

**IN THE INCOME TAX APPELLATE TRIBUNAL
“C” BENCH : BANGALORE**

BEFORE SMT. BEENA PILLAI, JUDICIAL MEMBER
AND
SHRI LAXMI PRASAD SAHU, ACCOUNTANT MEMBER

ITA No.78/Bang/2024
Assessment year : 2017-18

Mudur Vyavasaya Seva Sahakari Sangha Ltd., Mudur – 576 233. Kundapura Taluk, Udupi District. PAN : AAAAM 5489N	Vs.	The Income Tax Officer, Ward 2, Udupi.
APPELLANT		RESPONDENT

Appellant by	:	Shri Mahesh R. Uppin, Advocate
Respondent by	:	Shri V. Parithivel, Jt.CIT(DR)(ITAT), Bengaluru.

Date of hearing	:	28.03.2024
Date of Pronouncement	:	29.05.2024

ORDER

Per Laxmi Prasad Sahu, Accountant Member

This appeal is filed by the assessee against the DIN & Order No.ITBA/NFAC/S/250/2023-24/1056186260(1) dated 18.9.2023 of the CIT(Appeals), National Faceless Appeal Centre, Delhi [NFAC], for the AY 2017-18.

2. The concise grounds of appeal are as under:-

“ 1. Whether both the below authorities were justified in holding that the 'concept of mutuality' was dislodged in Appellant

society even when the appellant society had 1,706 Regular Members, 111 Associate Members and 638 Nominal Members (as noted in para 4.3 —page 16-17 of appellate order) and appellant had not violated the cap of 15% meant for Associate members stipulated under the Proviso to Sec. 18 of KCS Act, 1959.

2. Was C.I.T. (A) justified in sustaining addition for Interest on Investments of Rs. 14,33,142/- derived from SCDCC Bank and Interest on S.B. Ales Rs. 41,222/- aggregating to Rs. 14,74,364/- to the returned income u/s. 56 of the Act and holding that the said income was not liable for deduction u/s. 80P of the Act.

3. Whether in law and on facts, does the action of both the below authorities sustainable in holding that Interest on S.B. A/cs of Rs. 41,222/- [SCDCC Bank Rs.10,209/- and IDBI Bank Rs. 31,013/-] derived by the appellant being in the nature of short term investments was taxable in view of the law laid down by —

(a) Hon. High Court of Karnataka in ITA307/2014 - Tumkur Grain Merchants Souharda Co-operative Ltd. vs. I.T.O. and ITA 29/2015 - Guttigedarara Credit Co-op. Society Ltd. Mysore Vs. ITO. and

(b) Hon. High Court of Judicature at Hyderabad in W.P. No. 12727 and 12767/2016 -The Vavveru Co-op. Rural Bank Ltd. and Anr. Vs. The Chief C.I.T. & anr. vis-a-vis the judgement in Totgars Co-operative Sale Society Ltd.;

4. It is submitted, the issue of interest derived from investments in term deposits with SCDCC Bank stands covered by the judgement of this Hon. Tribunal dated 18-07-2023 in !TA No. 376-379/Bang/2023 in The Totgars' Co-operative Sale Society Ltd. Sirsi Vs. ACIT, Hubli.

5. Whether the appellate authority was justified in sustaining the addition in respect of -

(a) differential provision for interest payable on deposits of Rs. 32,20,465/- on the ground that appellant was following Hybrid system of accounting; and

(b) debits found in the audited Profit & Loss A/c of the appellant, viz: N.P.A. provision Rs. 1,97,847/- and Gratuity

provision Rs. 20,000/- aggregating to Rs. 2,17,847/- in the impugned order;

6. Whether or not the addition sustained in appeal referred to in para 5 supra opposed to Sec. 40A(7) and Sec. 43(2) of the Act and run contrary to :

(a) CBDT Circular No. 37/2016 dated 02-11-2016 which gives the relief in respect of any disallowance of business expenditure by way of deduction under Chapter-VI A of the Act to the extent profits so enhanced by such disallowance; and

(a) the decision of Hon. Bombay High Court in C.I.T. vs. M/s. Gem Plus Jewellery India Ltd. and also the decision of this Tribunal in ITA No. 436/Bang/2023 in Shreerama Credit Co-op. Society Ltd. Kundapura vs. ACIT, Circle 1, Udupi.

