M.P. Cooperative Bank Ltd., Jabalpur vs Addl. Commissioner Of Income Tax, M.P. ... on 19 January, 1996

Equivalent citations: [1996]218ITR438(SC), JT1996(1)SC487, 1996(1)SCALE511, (1996)2SCC541, [1996]1SCR773, AIRONLINE 1996 SC 534, (1996) 134 CUR TAX REP 92, 1996 (2) SCC 541, (1996) 218 ITR 438, (1996) 84 TAXMAN 640, (1996) 130 TAXATION 765, 1996 COOP TJ 182, (1996) 1 JT 487, 1996 UPTC 373, (1996) 1 JT 487 (SC), (1996) 1 SCR 773 (SC)

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Bench: A.M. Ahmadi, B.L. Hansaria

JUDGMENT

A.M. Ahmadi, C.J

1. Special leave granted in SLP (C) Nos. 5813-14 of 1982.

2. The assessee in all these cases is a Co-operative Society registered under the Madhya Pradesh Co-operative Societies (Amalgamation) Act, 1957, hereinafter called 'the Act'. While framing assessment for the relevant assessment years in question, the income Tax Officer, included in the taxable income of the assessee interest earned on securities earmarked against reserves and interest earned on Provident Fund deposits. The assessee contended that it was entitled to the benefit of Section 81 of the Income Tax Act as in force at all material time. The Income Tax Officer rejected this claim of exemption form tax put forward by the assessee. Since the assessee's contention did not find favour at the higher levels also, including the reference to the High Court, the assessee has approached this Court.

3. Section 81 of the Income-Tax Act on which the assessee's case is based thus at all material time:

> Income of co-operative societies - Income Tax shall not be payable by a co-operative society. --
>
> (i) in respect of the profits and gains of business carried on by it, if it is, -
>
> (a) a society engaged in carrying on the business of banking or providing credit facilities to its members;
>
> xxx xxx xxx Provided that, in the case of a co-operative society which is also engaged in activities other than those mentioned in this clause, nothing contained herein shall apply to that part of its profits and gains as is attributable to such activities and as

> exceeds fifteen thousand rupees.

On a plain reading of this provision it becomes clear that every income of a society carrying on banking business is not exempt from the payment of tax. Only the income from banking business is exempt from tax. The question which we are required to answer is whether the income from interest accruing on government securities ear-marked for Reserve Fund/Provident Fund can be said to be income derived by the assessee from the business of banking within the meaning of Section 81 to qualify for exemption. This question arises in the backdrop of the following facts.

4. The assessee is an Apex Body controlling all District Co-operative Banks. It is registered under the provisions of the Co-operative Societies Act, 1912 read with Section 6 of the Act. The assessee filed returns for the relevant Years claiming that the entire income was from banking business and, therefore, exempt from tax under Section 81 of the Income Tax Act. The Income Tax Officer rejected the claim in regard to interest being exempt under the said provision. There is no dispute, and indeed there can be none, that the assessee is engaged in carrying on the business of banking which, inter alia, includes the activity of providing credit facilities to its members, In the course of its business it receives deposits and makes advances to borrowers at a rate of interest higher than what it pays on deposits. A part of these deposits are, however, invested in the form of government securities with the State Bank of India or the Reserve Bank. Under Section 44 of the Co-operative Societies Act, the assessee is required to invest or deposit its funds to maintain a cover to the extent necessary and further provides that the Reserve Fund of the Society shall be invested and utilised as may be laid down by the Registrar, which it does by investing in government securities purchased with the bank's funds. The question is whether the interest earned by the assessee from government securities placed with the State Bank or the Reserve Bank can qualify for exemption under Section 81 of the Income Tax Act?

5. Before we proceed to answer this question we may refer to the M.P. Government's instructions No. CR 25/26 dated October 7, 1960 which, insofar as it concerns Apex Banks, reads as under:

> (C) APEX BANK The Reserve Fund of the Apex Bank shall be fully invested outside its business in Government securities. No part of its reserve fund should be utilised as its working capital.

