

# EY Tax Alert

Provisions under GST deeming transactions between Association and its members as supply held unconstitutional by Divisional bench of Kerala HC

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## Executive summary

This Tax Alert summarizes a recent ruling of the Kerala High Court (HC)<sup>1</sup> on levy of Goods and Services Tax (GST) on fee collected by Association from its members and the constitutional validity of the provisions of Section 2(17)(e) and Section 7(1)(aa) of the Central Goods and Services Tax Act, 2017 (CGST Act).

The key observations of the HC are:

- ▶ The GST framework requires presence of at least two parties, a provider and a recipient, for the concepts of "supply" and "service" to be applicable.
- ▶ Article 246A of the Constitution, which grants legislative powers to the Union and States to make laws regarding goods and services tax, uses the term "supply" without an artificial extension to include "deemed supply".
- ▶ The impugned amendment in Section 7(1) of the CGST Act redefine "supply" to include transactions between entities and their members for consideration but does not classify them as "services". Thus, the definition of "service" remains unchanged and there is no deemed "service" for clubs or associations providing services to its members.
- ▶ The concept of "supply" and "service" under the Constitution and CGST Act excluded transactions based on principle of mutuality. The amendment carried out by the legislature is unconstitutional since it incorporates a definition of supply that militates against the constitutional understanding of the terms.
- ▶ The Supreme Court ruling in case of Calcutta Club Ltd<sup>2</sup> affirms that the principle of mutuality remains intact even after the 46<sup>th</sup> Constitutional Amendment. As long as this judgment is a binding precedent and the Constitution is not amended to remove mutuality from the definitions of supply and service, the challenged amendment to the CGST Act will be unconstitutional.

Accordingly, the HC held that the provisions of Sections 2(17)(e) and 7(1)(aa) of the CGST Act are unconstitutional and ultra vires the provisions of Articles 246A, 366(12A), and 265 of the Constitution.

<sup>1</sup> 2025-VIL-338-KER

<sup>2</sup> 2019 (29) GSTL 545 (SC)



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## Background

- ▶ The petitioner is an Association of doctors which runs various schemes for its members. The member doctors contribute a certain fee for these schemes.
- ▶ Directorate General of GST Intelligence (DGGI) initiated tax recovery proceedings, contending that activities conducted by the association for its members under specific schemes constituted a supply of service.
- ▶ The petitioner contended that it was not liable to pay tax on the activities performed for its members under the aforesaid schemes, as these activities did not constitute a supply of service.
- ▶ As per the petitioner, when a club or association serves its members, the services are essentially provided by the members to themselves, creating no separate recipient for the services.
- ▶ Through Finance Act, 2021, amendments were made in Section 7(1) of the Central Goods and Services Tax Act, 2017 (CGST Act) to introduce a deeming provision making activities or transaction by a club/association to its members a deemed supply for the purposes of levy of tax.

The amendment was made retrospectively effective from 1 July 2017.

- ▶ Writ petition was filed before the Kerala High Court (HC) to declare the above amendment as unconstitutional and being *ultra virus*.

While the Single Judge bench of the Kerala HC held the amendment to be constitutionally valid, the retrospective applicability of the amendment was however, set aside.

- ▶ Aggrieved, the petitioner impugned the portion of the judgement which held the insertions as constitutionally valid, before the division bench of the HC.

On the other hand, Revenue impugned the latter portion of the judgement that set aside the retroactive operation of the amendment.

## Petitioner's Contentions

- ▶ It is long established common law that there is identity between a club/association and its members, under the principle of mutuality. Consequently, there can be no sale or service by a club to its members<sup>3</sup>.

The Supreme Court (SC) in case of Madras Gymkhana Club Employees Union vs. The

Management of the Gymkhana Club<sup>4</sup> has acknowledged that a club essentially serves its members, functioning as a self-serving institution. A club is intrinsically linked to its members and cannot be considered a separate entity with an existence apart from them.

It has been clarified by SC in Cricket Club of India Ltd vs. Bombay Labour Union<sup>5</sup> that activities of a club for its members have to be treated as activities of a self-serving institution, even if the club is incorporated as a limited company under the Companies Act.

SC in case of The Young Men's Indian Association<sup>6</sup> had struck down the levy of sales tax on supply of food/beverages made by a club to its members based on the principle that there could be no sale or transfer between a club and its members.

- ▶ The 46<sup>th</sup> Constitution amendment by which Article 366(29A) was introduced, had sought to define "tax on sale or purchase of goods" as including a tax on the supply of goods by an unincorporated association or body of persons to a member thereof for cash, deferred payment or other valuable consideration.

The 46<sup>th</sup> Constitutional Amendment did not eliminate the principle of mutuality. This principle remains intact, reinforcing the notion that there is no distinct separation between a club and its members.