7. The appellant craves leave to add, to amend, modify and / or to alter any of the foregoing grounds and also urge such other grounds at the time of hearing. ”

3. The brief facts of the case are that the assessee filed return of income on 03.10.2017 declaring total income of NIL after claiming deduction u/s. 80P of Rs.42,94,179 . The return was processed u/s. 143(1). The case was selected for scrutiny under complete scrutiny.

4. The AO noted that the society is having 3 categories of members. A class members participate in day to day affairs and C & D class members have no role in the management of society and have no voting rights. There were 1706 A class members, 638 B Class members and 111 D class members as per details given by the AO in para 3 of his order. The AO noted that A class members were 1706 and non-members were 749 (638 C Class Members and 111 D Class Members). The C & D Class members were more than 15% and there was violation of (amended) section 18 of the Karnataka Co-operative

Societies Act, 1959 [KCS Act]. The AO noted from the bye-laws, the definition of Members: the C & D Class of Members are not members and unequal rights among the A & C&D Class Members. The AO relying on Citizen Co-operative Society Ltd. (2017) 397 ITR (SC) issued notice proposing to disallow deduction u/s. 80P.

5. In response the assessee submitted that the society is providing credit facilities to its members and not engaged in banking business. Business is carried out exclusively with members. Definition of member is not given in Income Tax Act and hence section 2(f) of KCS Act will prevail which includes nominal and associate member. Therefore the judgment of Citizen Co-op. Society Ltd. (supra) is not applicable to assessee. The assessee submitted that it is eligible for deduction u/s. 80P(2) and relied on High Court of Karnataka judgment in CIT v. Sri Biluru Gurubasava Pattina Sahakara Sangha Niyamitha Bagalkot in ITA No.5006/2003 and Madras High Court judgment in TCA No.259/2016 in CIT v. Ammapet Primary Agricultural Co-op. Bank.

6. The AO observed that the facts were similar to Citizen Co-operative Society Ltd. (supra) and assessee had three categories of members and facts in the case of Sri Biluru Gurubasava Pattina Sahakara Sangha Niyamitha (supra) relied by the assessee are not applicable. The Madras High Court judgment in the case of Ammapet Primary Agricultural Co-op. Bank is as per Tamilnadu Co-op. Societies Act and the ITAT Bangalore decision in ITA

No.707/Bang/2019 was remanded back to the AO. The AO held that principle of mutuality is missing in assessee's case as held by the Hon'ble Apex Court in the case of Citizen Co-operative Society Ltd. (supra) . The AO therefore denied deduction u/s. 80P(2)(a)(i) and 80P(2)(d) of the Act and interest received on its investments from various banks and co-operative banks were assessed of Rs.14,74,364 as income from other sources.

7. The AO further noted that assessee is accounting for interest receipts on cash basis whereas it has debited the interest on deposits on accrual basis which is not allowable. The assessee submitted that as per Rule 22 of KCS Rules, the outstanding interest on members deposits is shown at the same time unrealized interest on loans is not accounted. This system is followed continuously and accepted system of accounting. The AO did not accept hybrid system of accounting and brought the excess provision of Rs.32,20,465 to tax.

8. The AO also noted that assessee has debited the provisions of employees gratuity fund – Rs.20,000, NPA provision Rs.1,97,847. The assessee submitted that gratuity provision for AY 2017-18 is already disallowed in the return of income. The NPA provision is in conformity with audit guidelines for bad and doubtful debts. Even if NPA provision is added back, the resultant increase in business profits will qualify for deduction u/s. 80P and consequently it would be of Nil tax effect. The AO treat the NPA provision of Rs.1,97,847 as unascertained liability and added to the income.

9. The AO noted that assessee has earned business profit of Rs.1,09,459 and claimed as deduction u/s. 80P. As per section 80P(2)(c) he restricted deduction to Rs.50,000 and observed that balance of Rs.59,459 was taxable. Since entire deduction claimed u/s. 80P(2)(a)(i) was already disallowed, no separate disallowance was made.

