

CASE NOTES ON RECENT JUDGEMENTS BY INDIAN COURTS IN CLARIFYING THE NATURE OF CERTAIN ASPECTS OF COOPERATION THROUGH THE PERSPECTIVE OF TAXATION.

1. NATIONAL COOPERATIVE DEVELOPMENT CORPORATION V. COMMISSIONER OF INCOME TAX CIVIL APPEAL NOS. 5105-5107 OF 2009
2. K. 2058, SARAVANAMPATTI PRIMARY AGRICULTURAL CO-OPERATIVE CREDIT SOCIETY LTD. V. ITO (2020) 426 ITR 251 / 187 DTR 185/ 313 CTR 459 MADRAS HIGH COURT
3. INCOME TAX OFFICER VS. VENKATESH PREMISES COOPERATIVE SOCIETY LTD. CIVIL APPEAL NO. 2706 OF 2018, SUPREME COURT OF INDIA

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Introduction:

This paper will present thematic summaries of two recent judgements of the Supreme Court of India, and one judgement of the Madras High Court at Chennai, which concern cooperatives and the law on taxation in India. The judgements have been selected based on the significance the courts have accorded to the character of cooperative societies and organizations promoting them, as can be said to have been recognized within international public-policy² applicable to cooperatives and intended to safeguard the unique identity of the cooperative enterprise form, which comprises of cooperative values and principles, and the basis for a definition for its legal form.

The judicial system in India is the result of a long historical development in which many factors have played their part. Courts in the present system can be classified into three broad categories: higher judiciary, lower judiciary, and tribunals that are dedicated to various areas such as human rights, taxation, debt recovery, telecommunication, competition, companies, cooperative societies, etc. The higher judiciary consists of the Supreme Court and the High Courts that are established under or regulated by the Constitution. It is pertinent to note that several High Courts were functioning before the Constitution of India was adopted and that, the jurisdiction, powers and authority of the High Courts that pre-date the Constitution and as conferred by relevant enactments continue to be exercised today and have not been abrogated by the Constitution of India. The High Courts of Bombay, Madras, Calcutta and Allahabad were created by “Letters Patent” which is a document issued under the seal of the Sovereign under the Indian High Courts Act, 1861. Though the Supreme Court of India is entirely the

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² The term ‘international public policy’ has been used to refer to all those instruments of international law that countries have given upon each other chiefly through the resolutions of the General Assembly of the United Nations and through International Labour Standards.

creation of the Constituion of India, 1950, it is not incorrect to state that India is perhaps the first country in the world to have a Supreme Court of Judicature (Calcutta) which was established by the Regulating Act, 1773.

The following flow chart is aimed to explain the redressal of disputes concerning taxation in India.

Taxpayer (Assessee) - - *Files Returns* --> **Assessing Officer** -- *Taxpayer files appeal on rejection of return* --> **Commissioner of Income Tax (Appeals)** --> **Income Tax Appellate Tribunal** ---- *substantial question of law* --> **High Court** and --> **Supreme Court of India**

Case Notes:

1. National Cooperative Development Corporation v. Commissioner of Income Tax³

The first case note is on case in which the Supreme Court of India decided a 44-year-old dispute between National Cooperative Development Corporation (NCDC) and the Commissioner of Income Tax (CIT) on the taxability of funds received by the Union Government, surplus funds and interest arising out of it. This judgement did not opine on the nature of cooperative societies. It did, however, settle a long-standing dispute concerning revenue expenditure and capital expenditure concerning an organization instituted statutorily to promote and develop cooperatives.

The court made a reference to the Swedish legal system and in it, tax-transparency as its hallmark trait and that the law requires public disclosure of ex-ante tax administration such as advance rulings. It is pertinent to note here that the Constitution (Ninety Seventh Amendment) Act, 2011 gave cooperatives the status of local self-government and inserted inter-alia, Article 243ZO. (1) to empower the Legislature of a State to provide for access by every member of a cooperative society to the books, information and accounts of the cooperative society kept in regular transaction of its business with such member. The newly acquired status of cooperatives of being akin to Associations and Unions⁴ made it come under the purview of the Right to Information Act, 2005.

