on by the assessee with the former partner or the Canara Bank. There is also no indication from the record to the effect that in the past years, the assessee had carried on the activities of lending moneys to any person other than the members constituting the association. We, therefore, proceed on the assumption that the assessee's claim that it confines its money-lending activity only to its members and to no outsiders, has to be accepted. If that be so, it follows automatically that the interest received by the assessee is distributed among the members forming the association and thus the principle of mutuality governs." 15. In Sports Club of Gujarat Ltd. v. CIT , the assessee-sports club was incorporated as a company. Its main object was to promote sports. The objects clause in the memorandum and articles of association empowered those in the management of the club to invest and deal with monies of the club not immediately required till such manner as may from time to time be determined by them. The assessee claimed exemption from income-tax for the years 1966-67, 1967-68, 1968-69 and 1969-70. But the Income-tax Officer rejected the claim. The Tribunal held that income assessable under the head "Profits and gains of business or profession" would not be exigible to tax on the principle of mutuality since the contributors and the participants represented one identical body. It, however, rejected the assessee's contention that the entire surplus should be exempted on the ground of mutuality. It was held that where an association receives income by indulging in mutual activity and non-mutual activity, then the principle of mutuality is not destroyed by the presence of transactions which are non-mutual in character. The principle of mutuality in such cases can be confined to transactions with members and the income earned from non-members would not be exempted on the principle of mutuality. The view expressed by the Tribunal was affirmed and it was held that so much of the income received by the assessee-club by way of interest is exigible to tax. It was observed (page 512) : "We now revert to the question whether the income derived by way of interest on fixed deposits from banks is exigible to tax notwithstanding the finding that the principle of mutuality applies to the assessee-club. We have already pointed out earlier that one of the essentials of mutuality is that the contributors to the common fund are entitled to participate in the surplus, thereby creating an identity between the participators and the contributors. Once such an identity is established, the surplus income would not be exigible to tax on the principle that no man can make a profit out of himself. However, as pointed out earlier, the objects clause in the memorandum and articles of association empowers those in the management of the assessee-club to invest and deal with moneys of the club not immediately required in such manner as may from time to time be determined by them. Under this clause, the investment need not be confined to investment by way of fixed deposits with banks. It can take any other form or shape, such as investment in shares, real estate, etc. When income is derived from such investment, whether by way of interest, dividend or rent, it is derived from a third party and is not by way of contribution from the members of the club. We have also noticed that Clause (vii) of the memorandum and articles of association provides that in the event of winding-up or dissolution of the club, if there remains any surplus after satisfying all the debts and liabilities, the same shall be paid or distributed amongst the members in equal shares. If the income derived from investments over a period of time is added to the surplus, there can be no doubt that when the surplus is distributed, a component of return on investment would go to the members in equal shares. This component of return which the members will receive will not be by way of a plough back of their own contributions by way of fees, etc., to the club. An association which receives such income can be said to be indulging in both mutual activity as well as non-mutual activity." 16. In CIT v. Ranchi Club Ltd. [1992] 196 ITR 137 (Patna) [FB], the question before the Full Bench of the Patna High Court was whether the Ranchi Club was a mutual concern and the income derived by the club from its house property let out to its members and their guests is not chargeable to tax and whether the income derived by the assessee-club from the sale of liquor, etc., to its members and their guests is not taxable in its hands. It was held that if an assessee is found to be indulging in both mutual activities as well as non-mutual activities that decides whether it can still claim exemption in respect of receipts relating to mutual activities. Reliance was placed upon the judgment in the case of CIT v. Madras Race Club ; Carlisle and Silloth Golf Club v. Smith [1912] 6 TC 48 (KB) and the judgment of the Gujarat High Court in Sports Club of Gujarat Ltd. v. CIT . It was held (page 145) ; "Therefore, by applying the principle of mutuality members' clubs always claim exemption in respect of surplus accruing to them out of the contributions received by the clubs from their members. But this principle cannot have any application in respect of the surplus received from non-members. It is not difficult to conceive of cases where one and the same concern may indulge in activities which are partly mutual and partly non-mutual. True, keeping in view the principle of mutuality, the surplus accruing to a members' club from the subscription charges