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Huzaima Bukhari and Dr Ikramul Haq

Taxation: Doctrine of mutuality

It is an established principle that what is not "income" under the income tax law cannot be taxed, and where there is no sale of "goods" or providing and rendering of services between two persons, natural or juridical, there cannot be any indirect taxes (General Sales Tax or Value Added Tax). In this context, the understanding and application of doctrine of mutuality is of pivotal importance. This doctrine explicitly provides that for tax purposes a person cannot make a profit out of himself or trade with himself. By extension, this applies where persons carry on any activity, trade or profession in such a way that they and those with whom they deal with are the same persons, the said transaction will not give rise to taxable profits and even for indirect taxes no chargeability will arise. The principle is, thus the basis for exempting certain incorporated and unincorporated bodies, typically mutual insurance companies, societies and clubs.

The doctrine of mutuality is explained in some details in IBFD International Tax Glossary, Fifth Edition [Page 274]. In a joint article, written by Rahul Agarwal [Advocate, Allahabad High Court] & Rishabh Srivastava [B.A. LL.B. (Hons.) (3rd year), Maharashtra National Law University, Nagpur], published in All India Federation of Tax Practioners (AIFTP) Journal of September 2020, titled, Mutuality under The Income Tax Act – Origin & Development, aptly points out:

Taxes on income are taxes on moneys or profits generated by a person in their transactions with others. No assessee can generate real income out of himself, which can be taxed. The doctrine of mutuality postulates that when transactions are carried out between people in mutual association with each other, i.e. where they contribute to a common fund for the betterment of the contributors and generate returns therefrom, such returns are not taxable. The exemption granted to a mutual concern is premised on the assumption that the concern is being run for the mutual benefit of the contributors and the contributions made by the members ought to be directed in that direction. The contributions to the mutual concern are held in trust for the benefit of the contributors, and required to be spent accordingly.

[underlined by us authors for emphasis].

"The essence of mutuality lies in the return for what one has contributed to a common fund. In order to claim exemption based on the doctrine, the fund has to fulfill the foremost requirement that all its contributors must be entitled to participate in the surplus and that all the participants in the surplus should be contributors to the common fund. There has to be complete identity between the contributors to the fund and the participators in the surplus. In the case of clubs, their profits are exempted from tax liability because of the underlying notion that they operate for the common benefit of the members wishing to enter into a social exchange with no commercial intent. Furthermore, all the members of the club generally not only have a common identity in the concern but also stand on an equal footing in terms of their rights," they added.

In pre-independence days, in National Mutual Life Association of Australasia Ltd. v. Commissioner of Income Tax [1936] 4 ITR 44 (PC), the Privy Council disapproved the overlooking of principle of mutuality by the taxation officer and taxing the premium. This order of the Privy Council reversed the judgement reported as Commissioner of Income Tax v. National Mutual Life Association of Australasia Ltd. [1933] 1 ITR 350 (Bom.) upholding the action of taxation officer.

After independence, in Commissioner of Income Tax, Karachi v. Pak Threadball Manufacturers Association, Karachi [1967] 16 TAX 77 (H.C.Kar.), the Sindh High Court disapproved the order of the

Appellate Tribunal for ignoring "the resolutions of the Association under which the donations were collected from the members. The question, therefore, does arise if on the facts and in the circumstances of this case income of the assessee from "donations" is covered by exemption provided in section 10(6) of the Income Tax Act, 1922 based on the doctrine of the mutuality".

The most comprehensive and the only reported case on determining the test of applying doctrine of mutuality in Pakistan is reported as Commissioner of Income Tax, Lahore v. The Lyallpur Central Co-operative Bank Ltd., Lyallpur [1959] 1-TAX (III-150) (H.C. West Pakistan, Lahore Bench) =1959 PTD 639=1959 PLD 627. The following are brief facts and findings in this case:

The assessee was registered under the Co-operative Societies Act 1912. Up to 1948, income of all co-operative societies and banks was exempt from payment of tax, but on the 20th August 1948, the exemption was withdrawn. Shortly after this, the Central Board of Revenue issued a circular that profits earned by co-operative credit societies registered under the Co-operative Societies' Act 1912 from dealing with their own members would continue to be exempt under the doctrine of mutuality. The Income Tax Officer while making assessment for the charge year 1950-51 declined to exclude such profits from the income of the assessee on the ground that it was not derived on the basis of mutuality. The Appellate Assistant Commissioner upheld the Income Tax Officers' order on the ground that since the assessee's business consisted of financing Co-operative Societies and other parties and loans were not restricted exclusively to members, the income in question had arisen not because of the relationship between the assessee and its members but because of the loans advanced to them. The Appellate Tribunal accepted the assessee's contention that the doctrine of mutuality was applicable in case of income derived from members because one could not assess income arising to oneself.

