[2021] UKUT 0249 (TCC)

Appeal number: UT/2020/000375 (V)

CORPORATION TAX – mutual trading – whether a "premium element adjustment" agreed between the MDU and an insurer, and which benefited the MDU's mutual fund, was taxable – appeal allowed

UPPER TRIBUNAL
(TAX AND CHANCERY CHAMBER)

THE MEDICAL DEFENCE UNION LIMITED **Appellant**

-and-

THE COMMISSIONERS FOR HER MAJESTY'S REVENUE AND CUSTOMS **Respondents**

TRIBUNAL: MRS JUSTICE FALK
JUDGE JONATHAN RICHARDS

Sitting in public by way of remote video hearing treated as taking place at The Royal Courts of Justice, Rolls Building, London on 26 to 28 July 2021

Jonathan Peacock QC and Edward Hellier, instructed by Baker & McKenzie LLP, for the Appellant

James Henderson and Laura Poots, instructed by the General Counsel and Solicitor for Her Majesty's Revenue and Customs, for the Respondents

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DECISION

1. The appellant company ("the MDU") is a company limited by guarantee that provides a range of benefits to its members who work in the medical profession. During the periods in dispute it arranged for its members to obtain insurance cover from third party insurance companies against the risk of claims for professional negligence. Because of its large membership, the MDU was able to negotiate favourable terms with those insurance companies, including an arrangement under which premiums payable in later years could be reduced, or rebated, if claims in earlier years were lower than expected. These proceedings concern the tax treatment of the "premium element adjustment" (the "PEA") arising under that arrangement; HMRC contend that it is a taxable receipt of the MDU and the MDU argues that it is not. The appeal also raises questions concerning the validity or otherwise of a discovery assessment that HMRC made in respect of the MDU's accounting period ended 31 December 2007.

2. In a decision released on 19 May 2020 (the "Decision"), the First-tier Tribunal (Tax Chamber) (the "FTT") decided, in agreement with HMRC, that the PEA did represent a taxable receipt of the MDU. It also concluded that HMRC's discovery assessment was validly made. With the permission of the FTT, the MDU appeals against both conclusions.

The Decision

Findings relevant to the taxability of the PEA

3. There is no appeal against the FTT's findings of fact, although the MDU does argue that the FTT misinterpreted the effect of certain contracts that dealt with the PEA and related matters. In paragraphs [4] to [13] below, we summarise the FTT's principal findings, some of which, such as those relating to the terms of contracts, are determinations of law, with references to numbers in square brackets being to paragraphs of the Decision unless we say otherwise.

4. The MDU has historically provided a range of benefits to its members, who pay membership subscriptions. Before 2000, the MDU provided its members with protection against professional negligence claims by maintaining a mutual fund, funded by part of the membership subscriptions, which was used to provide indemnity cover, on a discretionary basis, to members facing claims. HMRC accepted that the subscriptions that the MDU received and applied in maintaining the mutual fund were not taxable under the "mutuality" principle. Moreover, because the MDU provided its indemnity on a discretionary basis, it was accepted that it was not carrying on an insurance business.

5. During the 1990s, against a backdrop of increasing claims, and increasing awards of damages, the MDU became concerned that its mutual fund might not be sufficient to provide the level of cover that its members needed. It therefore entered into arrangements for third party insurance companies to provide insurance cover to MDU members that would sit alongside the discretionary indemnity that the MDU would continue to offer.

6. The identity of the insurance companies involved changed over time and the detail of the arrangements also varied. However, the following salient features were present throughout the period in dispute ([35]):

> (1) Each relevant insurance company (described generically in this decision as the "Insurer") agreed forms of insurance policy that would be provided to MDU members. Each member of the MDU would have an insurance policy (a "PI Policy") in their own name, although the Insurer retained the right not to issue a PI Policy to anyone it did not wish to insure. The Insurer did not provide a single insurance policy covering MDU members as a group.
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> (2) A company called MDU Services Limited ("Services") was incorporated for the purpose of administering the arrangements. The shares in Services were initially owned 50% by the MDU and Zurich Re (who was the initial Insurer under the arrangements). Subsequently Services became a wholly owned subsidiary of the MDU.
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> (3) Services collected an annual subscription amount from each MDU member. Part of the aggregate subscriptions received would be paid over to the Insurer, part retained to cover Services' costs and the balance would be remitted to the MDU. Services acted as agent for both the MDU and the Insurer in collecting membership subscriptions.

7. The MDU had over 130 years' experience of dealing with clinical negligence claims and it considered that its own estimates of likely claims costs were more likely to turn out to be correct than the estimates the Insurer used to price policies. Moreover, the MDU had a strong bargaining position as it had a large number of members and so was placing a large amount of insurance business with the Insurer and giving the Insurer the opportunity to sell other products to MDU members. We will consider the detailed mechanics of the PEA later in this decision. However, very broadly, the MDU was able to negotiate an arrangement under which the claims outcome of a particular year was reviewed after the event and, to the extent that premiums received in respect of MDU members had delivered the Insurer more than a threshold return on capital for a particular policy year, the amount of premium payable in subsequent years could be adjusted downwards or a partial rebate could be made. Because medical negligence claims can take many years from first notification to reach a conclusion, the review was undertaken over an extended period.

8. As a matter of arithmetic, and at this stage without considering the legal or tax effect of the PEA, the PEA was determined broadly as follows[1]:

> (1) PEA adjustments started on the fifth anniversary of the "Policy Period" in question (see [10] below for Policy Periods) and continued to be made for five successive Policy Periods thereafter. Those adjustments therefore took effect in later Policy Periods, but were computed by reference to

[1] For the time being, this summary is at a high level. Later in this decision, we analyse the contractual terms in more detail.

financial information and claims experience for the earlier Policy Period to which they related.

(2) For each Policy Period in respect of which it was calculated, the PEA was a proportion of the difference between the actual insurance operating return (the "IOR", which was broadly the amount of return that the Insurer actually made out of policies written in the relevant Policy Period) and a "goal IOR" (representing a target return to which the Insurer could aspire).