10. Aggrieved from the above order, the assessee filed appeal before the CIT(Appeals). The CIT(Appeals) relying on the decision of Citizen Co-operative Society Ltd. (supra) and Mavilayi Service Co-op. Bank Ltd. (Civil Appeal Nos.7343-7350 of 2019) and Karnataka High Court judgment in the case of Totgars Co-op. Sale Society [2010] 188 Taxman 282 (SC) sustained the disallowance made by the AO u/s. 80P(2)(a)(i) and 80P(2)(d) of the Act. The CIT(Appeals) further noted that the Hon'ble Supreme Court has gone into minute details for deciding the nature/character of principle of mutuality in para 25 to 28 of the judgment in the case of Bangalore Club [29 taxmann.com 29 (SC)] held that principle of mutuality is not satisfied in the case of assessee and dismissed the appeal of assessee.

11. Against the order of the CIT(Appeals), the assessee is in appeal before the ITAT.

12. The Id. AR reiterated submissions made before the lower authorities and submitted that assessee is eligible for deduction u/s 80P(2)(a)(i) as per judgment of Hon'ble Apex Court in Mavilayi Service Co-op. Bank Ltd. [2021] 123 taxmann.com 1 (SC) wherein it

is held that primary agricultural credit societies are entitled to the benefit of deduction u/s. 80P(2)(a)(i) of the Act on interest income earned from lending to members including nominal members. He submitted that interest income received on assessee's investments to another co-operative society are also eligible for deduction u/s. 80P(2)(d) because the co-operative banks are primarily co-operative societies as specified in section 80P(2)(d). He further submitted that the Id. CIT(A) has not considered the judgment in the case of Tumkur Grain Merchants Souharda Credit Co-op. Ltd. reported in 55 taxmann.com 447 and the ITAT decision in Totgars Co-operative Sale Society in ITA No.376 to 379/Bang/2023 wherein interest income earned from investment in co-operative bank by multipurpose co-operative society is held eligible for deduction u/s. 80P(2)(d) of the Act. He further submitted that the assessee is a primary agricultural co-operative society engaged mainly in the business of providing credit facilities to its members and providing financial aids as well as agricultural implements, seeds, fertilizers, pesticides etc. The assessee has earned interest on investments out of its operational fund used in business of lending to its members and not by investing surplus funds in short term deposits. The Id. CIT(A) has wrongly applied the judgment of Hon'ble Apex Court in the case of Totgars Co-operative Sale Society [2010] 322 ITR 283 and not considered that investment in co-operative bank is a statutory requirement under Karnataka Co-operative Societies Act, 1959. Hence it is attributable to carrying on of business and society is eligible for deduction u/s. 80P(2) of the Act.

He further submitted that interest income earned should not be taxed under the head income from other sources and it should be considered as business income. Even the assessee has not been granted deduction u/s. 80P(2)(d). The Id. CIT(A) has also not decided the issue in the light of Hon'ble Supreme Court judgment in the case of Kerala State Cooperative Agricultural and Rural Development Bank Ltd. in Civil Appeal No.10069/2016, order dated 14.09.2023 in which it has been held that co-operative bank is a co-operative society which is registered under Kerala Co-operative Societies Act and it is not a bank per se governed by RBI.

13. The Ld. DR relied on the order of the Ld.CIT(A) and he submitted that the interest income received by the assessee is not to be considered as a business income since the Hon'ble Jurisdictional High Court of Karnataka has settled this issue in the case of Totgars' Co-operative Sales Society Ltd. reported in (2017) 395 ITR 611 (Karnataka) dated 16.06.2017.

13.1 The Id. DR also submitted that the assessee has violated the principle of mutuality and relied on the judgment of Hon'ble Apex Court in the case of Citizen Co-operative Society Ltd. reported in (2017) 397 ITR 1 (SC) & Bangalore Club as relied by the Id. CIT (A). Accordingly the assessee is not eligible for deduction as observed by the lower authorities u/s 80P(2)(a)(i). He further submitted that in the case of Kerala State Co-operative Agricultural and Rural Development Bank Ltd. KSCARDB vs. Assessing Officer, (2023) 154 taxmann.com

305 the Hon'ble Supreme Court has clearly held that if the payer bank holds licence from RBI for carrying out banking business, then the interest received from such bank is not eligible for deduction u/s. 80P(2)(d), though the co-operative bank may be primarily formed as co-operative society and that the activity of the entity should be seen. He submitted that the interest received from co-operative bank is governed by Banking Regulation Act, 1949.

