Case No. D 1/79

Board of Review:

S. V. Gittins, *Chairman*, E. J. S. Tsu, Professor P. G. Willoughby & K. W. Young, M*embers*.

13 July 1979.

Profits tax – credit union – liability to tax – application of the mutuality principle – taxpayer a club.

The Deputy Commissioner of Inland Revenue by his Determination confirmed assessments for profits tax for the years of assessment 1971/72, 1972/73, 1973/74, 1974/75 and 1975/76, made against the taxpayer, a credit union. The assessments consisted of the surpluses of income over expenditure for each of the said years. The taxpayer appealed against the Determination. The appellant contended, as its first ground of appeal, that it was a mutual concern and that its surpluses were not assessable income for the purposes of Profits Tax and, as its second, that it came within section 24 of the Inland Revenue Ordinance.

On appeal the Board held that the mutuality principle did not apply to the appellant. The first ground of appeal therefore failed. As to the second ground, the Board took the view that, on the facts of the case, the appellant came within the definition of "club" as defined in the Oxford English Dictionary, meaning, *inter alia*, an association formed to combine the operations of persons interested in the promotion or prosecution of some object and, therefore, the appellant carried on a club or similar institution within section 24(1) of the Ordinance.

Decision: Appeal allowed on second ground of appeal. Assessments appealed against annulled.

B. H. Tisdall for the appellant.
A. K. Gill for the Commissioner of Inland Revenue.

Case referred to: -

1. Sydney Water Board Employees' Credit Union Ltd. v. Federal Commissioner of Taxation, (1973) 4 A.T.R. 157.

Reasons:

1. The Taxpayer has appealed to the Board of Review against the Determination of the Deputy Commissioner of Inland Revenue confirming assessments for profits Tax for the years of assessment 1971/72, 1972/73, 1973/74, 1974/75 and 1975/76.

2. The assessments consist of the surpluses of income over expenditure for each of the said years of assessment.

3. The grounds of appeal are: -

(a) that the Taxpayer is a mutual concern and that its surpluses are not assessable income for the purposes of profits tax;

(b) that the Taxpayer comes within section 24 of the Inland Revenue Ordinance, Cap. 112.

4. Facts found by the Deputy Commissioner which are set out in his Determination and are not disputed by the Taxpayer are as follows: -

(a) The objects, operations and management of a credit union are governed by its memorandum of association and by-laws.

(b) Paragraph 3 of Article I of the Union's By-laws states that its objects are: -

"(i) to act as a co-operative, non-profit association for the purpose of creating a source of credit available to its members at a fair and reasonable rate of interest;

(ii) to receive the savings of its members as payment on shares;

(iii) to promote thrift among its members; and

(iv) to make loans to its members, exclusively for provident or productive purposes."

(c) Article IV of the Union's By-laws provides for the issue of members' shares and provides, *inter alia*, for the manner of subscriptions, transfer, withdrawal and maximum holdings.

(d) Article VI of the Union's By-laws lays down rules for the granting of loans. Loans may be made only to members. Paragraph 26 of the Article limits loans to directors and members of the Supervisory and Credit Committees to the value of the borrower's shareholding in the Union, except where a loan in excess of that amount is approved "upon the unanimous vote of a majority of the Board, the Supervisory Committee and the Credit Committee, sitting together". Loans to members

generally are not so limited, but are subject to the Board's Loan Policy and the terms and conditions determined by the Credit Committee in each case.

(e) Article XIII provides for the creation of a Reserve Fund equal to 20% of the Union's net earnings annually. Pursuant to section 45 of the Credit Unions Ordinance, the Fund is kept as a reserve against losses incurred from loans made. There is a prohibition on the making of loans to members from the Fund.

(f) Article XIV provides for the disposal of annual surpluses, namely by –

(i) the placing of sums to the Reserve Fund;

(ii) the payment of an annual dividend to members, not exceeding 6% on all fully paid shares;

(iii) the appropriation of funds for the attainment of the objects of the Union or the credit union movement.

(g) The By-laws also make provision for, *inter alia*, the appointment of directors and committees, the operation of bank accounts, the power to borrow in furtherance of the Union's objects, and other matters pertaining to the constitution, management and operation of the Union.