(3) Adjustments taking effect in a particular Policy Period would represent the sum of PEAs calculated for relevant preceding Policy Periods. Those adjustments were calculated cumulatively as better information on claims became available. The actual adjustment made in a particular Policy Period therefore represented the change in aggregate PEAs for relevant Policy Periods since the previous year. If this process produced a positive PEA adjustment that took effect in a particular Policy Period, the aggregate premium payable to the Insurer for all PI Policies written in that Policy Period would be reduced by the amount of the PEA.

(4) There were specific arrangements to deal with the situation where claims experience for a particular Policy Period was worse than the Insurer expected. Very broadly, in periods relevant to these proceedings, a PEA for a particular Policy Period could never be negative and therefore the Insurer bore the risk that it charged too little for cover in that period. However, the process of cumulative adjustments that we have outlined in (3) above was capable of increasing, as well as decreasing, the aggregate premium payable to the Insurer in a particular Policy Period.

9. Two sets of contractual relationships were relevant. The first was a contractual relationship between Services, the MDU and the Insurer. Both parties were agreed that relevant aspects of that relationship could be found in a Professional Indemnity Insurance Supply and Services Agreement (a "PIISSA") dated 27 December 2007, and amended on 30 October 2009, made between, among others, Services, the MDU and the Insurer. (Although there were other versions of the PIISSA the parties agree that there were no relevant differences.) The second category of contractual relationship comprised the individual PI Policies that were formed between the Insurer and each individual member of the MDU.

10. At [63] to [84], the FTT made findings, largely of fact, as to how the PIISSA was operated in practice. The FTT indicated at [71(2)] that the way the parties made adjustments in respect of the PEA under the PIISSA might not have corresponded entirely to the contractual provisions agreed. We will consider that point later in this decision and for the time being simply summarise the FTT's factual findings as to how the PIISSA was operated in practice for Policy Periods up to the one that ended on 31 March 2013[2]:

[2] From 1 April 2013, MDU members no longer obtained a separate insurance policy from a third-party insurer.

(1) Each "Policy Period" under the PIISSA ran from 1 April in one year to 31 March in the next year.

(2) Each October before the start of the Policy Period, the MDU would provide the Insurer with relevant data. Based on that, the Insurer would present the MDU with its calculation of the aggregate premium that the Insurer would wish to charge for providing PI Policies to all those individual members of the MDU that it was prepared to cover. That figure was necessarily an estimate on the part of the Insurer since the number of MDU members and the composition of the MDU's membership would fluctuate with new members joining each year and others leaving the MDU.

(3) There was a contractual mechanism that could be operated if the MDU was dissatisfied with the Insurer's proposal, but it was not suggested that either the existence of that contractual mechanism, or the way it was applied in particular cases, had any bearing on this dispute. The FTT focused, as do we, on the situation where discussions between the MDU and the Insurer led to the determination of an "Agreed Premium" representing the aggregate premium that the Insurer would wish to charge to write PI Policies covering the entirety of the MDU's estimated membership.

(4) By the February before the commencement of the Policy Period, negotiations with the Insurer as to the aggregate premiums would have concluded. The MDU would at that point calculate the "Insurance Premium Percentage" under the PIISSA. That figure was calculated by dividing the Agreed Premium by the aggregate subscriptions that the MDU expected to receive in the Policy Period.

(5) The figures described set out at (4) above were also calculated at a point where the MDU's actual membership in the Policy Period was not known. The Insurer did not know, when the Insurance Premium Percentage was calculated, how many individual PI Policies it would be writing in the forthcoming Policy Period. Nor did the Insurer know how many policies it would be writing for different categories of medical practitioner. The MDU did not know how much it would receive from members by way of subscription. The Insurance Premium Percentage therefore represented the quotient of two estimated numbers.

(6) Meanwhile, and again before the start of the Policy Period, the PEA applicable for that period would be calculated. That was an aggregate figure, based on actual claims experience of PI Policies with MDU members written in relevant prior Policy Periods.

(7) From the start of the next Policy Period on 1 April, Services would start receiving membership subscriptions from individual members. Some of those subscriptions would be payable in instalments. Those subscriptions would all be paid into a bank account in Services' name.

(8) Services would perform a "truing up" process at the end of each month which would involve it calculating how much of the membership subscriptions it had received from MDU members in the previous calendar

month should be paid over to the MDU and how much should be paid over to the Insurer. It would perform that calculation as follows:

(a) As a starting point, it would multiply the cash subscriptions actually received in that month by the Insurance Premium Percentage to calculate a gross amount notionally due to the Insurer before adjustment for the PEA.

(b) If there was a PEA adjustment to be made for the Policy Period, Services would divide the PEA between the individual calendar months comprising that Policy Period. In practice, that adjustment was made at or around the time the PEA was calculated pro rata to the amount of subscriptions expected to be received in any calendar month.

(c) The difference between the figures in (a) and (b) above was paid into a segregated bank account that Services operated for the Insurer.

(d) Services would deduct its own costs out of the balance remaining.

(e) The final balance remaining, after deduction of Services' costs, was paid over into a different segregated account that Services held in the name of the MDU.

(f) The MDU and the Insurer would subsequently be paid out of the two segregated accounts mentioned at (c) and (e) above.

11. By 2013, the climate surrounding claims for medical negligence had changed significantly. The MDU considered that its discretionary indemnity, backed by the mutual fund, could be relied upon to provide its members with adequate protection. Accordingly, no insurer was called upon to provide individual contracts of insurance to MDU members for Policy Periods beginning on or after 1 April 2013. However, it was still necessary to calculate a PEA reflecting the outcome of the claims experience in Policy Periods prior to that commencing on 1 April 2013. Since there were no premiums payable to the Insurer from 1 April 2013, it was no longer possible to deal with the PEA as set out in paragraph [10(8)] above. Accordingly, the PEA calculated in respect of that Policy Period was paid in cash by the Insurer to the MDU in 2014.

12. The FTT had evidence about the process that would be followed by members wishing either to renew an existing subscription to the MDU, or to become members of the MDU for the first time. At [91] of the Decision, the FTT made the following finding of fact that was central to its overall reasoning:

> There was no reference in the renewal letters, in the Application Guide (or Application Form), nor in the terms of the PI Policy to the PEA, either in general terms or as a specific reference to the amounts that members or applicants paid for their PI Policies. Dr Tomkins confirmed that there was no communication to individual MDU members about the PEA. An MDU member or applicant would only find out about the PEA on a close reading of the MDU's annual report and accounts (and even

> then, the detailed mechanics of the PEA, or how it was put into effect, were not disclosed).

