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Tax alert: Principle of mutuality not applicable on interest earned from fixed deposit with banks

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The Supreme Court has held that the principle of mutuality would not apply to interest income earned on fixed deposits made by clubs, in banks, irrespective of whether or not the banks are corporate members of the club and would be liable to be taxed in the hands of the club.

In a nutshell

The triple test for applying the principle of mutuality are as follows:

- the identity of the contributors and recipients of the common fund;
- the status of the association or company, as an instrument obedient to the mandate of its members; and
- the absence of possibility for contributors of the fund to derive profits from contributions made by them.

In order for the triple test to apply to the different and varied transactions of the clubs, it is necessary to lift the veil and discern the nature of each transaction: whether there is third party intervention which is the reason for earning the income; or it is an income generated between the members and the club, as such, i.e., only between the members of the club. When the transactions of the club are viewed in the aforesaid prism, then, it has to be discerned whether the principle of mutuality would apply in each of the transactions.

In relation to transaction, namely, deposit of surplus funds earned by the clubs in banks which are members of the club, the principle of mutuality applies till the stage of deposit of funds and would lose its application once the funds are deposited as FD in the banks. This is because the funds would be exposed to commercial banking operations which means that the deposits could be used for lending to third parties and earning a higher interest thereon and by paying a lower rate of interest on the FDs to the clubs.

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Background:

- The question for consideration before the Supreme Court (SC) under the subject appeals[1], was whether the deposit of surplus funds by the taxpayer clubs (Clubs) by way of bank deposits in various banks, would be liable to be taxed in the hands of the Clubs, or whether the principle of mutuality would apply and the interest earned from the deposits would not be subject to tax under the provisions of the Income-tax Act, 1961 (ITA)?
- The High Courts (HCs) in the cases under appeal, had uniformly held that the interest earned on the bank deposits made by the Clubs would be liable to be taxed in the hands of the Clubs and that the principle of mutuality would not apply.
- The subject litigation arose due to divergent rulings of various courts, especially SC[2]:
  - In an earlier ruling[3] covering 23 cases, the SC had classified them into 5 groups (Group A to Group E). Group E pertained to income earned from renting of rooms and interest earned from Fixed Deposits (FDs), National Savings Certificates (NSCs) etc. were de-linked. The cases in Group E were not decided, but in the remaining cases, the SC upheld the principle of mutuality as being applicable to the income earned by the Club and accordingly, had held such income to be exempt from payment of income tax.
  - Subsequent to delinking of the Group E cases, the SC, in a batch of appeals[4] which formed Group E cases, passed an order as under:

    "One of the questions which the High Court had decided in other cases relating to the same assessee was that the doctrine of mutuality applied and, therefore, the income earned by the assessee from the rooms let out to its members could not be subjected to tax. No appeal had been filed against the said decision and the matters stood concluded as far as the assessee was concerned. This being so, no useful purpose would be served in proceeding with the appeals on the other questions when the respondent cannot be taxed because of the principle of mutuality."
  - Thereafter, the SC in another ruling[5] denied the exemption which was earlier available (on the basis of above order), holding that the interest earned from the banks would not fall within the ambit of the mutuality principle and would therefore, be liable to income tax in the hands of the Club.

Decision of the SC:

The following points arose for consideration before the SC:

- Whether the judgment[5] of the SC would call for reconsideration in light of the order in an earlier ruling[4] ?
- Whether the interest on income earned by Clubs would be covered under the principle of mutuality and therefore be exempt from payment of tax?

In this regard, the SC noted /observed the following:

Ratio decidendi

- It is a settled position of law that only the ratio decidendi of a judgment is binding as a precedent.
- According to the well-settled theory of precedents, every decision contains three basic ingredients:

[1] Secundrabad Club etc. vs. CIT – V [2023] 153 taxmann.com 441 (SC)

[2] CIT vs Bankipur Club Ltd [1997] 92 Taxman 278 (SC), CIT vs Cawnpore Club Ltd [2004] 140 Taxman 378 (SC), Bangalore Club vs CIT [2013] 29 taxmann.com 29 (SC)

[3] CIT vs Bankipur Club Ltd [1997] 92 Taxman 278 (SC)

[4] CIT vs Cawnpore Club Ltd [2004] 140 Taxman 378 (SC)

[5] Bangalore Club vs CIT [2013] 29 taxmann.com 29 (SC)

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(i) findings of material facts, direct and inferential. An inferential finding of fact is the inference which the judge draws from the direct or perceptible facts;

(ii) statements of the principles of law applicable to the legal problems disclosed by the facts; and

(iii) judgment based on the combined effect of (i) and (ii) above.