5. At the hearing before the Board Mr. A gave evidence *inter alia* as follows: -

(a) The purpose of the Credit Union movement, which is world wide, are to promote fellowship and mutual help, promote thrift, and to provide financial assistance among persons having a common bond.

(b) These are the purposes of the Taxpayer [see paragraph *4(b)* above].

(c) Loans are only made to members and only for provident or productive purposes.

(d) In answer to questions by the Commissioner's representative: all borrowers pay interest on their loans, all subscribers receive dividends on their shares, and some subscribers do not borrow.

The Board accepts the evidence of Mr. A set out above and finds accordingly.

6. As to the first ground of appeal, for the mutuality principle to apply there must be "complete identity between contributors and participators" (see *Whiteman and Wheatcroft on Income Tax*, 2nd ed. 253). In the present case only borrowers from the Taxpayer contribute to the surpluses whereas all its members, borrowers and non-borrowers, participate in the surpluses.

7. In the Australian case of **Sydney Water Board Employees' Credit Union Ltd. v. Federal Commissioner of Taxation**[1] the Full High Court of Australia at 163 said –

> "Once attention is given to the relationship which exists between the taxpayer and its borrowing members (who, according to the argument, comprise the relevant class of contributors), and the nature of the transactions in which they engage, it is apparent that the mutuality principle has no application here."
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> "The so-called 'contributors', the borrowing members, are, as the facts show, a proportion only of the total class of members. The taxpayer was not incorporated as a convenient agent for them, as distinct from the entire class of members. The suggestion that the amount of interest paid in a particular year is the common fund is artificial for neither the taxpayer's rules, nor its accounts, nor its mode of conducting business lends any support to the suggestion or to the notion that it is a fund in which the borrowing members as a class have any rights. Indeed, the suggestion is at odds with the concept which underlies the objects of the credit union, that is, that a fund will be created from loans by members having money to lend at interest and that the fund will be lent at interest to members desiring loans."
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> "In other important respects the circumstances do not come within the mutuality principle. Interest is paid by borrowers in discharge of a legal obligation to pay it; when paid it forms part of the general funds of the taxpayer to be dealt with as it thinks fit; payment by a borrower is not in any sense a pre-estimate of the amount which will be required to meet his proportion of mutual liabilities incurred on behalf of all borrowers; nor is interest paid on the footing that there will be a refund to the borrower of any part of the payment which is not required to meet mutual liabilities.".

8. We adopt the principles set out in the Australian case and hold that the mutuality principle is not applicable to the Taxpayer. We would add that the United Kingdom has recently enacted a Credit Unions Act 1979 (c.74) section 25 of which provides for exemption from Corporation Tax for credit unions. The fact that it was thought necessary to create such an exemption in the United Kingdom, where the principles governing mutual trading are similar to those applicable in Australia and Hong Kong, is in our opinion support for the approach adopted by the Full Court of Australia. The first ground of appeal therefore fails.

9. As to the second ground of appeal, section 24(1) of Cap. 112 states –

> "Where a person carries on a club or similar institution which receives from its members not less than half of its gross receipts on revenue account (including entrance fees and subscriptions), such person shall be deemed not to carry on a business; but where less than half of its gross receipts are received from members, the whole of the income from transactions both with members and others (including entrance fees and subscriptions)

[1] (1973) 4 A.T.R. 157.

shall be deemed to be receipts from a business, and such person shall be chargeable in respect of the profits therefrom."

10. It was conceded by the Revenue that the Taxpayer received from its members more than 50% of its receipts on revenue account. Taxpayer is therefore left to satisfy the Board that it "carries on a club or similar institution".

11. In his determination of the Taxpayer's objection the Deputy Commissioner of Inland Revenue considered that "the members of a credit union join principally to take advantage of the borrowing facilities and to receive dividends on the shares they hold (i.e. the gain they receive as members)". In the light of the gain factor the Deputy Commissioner thought that the Taxpayer could not be regarded as a "club or similar institution" for the purposes of section 24(1).

12. The Inland Revenue Ordinance does not define the words "club or similar institution" and the Deputy Commissioner relied upon the definition in 6 Halsbury's Laws of England, 4th ed. at 201.

13. 6 Halsbury's Laws of England, 4th edition 201, states: -

"*Definition.* A club, except a proprietary club or an investment club, may be denned as a society of persons associated together, not for the purposes of trade, but for the purposes of social reasons, the promotion of politics, sport, art, science or literature, or for any other lawful purpose; but trading activities will not destroy the nature of a club if they are merely incidental to the club's purposes."