SC in State of West Bengal & Ors vs. Calcutta Club Ltd<sup>7</sup> emphatically held that the principle of mutuality continued even after the Constitutional Amendment. It also recognized that there could be no service between a club and its members.

- ▶ The plain meaning of "supply of goods or services" is supply by one person to another.

The scope of the legislative power granted by the Constitution to levy GST is that such a tax can be levied only where there is supply of goods/service by one person to another.

The Finance Act, 2021, retrospectively introduced Section 7(1)(aa), creating a legal fiction that treats clubs/associations and their members as separate entities from the start of the GST regime.

Further, the taxable event was also artificially enlarged to include "activities or transactions" between a club/association and its members.

Attention in this regard is placed on SC ruling in case of State of Madras v. Gannon Dunkerley & Co<sup>8</sup>. The SC invalidated an attempt of the State Legislature to redefine "sale" to include "works contract" asserting

<sup>3</sup> [(1882) 8 QBD 373]

<sup>4</sup> 1967 SCC OnLine SC 51

<sup>5</sup> AIR 1969 SC 276

<sup>6</sup> (1970) 1 SCC 462

<sup>7</sup> [2019 (29) GSTL 545 (SC)]

<sup>8</sup> [AIR 1958 SC 560]

that the established meaning of constitutional phrase cannot be statutorily expanded.

There are various cases where State Legislatures attempted to expand the definition of "sale" to broaden the tax base, however, SC<sup>9</sup> consistently struck down these amendments as exceeding the constitutional meaning of "sale" in Entry 54 of List II.

- ▶ If the legislative power granted by the Constitution is to be expanded beyond its established legal meanings, it can only be achieved through a constitutional amendment that explicitly alters the long-recognized principle of mutuality.

This would involve granting Parliament and State Legislatures the authority to levy GST on self-sale or self-services between a club and its members.

The well settled principle of mutuality can only be altered by a constitutional amendment and not by a statutory amendment.

- ▶ Even if one assumes that the 46<sup>th</sup> Constitutional amendment has done away with mutuality, it has done so only in respect of goods.

As regard to service, the position would continue to be governed by the known legal connotations of mutuality. Consequently, there could be no levy of GST on "service" by a club/association to its members.

- ▶ While legislatures can enact retrospective laws, these laws must not be unreasonable or arbitrary. If a retrospective law is confiscatory in nature, it is deemed unreasonable and thus, unconstitutional.

The insertion under Section 7(1) of the CGST Act creates a new levy of tax on clubs and associations. This is done by overturning a long-held position of law i.e., the mutuality of clubs and association.

Though the amendment seeks to overturn a well-settled position in law, it is unfortunately couched in the language of clarification.

Whether a change is truly clarificatory or constitutes a substantive change (and thus, not retrospective) is a matter of statutory interpretation, which is for the courts to determine.

The source of power for enacting the CGST Act is from Article 246A and Article 366(12A) of the Constitution. Article 246A is an enabling provision notwithstanding Articles 246 and 254.

Neither in Article 246A nor in 366(12A) there are any limitations imposed on the Parliament or State Legislature with regard to imposition of such tax.

The field is wide open for the Parliament and the Legislature to identify the person to be taxed and to define what would be supply and to define what would be referable to the term person.

Therefore, Section 2(17)(e) and the amendment in Section 7(1), which deems the supply of goods and services by an association to its members as taxable supplies, falls within the powers of Parliament and the Legislature.

- ▶ Even if the SC judgment in the Calcutta Club Ltd is made applicable post the introduction of Articles 246A and 366A by the 101<sup>st</sup> Constitutional amendment, the Legislature retains the authority to amend the law to counter the judgment's basis.
- ▶ The amendment introduced in Section 7(1) (aa) of the CGST Act, is altering the definition of "supply" but not "service."

This is not a flaw, as Section 9 of the CGST Act defines the taxable event as the supply of goods or services, making the amendment sufficient to treat an association and its members as distinct entities without needing to redefine "service."

Even if there were a perceived flaw in not amending the definition of "service," Courts are expected to interpret laws harmoniously, considering the legislative intent. If a provision appears incomplete, Courts may supply necessary words to fulfill the statute's purpose.

- ▶ It is settled law that the Parliament has got the authority to make laws prospectively and retrospectively. Only limitation is that a vested right cannot be taken away by the retrospective enactment.

There is no vested right of the appellant association which is being taken away. It is only the liability which was always on them is sought to be enforced by way of the amendment.

- ▶ The provisions as they stood even prior to the amendment, enabled levy of tax on supply of goods and services from an association to its members. The amendment was only clarificatory in nature.
- ▶ The doctrine of mutuality cannot pose a limitation on the plenary power of the Union and the States to enact laws with respect to Goods and Services Tax, as conferred under Article 246A.