3. All investments of Reserve fund shall be specially marked as "Reserve Fund Investment" and shall be shown separately in the annual balance sheets. The Reserve Fund deposit at every level shall carry the maximum rate of interest which a Central Bank or Apex Bank pays on fixed deposits for longest period or 3% whichever is higher. No part of the Reserve Fund deposits shall be drawn without the previous sanction of the Registrar, in the case of Apex Bank, Central Banks and Large Sized Societies and in the case of other primary societies without the permission of the Deputy Registrars. Such Approval can be given when the Amount is either required to meet losses, or, when the society is to be wound up. These eventualities will, however, be very rare.

6. Obviously as per the above instructions no part of the Reserve Fund can be utilised as working capital nor can any part of the Reserve Fund deposits be withdrawn except with the permission of

the Registrar to meet losses or at the time of winding up and not otherwise. In the circumstances the Revenue contends that the securities relating to the Reserve Fund can never be considered to be the circulating or working capital of the bank or its stock-in-trade to qualify for exemption under Section 81 of the Income Tax Act.

7. Insofar as interest on Provident Fund deposits are concerned, admittedly the same was included in the Profit and Loss Account of the Bank. It appears from the observations in paragraph 11 of the appellate order of the Tribunal that even the assessee's counsel found it difficult to justify the claim and said that it ought not to have been included in the Profit and Loss Account of the Bank since it belonged to the Provident Fund as the Bank was merely holding those deposits as Trustees. The Tribunal did not examine this contention, and in our opinion rightly, since the same was not agitated before the authorities below and no foundation was laid for the same. The Tribunal held that since the interest earned therefrom was included in the Profit and Loss Account of the assessee and was shown as earnings, it was liable to tax since it did not form part of the assessee's stock-in-trade or circulating capital and could not, therefore, be described as income from the business of banking to qualify for exemption. The Tribunal, therefore, held that this income was liable to tax. Mr. Salve, the learned Senior Counsel for the assessee with his usual fairness stated that in the absence of the foundational facts, the Tribunal was justified in refusing to examine the contention of the assessee's counsel and he was not in a position to assail the Tribunal's approach. He, therefore, did not press the contention under this head. We are, therefore, left with the first contention only, namely, whether interest on government securities earned by the assessee is exempt from tax under Section 81 of the Income Tax Act.

8. There can be no doubt that the object of Section 81 was to encourage the co-operative movement in the country by providing tax exemption to those co-operatives engaged in activities set out in Clauses (a) to (f) thereof. One such activity is the carrying on of the business of banking or providing credit facilities to its members by a co-operative society. The section, therefore, provides that income-tax shall not be payable by a co-operative society in respect of the profits and gains of business carried on by it, if it arises from the business of banking or providing credit facilities for its members. However, if such a co-operative society also engages itself in activities other than the business of banking or providing credit facilities the profits derived from such business shall not be exempt from tax if it exceeds rupees fifteen thousand. It is, therefore, obvious that the entire income derived by a co-operative society from the business of banking or providing credit facilities to its members is exempt from income tax, but if that society also engages itself in any other activity and earns profit therefrom, the income so derived becomes liable to assessment and payment of income tax if it exceeds the ceiling amount. The normal banking activity is to receive deposits and utilise such deposits by advancing loans, etc., to borrowers. Since the rate at which interest is paid to depositors is lower than the rate charged from borrowers, the difference in the rates generates income for the banks. The banks may have to maintain certain reserves to meet with emergencies, e.g. a spurt in withdrawals by depositors for diverse reasons. Investments which permit withdrawals at short notice would, therefore, be a part of the requirement of banking business and interest accruing on such investments would be outside the tax-net. That is why this Court in Bihar State Co-operative Bank Ltd. v. Commissioner of Income Tax , while dealing with income derived by way of interest on short-term deposits by the bank, held that it was income from normal banking