The NCDC (assessee) is established under the National Cooperative Development Corporation Act, 1962 (NCDC Act). It functions under section 9 to facilitate financial aid, start-up funds, loans, grants and subsidies to cooperative societies in India. NCDC is funded by way of grants and loans forwarded to it by the Union Government under the NCDC Act

³ Civil Appeal Nos. 5105-5107 of 2009/[2020] 47 ITR 288 (SC) [11-09-2020]

⁴ Article 19. Protection of certain rights regarding freedom of speech, etc.—(1) All citizens shall have the right

(a) to freedom of speech and expression;

(b) to assemble peaceably and without arms;

(c) to form associations or unions ²[or co-operative societies];

(d) to move freely throughout the territory of India;

(e) to reside and settle in any part of the territory of India; [and]⁴

(g) to practise any profession, or to carry on any occupation, trade or business.

section 12⁵, and, to maintain such monies with the NCDC fund created under section 13 (1) ⁶, the assessee invests surplus funds in fixed-deposits or term-deposits, which generate income. The issue that arose was whether the interest earned on the funds and disbursed as loans and non-returnable aid to national and state cooperative societies and federations, was eligible for a tax-deduction. The Assessing Officer of the Income Tax department rendered the opinion that non-returnable grants were capital expense and not a revenue expenditure, and thus not allowed for deduction. The matter was appealed and the Commissioner (Appeals) decided that the grants made by the assessee out of the interest generated by the fixed/term deposits were within the scope of its activities and were of a capital nature. They resulted in the acquisition of assets but not directly by the assessee. The Commissioner concluded that the assessee's expenditure, as it was related to its main business of extending loans and grants, was allowable for deduction- under section 37⁷ of the Income Tax Act.

The matter was taken to a second appeal, where this time, the Income Tax Appellate Tribunal set aside the order delivered by the Commissioner (Appeals) and held that the assessee received grants and other monies in a single fund under section 12 of the NCDC Act. That could not be treated as income and disbursements made from such a fund could be treated as revenue expenditure. The matter was further appealed at the High Court at Delhi where the court held that the central purpose and business of the assessee was receiving grants from the Government of India and forwarding them to cooperatives as loans. The interest earned from such loans fell under Chapter IV of the Income Tax Act as the profits and gains of business, being part of its normal business activity. The court said further that in order to claim for deductions as an item of revenue expense, the assessee had to first establish that its grants to state and national cooperatives, given from funds accumulated through interest earned on surpluses, were expenditure, and concluded that since the loans extended by the assessee did not irretrievably leave its 'hands', they could not be claimed as an expenditure. The law on taxation in India is quite straightforward in determining the taxation status of the assessee.

⁵ Section 12 (NCDC Act, 1962). Grants by the Central Government to Corporation.—The Central Government shall, after due appropriation made by Parliament by law in this behalf, pay to the Corporation— (a) by way of grant each year, such sum of money as is required by the Corporation for giving subsidies to State Governments and for meeting its administrative expenses; *** (b) by way of loan, such sum of money on such terms and conditions as the Central Government may determine; [and] [(c) such additional grants, if any, for the purposes of this Act.]

⁶ Section 13 (NCDC Act, 1962). Corporation to maintain fund.—(1) The Corporation shall maintain a fund called the National Co-operative Development Fund (hereinafter referred to as the Fund) to which shall be credited—(a) all moneys and other securities transferred to it under clause (a) of sub-section (2) of section 24; (b) the grants and other sums of money by way of loans paid to the Corporation by the Central Government under section 12; [(bb) all moneys received under section 12B; (bbb) all moneys received for services rendered;] [(ba) all moneys borrowed under section 12A;] (c) such additional grants, if any, as the Central Government may make to the Corporation for the purposes of this Act; and (d) such sums of money as may, from time to time, be realised out of repayment of loans made from the Fund or from interest on loans or dividends [or other realisations] on investments made from the Fund.

⁷ Section 37 of the Income Tax Act, 1961: in the case of an assessee, being an individual or a Hindu undivided family, any income chargeable under the head —Capital gains arising from the transfer of agricultural land, where— (i) such land is situate in any area referred to in item (a) or item (b) of sub-clause (iii) of clause (14) of section 2; (ii) such land, during the period of two years immediately preceding the date of transfer, was being used for agricultural purposes by such Hindu undivided family or individual or a parent of his; (iii) such transfer is by way of compulsory acquisition under any law, or a transfer the consideration for which is determined or approved by the Central Government or the Reserve Bank of India; (iv) such income has arisen from the compensation or consideration for such transfer received by such assessee on or after the 1st day of April, 2004. Explanation. —For the purposes of this clause, the expression —compensation or consideration includes the compensation or consideration enhanced or further enhanced by any court, Tribunal or other authority

(A) The Funds received from the Government of India are treated as capital receipts and are not tax-chargeable; (B) With respect to interest, gain on such grants is taxable.

