

TAX FLASH NEWS

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Though an entity is operating under the non-profit principle, it is not eligible for tax exemption in the absence of elements of mutuality – Supreme Court

Recently, the Supreme Court in the case of Yum Restaurants (Marketing) Pvt Ltd.¹ (the taxpayer) held that the taxpayer had failed to prove the existence of mutuality and therefore the exemption cannot be granted. The Supreme Court observed that the taxpayer was realising money both from the members as well as non-members in the course of the same activity carried on by it. The moment a transaction opens itself to non-members, either in the contribution or the surplus, the uniformity of identity is impaired, and the transaction assumes the taint of a commercial transaction. Further for the conduct of Advertising, Marketing and Promotion (AMP) activities, holding company of the taxpayer was not under any obligation to make such contribution. It was a complete violation of the terms of approval. Further the franchisees did not enjoy any 'entitlement' or 'right' on the surplus remaining after the operations.

Facts of the case

The taxpayer, a 100 per cent subsidiary of an Indian company (YRIPL), is obligated to operate on a non-profit basis on the principles of mutuality. The taxpayer was formed for undertaking the activities relating to AMP activities for and on behalf of YRIPL and its franchisees. The taxpayer obtained an approval from Secretariat for Industrial Assistance (SIA) for the economisation of the cost of advertising and promotion of the franchise as per needs.

Subsequently, the taxpayer entered into a Tripartite Operating Agreement with YRIPL and its franchisees whereby the taxpayer received fixed contributions to the extent of 5 per cent of gross sales for the proper conduct of AMP activities for the mutual benefit of

YRIPL and its franchisees. The taxpayer was a non-profit making enterprise governed by the principle of mutuality.

During the Assessment Year (AY) 2001-02, the taxpayer declared excess of income over expenditure. However, in the return of income the taxpayer claimed exemption with respect to such excess income. The Assessing Officer (AO) held that the taxpayer had undertaken commercial activities and hence it was liable to pay tax. The Commissioner of Income-tax (Appeals) [CIT(A)] upheld the order of the AO and held that the AMP activities were quite critical component of running a successful business venture. It was intrinsically linked to sales and profit of the franchisees. Accordingly, it cannot be held that such activity was immune from the taint of commerciality.

The Tribunal observed that contributions was also received from a third-party vendor which was neither a franchisee nor a beneficiary of the taxpayer. Similarly, some contribution was also received from YRIPL which was not under any obligation to pay under the agreement. Some of the essential requirement that of the contributors to the common fund was missing e.g. participation in the surplus, beneficiaries of the contribution, etc.. Therefore, the principles of mutuality cannot be applied. The High Court upheld the order of the Tribunal.

Supreme Court's decision

Doctrine of mutuality

As per the doctrine of mutuality 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,

¹ Yum Restaurants (Marketing) Pvt Ltd v. CIT (Civil Appeal No. 2847 of 2010) - Taxsutra.com

then a profit motive cannot be attached to such a venture. Thus, for the lack of a profit motive, the excess of income over the expenditure cannot be regarded as 'income' taxable under the Income-tax Act, 1961 (the Act). Only 'income' or 'profits' or 'gains' is taxable under the Act as they accrue to a person in his dealings with other party or parties that do not share the same identity with the taxpayer. The Supreme Court referred various decisions² on the principle of mutuality.

The Supreme Court observed that the legal position on what constitutes a mutual concern has been settled. However, the factual determination of the same on a case to case basis poses a complex issue and it needs to be examined deeply.

Test of commonality

The first element involves the test of commonality that is of identity between the members or participators in the mutual concern and the beneficiaries thereof. This test requires that no person ought to contribute to the common fund without having the entitlement to participate as a beneficiary in the surplus thereof. Common identity, as it occurs in the present context, signifies that the class of members should stay intact as the transaction progresses from the stage of contributions to that of returns/surplus. It must manifest uniformity in the class of participants in the transaction. The moment such a transaction opens itself to non-members, either in the contribution or the surplus, the uniformity of identity is impaired, and the transaction assumes the taint of a commercial transaction.