14. Considering the rival submissions, we note that the assessee is registered under Karnataka Co-operative Society Act 1959. During the course of assessment proceedings, the AO asked to submit details as per notice u/s 142(1) and the AO noted as per Bye-laws that there are A class members, B class members, & C & D Class members. These C & D Class members are Non-Members as per bye-laws of the society. A class members participate in day to day affairs, B Class of members is capital by State Government and C & D class members are (1) who does not possess A Class Shares (2) Non Members having deposits (3) Self-help Group, Commission Agents, individual Business, other businessmen etc. have no role in the management of society, have no voting rights & no entitlement for share in the assets or profits. The sec. 20(2)(a) of the Karnataka Co-operative Society Act denies any right to vote to a nominal or associate members. Further the Nominal/Associate members are not entitled to attend the general meetings of the society, not eligible to contest on election. As per bye-laws society collects Rs. 10/- from C Class Members & Rs. 100 for D Class Members as membership fee but there is no B Class members.

15. The AO further noted that A class members are 1706, C Class members are 638 and D Class Members are 111 as on 31/03/2017. The non-members are almost half of the regular members. The assessee is doing business with non-members and the profit from such business is divided among the members of the society. The Id. DR submitted that as per the Karnataka Co-operative Society Act sec. 18 amended by the Act 2014, the associated/nominal members should not exceed 15% of the regular members, if it exceeds, then it has to be regularized within the period of six months. We note that the lower authorities have disallowed deduction on interest income received from providing credit facilities from all the members by following the judgment of Hon'ble Apex Court in the case of Citizen Co-operative Society Ltd., Hyderabad Vs. ACIT noted supra. The decision relied on by the Id. AR in the case of Mavilayi Service Co-operative Bank Ltd., (supra) is under Kerala Co-operative Societies Act in which it has been held that proportionate deduction u/s. 80P(2)(a)(i) should be granted to the assessee from the interest income received from providing credit facilities to its members but not from the non-members. The Para 33 of the said judgement says as under:-

“.....Once it is clear that the co-operative society in question is providing credit facilities to its members, the fact that it is providing credit facilities to non-members does not disentitle the society in question from availing of the deduction. The distinction between eligibility for deduction and attributability of amount of profits and gains to an activity is a real one. Since profits and gains from credit facilities given to non-members cannot be said to be attributable to the activity of providing credit facilities to its members, such amount cannot be deducted.”

16. The ratio of Hon'ble Apex Court in the case of Mavilayi Service Co-operative Bank Ltd. (supra) is very much applicable for computing the income attributable to the business of the assessee among the members and non-members. The assessee is governed by Karnataka Co-operative Societies Act, 1959 and assessee has to follow section 18 (amended) Act of 2014 and bye-laws of the society. We note that Id. AO in para 4.3 has observed that class C & D category members do not have a right in share of profits of the assessee. However this is not clear from the bye laws reproduced in the assessment order. We also note from para 4.3 of the assessment order that the AO has observed as under:-

“Further, as per the byelaw of the assessee society, society collects Rs.10/- as nominal membership fee for C class members and are not allowed to contribute to the society by way of subscribing shares of the society and are not entitled for profits of the society.”

It is clear from the above observation from para 4.2 & 4.3 of AO, there is contradictory observation. In the event it is found that there is a violation of principle of mutuality in respect of share of profits earned by the assessee, the same cannot be claimed u/s. 80P(2)(a)(i) on such income. The assessee is directed to produce the quantum of interest income received to all the categories of members for AO to carry out necessary verification. Accordingly we remit this issue to the AO for fresh consideration and determination of the interest received from members and non-members from providing credit facilities and decide the issue as per law. The AO shall grant deduction on such interest

income u/s 80P(2)(a)(i) of the Act that satisfies principle of mutuality as per bye-laws. Accordingly this issue is partly allowed.