[underlined by us the authors for emphasis]

After discussing a wealth of case law, the Department's reference in the above case failed and the Tribunal's finding was upheld. In this case their Lordships have considered the doctrine of mutuality at a great length, considering a number of cases cited at bar. Their Lordships laid down five point criteria in determining the applicability of the doctrine of mutuality. After applying the said criterion, their Lordships observed that interest on loans advanced to members of the assessee should be exempt from tax. The following cases were referred in this judgement:

Last v. London Assurance Corporation (2 Tax cases 100 CH. L.); Styles (Surveyor of Taxes) v. New York Life Insurance Company (2 Tax cases 460 CH. L.); Secretary, Board of Revenue (Income Tax) Madras v. The Mylopore Hindu Permanent Fund Ltd. 1 Income Tax cases 217 (Madras); Trichmopoly Tennore Hindu Permanent Fund Ltd., v. Commissioner of Income Tax Madras (1937 ITR 703); Commissioner of Income Tax Madras v. Salem District Urban Bank Ltd. (1940 ITR 269); The English and Scottish Joint Co-operative Wholesale Society Ltd. v. Commissioner of Agr. Income Tax Assam (1945 ITR 295); The English and Scottish Joint Co-operative Wholesale Society Ltd. v. Commissioner of Agr. Income Tax Assam (1948 ITR 270 (P.C.) and Municipal Mutual Insurance Ltd. v. Hills (16 Tax cases 430).

In the article, Mutuality under The Income Tax Act – Origin & Development, it is further explained: "Doctrine of mutuality also applies in indirect tax law. Applying the principle that no person can sell goods to himself, the turnover of sales of clubs, societies etc. has been held exempt from the purview of indirect tax laws [State of West Bengal v. Calcutta Club Ltd., and CTO v. Young Men's Indian Association (1970) 1 SCC 462 (5j).]

In New York Life Insurance Co. v. Styles (Surveyor of Taxes) [(1889) 2 Tax Cas 460.], the company issued life insurance policies of two kinds namely, participating and non-participating policies. There were no shareholders of the company in the ordinary sense of term, but each holder of a participating policy, ipso facto became a member of the company; each holder of a participating policy was entitled

to a share in the assets and liable for a share in the losses. The company calculated the probable death rate amongst its members along with the probable expenses liability and thereafter required its members to contribute premia. At the end of the year, accounts were drawn up. Greater part of the surplus of premia over the expenditure referable to the policies was returned to the members while the balance was carried forward as a fund to the credit of the general body of members. While considering the question whether the surplus returned was liable to be taxed, the majority of the judges held that "the members of the assessee company had merely associated themselves together for insuring each other's life on the principle of the mutual assurance and the returns were, therefore, not liable to tax".

There is another important elementary principle of income-tax law that a man cannot be taxed on profits that might have but has not been made [Sharkey (Inspector of Taxes) v Wernher [1956] reported as 29 ITR 962 (HL). This doctrine is based on the principle that the assessable profits must be real and they have to be ascertained on the ordinary principles of trading and commercial accounting. This principle is also elaborated in Kedarnath Jute Mfg. Co. Ltd. v. CIT [1971] 82 ITR 363 (SC).

In Sir Kikabhai Premchand v. CIT [1953] 24 ITR 506 (SC), it was held by the Indian Supreme Court that "there cannot be any element of profit if an assessee appropriate to himself part of his stock-in-trade". The concept of fictional sale and a fictional profit which in fact and in truth is non-existent goes against the concept of real income on commercial basis. It would then mean that "a man is selling to, and making a profit out of himself". It is against all canons of mercantile and income-tax law withdrawing of stock-in-trade by a businessman is not a business transaction and by the act of withdrawal no profit can be said to accrue to him. It is sufficient if the businessman has credited the business with the cost price of the stock so withdrawn.