business and was, therefore, exempt from the liability to pay income-tax. This Court held that since the society was engaged in banking activity, its normal business was to deal in money and credit and, therefore, the money laid out in the form of short-term deposit did not cease to be a circulating capital and interest earned thereon cannot be other than income generated from the business of banking and was, therefore, exempt from tax. The same view was reiterated in Commissioner of Income Tax v. Bombay State Co-operative Bank Ltd. , Malabar Co-operative Central Bank Ltd. v. Commissioner of Income Tax, Kerala (Kerala) and Commissioner of Income Tax, Orissa v. Orissa State Co-operative Housing Corpn. Ltd. . The Privy Council in Punjab Co-operative Bank Ltd, v. Commissioner of Income Tax (1940) 8 ITR 635 also held that bankers have always to keep sufficient cash or readily realisable securities to meet with any probable demand of depositors in the normal course of banking business and such founds, counsel argued, would really form part of the bank's circulating capital and, therefore, interest earned thereon would be exempt from tax.

9. Placing strong reliance on the aforesaid line of reasoning, counsel for the assessee argued, that interest earned on government securities placed with the State Bank or Reserve Bank would be income earned by the bank form its circulating capital and in any case in the normal course of banking business and cannot therefore be brought to tax. It was said that the government securities form part of the bank's stock-in-trade and an) income earned thereon would be outside the tax-net. Counsel for the revenue, however, distinguished the decisions relied on by the assessee mainly on the ground that the bank's funds were utilised in short-term deposits or in government securities which could be easily encashed to meet with a probable sudden rush of depositors and, therefore, the fund employed for the purpose never went out of circulation but was kept apart to meet a probable eventuality and, therefore, a business obligation. He pointed out that in the case of Reserve Fund Investments no part of the deposits was permitted to be withdrawn unless the money was required to meet losses or the society had to be wound up and that too with the Registrar's permission only. Therefore, he submitted, these securities could not be utilised as a working capital nor did they form part of the circulating capital or stock-in-trade of the bank and hence the interest earned thereon and shown as forming part of the income of the society cannot qualify for exemption.

10. Counsel for the revenue did not join issue on the proposition that if circulating capital or stock-in-trade of a co-operative bank is invested in securities, interest earned thereon would be income from banking business and would, therefore, qualify for exemption. However, can the investment in securities of the Reserve Fund be said to be investment of circulating capital or stock-in-trade, more so when it is noticed that the co-operative bank does not have an absolute and unfettered right to withdraw the same whenever it liked? We have noticed that the co-operative bank is legally obliged to place certain government securities with the State Bank/Reserve Bank and these securities cannot be withdrawn by the said bank at its sweet will and can only be withdrawn in certain situations referred to earlier. That is because the investment of the Reserve Fund in securities is not to meet with the probable eventuality to pay off the depositors should they demand the same. It is, therefore, difficult to comprehend how such government securities relating to Reserve Fund can be considered the bank's stock-in-trade or circulating capital. It is clearly understood in banking parlance that circulating capital is that which is put into circulation or turned over to earn profits. Government securities coming out of Reserve Fund which cannot be easily

encashed and which can be utilised only when the contingencies mentioned therein arise cannot be considered to be circulating capital or stock-in-trade. It is more or less in the nature of a fixed asset of the society, being out of circulation for an indefinite period. It is, so to say, at arm's length from the normal banking business, to be utilised on the happening of certain events, events which may virtually bring a cessation of the business. If that be the purpose and object of setting apart the funds in the form of government securities and the like, it cannot be reasonably contended that the funds placed in cold storage continue to constitute the bank's stock-in-trade or circulating capital. The learned Counsel for the revenue was, therefore, right in contending that the case law cited at the Bar by the learned Counsel for the assessee cannot come to the rescue of the assessee.