13. The FTT used the expression the "Individual Subscription" to describe the subscription that a member paid for membership of the MDU and the term the "Individual Premium" to describe the premium it considered payable under an MDU member's individual PI Policy (see [35(8)]). At [94] it made the following finding that underpinned much of its later analysis:

> 94. We therefore find that when the member or the applicant paid his Individual Subscription, which comprised:
>
> > (1) an amount representing the premium for his PI Policy, being the Insurance Premium Percentage of the Individual Subscription (without taking account of the PEA), and
> >
> > (2) an amount representing his contribution to the MDU's discretionary mutual fund (being the balance).

There is some typographical error in this paragraph. Perhaps the word "which" in the first phrase should read "this". However, the parties were agreed that in this paragraph, the FTT was finding that the Individual Premium (using its phrase) took no account of the PEA.

The FTT's conclusions as to taxability of the PEA

14. The FTT concluded that the PEA represented a taxable receipt of the MDU in all relevant periods. Before the FTT, the MDU relied in part on a submission that the PEA could not be taxable because there was no taxable "source" and the FTT therefore naturally ordered its reasoning to respond to that submission. Before us, the MDU has placed much less reliance on the significance of a taxable "source". Therefore, rather than summarising the entirety of the FTT's reasoning, we will give a flavour of the essence of it sufficient to put in context the challenges to the FTT's conclusions that the MDU now makes.

15. At the heart of the FTT's reasoning was the proposition that an individual PI Policy provided for a premium that was not adjusted by the PEA (see the finding at [94] that we have already highlighted). Therefore, the FTT found that the aggregate amount of premiums that the Insurer was entitled to receive from those members (which Services collected as the Insurer's agent) similarly was not adjusted by the PEA.

16. Accordingly, the FTT reasoned that the Insurer's contractual <u>entitlement</u> was to receive "gross" premiums from the MDU members that were not reduced by the PEA. However, in the performance of its obligations to the Insurer, Services only paid over a lower sum that had been reduced by the PEA. Services could only properly pay over the lower sum if either Services, or the MDU, had a contractual entitlement to receive an amount equal to the PEA from the Insurer. Accordingly, Services' payment of the lesser sum to the Insurer involved a process under which the entitlement of Services or the MDU to receive the PEA from the Insurer was set off against the obligation of Services to account to the Insurer for gross premiums for PI Policies.

17. Therefore, using illustrative numbers which formed the basis of the parties' submissions before us, the FTT reasoned that the Insurer had a contractual entitlement to receive 100 by way of gross aggregate premiums for PI policies. It had a contractual obligation to pay the MDU the PEA of 10. The two contractual obligations were set off or netted against each other with the result that the Insurer received a net 90 from Services. The FTT therefore rejected the first plank of the MDU's argument, namely that there was no "receipt" or no taxable "source", reasoning (i) that there was a receipt of 10 in the above example and (ii) there was a taxable "source" for that payment, namely the MDU's rights under the PIISSA.

18. The next issue was whether the receipt of 10 that the FTT had identified was subject to tax or whether an application of the "mutuality" principle meant that it escaped tax. A number of authorities were cited to the FTT on the scope of the mutuality principle. Having considered those authorities, the FTT concluded that the receipt was taxable for the following reasons:

> 148. Not all amounts that accrue for the benefit of a mutual fund benefit from the mutual exemption. This is perhaps most clearly seen in the *Municipal Mutual* case, where the surplus on the "other" fund was applied for the benefit of the (mutual) "fire" fund. Even though the surplus from the "other" business accrued for the benefit of the mutual fund, the House of Lords confirmed that the income from the "other" business was taxable. We agree with Mr Henderson, that we cannot take the high-level approach adopted by the MDU in the application of the mutuality exemption.
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> 149. We find that the PEA arises from the insurance business conducted between the insurers and the MDU members. The PEA, in effect, allocates to the MDU the benefit of some of the profits derived from the PI Policies in consequence of commercial negotiations between the MDU and the insurers. This is not a "miscalculation" of the kind that Lord Macmillan considered in his speech in *Municipal Mutual*. The PEA has more similarities to the transfer of the surplus achieved by *Municipal Mutual* in its "other" business to the benefit of its mutual "fire" fund. We find that the PEA is a payment from the insurers to the MDU for providing them with the PI Policy business and as a result of the commercial negotiations relating to the provisions of those and other insurance policies.
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> 150. We find that the PEA does not benefit from the mutuality exemption.

The Grounds of Appeal

19. With the permission of the FTT, the MDU appeals against the FTT's decision as to the taxability of the PEA on the following grounds:

> (1) As Ground 1, the MDU argues that the FTT was wrong to conclude that the PEA was a payment made by the Insurer to the MDU. Properly understood, the PEA was simply a downwards adjustment to the premium due to the insurer, and was properly treated as part of the subscriptions that

the MDU received from its members, to which the mutuality principle applied.

(2) As Ground 2, the MDU argues that, to the extent that the PEA did represent a payment made by the Insurer to the MDU, the FTT was wrong to conclude that it fell outside the scope of the mutuality principle.

20. In 2014 the MDU did receive a payment from the Insurer (see [11] above). The MDU accepts that the arguments deployed as Ground 1 cannot be advanced in relation to that 2014 payment, although it does contend as an aspect of Ground 2 that the mutuality principle applied to it. In relation to the years 2007 to 2013, Grounds 1 and 2 are relied on as alternatives.

21. For their part, HMRC see little distinction between the arguments relevant to Ground 1 and those applicable to Ground 2. They argue that, continuing with the indicative figures set out in paragraph [17] above, the Insurer had a contractual obligation to pay the MDU 10. Up until the 2013 Policy Period that contractual obligation was discharged by setting it off against amounts due to the Insurer. In the 2014 Policy Period it was discharged by the Insurer making a cash payment to the MDU. However, whatever the mechanism by which it was discharged, the contractual obligation to pay 10 was owed by the Insurer, and not by members of the MDU, and for that reason the PEA could not fall within the scope of the mutuality principle.

