No liability to withhold tax on payment made at cost to member company on the concept of mutuality

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In brief

In a recent judgement, the Mumbai Bench of the Income-tax Appellate Tribunal (Tribunal) has held that the payment made by the taxpayer, in accordance with the membership agreement, to its member entity, registered in Switzerland for coordinating the activities of the members, raising professional standards, etc., shall not be taxable on the basis of mutuality. On that basis, the Tribunal further held that the taxpayer is not required to withhold taxes under section 195 of the Income-tax Act, 1961 (Act) on such payments.

In detail

Facts

- The taxpayer[1], a partnership firm set up in India was engaged in the business of providing services to its clients, such as auditing, accounting, taxation, management consultancy, etc.
- The taxpayer was an Indian member firm of ABC International (ABCI), which was a non-commercial association established under the law of the Swiss Confederation. The object of ABCI was development, coordination, support promotion and facilitation of the operation of ABC member firms *vis-a-vis* their clients.
- The taxpayer entered into a partnership agreement and license agreement with ABCI. The taxpayer made certain payments to ABCI for discharging its function within the terms of the Membership Agreement. The taxpayer had not withheld tax on the payment made under section 195 of Act based on the contention that principle of mutuality applied in case of the taxpayer and that the amount remitted by the taxpayer outside India was in the nature of reimbursement of cost to ABCI.
- The Revenue in the proceedings under section 201 of the Act considered that the expenses incurred by the taxpayer on account of the reimbursement of cost was in the nature of "royalty" under section 9(1)(vi) of the Act, and the taxpayer was liable to withhold tax on the same under section 195 of the Act. Accordingly, the revenue authorities charged interest under section 201(1A) and the taxpayer was treated as a ""taxpayer in default".
- The Commissioner of Income-tax (Appeals) [CIT(A)], reversing the order of the Revenue, observed that ABCI was a mutual association and its receipt would not constitute the income chargeable to tax. Therefore, the CIT(A) held that the taxpayer was not obliged to withhold any tax on such receipt.

[1] TS-150-ITAT-2017(Mumbai-Tribunal)

- The Revenue was aggrieved with the order of the CIT(A) and filed an appeal before the Tribunal.

Issue before the Tribunal

Whether payments made by the taxpayer to ABCI was in the nature of royalty, and thereby, whether the taxpayer was liable to withhold tax on such payments under section 195 of the Act?

Taxpayer's contention

- ABCI was a mutual association/ organisation and the taxpayer was a member of organisation. ABCI helped in co-ordinating the activities of the members, doubling-up abilities and raising professional standards which required certain costs. As per the arrangement between the members, the costs of ABCI would be pooled by its member firms. Thus, the members had access to all benefits that arose from such membership and would accordingly reimburse their respective shares of cost incurred. According to the agreement, such reimbursement was granted on the basis of respective turnover of the member firms.
- ABCI did not charge any mark-up on the cost recovered from member firms and operated on no-profit and no-loss model. If surplus was generated, the same was adjusted in the subsequent year's contribution.
- The costs of ABCI were estimated at the beginning of the year and recovered from the member firms at the end of the year, the actual costs were taken into consideration and the share of cost of each member was determined.
- The principle of mutuality applied and the amount remitted by the taxpayer outside India was in the nature of reimbursement of costs to ABCI. Thus, the taxpayer was not liable to withhold tax at the time of payment.

Revenue's contentions

- The taxpayer acquired goodwill associated with the name of "ABC" and various other consequential benefits, additional and incidental incentives through payments made to ABCI. The payment to ABCI was for the use of the brand name, and therefore, covered by the definition of "Royalty."
- The relation between the taxpayer and ABCI was that of franchisee and not of a member of mutual association. The main objective of ABCI has a commercial taint and its elementary aim was to create an international chain of professionals who could practice across the globe by using its name and marks, in terms of making payments of percentage from the respective turnover.

Tribunal's ruling

- Under section 28(iii) of the Act, income derived by a trade, professional or similar association from specific services performed for its members was chargeable to income tax under the head "profits and gains of business or profession." The concept behind section 28(iii) of the Act is to cut at the mutuality principle being relied upon in support of a claim for exemption, when the taxpayer actually derives income as a result of rendering its specific services for its members in a commercial manner.
- The Tribunal relied on various decisions of the Supreme Court and High Courts[2] and emphasised the following settled principles on the principle of mutuality:
  - i) "A person cannot trade with himself" is the basic idea in the principle of mutuality. It is on this hypothesis that the income, which falls within the purview of the "doctrine of mutuality," is exempt from taxation.
  - ii) There must be complete identity between the contributors and the participants. This means identity as a class so that at any given moment of time the persons who are contributing are identical with the persons entitled to participate. It does not matter that the class may be diminished by persons going out of the scheme or increased by others coming in. At the same time, it does not mean that each member should contribute to the common fund or that each member should participate in the surplus or get back from the surplus precisely what they paid.
  - iii) The actions of the participants and the contributors must be in furtherance of the mandate of the association.
  - iv) There must be no scope of profiteering from the fund for contributors. The contributions made could only be expended or

[2] - CIT *v.* Royal Western India Turf Club Limited [1953] 24 ITR 551 (SC).
- CIT *v.* Bankipur Club Limited [1997] 226 ITR 97 (SC)
- Bangalore Club *v.* CIT [2013] 350 ITR 509 (SC)
- CIT *v.* Standing Conference of Public Enterprises (SCOPE) [2009] 319 ITR 179 (Del)

returned to themselves.

v) Simply because some incidental activity generates revenue, it does not give any justification to hold that it is tainted with commerciality and reaches the point where a mutual relationship ends and that of trading begins.

Applying the above principles to facts of the taxpayer, the Tribunal held that the taxpayer falls within the four corners of the ambit of the "Principle of Mutuality." On the said basis, the Tribunal further held that income would not be taxable in the hands of ABCI, and therefore, the taxpayer need not be required to withhold taxes on such payments.

The takeaways

The "Principle of Mutuality" is based on the concept that income derived from oneself cannot be treated as income. Although this principle does not evolve from the Act; however, the courts have accepted and applied this principle in many cases. Where one of the group companies has been created for rendering services at cost to other group companies and all other principles of mutuality are fulfilled, the argument of mutuality principle could be taken for non-withholding of taxes on payments made, besides the argument of reimbursement at cost.

Let's talk

For a deeper discussion of how this issue might affect your business, please contact your local PwC advisor

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