## Revenue's Contentions

- ▶ SC judgement in case of Calcutta Club Ltd (*supra*) is not applicable, as it pertains to the interpretation of the West Bengal Sales Tax Act and service tax, which are linked to entry 54 of List 2 and entry 97 of List 1, both of which derive authority from Article 246 of the Constitution of India.

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<sup>9</sup> (1963) 14 STC 316; AIR 1958 SC 560; AIR 1965 SC 1082; (1967) 20 STC 115 (Mad.); (1980) 2 SCC 167]

# High Court Ruling

- ▶ The key issue in this proceeding is whether a legislature can impose a tax specifically if the Constitution defines a taxable transaction as requiring two parties.
- ▶ The GST framework under the Constitution is designed as a tax on the "supply" of "goods or services or both," with specific meanings assigned to these terms through judicial interpretation.

While the concept of "goods" can exist independently, the concepts of "supply" and "service" necessitate the presence of at least two parties.

This principle was affirmed in *Ranchi Club v. Chief Commissioner of Central Excise & Service Tax*<sup>10</sup>, which was also referenced in the SC ruling in case of *Calcutta Club Ltd (supra)*.

Therefore, the scheme of GST under the Constitution also contemplates the existence of at least two persons. There should be a provider and a recipient before one can infer either a "supply" or a "service" for the purposes of the levy.

- ▶ Article 246A of the Constitution which grants legislative powers to the Union and States to make laws regarding goods and services tax, uses the term "supply" without an artificial extension to include "deemed supply."
- ▶ Further, the 46<sup>th</sup> Constitutional Amendment explicitly amended the Constitution to classify transactions outside the traditional sale of goods as "Sales" or "Purchases" for the purpose of levying sales tax through its deeming provisions.

The amendment to the CGST Act in the instant case modifies the definition of "supply" to include "activities or transactions" by a person, other than an individual, to its members for consideration a supply. However, it does not classify such supply as a "service."

As a result, such supply has not been deemed to be a "service", and the concept of "service" itself has not undergone a change, to include within its fold such activities or transactions.

Therefore, even with the introduction of a deemed "supply" through the amendments, there is no deemed "service" when a club or association provides services to its members, as the definition of "service" remains unchanged.

- ▶ When the SC has interpreted a word or concept in the Constitution, a legislative body cannot assign a meaning that contradicts that interpretation, as its legislative authority derives from the Constitution.

The concepts of "supply" and "service" under the Constitution and the CGST Act, prior to amendment, excluded transactions based on the principle of mutuality i.e., a supply or service from one entity to itself.

The amendment carried out by the legislature is unconstitutional since it incorporates a definition of supply that militates against the constitutional understanding of the terms.

- ▶ In past instances where State legislatures sought to expand the tax base by altering the definition of "sale," the SC invalidated these amendments, ruling that they exceeded the constitutional meaning of the said term.

To get over the said decisions of the SC, the Constitution has to be amended.

- ▶ The concepts of "supply" and "service" have been judicially interpreted as requiring at least two persons - a provider and a recipient.

The SC's ruling in *Calcutta Club Ltd. (supra)* confirmed that the principle of mutuality persists even after the 46<sup>th</sup> Amendment to the Constitution.

As long as this judgment remains a binding precedent and the Constitution is not amended to eliminate the concept of mutuality from the definitions of supply and service, the impugned amendment to the CGST Act shall fail the test of constitutionality.

- ▶ Accordingly, the court held that the provisions of Section 2(17)(e) and Section 7(1)(aa) of the explanation thereto of the CGST Act as unconstitutional and being *ultra vires* the provisions of Article 246A read with Article 366 (12A) and Article 265 of the Constitution.
- ▶ Given the unconstitutionality of the impugned statutory provisions, the Court held that it will be unnecessary to assess their retrospective operation.

However, it agreed with the findings of the Single Judge that retrospective operation of the amendments in the present case would be illegal, had such amendments were held to be valid.

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<sup>10</sup> 2012 SCC Online SC 306

## Comments

- a. The ruling is likely to provide relief to all member-based organizations, including co-operative and credit societies, associations, industry chambers and trade bodies, where members mutually contribute towards various facilities and benefits received by them. However, the Revenue may litigate the judgement before the SC.
- b. Madras HC has also admitted a writ petition challenging the constitutional validity of the amendments made in Section 7(1)(aa) of the CGST Act through Finance Act, 2021 [W.P.No.4863 of 2022].
- c. Last year, Karnataka HC ruled on the doctrine of mutuality under service tax, stating that there can be no service between a trust and its contributors, as they cannot be treated as separate entities [TS-52-HC-2024(KAR)].
- d. Implication of the HC ruling under GST regime, laying emphasis on concept of mutuality and existence of two parties in a transaction involving supply of service, will need to be evaluated for activities between distinct persons which are treated as deemed supply in terms of Schedule I to the CGST Act.

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