The emphasis on the words *member* and *non-member* is of import because the doctrine of mutuality does not prohibit the inclusion or exclusion of new members. What is prohibited is the infusion of a participant in the transaction who does not become a 'member' of the common fund, at par with other members, and yet participates either in the contribution or surplus without subjecting itself to mutual rights and obligations. The principle of common identity prohibits any one-dimensional alteration in the nature of participation in the mutual fund as the transaction fructifies. Any such alteration would lead to the non-uniform participation of an external element or entity in the transaction, thereby opening the scope for a manifest or latent profit-based dealing in the transaction with parties outside the closed circuit of members.

Contribution from third-party

In the present case, the taxpayer was realising money both from the members as well as non-members in the course of the same activity carried on by it. The Supreme Court, in *Royal Western India Turf Club Ltd.* held that such operations to be antithetical to mutuality.

² CIT v. Bankipur Club Ltd. (1997) 5 SCC 394, Bangalore Club v. Commissioner of Income Tax & Anr. 2013) 5 SCC 509, New York Life Insurance Co. v. Styles (Surveyor of Taxes) 1889) 2 TC 460, The English and Scottish Joint Co-operative Wholesale Society Ltd v. Commissioner of Agricultural Income-tax, Assam- [AIR 1948 PC 142], CIT, Bombay City v. Royal Western India Turf Club Ltd- [AIR 1954 SC 85]

The basis of mutuality was missing as far as third-party vendor was concerned. Even if any indirect benefit was being reaped by third-party vendor, the same cannot be said to be in lieu of it being a member of the purported mutual concern and therefore, cannot be used to fill the missing links in the chain of mutuality. The surplus of a mutual operation was meant to be utilised by the members of the mutual concern as members enjoy a proximate connection with the mutual operation. Non-members have no proximate connection with the affairs of the mutual concern. Thus, the first limb of the three-pronged test stands severed.

Contribution from YRIPL

As per the terms of the SIA approval, YRIPL and franchisees were equally obligated to make contribution of a fixed percentage to the taxpayer. This requirement was incorporated as a pre-condition for the grant of permission to operate as a mutual concern. However, drifting from this mandate, the Tripartite Agreement made it discretionary upon YRIPL to contribute to the common pool, thereby putting it at a higher pedestal than the franchisees. Thus, clause in Tripartite agreement is not in conformity with the terms of approval. The Supreme Court observed that the participation of the franchisees in the management of the taxpayer was again subject to approval by YRIPL, which falls within its sole discretion.

On reference to the clause of the Tripartite agreement, it was observed that YRIPL and the franchisees stand on two substantially different footings. The franchisees were obligated to contribute a fixed percentage for the conduct of AMP activities whereas YRIPL was under no such obligation and hence it was a complete violation of the terms of SIA approval. Moreover, even upon request for the grant of funds by the taxpayer, YRIPL was not bound to accede to the request and enjoys a 'sole and absolute' discretion to decide against such request.

Test of participation in surplus of the mutual concern

On reference to the clause of the agreement it is clear that the franchisees do not enjoy any 'entitlement' or 'right' on the surplus remaining after the operations have been carried out for a given assessment year. The taxpayer may refund the surplus subject to the approval of its board of directors. It implies that the franchisees/contributors cannot claim a refund of their remaining amount as a matter of right.

The reason behind the refund of surplus to the contributors or mandatory utilisation of the same in the subsequent assessment year was to reduce their burden of contribution in the next year proportionate to the surplus remaining from the previous year. Thus, the fulfilment of this condition becomes essential.

In the present case, even if any surplus is remaining in a given assessment year, it is unlikely to reduce the liability of the franchisees in the following year as their liability to the extent of 5 per cent is fixed and non-negotiable, irrespective of whether any funds are surplus in the previous year. The only entity that could derive any benefit from the surplus funds is YRIPL. This is antithetical to the third test of mutuality.

The doctrine of mutuality, in principle, entails that there should not be any profit earning motive, either directly or indirectly. The third test of mutuality requires that the purported mutual operations must be marked by an impossibility of profits and this crucial test is also not fulfilled in the present case.

The taxpayer had acted in contravention of the terms of approval. The SIA approval was not only a binding document but also a conditional document with a defined set of preconditions for the functioning of the taxpayer as a mutual concern. The SIA approval categorically reads that the grant of approval is subject to the terms and conditions specified therein and any contravention thereof would be infraction of the mandate of the government approval.

Accordingly, the Supreme Court held that since the taxpayer failed to fulfil the stipulations and to prove the existence of mutuality, the tax exemption cannot be granted to the taxpayer.