22. However one chooses to analyse matters, it is necessary to understand the contractual effect of both the PI Policies between MDU members and the Insurer and of the PIISSA. We will therefore start with our analysis of these contracts and consider the MDU's grounds of appeal by applying the law on mutual trading in the light of the contracts' terms.

The effect of the relevant contracts

PI Policies

23. As we have noted, the FTT placed considerable emphasis on its conclusion, summarised at [94] of the Decision, that what the FTT termed the "Individual Premium", payable by a member of the MDU to the Insurer for the PI Policy issued to that member, was the Insurance Premium Percentage applied to the member's total subscription without any adjustment for the PEA. The FTT considered that conclusion followed because of (i) evidence suggesting that the PEA was not referred to in the material that the MDU sent to members in connection with their applications for membership, or renewals of existing memberships (see [91] of the Decision), and (ii) the fact that the small print of the renewal letter for 2008/09 indicated that 55.71% of total subscription income contributed to the aggregate insurance premium. 55.71% was the Insurance Premium Percentage for 2008/09, unadjusted by the PEA.

24. For the reasons that follow we consider that the FTT erred in law in reaching its conclusions as to the amount of "Individual Premium" payable by MDU members to the Insurer.

25. It was not immediately obvious how the individual PI Policies between the Insurer and the MDU members came into being. However, Mr Henderson's oral submissions were of great assistance in resolving that issue as he pointed out that, by a "Terms of Business Agreement", Services was constituted the agent of the Insurer with authority to conclude contracts with individual members of the MDU on behalf of the Insurer. Because it was performing that role, Services was required to have, and did have, authorisation from the Financial Services Authority (as it then was) to act as an "insurance intermediary". As a result of that explanation, and the findings of the FTT set out in the Decision, we have concluded that individual PI Policies came into existence by the following process:

(1) A prospective new member of the MDU would first have a discussion with someone at the MDU. Having obtained details about the medical professional's practice, Services would send the prospective member an "Application Guide" together with an application form. The Application Guide set out the terms of the insurance policy that the Insurer was, in principle, prepared to offer (see [88] of the Decision).

(2) In the application form, medical professionals confirmed details of their practices. The subscription payable to the MDU would be pre-printed on the application form. There would be no breakdown in any of the documentation, including the terms of the PI Policy, setting out how much was payable to the Insurer as insurance premium and how much was payable to the MDU (see [88], [89] and [91] of the Decision). The application form made it clear that it constituted an application both for membership of the MDU and for a PI Policy to be issued by the Insurer.

(3) Services had authority from the MDU to accept the application for membership and had authority from the Insurer to accept the application for insurance. If it accepted both applications then the medical professional would become an MDU member for a year and would obtain a PI Policy for the same period. The PI Policy would terminate if membership of the MDU ceased.

(4) Services would send an MDU member whose subscription was coming up for renewal a letter in advance of the renewal date. The renewal letter for the 2008/09 Policy Period contained some information on aggregate insurance premiums payable to the Insurer that we discuss further below. However, as with new memberships, there was nothing in the renewal letter or accompanying documentation specifying a premium that the individual was obliged to pay to the Insurer (see [91] of the Decision). The renewal letter would invite the member to notify any material changes to the details that the MDU held. Services had authority, as agent for both the MDU and for the Insurer, to renew both MDU membership and the PI Policy.

26. Thus far in the analysis, it is clear that at no stage did any of the material sent to a new or renewing member of the MDU specify any "Individual Premium" chargeable for the PI Policy, as the FTT recognised at [91] of the Decision. Yet the FTT found, at [94] of the Decision, that the "Individual Premium" payable under an individual PI Policy was the Insurance Premium Percentage multiplied by the total subscription

payable to the MDU. Two factors led the FTT to that conclusion: first the fact that renewal letters for 2008/09 gave some indication as to how much the Insurer might receive in aggregate for writing all of the PI Policies for MDU members, and second its perception that the "Individual Premium" was not retrospectively adjusted by the PEA.

27. The FTT's first point related to some small print at the end of the renewal letters for 2008/09 that read as follows:

> Insurance premiums for the membership as a whole are calculated on an aggregate basis. At the time of publication, 55.71% (excluding Insurance Premium Tax) of total subscription income relating to insured members is contributed towards the aggregate premium.

28. As already mentioned, the 55.71% figure was identical to the Insurance Premium Percentage for 2008/09, unadjusted by the PEA. However, even taking into account Services' power to enter into insurance contracts as agent for the Insurer, this text cannot be read as fixing a term of the PI Policy between an MDU member and the Insurer. The statement does not purport to say that an individual MDU member had a contractual obligation to pay 55.71% of the total MDU subscription to the Insurer. Rather, the statement simply conveys information to renewing policy holders as to the estimated total amount that the Insurer would receive for writing all PI Policies. The renewal letter could, more accurately, have explained that the PEA would operate to adjust downwards the aggregate premium that the Insurer would receive. However, inaccurate as it was, the small print we have quoted remained an estimate designed to convey information, as emphasised by the use of the phrase "at the time of publication". This small print was not intended to have any contractual effect and the FTT erred in law in concluding that it did.

29. The FTT's reliance on the absence of retrospective adjustments to the "Individual Premium" involved circularity of reasoning. The FTT was assuming that there was such a thing as the "Individual Premium". Having noted, correctly, at [92] that no attempt was made to allocate the PEA between individual members of the MDU and having seen the reference to the figure of 55.71% (corresponding to the Insurance Premium Percentage) in the renewal letter, the FTT reasoned that the Individual Premium was, therefore, the Insurance Premium Percentage multiplied by a member's individual subscription to the MDU. However, the FTT should have paused to consider whether, given the absence of any attempt to specify any premium payable by an individual under a PI Policy, there was an "Individual Premium" at all.

30. Had it asked itself this question, it would not have fallen into error. The bargain between an individual MDU member and the Insurer did not require any "Individual Premium" to be specified. The individual gave consideration consisting of the payment of an undifferentiated aggregate sum to Services (who acted as agent for both the MDU and the Insurer) in return for both (i) the Insurer's agreement to provide the member with a PI Policy and (ii) the MDU's agreement to grant membership of the MDU. There was no need, from the perspective of the individual MDU member, for the sum to be split into a price payable for MDU membership and a price for a PI Policy. Certainly, the MDU and the Insurer needed to agree, between themselves, how much of the

aggregate membership subscriptions the MDU could keep and how much had to be paid over to the Insurer. However, that was the province of the PIISSA, to which individual MDU members were not party, rather than individual PI Policies.