Business arises out of commercial transactions between two or more persons. In Commissioner of Income Tax v Mazagaon Dock Ltd. [1955] 28 ITR 35 (Bom.), it was held: "Business is not a unilateral act. Business is brought about by a transaction between two or more persons, and if there is an activity which is business activity and that activity is carried on between two persons, then each is carrying on business with the other".

In the light of above binding case law of Pakistani courts and, it can be concluded that:

a. In the case of clubs, their profits are exempted from tax liability because of the underlying notion that they operate for the common benefit of the members wishing to enter into a social exchange with no commercial intent. Furthermore, all the members of the club generally not only have a common identity in the concern but also stand on an equal footing in terms of their rights.

b. Turnover of sales of clubs, societies, trusts etc. has been held exempt from the purview of indirect tax laws.

c. Even in the case of a mutual association, it is not necessary that every activity of the association is exempted from tax. An association may engage in activities which can be described as mutual and those that are not.

d. Life insurance premium and the surrendered value of policy are not taxable. The Central Board of Revenue [now renamed as Federal Board of Revenue and established under Federal Board of Revenue Act, 2007] in 1991 conveyed in C.No.ITJI-1(7)/84.Vol-I (pt-I) dated 28.08.1991: "I am directed to say that provisions of section 50(4) do not apply to payment of insurance premium and claims". This position is applicable under section 153 of the Income Tax Ordinance, 2001 as well in view of its section 239(12) which says: "Any notification issued under section 50 of the repealed Ordinance and in force on the commencement of this Ordinance shall continue to remain in force, unless amended, modified, cancelled or repealed by, or under, this Ordinance".

e. Mutuality is not destroyed by the presence of transactions which are non-mutual in character and mutuality can be confined in such cases to transactions with members. The two activities in appropriate cases can be separated and the profits derived from non-members, can be taxed.

f. In case, the object of the taxpayer is to carry on a particular business and funds are realised both from the members and from non-members, for the same consideration by giving the same or similar facilities to all alike in respect of the same business, and the dealings as a whole disclose, the same profit-earning motive, the activities of the taxpayer are tainted with commerciality and cannot claim exemption by relying upon the doctrine of mutuality.

The taxpayers in Pakistan engaged exclusively with their members, as corporate or incorporated entities, are not taking the benefit of doctrine of mutuality for want of proper advice or lack of assistance by tax authorities at federal and provincial levels. It is unjust and against the principles of stare decisis that in Pakistan has constitutional command. Usually, it is not recognised even in our professional circles that the rule is not merely a judicial theory but is regulated by the command of Constitution and statutory provisions of the Law Reports Act, 1875.

In the Constitution of Pakistan, the doctrine of stare decisis is reflected in Article 189 and 201, which reads as under:

"189. Any decision of the Supreme Court shall, to the extent that it decides a question of law or is based upon or enunciates a principle of law, be binding on all other courts in Pakistan."

"201. Subject to Article 189, any decision of a High Court shall, to the extent that it decides a question of law or is based upon or enunciates a principle of law, be binding on all courts subordinate to it."

Judgments of the Federal Shariat Court, a Service Tribunal, the Income Tax Appellate Tribunal and the National Industrial Relations Commission have the force of precedent which can be inferred from Explanation to section 5 of the Law Reports Act, 1875 which reads as follows:-

"Explanation: For the purpose of this Act the expression, Court or Tribunal includes the Federal Shariat Court, a Service Tribunal, the Income Tax Appellate Tribunal and the National Industrial Relations Commission."

As evident from the above, the doctrine of stare decisis has constitutional and statutory command and thus needs to be implemented in letter and spirit. Any violation of this rule will amount to violation of the Constitution and law of the land. It is further to be noted that pre-independence judgments are binding unless overruled by Pakistan courts [Ramkola Sugar Mills Ltd v CIT (1960) 2 Tax (Suppl. 29) (S.C.Pak)]. In view of this, under the binding judgements the doctrine of mutuality cannot be denied, wherever applicable, unless a specific statutory command overrides it.

(The writers, lawyers and partners in Huzaima, Ikram & Ijaz, are member Adjunct Faculty of Lahore University of Management Sciences (LUMS))