Diversion of income overriding title

The Supreme Court observed that the law on what amounts to a case of diversion before accrual and what amounts to application post accrual is well settled. The Supreme Court referred to various decisions³. The Supreme Court observed that the question of diversion by overriding title was neither framed nor agitated in the appeal before the High Court or before the Supreme Court. Further, neither the Tribunal nor the High Court has dealt with the matter. The rectification application raising that ground is still pending before the Tribunal. Therefore, Supreme Court did not expresse any opinion either way as regards the tenability of the said application or otherwise.

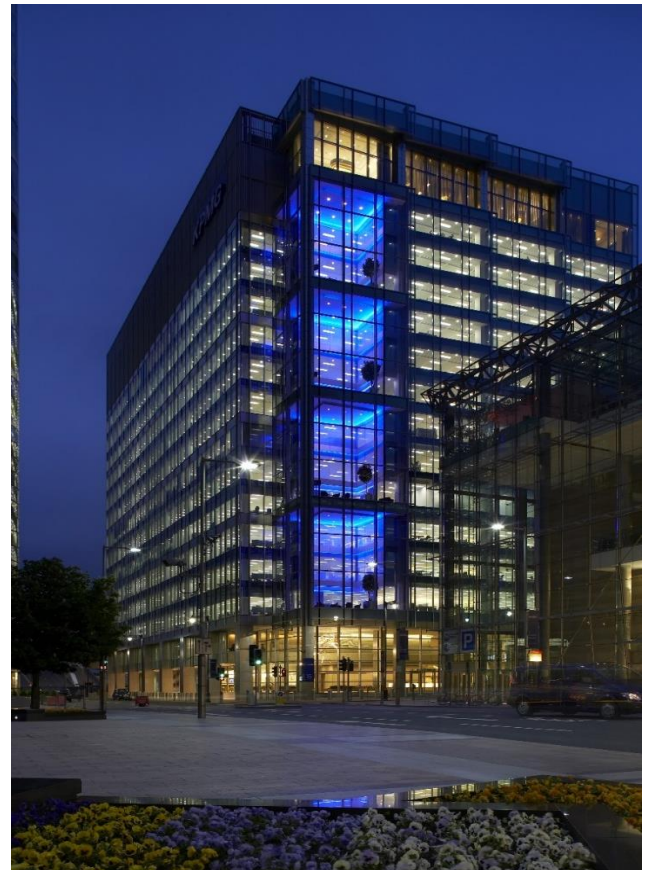
Our comments

In the case of Salem District Urban Bank Ltd⁴ the Madras Hugh Court held that a co-operative society, which carries on ordinary banking business with non-members also was not a mutual benefit society and it was not eligible for tax exemption. The Calcutta High Court in the case of Automobile Association of Bengal⁵ where the taxpayer running on no-profit basis, collected advertisements from both non-members

and members, held that the profits so made from advertisement went to increase the funds of the taxpayer and benefits out of the same came to the members but not qua contributors or advertisers and thus, there was absence of mutuality and profit made on the same was taxable.

On the other hand some of the Courts⁶ have held that merely because the taxpayer had entered into transactions with non-members and earned profits out of transactions held with them, right to claim exemption on the principle of mutuality in respect of transactions held by it with its members is not lost. The principle of establishing identity between the contributors and participators would apply only in respect of contributions made by the members. The Court concluded that the taxpayer being a mutual concern, the income derived from the property let out to its members and their guests and sale of liquor etc. to its members would not be taxable.

The Supreme Court in the present case has held that the taxpayer does not fulfill the conditions of the mutuality and therefore it's income was not eligible for tax exemption.



³ Dalmia Cement Ltd v. CIT (1999) 4 SCC 124, Associated Power Co. Ltd. v. CIT (1996) 7 SCC 221, CIT v. The Travancore Sugars & Chemical Ltd (1973) 3 SCC 274

⁴ CIT v. Salem District Urban Bank Ltd [1940] 8 ITR 269 (Mad)

⁵ Automobile Association of Bengal v. CIT [1968] 69 ITR 878 (Cal)

⁶ CIT v. Ranchi Club Ltd. 1992] 196 ITR 137 (Pat)(FB), Standing Conferecne of Public Enterprises [2009] 319 ITR 179 (Del)

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