

Tax Alert | Delivering clarity

15 May 2020

Supreme Court rules on principle of mutuality

The Hon'ble Supreme Court has examined and ruled that the principle of mutuality was not met in the case under consideration

Facts of the case:

- Yum Restaurants (Marketing) Pvt. Ltd. (taxpayer)¹ a wholly-owned Indian subsidiary of Yum! Restaurants (India) Pvt. Ltd. (YRIPL) undertakes Advertising, Marketing and Promotion (AMP) for YRIPL and its franchises.
- YRIPL had obtained an approval from the Secretariat Industrial Assistance (SIA) for setting up the taxpayer company. The SIA approval was subject to certain conditions, which amongst others included:
 - The franchises and YRIPL to contribute a fixed percentage of their revenue to the taxpayer company, for economising the cost of advertising and promotion for franchises;
 - The contributions and other income will not be for the benefit of any individual contributor;
 - Management of the taxpayer company would be with YRIPL and the decisions on application of the contributions were to be made by YRIPL, in consultation with the franchisees;
 - The taxpayer company would be a non-profit enterprise governed by the principles of mutuality and will not be allowed to repatriate dividends.
- In furtherance to the approval from SIA, the taxpayer entered into a Tripartite Operating Agreement (Agreement) with YRIPL and its franchises. The key terms amongst others included the following:
 - The taxpayer would receive a fixed contribution of 5% of gross sales for conducting AMP for the mutual benefit of YRIPL and the franchises;
 - The funds would be allocated to the respective brand funds established;
 - YRIPL does not have an obligation but may contribute (on request from the taxpayer) at its discretion to support the AMP activities.
- The taxpayer filed its return of income for the Financial Year (FY) 2000-01 corresponding to the Assessment Year (AY) 2001-02, declaring 'Nil' income based on the principle of mutuality.
- The Assessing Officer (AO) did not accept the taxpayer's contention of the principle of mutuality (as YRIPL was not obligated to pay any contribution to the taxpayer) and taxed the excess of receipts over expenditure in the hands of the taxpayer.
- On appeal by the taxpayer, the addition was confirmed by the Commissioner of Income Tax (Appeals) on the basis that AMP activity carried out by the taxpayer was a critical component of running a successful business and thus, the principle mutuality was missing.
- On further appeal by the taxpayer, the Income-Tax Appellate Tribunal (ITAT) and the High Court (HC) confirmed the addition on the following basis:

¹ 116 taxmann.com 374 (SC)

- Taxpayer received contributions from Pepsi Foods Ltd (PFL) which was neither a franchisee nor a beneficiary. Further, YRIPL was not obligated to pay any contributions. Thus, the principle of mutuality was missing.
- The taxpayer appealed against the High Court's order before the Supreme Court (SC).

Provisions which are relevant for the case under consideration:

- The doctrine of mutuality refers to the principle that a man cannot engage into a business with himself. If the identity of the seller and the buyer; or the vendor and the consumer; or the contributor and the participator is marked by oneness, then a profit motive cannot be attached to such a venture.
- Thus, the excess of income over expenditure of such a venture is not taxable under the Indian domestic income-tax law on the lack of a profit motive.

Decision of the Supreme Court (SC):

- The SC held that existence of mutuality is a factual exercise. The SC relying on the case of Royal Western India Turf Club² and Bangalore Club², noted that the following three conditions / tests were relevant for existence of mutuality and examined them in the case under consideration:
 - Identity of the contributors to and the recipients from the fund;
 - Treatment of the company as an instrument obedient to their mandate; and
 - Impossibility that contributors should derive profits from contributions made by themselves.
- Condition 1: Identity of the contributors to and the recipients from the fund
 - The SC held that the members or participators and the beneficiaries in the mutual concern need to be common (viz. a person can contribute only if he is a beneficiary to the common fund and vice versa). This did not restrict inclusion or exclusion of members;
 - Further, the SC relied on the British Tax Encyclopedia³ and held that there should be completeness in identity of contributor and participator (viz. there was oneness or equality in sharing of surplus / profits) so that there is no interference by an outside party;
 - In the case under consideration, the SC noted that PFL was a contributor to the common pool of funds of the taxpayer. However, PFL did not participate in the surplus of the taxpayer as a beneficiary (as it was neither a member of the taxpayer nor did it have any right of participation in the surplus).
 - In view of the above and relying on the case of Royal Western India Turf Club and Bankipur Club⁴, the SC held that the taxpayer had realised money from both members and non-members in the course of same activity. Thus, the first condition of mutuality was not satisfied.