The matter reached the Supreme Court in the 1970s where the Appellant argued that the Delhi High Court had erroneously discussed the issue as it was one of the loans as opposed to grants which was the subject matter of the reference. The Revenue Department contended that since the interest income was merged with the common fund, the monies lost their revenue character and became capital receipt and, that grants to national cooperatives were not in the course of trade and business of the assessee but an ‘application of income’ and therefore were not an expenditure of a capital nature. The Supreme Court stated that section 56⁸ of the Income Tax Act describing income from other sources, was in the nature of a ‘residuary clause’ which was to say that income of every kind which is not to be excluded from total income under the Income Tax Act is chargeable under this head if it is not chargeable under section 14⁹ heads A to E. The Court further stated “Tax transparency has been a hallmark trait of the Swedish legal system. Swedish law requires public disclosure of ex ante tax administration such as advance rulings. Both the taxpayer as well as the Swedish Tax Agency can request an advance tax ruling, these rulings are published without information identifying the taxpayer that requested them. The Skatterättsnämnden, or the Council for Advance Tax Rulings is the Swedish Government agency which is vested with this power. The advance ruling system has played a crucial role in Sweden’s position as a country with one of the highest tax compliance rates in the world. 19. The aim of any properly framed advance ruling system ought to be a dialogue between taxpayers and revenue authorities to fulfil the mutually beneficial purpose for taxpayers and revenue authorities of bolstering tax compliance and boosting tax morale. This mechanism should not become another stage in the litigation process.”

The Court allowed disbursement of irretrievable grants as a deductible expense since such grants were made out of monies earned as interest taxed and as business income and the assessee was able to demonstrate a link of such grants with the interest income. In other words, the Court ruled that the interest was used by the assessee to make further grant aid to cooperatives and that, the interest was revenue in nature and the grants were deductible against the taxable interest income. On the question of whether the merging of Government grants and interest income led to the money losing its nature as revenue, the Court held that as the interest income was already subject to tax as business income, the assessee could deduct grants given out of this interest income for tax purposes. The Supreme Court upheld the view of the Commissioner (Appeals)’s order that the grants made by the assessee fell within their authorised activities inter-linked with the main activity of advancing loans on interest to cooperative societies, and was thus deductible while computing business income.

⁸ Section 56 of the Income Tax Act, 1961. Income from other sources.—(1) Income of every kind which is not to be excluded from the total income under this Act shall be chargeable to income-tax under the head —Income from other sources, if it is not chargeable to income-tax under any of the heads specified in chapter IV, items A to E. (2) In particular, and without prejudice to the generality of the provisions of sub-section (1), the following incomes, shall be chargeable to income-tax under the head —Income from other sources

⁹ Section 14 of the Income Tax Act provides for the Computation of Total Income; Heads A – E cover income from Salaries, House property, Profits and gains of business of profession and Capital gains

2. K.2058, Saravanampatti Primary Agricultural Cooperative Credit Society v. Income Tax Officer, Non-Corp. Ward-2(5), Coimbatore¹⁰

This case dealt with section 80P¹¹ of the Income Tax Act, 1961 that provides for the deductions in respect of the income of cooperative societies. 9 Writ Petitions were filed by 9 Primary Agricultural Cooperative Credit Societies. The matters were taken up together as the issues arising were common. The petitioners had filed income returns claiming exemption under section 80P of the Income Tax Act.

The Assessing Officer (respondent) called for explanations of the assessee/petitioner in regard to investments, advances and loans in determining the deductions under the Act. The respondent opined that the income arising from deposits/investment of funds in banks was not deductible and liable to be taxed under section 56 of the Income Tax Act. The Assessing Officer relied on Totgars Cooperative Sale Society Ltd. Vs. Income Tax Officer¹².

The petitioners argued the Totgars case was different as Totgars was a sales society whereas they were Primary Agricultural Cooperative Credit Society and that, the funds that were deposited and gave rise to the interest were not surplus funds but a mandatory statutory reserve. In the case of Commissioner of Income Tax v. Nawanshahar Central Cooperative Bank Ltd.¹³, the Supreme Court observed that the nature of the statutory reserve which the petitioners in the case instant argued was not surplus funds, and that the orders rejecting the claim for special deduction of interest on the statutory reserve were not valid.

The Assessing Authority rejected the submissions of the petitioner stating that a statutory reserve can be considered surplus reserve. The High Court at Madras in this case stated that the assessee societies were registered under a legislation that mandated cooperatives to place a portion of their funds as a statutory reserve with a district cooperative bank, and that this reserve formed an essential feature of the operations of cooperatives and any interest generated therefrom would be operational income entitled to deduction under section 80P of the Income Tax Act.

The Court held “as regards to the claim of the assessees for exemption by application of the principle of mutuality and its rejection, there were cases of other identically placed agricultural cooperative marketing societies that the Department had carried or intended to carry to the Supreme Court”. Since the questions of law in this regard were still at large, the assessees had to file a statutory appeal before the Commissioner of Income Tax (Appeals). The matter is pending for further decision.