For the purposes of the parties themselves and their privies, ingredient (iii) is the material element in the decision, for, it determines finally their rights and liabilities in relation to the subject-matter of the action. It is the judgment that estops the parties from reopening the dispute. However, for the purpose of the doctrine of precedent, ingredient (ii) is the vital element in the decision. This is the ratio decidendi. It is not everything said by a judge when giving a judgment that constitutes a precedent. The only thing in a judge's decision is binding on a party is the principle upon which the case is decided and for this reason it is important to analyse a decision and isolate from it the ratio decidendi.

- What is binding in terms of Article 141 of the Constitution is the ratio of the judgment and, the ratio decidendi of a judgment is the reason assigned in support of the conclusion. The reasoning of a judgment can be discerned only upon reading of a judgment in its entirety and the same has to be culled out thereafter.
- In a subsequent case, a decision cannot be relied upon in support of a proposition that it did not decide. Therefore, the context or the question, while considering which, a judgment has been rendered, assumes significance.
- As against the ratio decidendi of a judgment, an obiter dictum is an observation by a court on a legal question which may not be necessary for the decision pronounced by the court. However, the obiter dictum of the SC is binding under Article 141 to the extent of the observations on points raised and decided by the court in a case. Although the obiter dictum of the SC is binding on all courts, it has only persuasive authority as far as the SC itself is concerned.
- The precedential value of an order of the SC which is not preceded by a detailed judgment would be lacking inasmuch as an issue would not have been categorically dealt with. Further, the declaration of the law by the SC can be said to have been made only when it is contained in a speaking order, either expressly or by necessary implication, and not by dismissal in limine.

Whether the earlier order[4] constituted a binding precedent?

- While carefully reading the order, it could be discerned that the High Court (HC) had clearly spelt out that in the case of income earned from letting out of rooms/property to its members, the same would not be subjected to tax. On the aforesaid aspect, the Revenue had not filed any appeal before this court, and therefore, on that aspect, the matter should conclude in favour of the taxpayer therein.
- Further, without going into the other aspects of the case, it was noted that the taxpayer therein could not be taxed on the principle of mutuality. Therefore, it would not serve any purpose to proceed with the appeals on the other questions. What those other questions were had not been spelt out in the order nor had reasons been assigned as to on what aspect or activities of the said Club and its transactions, the principle of mutuality would apply. In the absence of there being any clear indication in the discussion or analysis and there being a simple closure of a case, it would clearly imply that the doctrine of mutuality would apply only to those activities to which it would normally apply.
- If an order is brief and meant only for the purpose of closure of the controversy involved in a particular case and with a view to conclude the case, undoubtedly, such an order is binding on the parties to the said order, but it cannot act as a precedent for subsequent cases.

Thus, the order passed in the earlier ruling,[4] was not a binding precedent which had to be followed in subsequent

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rulings[5] so as to make the latter decision per incuriam.

Principle of mutuality

- The principle of mutuality is rooted in common sense. A person cannot make profit from self. This implies that a person cannot earn profit from an association that he shares a common identity with.
- The essence of the principle lies in the commonality of the contributors and the participants who are also beneficiaries. There has to be a complete identity between the contributors and the participants. Therefore, it follows, that any surplus in the common fund shall not constitute income but will only be an increase in the common fund meant to meet sudden eventualities.
- The Privy Council in an earlier ruling[6] crystalized the triple test for applying the principle of mutuality:
  - the identity of the contributors and recipients of the common fund;
  - the status of the association or company, as an instrument obedient to the mandate of its members; and
  - the absence of possibility for contributors of the fund to derive profits from contributions made by them.

  Substantial emphasis was placed on the pricing of the services offered and the profit motive behind the same.
- Reference was also made to various cases from the countries England, America, Australia[7] on the aspect of principle of mutuality. Reference was also made to an earlier ruling[5] of the SC in this regard.

Whether principle of mutuality would apply on interest earned on FD made in banks by the Clubs?

- Banks utilising the funds of the clubs deposited in FD receipts, for their banking business, would completely rupture the "privity of mutuality" and as a result, the element of complete identity between the contributors and participators would be lost. Consequently, the first condition for the claim of mutuality would not be satisfied.
- The question asked therefore is – at what point does the relationship of mutuality end and that of trading begin? If there is an entry of a third party or non-member to deal with the contributions of or of funds of the club or to utilise the funds of the club and return the same with interest, then, the relationship of the parties is not on the basis of a privity of mutuality. The essential condition of mutuality, i.e., identity between the contributors and participators would end. The relationship would then be like any other commercial relationship such as that between a customer and a bank where the fixed deposit is made by the customer for the purpose of earning an interest income.
- If the principle of mutuality is to apply, then, where a number of people contribute to a fund are ultimately paid the surplus from the fund, it is a mere repayment of the contributors' own money. However, if the very same surplus fund is not applied for the common purpose of the club or towards the benefit of the members of the club directly, but is invested with a third party who has the right to utilise the said funds, subject to payment of interest on it, and repayment of the principal when desired by the club, then, in such an event, the club loses its control over the said funds.
- Conversely, when the facilities of the club are offered to members as well as to non-members for a price, there is a vital distinction between the transactions, i.e., between the club and its members vis-a-vis club and non-