31. In his oral submissions, Mr Henderson submitted that this analysis was at odds with principles of contract law, but we do not agree. The individual medical professional gave good consideration for the Insurer's provision of the PI Policy by agreeing to become or remain a member of the MDU, which in turn required the individual to pay a subscription to the MDU. The agreement to pay a subscription to the MDU also served as consideration for the MDU's separate promise to provide the benefits of membership. But we do not agree that there is any provision of contract law that required the individual to agree an allocation of the consideration paid as between the various benefits received from the MDU on one hand and the Insurer on the other. The analysis is slightly complicated by Services' role in receiving sums as agent for both the MDU and the Insurer. However, people frequently pay sums in return for a whole package of promises without any requirement to ascribe a monetary value to each constituent of that package. We are not aware of any principle that prevents such an arrangement being legally effective, even if parts of the package are provided by different entities under separate contracts.

32. Nor do we accept HMRC's argument that an "Individual Premium" had to be identified in each individual PI Policy as otherwise Services would be in the difficult position of not knowing exactly how much of each payment it received as agent for the MDU and how much as agent for the Insurer (because the "Individual Premium" could be identified as a fixed percentage of each subscription actually received, whereas the calculation of the PEA would produce a fixed amount which adjusted the aggregate amount payable to the Insurer over the year in question). We consider that the difficulties Services faced were overstated: it was holding the amounts received for one or other principal, and the precise proportions in which it was doing so would in fact become clear at the end of each month as part of the process described in paragraph [10(8)] above pursuant to the provisions of Clause 10.3 of the PIISSA set out in paragraph [40] below. In any event, any practical difficulty that Services faced was for it to overcome. We do not consider that any such practical difficulties should inform the construction of the individual PI Policies. Those policies simply did not specify the premium payable under them as a proportion of the subscriptions paid.

The PIISSA

33. As we have explained, the PIISSA functioned, in part, as an agreement between the MDU and the Insurer as to how the gross cash sum, collected from members by Services, acting as agent for both the MDU and the Insurer, should be shared out.

34. Clause 7 of the PIISSA set the scene for this function of the PIISSA as follows:

> **7 SUBSCRIPTIONS**
>
> 7.1 MDU shall set the subscriptions to be charged by it to Healthcare Professionals and other Healthcare Practitioners (the ***Subscriptions***).

> 7.2 The Subscriptions shall include (in addition to VAT and/or IPT) a premium element, being the premiums charged to the Healthcare Practitioners for the PI Insurance, agreed in accordance with clause 8 or determined in accordance with clause 9, and in each case adjusted as provided in clause 11 (the aggregate amount of such premiums being the ***Premium Element***).

35. Understandably, there was much discussion at the hearing before us as to the significance or otherwise of the words "in each case adjusted as provided in clause 11" because clause 11 dealt with the PEA. We address that issue below. However, we also consider it significant that the "Premium Element" is defined by reference to the aggregate premiums charged for PI Policies. Clause 7.2 does not purport to say anything about the proportion of any individual MDU member's subscription that is, as between that member and the Insurer, to be treated as paid for a PI Policy. The PIISSA could not in any event have an effect on the bargain between an MDU member and the Insurer, because the MDU members were not party to the PIISSA.

36. Clause 8 of the PIISSA set out the mechanism, to which we have already referred when summarising the FTT's findings of fact at [10] above, for the MDU and the Insurer to agree the Premium Element for each Policy Period. Clause 8.1(c) required the MDU and the Insurer to set out their respective proposals as to the Premium Element by the 20 January prior to commencement of each Policy Period. The PIISSA then provided for a period of discussion and consultation with a view to reaching agreement on the Premium Element for the following Policy Period by 31 January in each year, which was defined as an "Agreed Premium". The PIISSA on which we focused, dated 27 December 2007 (as varied on 30 October 2009) provided that, for the first Policy Period of operation of that PIISSA, the Agreed Premium was to be taken to be £100,022,433. That figure had no doubt been agreed before the PIISSA was executed so that, in the circumstances, it was considered unnecessary to follow the usual procedure for the first Policy Period. It was common ground that the figure of £100,022,433 made no adjustment for the PEA.

37. In his oral submissions, Mr Peacock QC argued that the strict effect of clause 8 was that any "Agreed Premium" that emerged should have taken into account adjustments for the PEA. He reasoned that an Agreed Premium represented an agreement on the Premium Element and that the definition of "Premium Element" in clause 7.2 to which we have referred included adjustments pursuant to clause 11 which dealt with the PEA. This reflected clause 8.1(f), which provided that if agreement was reached on the Premium Element, "then such amount, as adjusted in accordance with clause 11, shall constitute the ***Agreed Premium***". Therefore, in Mr Peacock's submission, the procedure followed in practice involved a departure from the strict letter of the PIISSA as it involved the PEA being taken into account at a later stage.

38. We prefer the submission of Mr Henderson to the effect that clauses 10 and 11 of the PIISSA demonstrate that, despite the apparent indication to the contrary in the wording of clauses 7 and 8, any Agreed Premium was not required to be adjusted by reference to the PEA.

39. Clause 10 required the parties to calculate, on the last day of February immediately before the relevant Policy Period, the "Insurance Premium Percentage" to which we have already referred. Where the parties determined an Agreed Premium, that Insurance Premium Percentage would be the Agreed Premium divided by the aggregate subscriptions which the MDU expected to charge its members for that Policy Period, expressed as a percentage. Accordingly, if the PEA was taken into account in the Agreed Premium, the Insurance Premium Percentage would be lower than it would otherwise have been and the Insurer's share of the subscriptions received from MDU members would similarly be reduced.