And at 282 –

"Taxation. A members' club is not ordinarily carried on with a view to making a profit and is not liable to income tax on the result of mutual transactions with its members. The element of mutuality exists where persons associate together to achieve an object for their mutual benefit, all the contributors to the common fund being entitled to participate in the surplus and all the participators in the surplus being contributors to the common fund. If the club facilities are extended to non-members, this element of mutuality is lacking and to that extent the resulting profits are liable to corporation taxation.".

23 Halsbury 1344 –

"*Clubs and societies.* Members' clubs and societies, where the members are also the owners of any assets and the facilities are not available to non-members, are not liable to income tax under Cases I or II of Schedule D, or corporation tax, because they do not carry on a trade. They are liable to tax on interest, dividends, rents etc. under the appropriate Cases or Schedules. This is the case even where the members have formed a company and surplus subscriptions are carried to reserve and not immediately returned. It is necessary that the contributors should be the same people as those entitled to share in

the surplus. If such a club or society trades with non-members it is liable to tax on the profits of such trading. The necessary quality of mutuality which removes a club or society from the category of traders must be genuine, and there must be a reasonable relationship between what members contribute and what they may expect to withdraw, although this need not amount to complete equality."

14. After carefully considering the definition and other passages in Halsbury that have been quoted in paragraph 13 above, we do not think that they support the Deputy Commissioner's argument that an association which is concerned in making gains for its members, other than as an incidental trading activity, cannot be a club. It may be possible to generalise in the case of private members' clubs and state that they are not formed for the purposes of trade but, as is clear from Halsbury itself, the concept of a "club" is wider than this and embraces many other associations. Indeed Halsbury refers to proprietary clubs and investment clubs as a species of club even though their main object is that of making gains. Furthermore, having stated that a club is a society of persons associated other than for the purposes of trade, Halsbury appears to in part contradict this by stating that "trading activities will not destroy the nature of a club if they are merely incidental to the club's purposes". If the definition in Halsbury is to be regarded as authoritative for the purposes of section 24(1) much will then turn on the meaning of the word "incidental". We do not, however, feel that it would be right to try to apply the Halsbury definition in this context. It seems to us that it was only intended as an introductory description covering many club situations and was never intended to be an exhaustive definition that could be the subject of strict construction in the interpretation of a statute. In our opinion it does not assist much in the construction of the words 'club or similar institution' in section 24(1) and we have therefore turned to the Oxford English Dictionary for further guidance. Before considering this line of approach, however, we should add that if we are wrong in rejecting the Halsbury definition, it is nevertheless our view that the trading activities of the Taxpayer are incidental to its main objects as set out in paragraph *4(b)* above.

15. The Oxford English Dictionary Vol. II at 534, gives a number of meanings to the word "Club". The following are relevant: -

(a) "12. A knot of men associated together; a set, a clique; early applied to a private association with a political object; a secret society."

(b) "13. An association or society of persons of like sympathies, of a common vocation, or otherwise mutually acceptable, meeting periodically (under certain regulations) at some house of entertainment, for social intercourse and cooperation."

"… 'club' has developed in two directions; that mainly connected with entertainment having become a permanent institution as described in sense 15, while the occasionally or periodically meeting club has usually primary objects apart from conviviality, as in 14."

(c) "14. An association formed to combine the operations of persons interested in the promotion or prosecution of some object; the purpose is often indicated in the title, as Alpine, Athletic, Chess, Cricket, Football, Literary, Natural History Field, Tennis, Yacht Club, etc.; Benefit, Clothing, Coal, Goose Club, etc."

(d) "15. An association of persons (admittance into which is usually guarded by ballot), formed mainly for social purposes, and having a building (or part of one) appropriated to the exclusive use of the members, and always open to them as a place of resort, or, in some cases, of temporary residence; the club may be political, literary, military, etc., according to the aims and occupations of its members, but its main feature is to provide a place of resort, social intercourse, and entertainment."

16. On the facts of this case we take the view that the Taxpayer comes within the meaning of "club" in paragraph 15(c) above, and therefore "carries on a club or similar institution" within section 24(1).

17. The second ground of appeal succeeds and we allow the appeal on this ground. The assessments appealed against are annulled.