[6] English and Scottish Joint Co-Operative Wholesale Society Ltd. vs. Commissioner of Agricultural Income-Tax [1948] SCC OnLine PC 41

[7] Trustees and Committee of Doctor's Cave Bathing Club vs. the CIT reported in (1971) UKPC 30, The Carlisle & Silloth Golf Club vs. Smith (1912) 6 TC 48, Revesby Credit Union Cooperative Ltd. vs. Federal Commissioner of Taxation (1965) 112 CLR 564, Commissioner of Taxation And: Australian Music Traders Association, (1990) FCA 261, Social Credit Savings and Loans Society Limited vs. Commissioner of Taxation (1971) 125 CLR 560 and Sydney Water Board Employees' Credit Union Limited vs. Commissioner of Taxation (1973) 129 CLR 446.

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members. When the facilities of a club are extended to the members of the club who contribute towards the income generated by the club, there is an identity between the contributors and the recipients and, therefore, the principle of mutuality would apply. However, if the same facilities of the club are offered to non-members or to the public for the purpose of earning an additional income, then, it is in the nature of a commercial transaction and thus becomes a profitable venture. In such a case, the principle of mutuality would not apply.

- In order for the triple test to apply to the different and varied transactions of the clubs, it is necessary to lift the veil and discern the nature of each transaction: whether there is third party intervention which is the reason for earning the income; or it is an income generated between the members and the club, as such, i.e., only between the members of the club. When the transactions of the club are viewed in the aforesaid prism then, it has to be discerned whether the principle of mutuality would apply in each of the transactions.

Thus, the SC held that the interest income earned by the clubs from the banks would not attract principle of mutuality and would be liable to be taxed in the hands of the club.

Conclusion:

In view of the above, the SC in the case under consideration, held the following:

— The order of SC in an earlier ruling[4] could not be treated as a precedent within the meaning of Article 141 of the Constitution of India, as the said order did not declare any law and the appeals filed by the Revenue as against the taxpayer in that case, were disposed of without going into the larger question as to whether taxpayer could be taxed on the interest income earned on FDs made by it in the banks, or whether the principle of mutuality would apply to the said income.

— The SC judgment in other ruling[5] would not call for reconsideration and is not per incuriam even though it had not considered the earlier order[4] of SC.

— Consequently, the principle of mutuality would not apply to interest income earned on FDs made by the taxpayer in the banks irrespective whether the banks are corporate members of the club or not. Thus, the interest income earned on FDs made in the banks by the taxpayer would be treated like any other income from other sources within the meaning of section 2(24) of ITA.

— Conversely, if any income is earned by the Clubs through its assets and resources, from persons who are not members of the Clubs, such income would also not be covered under the principle of mutuality and would be liable to be taxed under the provisions of the ITA.

Comments:

The test of applicability of the principle of mutuality to association clubs depends on facts of each case. Whether this principle of mutuality applies to interest income earned by such clubs from fixed deposit made in the banks has been a subject of litigation.

This ruling, while holding that the principle of mutuality would not apply to interest earned on FDs, has held / upheld the following principles:

- Only the ratio decidendi of a judgment is binding as a precedent. As against the ratio decidendi of a judgment, an obiter dictum is an observation by a court on a legal question which may not be necessary for the decision pronounced by the court. However, the obiter dictum of the SC is binding under Article 141 to the extent of the observations on points raised and decided by the court in a case. Although the obiter dictum of the SC is binding on all courts, it has only persuasive authority as far as the SC itself is concerned.

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  - the identity of the contributors and recipients of the common fund;
  - the status of the association or company, as an instrument obedient to the mandate of its members; and
  - the absence of possibility for contributors of the fund to derive profits from contributions made by them.

Considering the said principles, the SC in this ruling has held that the interest income earned by the clubs from the banks would not attract principle of mutuality and would be liable to be taxed in the hands of the club as:

- In order for the triple test to apply to the different and varied transactions of the clubs, it is necessary to lift the veil and discern the nature of each transaction: whether there is third party intervention which is the reason for earning the income; or it is an income generated between the members and the club, as such, i.e., only between the members of the club. When the transactions of the club are viewed in the aforesaid prism then, it has to be discerned whether the principle of mutuality would apply in each of the transactions.
- In relation to transaction, namely, deposit of surplus funds earned by the clubs, in banks, which are members of the club, the principle of mutuality applies till the stage of deposit of funds, and would lose its application once the funds are deposited as FD in the banks. This is because the funds would be exposed to commercial banking operations which means that the deposits could be used for lending to third parties and earning a higher interest thereon and by paying a lower rate of interest on the FDs to the clubs.

Taxpayers may want to evaluate the impact of this ruling to the specific facts of their cases.

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