11. We may make a brief reference to two more cases to which our attention was drawn by the learned Counsel for the revenue. The first case is of Commissioner of Income Tax, Lucknow v. U.P. Cooperative Federation Ltd. . In that case, the Apex Co-operative Society, which was expected to regulate the supply of sugar, coal, cloth, etc., to its members, had received two sums, namely (i) No. 9,000 as interest on cash security deposit with a co-operative sugar factory for carrying on sugar agency business; and (ii) No. 51,295 as interest on amounts which it had advanced to its members since they were not able to arrange for the entire finance needed to lift the stocks. This Court held that the first amount did not qualify for exemption because it represented only interest on security deposit and could not be mixed up with other sum received in the course of business. Even the learned Counsel for the assessee did not, press for exemption so far as that claim is concerned. The second claim was allowed on the ground that the money had to be provided to run the business and generate profit and the funding was, therefore, in the nature of 'investment' within the meaning of the relevant provision, in that, the money was ultimately to be utilised by the member society for the purchase of stocks. The distinction is obvious, namely, where the money is ultimately to be used for business purpose, either directly or through the member-bank, the interest thereon would qualify for exemption and not otherwise. The second case to which our attention was drawn is of Assam Co-operative Apex Marketing Society, Ltd. v. CIT (Addl.) . In that case the appellant was appointed as the procuring agent for paddy by the Assam Government. The members of the appellant were primary marketing societies and societies at the village level, with membership of agriculturists, being the members of the former. Thus no agriculturist was the direct member of the appellant. So, the produce was received by the village level societies from its agriculturist-members and was then passed on to the primary societies which in turn made it over to the appellant. A Commission was charged for the procuring activity which was divided between the three, the appellant and the village society each taking 19 paise in a rupee and the remaining 62 paise went to the primary society. The question was whether the appellant's share in the commission could be brought to tax. The Tribunal as well as the High Court on reference held that the assessee was not entitled to exemption and this Court affirmed the finding on the following line of reasoning.

A reading of Clause (i) of Section 81 shows that the idea and intention behind the said clause was to encourage basic level societies engaged in cottage industries, marketing agricultural produce of its members and those engaged in purchasing and supplying agricultural implements, seeds, etc., to their members and so on. The words 'agricultural produce of its members' must be understood consistent with this object and if so understood, the words mean the agricultural produce produced by the members. If it is not so understood, even a co-operative society comprising traders dealing in

agricultural produce would also become entitled to exemption which could never have been the intention of Parliament. The agricultural produce produced by the agriculturist can legitimately be called agricultural produce in his hands but in the hands of traders, it would be appropriate to call it agricultural commodities; it would not be his agricultural produce. Accordingly, it must be held in this case that since the agricultural produce marketed by the assessee was not the agricultural produce produced by its members, namely, primary co-operative society, the assessee cannot claim the benefit of the said exemption.

12. The learned Counsel for the assessee tried to distinguish both these cases but in our opinion the purport of the decisions is obvious. However, even if we were to agree with learned Counsel for the assessee that both cases had no application to the facts of these appeals, it would make no difference because we have on first principles come to the conclusion, for reasons set out hereinbefore, that the interest on government securities placed with the State Bank of India/Reserve Bank of India, cannot qualify for exemption under Section 81 (now Section 80 p) of the Income Tax Act.

13. Before we part, we must take note of Shri Salve's contention that the proviso to Section 81 would apply in the case of that co-operative society alone which is engaged in an activity other then those mentioned in Clauses (a) to (f) which not being so as regards the appellants, the proviso has no application; and so, no part of its profit or gain can attract income tax. We do not think this to be the correct reading of the proviso, notwithstanding the use of the word "also". According to us, what the proviso seeks to convey is that even if a co-operative society is engaged only in the business of banking, but part of its activity is not attributable to engagement in such activity, income derived from that part of activity would become taxable. And as held above, the income derived from the investment in Government securities placed with the State Bank of India/Reserve Bank of India cannot be regarded as an essential part of its banking activity inasmuch as the same does not form part of its stock-in-trade or working/circulating capital. Therefore, we see no force in Mr. Salve's premises.

14. For the above reasons we see no merit in these appeals and dismiss the same with costs.