received from its members cannot be said to be income within the meaning of the Act. But, if such receipts are from sources other than the members, then still can it be said that such receipts are not taxable in the hands of the club ? The answer is obvious. No exemption can be claimed in respect of such receipts on the plea of mutuality. To illustrate, a members' club may have income by way of interest, security, house property, capital gains and income from other sources. But such income cannot be said to be arising out of the surplus of the receipts from the members of the club." 17. In CIT v. Kumbakonam Mutual Benefit Fund Ltd. [1964] 53 ITR 241, the Supreme Court examined the questions as to whether a company limited by shares which carried on banking business restricted to its shareholders received monthly contributions by way of recurring deposits from the shareholders and at the end of a fixed period returned an amount covering the deposits and guaranteed interest thereon for that period was exempted from payment of tax on the profits derived from the transactions with its shareholders. It was held that company was not entitled to exemption from payment of tax on the plea of mutuality. It was held (page 249) : "It seems to us that it is difficult to hold that Styles' case [18891 2 TC 460 (HL), applies to the facts of the case. A shareholder in the asses-see-company is entitled to participate in the profits without contributing to the funds of the company by taking loans. He is entitled to receive his dividend as long as he holds a share. He has not to fulfil any other condition. His position is in no way different from a shareholder in a banking company, limited by shares. Indeed, the position of the assessee is no different from an ordinary bank except that it lends money to and receives deposits from its shareholders. This does not by itself make its income any the less income from business within Section 10 of the Indian Income-tax Act." 18. From these judgments it gets established that no taxable profit can be said to emerge from out of mutuality on the ground that "no man can trade with himself". The essence of mutuality lies in the return for what one has contributed to a common fund. The fund should fulfil the essential requirements that all the contributors to the common fund must be entitled to participate in the surplus and that all the participators in the surplus should be contributors to the common fund. There must be complete identity between the contributors to the fund and the participators in the surplus. It does not mean that each member should contribute to the common fund or that each member should participate in the surplus or get back from the surplus precisely what he had paid. The principle of mutuality is not destroyed by the presence of transactions which are non-mutual in character and the principle of mutuality can, in such cases be confined to transactions with members. The two activities in appropriate cases can be separated and the profits derived from non-members, can be brought to tax. 19. If the facts of the present case are examined in the light of the principles applicable to the concept of mutuality, then it has to be held that the ingredients of mutuality are missing in the present case. Apart from the contributions made by the members there are other sources of funding of the trust fund. The trust fund can be augmented by contribution made by the ITI management ; donations ; interest or other income accrued or earned from the said funds or any investment thereof and investment made from out of the funds. The object of the trust is to invest the funds of the trust in banks and securities for earning interest to discharge the liabilities and obligations created under the trust. The fund is a welfare fund established for providing benefit to the employees on retirement/termination of service/death, etc., of such employees. It is not a case of surplus from the contributions made by the members. It is also not a case where the assessee had advanced its funds to its members and had earned interest of those loans. As already observed the income was earned by making deposits by way of investment in the bank. It is a case where the assessee invested its surplus funds in various banks and earned interest on the deposits. As was held in CIT v. Ranchi Club Limited [1992] 196 ITR 137 (Patna) [KB] by the Patna High Court, the principle of mutuality could be confined in respect of surplus accrued to the club out of the contributions received by the club from its members. But this principle would have no application in respect of surplus received from non-members. In the case on hand, the tax sought to be levied is not on the surplus from out of the contributions made by the members or from the interest earned on the money advanced to its members. The deposits in the banks were made for earning interest by way of income. The principle that no person can trade with himself does not arise in this case as the monies had been invested by the assessee with the bank to earn income to enable the assessee to discharge its obligations created under the trust. It is clear that income earned from outside agency on interest or securities from the bank would not be covered on the principles of mutuality for claiming exemption from tax and, therefore, it could not be excluded from the arena of taxation. 20. For the reasons stated, it is held that the assessee was not entitled to exemption from tax on the principle of mutuality. Question No. 2 is answered in the affirmative, i.e., in favour of the Revenue and against the assessee. No costs.