40. However, clauses 10.3 and 11 of the PIISSA envisaged that the PEA would take effect, not by way of a reduced Insurance Premium Percentage, but by way of adjustments in a monthly accounting process. That emerged from clauses 10.2, 10.3 and 11 of the PIISSA which provided, so far as material, as follows:

> 10.2 MDUSL [i.e. Services] shall, as the agent of the MDU and SCOR UK [the relevant Insurer], collect the Subscriptions from Healthcare Practitioners in accordance with clause 4.
>
> 10.3 MDUSL shall account to SCOR UK for the Premium Element…by paying to SCOR UK a proportion of the Subscriptions collected from Healthcare Practitioners during each calendar month which is equal to the Insurance Premium Percentage for the Policy Period in which that calendar month falls (as adjusted in accordance with clause 11.1) by no later than the final Business Day of the immediately following calendar month, together with any applicable VAT and IPT.
>
> **11 ADJUSTMENT OF PREMIUM ELEMENT**
>
> 11.1 Each payment of the Premium Element to be made to SCOR UK pursuant to clause 10.3:
>
> …
>
> (b) in respect of Policy Periods beginning on or after 1 April 2009, shall be adjusted, if required, in accordance with the PEA.
>
> …
>
> 11.3 Following termination of this Agreement, the PEA shall continue to be calculated and allocated to the MDU in respect of the Policy Period in which termination of the Agreement occurs…provided that the PEA for any Policy Period which is treated as accrued in the last annual audited accounts of [the Insurer] prior to the date on which termination of this Agreement becomes effective shall be paid to the MDU promptly upon termination of this Agreement becoming effective.

Clause 4, referred to in clause 10.2, listed the services to be provided by Services to the Insurer. These included collecting the Premium Element as part of the subscriptions and accounting for it to the Insurer in accordance with clause 10.3 (clause 4.1(a)(iv) and (v)). (We also note in passing that clause 11.2 contemplated that insurance premium tax ("IPT") would be calculated by reference to the Premium Element as adjusted by the PEA. No-one suggested to us that HMRC were challenging this treatment, although

it is also clear that the IPT treatment for the Insurer cannot determine the corporation tax treatment of the PEA for the MDU.)

41. Clauses 10 and 11 set out two regimes governing adjustments for the PEA:

> (1) For so long as the PIISSA remained in force, there would be a Premium Element due to the Insurer. In that case, Services would, by clause 10.3, have an obligation to account for that Premium Element by applying the Insurance Premium Percentage to the total subscriptions received and reducing the result by the PEA. (There is a question of interpretation as to whether the words "as adjusted in accordance with clause 11.1" that appear in clause 10.3 refer to the Insurance Premium Percentage or back to the "proportion of the Subscriptions charged to Healthcare Professionals" referred to earlier. In our judgment, the latter interpretation is correct since clause 11.1 envisages the adjustment of payments made under clause 10.3 rather than adjustments to the Insurance Premium Percentage.)
>
> (2) Once the PIISSA was terminated, the Insurer would no longer be writing PI Policies and so there would be no Premium Element that could be adjusted by the PEA. In that case, the Insurer had a contractual obligation under clause 11.3 to make a payment in respect of the PEA.

42. Where the first of these regimes applied, the Insurer's contractual entitlement was only to receive payments that were reduced by the PEA. It had no contractual entitlement to receive a payment that was unreduced by the PEA. The Premium Element to which it was entitled under clause 10.3 was net of the adjustment provided for by clause 11.1.

43. We acknowledge that the definition of "Premium Element" in clause 7.2 contemplates adjustments in respect of the PEA, and that there is a similar reference in the definition of Agreed Premium in clause 8.1(f). However, this does not mean that the Agreement requires every use of the term "Premium Element" or "Agreed Premium" to factor in adjustments for the PEA where that would otherwise go against the grain of the Agreement and not make business sense. Including the effect of the PEA in the Insurance Premium Percentage would go against the grain of the Agreement and not make business sense since (i) the Agreement demonstrated that adjustments in respect of the PEA were to be factored in by reducing the Insurer's entitlement under clause 10.3, and (ii) there would be double counting if the PEA was also factored into the calculation of the Insurance Premium Percentage. Rather, the references to adjustment in clauses 7 and 8 are to the specific adjustment mechanism contemplated by clause 11, namely a reduction to the Premium Element paid to the Insurer under clause 10.3. The requirement to account to the Insurer under clause 4 is also expressly required to be done "in accordance with clause 10.3" (clause 4.1(a)(v)).

44. Mr Henderson submitted that the adjustment process involved a set-off, operated by Services, under which the PEA was set against an (unadjusted) Premium Element, and thus represented a receipt. However, that presupposes that the Premium Element to which the Insurer was entitled was the unadjusted amount. We do not consider that that is the correct interpretation of the contract. The fact that the agreement separately

provided for a payment of any PEA following termination (clause 11.3) does not affect this.

45. It follows, in our judgment, that the FTT was wrong to conclude at [149] of the Decision, for Policy Periods up to that commencing on 1 April 2013, that the "PEA is a payment from the insurers to the MDU for providing them with the PI Policy business". The MDU had no contractual right to receive any payment in respect of the PEA in those years. Rather, in Policy Periods up to 2013, the PEA simply reduced the amount to which the Insurer was entitled.

46. The FTT was clearly influenced in its conclusion that the PEA was a payment to the MDU by its perception that each individual had an obligation to pay an "Individual Premium" under the PI Policy that was not adjusted by the PEA. We have already explained the error of law that the FTT made in reaching that conclusion. We acknowledge, however, that the use of the defined term "Premium Element" in a variety of ways in the PIISSA might have caused a degree of confusion. For example, even though the Premium Element was, by clause 7.2, defined by reference to aggregate premiums, clause 4.1(a)(iii) stated that Services was responsible for "invoicing the Premium Element … to Healthcare Professionals" and as already mentioned clause 4.1(iv) referred to Services "collecting payment of the Premium Element…from Healthcare Professionals". Instances such as this may well have caused the FTT to approach matters by asking whether each MDU member paid an "Individual Premium" that was unadjusted by the PEA. However, inaccuracies such as these in the PIISSA were not capable of supporting a conclusion that each MDU member paid an "Individual Premium" under the PI Policy that was unadjusted by the PEA. The MDU members were not party to the PIISSA nor, as the FTT found, in most cases even aware of it. Accordingly, the drafting of the PIISSA is of little, if any, assistance in ascertaining the terms of individual PI Policies.

47. The analysis for the Policy Period commencing on 1 April 2013 is different. In that year, no PI Policies were being written and the MDU clearly had a contractual right to receive, from the Insurer, a payment in respect of the PEA.