¹⁰ 2020 [426] ITR 251 (Madras) [31-01-2020]

¹¹ 80P. Deduction in respect of income of co-operative societies.—(1) Where, in the case of an assessee being a co-operative society, the gross total income includes any income referred to in sub-section (2), there shall be deducted, in accordance with and subject to the provisions of this section, the sums specified in sub-section (2), in computing the total income of the assessee.

¹² [2010] 322 ITR 283

¹³ [2007] 289 ITR 6

3. Income Tax Officer Vs. Venkatesh Premises Cooperative Society Ltd. Civil Appeal No. 2706 Of 2018, Supreme Court of India

This case led to one of the landmark judgements concerning the principle of mutuality and the charge of income tax based on the receipts by cooperatives from its members. In this case, a housing society was collected non-occupancy charges, transfer charges and others, and the question arose whether these charges were exempt from income tax.

The dispute of the tax authorities revolved around a notification dated 09.08.2001, issued under section 79A of the Maharashtra Cooperative Societies Act, 1960¹⁴ and its applicability on such societies. Relying on the notification, the revenue department contended that, as cooperative housing societies received service charges/ maintenance charges in excess of 10 per cent of the non-occupancy charges which was beyond the law, the principle of mutuality failed in such cases and that the receipts were in the nature of business, having an element of commerciality and hence, principle of mutuality does not apply.

The Assessing Officer held that non-occupancy charged levied by a cooperative from its members to the extent it was over 10% of the service charges stood excluded from the principle of mutuality and was taxable.

The Commissioner of Income Tax (Appeals) upheld this observation and further held that the transfer fee paid by the transferee member was liable to tax as the transferee did not have the status of a member at the time of such payment and, therefore, the principles of mutuality did not apply.

The High Court at Bombay, while dismissing the appeal of the tax department, ruled that the receipts of the societies were not in the nature of business income, generating profits/surplus and therefore, not taxable.

¹⁴ Section 79A - 2 [Government's power] to give directions in the public interest, etc.

(1) 3 [If the State Government, on receipt of a report from the Registrar or otherwise, is satisfied] that in the public interest or for the purposes of securing proper implementation of co-operative production and other development programmes approved or undertaken by Government, or to secure the proper management of the business of the society generally, or for preventing the affairs of the society being conducted in a manner detrimental to the interests of the members or of the depositors or the creditors thereof, it is necessary to issue directions to any class of societies generally or to any society or societies in particular, 4 [the State Government may issue] directions to them from time to time, and all societies or the societies concerned, as the case may be, shall be bound to comply with such directions. (2) 5 [The State Government may] modify or cancel any directions issued under subsection (1), and in modifying or cancelling such directions may impose such conditions as 6 [it may deem fit.] 7 [(3) Where the Registrar is satisfied that any person was responsible for complying with any directions or modified directions issued to a society under sub-sections (1) and (2) and he has failed without any good reason or justification, to comply with the directions, the Registrar may by order-- (a) if the person is a member of the committee of the society, remove the member from the committee and appoint any other person as member of the committee for the remainder of the term of his office and declare him to be disqualified to be such member for a period of six years from the date of the order; (b) if the person is an employee of the society, direct the committee to remove such person from employment of the society forthwith, and if any member or members of the committee, without any good reason or justification, fail to comply with this order, remove the members, appoint other persons as members and declare them disqualified as provided in clause (a) above: Provided that, before making any order under this sub-section, the Registrar shall give a reasonable opportunity of being heard to the person or persons concerned and consult the federal society if it is affiliated. Any order made by the Registrar under this section shall be final.

The matter reached the Supreme Court of India which held that the Doctrine of Mutuality was based on common law principles and was premised on the theory that a person cannot make a profit from himself and an amount received from oneself was therefore not an income and thus not taxable.

It further held that the surplus in the common fund of cooperative societies did not constitute income and was to meet sudden eventualities, and that the common feature of mutual organizations in general was **that** the participants did not have property rights to their share in the common fund, nor can they sell their share and cessation from membership, **which** would result in the loss of right to participate without receiving a financial benefit from the cessation of such membership.

Conclusion

There is no specific conclusion that is being offered but for the fact that there is a sound legal basis for equitable treatment for cooperatives as far as income and income tax are concerned. Two of the three cases noted in this article bring out this specific legal basis as being that concerning ‘exchange’ or ‘interaction’ among members as income or not. The higher judiciary in India has clarified the position as “not”. The specific developments in India and the legal reasoning the judgements have offered to clarify the existing understanding on cooperatives, could potentially encourage lawyers from jurisdictions other than India, to deduce further, the prevailing legal basis for according equitable and, where warranted, differential tax treatment to cooperatives especially for the financial results of transactions among members as well as reserve funds that are instituted within cooperatives for the direct benefit of members and their communities of operation.