17. Further in respect of deduction u/s 80P(2)(d), considering the rival submissions, we note that here the issue is that whether the assessee is eligible to claim of deduction u/s. 80P(2)(a)(i) and/or 80P(2)(d) on the interest income earned on its investments amount made with District co-operative banks. The Ld.CIT(A) has not accepted the claim of the assessee by relying on the judgment of Hon'ble Karnataka High Court in case of Totgars' Co-operative Sales Society Ltd. (supra) and Hon'ble Apex Court in the case of Citizens Co-operative Society Ltd. noted supra. During the course of hearing, the Ld.AR of the assessee relied on the Circular No. 18/2015 dated 02.11.2015 and submitted that as per the provisions of the Karnataka Co-operative Societies Act, the assessee is required to maintain SLR from the deposits received from the members and has to invest 100% from the general reserve and 25% from the deposits collected from members. Accordingly, assessee has invested in the fixed deposits. As per the circular, the income received from the investments should be treated as business income u/s. 28 and assessee is eligible to make a claim of deduction u/s. 80P(2)(a)(i) as business income. Further, the assessee also submitted that the investments were made in co-operative banks which are co-operative society. It is submitted by the ld. AR that interest received on such investments are to be allowed for deduction u/s. 80P(2). In support of his argument, the assessee relied on the following decisions:

- (i) Mavilayi Service Co-op. Bank Ltd. [2021] 123 taxmann.com 1 (SC).
- (ii) Tumkur Merchants Souharda Credit Co-op. Ltd. reported in 55 taxmann.com 447.
- (iii) ITAT decision in Totgars Co-operative Sale Society in ITA No.376 to 379/Bang/2023.
- (iv) Guttigedarara Credit Co-op. Society Ltd., Mysore, ITA 29/2015
- (v) Honnali Credit Co-opp. Society Ltd. ITA No.2752 & 2753/Bang/2017.
- (vi) Trapaj Vibhageeya Khet Udyog Mal Rupantar Food Processing Sahakari Mandali Ltd. v. DCIT, Cir. 2, Bhavnagar.

18. We note from plain reading of Circular No. 18/2015 dated 02.11.2015 it is applicable to those co-operative societies / co-operative banks in which the Banking Regulation Act, 1949 applies. During the course of hearing the assessee was asked to submit the requirement of SLR as per Karnataka Cooperative Societies Act and the quantum and period for calculating SLR, the assessee was unable to give reply. Rule 23 of the Karnataka Co-operative Societies Rules states that reserve fund belongs to the society and is intended to meet the unforeseen losses. Further if the cooperative society wants to invest reserve fund or any portion thereof for any other purpose as prescribed under section 58 (a) to (d) of the Karnataka Co-operative Societies Act permission is to be taken from the Registrar of Co-operative Societies. Therefore the argument of the assessee that interest income on such investment is operational income is rejected. Even if the maintainability of SLR requirement is out of internal fund/external funds then no deduction shall be allowed u/s. 80P(2)(a)(i), since the interest income received on such investments from co-operative banks

is not attributable to main business of the appellant. The issue regarding the word “attributable” has been discussed elaborately by the Hon’ble Apex Court in the case of M/s Totgar’s Co-operative Sales Society (2010) reported in [2010] 188 Taxman 282 (SC) where it is held by the Hon’ble Supreme Court that the deduction u/s 80P is available only to the income which is attributable to the business operation. Since the interest income received by the appellant was not attributable to the main business of the appellant the same is not allowable as deduction u/s 80P(2)(a)(i) of the Act.

19. We note from the submissions of the Id. AR that the assessee has invested in commercial bank as well as in co-operative banks and earned interest thereon. Section 80P(2)(d) describes that if the assessee has received interest from the co-operative society, then the assessee is eligible for claim of deduction on such interest received. In the judgment of Hon’ble Apex Court in the case of Kerala State Co-operative Agricultural and Rural Development Bank Ltd. (KSCARDB) vs. The Assessing Officer, Trivandrum & Ors. (2023) 154 taxmann.com 305 (Supreme Court) it has been discussed in detail the definition of co-operative banks and co-operative society. If the payer bank falls under the definition of co-operative bank/ bank in the light of the judgment of Hon’ble Apex Court then the assessee is not eligible to get deduction u/s. 80P(2)(d) on such interest income received from co-operative banks. We note that the assessee has also received interest from co-operative banks which is governed by the Banking Regulation Act of 1949 and this argument of the Id. DR has not been denied by the