The law on mutual trading

48. At its heart, the law on mutual trading is concerned with situations where, as Rowlatt J put it at first instance in *Municipal Mutual Insurance Ltd v Hills* (1931) 16 TC 430 at 438:

> … a certain class of people are associating together to put up money to achieve an object for each other, and divide what is not wanted among themselves in that character, namely in the character of the persons who put it up.

49. In such cases, the people in association will typically pay their money into a common fund with the question arising whether a surplus on that fund is a "profit" that can be chargeable to income tax (or corporation tax). Insurance and quasi-insurance arrangements often involve such common funds, which is why much of the development of the law has taken place in the context of such arrangements. However,

both parties are agreed that the principles set out below can apply outside the insurance context.

50. In the House of Lords in *Municipal Mutual* at p.441 Viscount Dunedin set out the following approach to deciding whether there was a taxable profit in cases involving so-called "mutual trading":

> Any person, or set of persons, or company, carrying on the business of insurance, charges premiums and has to meet claims on the policies for which the premiums have been paid and, if it transpires in the course of business that the amount obtained by the premiums has been more than sufficient to meet the claims, this is a surplus. If that surplus is a profit it must bear Income Tax, secus if it is not: and whether it is a profit or not depends… upon the question: To whom does it go? If it goes to the insurer or insurers it is a profit. If it simply goes back to the insured either in reduction of his premium or in enhancing the sum insured, it is in essence merely a return of his own money which he has overpaid and is not a profit.

51. Viscount Dunedin's formulation requires identification of the persons who contributed to the surplus and the persons who benefit from it. If the surplus simply "goes back" (in the requisite sense) to the people who generated it, it is not a "profit" that can be taxed. Lord Macmillan's speech emphasised the centrality of these two questions saying, at p.448:

> The cardinal requirement is that all the contributors to the common fund must be entitled to participate in the surplus and that all the participators in the surplus must be contributors to the common fund; in other words, there must be complete identity between the contributors and the participators.

52. We were referred to other authorities that expanded on aspects of this "cardinal requirement", from which we have identified the following principles:

> (1) In the first place, there must be some form of a "common fund", described by Hamilton J in *The Carlisle and Silloth Golf Club v Smith* [1912] 2 KB 177, 187 as involving a situation where "owing to relations of membership or family bonds, persons club together and reduce the common expenditure on some common object by contributions which they fix roughly with some reference to the cost".
>
> (2) If a club or similar association carries out an activity with outsiders which is different in nature from the activity carried on by, or with, the members then the receipts from that separate activity are unlikely to amount to a mutual activity. In the *Carlisle* case the activity carried out by a members' golf club of charging green fees to visitors was regarded as different from the ordinary functions of the club, and was a taxable activity. Hamilton J's decision was upheld by the Court of Appeal at ([1913] 3 KB 75), where Kennedy LJ referred to that separate activity at p.83 as "the business of supplying to the public for reward a recreation ground fitted for the enjoyment of the game of golf". (Of course, in such a case the

requirement for complete identity between the contributors to and participants in any surplus is also unlikely to be met.)

(3) The requirement for a "complete identity" between contributors to the common fund and those entitled to the surplus is not breached by reason only of the fact that the beneficial owner of the common fund is a body with separate legal personality (see *New York Life Insurance Co v Styles* (1882) 2 TC 460) and that the common fund is therefore not owned beneficially by the contributors themselves.

(4) However, the principle in *New York Life Insurance Co v Styles* does not provide a general licence for the corporate veil to be pierced. Where the common fund is beneficially owned by a body with separate legal personality, a surplus on that common fund is protected from being a profit for tax purposes only when persons participate in the surplus in the same capacity as they were participating when contributing to the surplus. Therefore, at first instance in *Jones v The South-West Lancashire Coal Owners' Association Ltd* (1927) 11 TC 790, Rowlatt J explained at pp.822-823 that profits made by a railway company that chose to do business only with its shareholders would be taxable since those shareholders would be contributing to the surplus in their capacity as passengers, but benefiting from it in their capacity as shareholders.

(5) It does not matter that the persons entitled to participate in the surplus are different in identity from the persons who contributed to it. It does not matter whether individuals benefit from the surplus in proportions identical to those in which they contributed to the surplus. Instead, what is required is that the <u>class</u> of persons entitled to benefit from the surplus is the same as the class of persons who contributed to the surplus. Nor is there any requirement that the entitlement to participate in the surplus arises as soon as the surplus itself is generated, or that the entitlement takes a particular form. All of these propositions follow from the speech of Viscount Cave in the House of Lords' decision in *Jones v The South-West Lancashire Coal Owners' Association Limited*, in which he said at pp.838-9:

> Counsel for the Appellant contended that the present case was distinguishable from the New York Life Insurance Company's case on the ground that, whereas the company there in question returned to its participating policy-holders the surplus of its receipts over its expenditure at the end of each year, the Articles of the Respondent Association require that surplus to be carried to reserve and not at once returned to the members. I do not think this a sound distinction. In this case, as in the New York Life Insurance Company's case, there are no shareholders interested, and the whole of the yearly surplus remains to the credit of the members and must either be applied to meeting their future claims or be returned to them on retirement. Sooner or later, in meal or in malt, the whole of the Association's receipts must go back to the policy-holders as a class, though not precisely in the proportions in which they have contributed to them; and the Association does not in any true sense make a profit out of their contributions. It may be added

> that in that case, as in this, some part of the receipts of each year was carried forward as funds in hand.

53. A central issue in these proceedings is whether, to the extent that the PEA resulted in a surplus in the MDU's mutual fund, it was the members of the MDU or the Insurer who contributed to that surplus. Mr Henderson argued that we should not conclude that since the mutual fund was ultimately maintained by members' subscriptions, it necessarily followed that only members were contributing to that surplus. In support of his proposition that we should not "paint with a broad brush" and ignore the contribution made by the Insurer, he relied on the decision of the Privy Council in *Walter Fletcher v Income Tax Commissioner* [1972] AC 414. That case concerned a private bathing club in Jamaica whose membership consisted of "hotel members", bodies corporate, who paid much the greatest share of membership contributions to secure access to the club for their guests and "ordinary members", private individuals, whose aggregate contributions were much lower. It was found as a fact that hotel members made the contributions themselves; they did not act as a conduit for their guests. There were three or four hotel members and over 450 ordinary members. Each hotel member and ordinary member had one vote each and a pro-rata proprietary interest in the club's assets. This constitution meant that the hotel members, despite making the more significant contributions, enjoyed only a small proprietary interest in the assets and could easily be outvoted by the ordinary members.