² Commissioner of Income Tax, Bombay City vs Royal Western India Turf Club Ltd. AIR 1954 SC 85

³ British Tax Encyclopaedia British Tax Encyclopedia (I), 1962 Edition, Pgs. 1200 and 1201

⁴ Commissioner of Income Tax, Bombay City vs Royal Western India Turf Club Ltd. AIR 1954 SC 85; Commissioner of Income Tax, Bihar vs Bankipur Club Ltd. [1997] 5 SCC 394

- Conditions 2 and 3: Non-profiteering and obedience to mandate

The SC noted the relevant clauses of the Agreement, conditions of the SIA approval and held that conditions 2 and 3 relating to the principle of mutuality were not satisfied due to the following reasons:

- The taxpayer received money from PFL (which did not have right to participate in surplus);
- The franchisees were obligated to contribute a fixed percentage for the conduct of AMP activities, whereas YRIPL was under no such obligation to pay the contribution. Thus, YRIPL had an overriding discretion over other members (i.e. franchisees) which resulted in a differential treatment;
- The taxpayer could refund surplus only after obtaining the approval of its board of directors (which was controlled by YRIPL). Thus, the franchisees could not claim a refund as a matter of right and could lead to a situation whereby YRIPL derived profit (by claiming refund of surplus) without any obligation to contribute;
- The Agreement relieved the taxpayer from specific obligation of spending contributions for the benefit of contributors;
- The true intention for the incorporation of the taxpayer was to manage the business of YRIPL at the national level;
- The taxpayer contravened conditions mentioned in the SIA approval.

In view of the above, the SC held that the taxpayer had failed to fulfill the conditions / test under Issue 1 relating to existence of mutuality and upheld the decision of the HC.

Comments:

- This ruling emphasises the key conditions required to be satisfied for achieving principle of mutuality viz.:
 - Common and completeness of identity;
 - Non-profiteering; and
 - Obedience to mandate.
- Taxpayers claiming exemption based on the principle of mutuality need to evaluate if there is any impact arising out of the case under consideration.



Deloitte refers to one or more of Deloitte Touche Tohmatsu Limited, a UK private company limited by guarantee, and its network of member firms, each of which is Deloitte refers to one or more of Deloitte Touche Tohmatsu Limited, a UK private company limited by guarantee ("DTTL"), its network of member firms, and their related entities. DTTL and each of its member firms are legally separate and independent entities. DTTL (also referred to as "Deloitte Global") does not provide services to clients. Please see www.deloitte.com/about for a more detailed description of DTTL and its member firms.

This material and the information contained herein prepared by Deloitte Touche Tohmatsu India LLP (DTTI LLP) is intended to provide general information on a particular subject or subjects and is not an exhaustive treatment of such subject(s). This material contains information sourced from third party sites (external sites).

DTTI LLP is not responsible for any loss whatsoever caused due to reliance placed on information sourced from such external sites. None of DTTI LLP, Deloitte Touche Tohmatsu Limited, its member firms, or their related entities (collectively, the "Deloitte Network") is, by means of this material, rendering professional advice or services. This information is not intended to be relied upon as the sole basis for any decision which may affect you or your business. Before making any decision or taking any action that might affect your personal finances or business, you should consult a qualified professional adviser.

No entity in the Deloitte Network shall be responsible for any loss whatsoever sustained by any person who relies on this material.

©2020 Deloitte Touche Tohmatsu India LLP. Member of Deloitte Touche Tohmatsu Limited