ld. AR of the assessee. The Section 80P(2)(d) describes that if the assessee has received interest/dividend from the co-operative society, then the assessee is eligible for claim of deduction on such interest/dividend, however we note that the assessee has received interest from co-operative bank but it is not clear whether the interest payer (co-operative bank) is a bank and registered with Reserve Bank of India and holding licence from RBI for carrying out banking business as per RBI Act. In addition, the judgment of Hon'ble Apex Court in the case of Kerala State Co-operative Agricultural and Rural Development Bank Ltd. KSCARDB vs. The Assessing Officer, Trivandrum & Ors. (supra) in which it has been discussed in detail the definition of co-operative banks and co-operative society. If the payer bank falls under the definition of co-operative bank in the light of the judgment of Hon'ble Apex Court then the assessee is not eligible to get deduction u/s. 80P(2)(d) on such interest income received from co-operative banks, therefore this issue is also remitted back to the AO for verification of interest received from co-operative bank in above terms. If AO finds that the co-operative bank is carrying its banking business activities in the light of the above judgment, the deduction u/s. 80P(2)(d) on such interest income should not be granted.

20. We further note that the assessee has received interest from other co-operative banks/commercial banks on its investments. The revenue authorities have considered the entire interest as income from other sources u/s. 56 including the interest received from co-operative bank and no expenses u/s. 57(iii) has been allowed to the assessee for

earning of such income. While calculating the income, the net income should be considered as taxable income after reducing the expenditure incurred towards earning of such income. Therefore relying on the judgment of Hon'ble Jurisdictional High Court in case of Totgars' Co-operative Sales Society Ltd. vs ITO Sirsi, reported in (2015) 58 taxmann.com 35 (Karnataka), the assessee is eligible for claim of its cost of funds on the interest income received from banks. Reliance is also placed on the judgment of Co-ordinate Bench of the Tribunal in case of The West Coast Paper Mill Employees Souharda Credit Co-op. Ltd. Accordingly, the assessee is directed to provide the details of cost of funds before the assessing officer. Therefore for allowing cost of funds, we are remitting this issue to the assessing officer for determining the cost of funds for earning entire interest income from bank (co-operative bank and scheduled bank).

21. In respect of ground No. 5(a) the specific contention of assessee is that these expenditures are ascertained liabilities as on the date of closure of books of accounts. The objection raised by the Revenue is that the assessee is maintaining hybrid system of accounting. The interest receipts on loans and advances are recorded on receipt basis whereas it has debited the interest on deposits on accrual basis. The assessee reiterated the submissions before the lower authorities and submitted that the assessee is following Rule 22 of Karnataka Co-operative Societies Rules, 1960. We noted that the assessee should have followed the mercantile system of accounting for computing income for the year under consideration. The assessee is following

cash system for receipt of interest on deposit, however for payment of interest it is following accrual system of accounting which is not permissible. There should be matching concept for determining the income and expenditure. Further in respect of ground No.5(b) the assessee has made provision for NPA of Rs.1,97,847 and gratuity provision of Rs.,20,000, these are merely provisions and it is not ascertained liability which are not allowable. Accordingly we uphold the addition sustained by the CIT(Appeals). However, the disallowances sustained will increase the business profits of assessee. The assessee is eligible for proportionate deduction u/s. 80P(2)(a)(i) of the Act as discussed above in para no. 16 above. As per CBDT Circular No.37/2016 dated 02.11.2016 the assessee is eligible for deduction on such increased profit if these disallowances are not part of the income from other sources. The AO is directed to allow deduction u/s. 80P(2)(a)(i) on such increased profit proportionately.

22. In the result, the appeal of the assessee is partly allowed for statistical purposes.

Pronounced in the open court on this 29th day of May, 2024

Sd/-

(BEENA PILLAI)
JUDICIAL MEMBER

Sd/-

(LAXMI PRASAD SAHU)
ACCOUNTANT MEMBER

Bangalore,
Dated, the 29th May, 2024.

/Desai S Murthy /

Copy to:

1. Appellant
2. Respondent
3. Pr. CIT
4. CIT(A)
5. DR, ITAT, Bangalore.

By order

Assistant Registrar
ITAT, Bangalore.