54. The question arose as to whether Lord Macmillan's "cardinal requirement" was met. Mr Henderson referred us to a passage of Lord Wilberforce's speech in which he said at p.423E:

> Their Lordships do not consider that it is legitimate to have regard to some "substance" of the arrangement – in the sense that it is permissible to look through the hotel members to their guests and to conclude that the hotel subscriptions come "in reality" from the hotel guests. Such a conclusion could only be justified by departing from the finding of the trial judge that hotel guests do not make payment to the club.

55. We do not read this passage as a general injunction against "painting with a broad brush". Lord Wilberforce was simply saying that the Privy Council would not make factual findings that departed from those of the trial judge. At p.423F-G he emphasised the multifactorial nature of the test, saying:

> It may not be an essential condition of mutuality that contributions to the fund and rights in it should be equal; but if mutuality is to have any meaning there must be a reasonable relationship, contemplated or in result, between what a member contributes and what, with due allowance for interim benefits of enjoyment, he may expect or be entitled to draw from the fund: between his liabilities and his rights.

56. It is also worth noting the stress laid by the Privy Council on the significance of the nature of the transactions. The fact that hotel members were, like ordinary members, members of the club, did not prevent the arrangement with the hotels from continuing to be characterised as "essentially a trading relationship", as it had been before they became members. Lord Wilberforce said at p.424D:

> What is, and always has been, of significance is not the fact of membership or non-membership but the nature of the transactions: if these were trading transactions, the addition of membership makes no difference…

57. Finally, as we have noted, the FTT based its conclusions in part on what it considered to be an analogy with the judgment of the House of Lords in the *Municipal Mutual* case, and we should therefore say something more about that authority. In that case the taxpayer company was formed for the purpose of insuring against fire. The effective control of the company was in the hands of holders of fire policies and those holders were members of the company and entitled, in the event of a winding-up, to receive surplus assets of the company. Over time, the company came to write "other" insurance business. Some of that "other" business was written with persons who did not hold fire policies, but some of it was written with holders of fire policies. Surpluses generated from the writing of fire insurance and "other" insurance were used in reducing premiums payable for fire insurance alone. HMRC accepted that any surplus generated by fire insurance premiums was not a taxable profit by application of the mutuality principle. The taxpayer accepted that any surplus generated on "other" insurance policies written with persons who did not hold fire policies was taxable. The dispute concerned the treatment of the surplus on "other" business attributable to persons who also held fire policies. It was held that this surplus fell outside the scope of the mutuality principle and was taxable.

58. In our judgment, the *ratio* of the decision was that, although holders of fire policies would benefit from the surplus generated by "other" insurance policies that they entered into, they did not benefit from that surplus in the correct capacity. They contributed to the surplus at issue in their capacity as holders of "other" policies but they benefited from that surplus in their capacity as holders of fire policies. Rowlatt J at first instance expressly decided the case on that basis, giving the same example of a railway company that does business with its shareholders as he had given in *Jones v The South-West Lancashire Coal Owners' Association*. All of their Lordships made this essential point in their speeches even if they did not express it in identical terms to those used by Rowlatt J.

Discussion

2007 to 2013

59. The FTT's conclusions in relation to 2007 to 2013 were vitiated by an error of law consisting of an incorrect conclusion that each MDU member was required to pay an "Individual Premium" under their PI Policy that was unreduced by the PEA. That error of law was material to the FTT's conclusion and, accordingly, we set aside the FTT's decision for those years. We will remake the FTT's decision by applying the law on mutual trading, including Lord Macmillan's "cardinal requirement" in the light of a correct appreciation of the various contracts.

60. HMRC argue that, in paying "Individual Premiums" to the Insurer MDU members were not contributing to any common fund. It follows in HMRC's submission that any

payment of the PEA from the Insurer to the MDU could not form part of the surplus of that common fund.

61. We reject the premise of that argument. As we have concluded, in years up to 2013 MDU members were not paying "Individual Premiums" to the Insurer. Rather, each member paid a membership subscription set by the MDU, with that payment standing as consideration for both the MDU's agreement to provide membership and the Insurer's agreement to provide a PI Policy. In years up to 2013, the PIISSA operated to determine how much of that membership subscription the MDU could keep and how much it had to pay over to the Insurer. Accordingly, the focus should not be on the notion of an "Individual Premium", but rather on the membership subscriptions that the members were paying. HMRC do not dispute that ordinary membership subscriptions were paid into the requisite common fund (as demonstrated by its acceptance, outside the context of this particular dispute, that membership subscriptions paid by MDU members are not taxable by operation of the mutuality principle).

62. The next task is to identify those persons who are contributors to that common fund. The MDU says that the contributors are the members alone. HMRC say that the Insurer was also a contributor to the extent of the PEA. In the years up to 2013, we consider this question is determined by our analysis of the PIISSA and the individual PI Policies as set out at [30] and [45] above. When the terms of those contracts are properly appreciated, the Insurer was not a contributor because, in years up to 2013, it had no contractual obligation to pay (and did not pay) the PEA to the MDU. On the contrary, the PEA operated as a reduction in the amount that was to be paid to the Insurer pursuant to the PIISSA. It follows that the only contributors to the common fund up until 2013 were the individual MDU members.

63. The remainder of the "cardinal requirement" that Lord Macmillan set out in *Municipal Mutual* is satisfied. The class of persons that benefit from the mutual fund is the members of the MDU from time to time. That is precisely the class of beneficiaries that made the contributions to the mutual fund. HMRC evidently do not dissent from this proposition because they accept that, absent the complexities to which the PEA gives rise, ordinary members' contributions to the MDU are not subject to corporation tax.

64. We remake the Decision so as to allow the MDU's appeals against HMRC's discovery assessment for the accounting period ended 31 December 2007 and against HMRC's closure notices for the accounting periods ended 31 December 2008, 2009, 2010 and 2011.

2014

65. Different considerations arise in 2014, as in that year the Insurer made an actual payment to the MDU in respect of the PEA. For that year, the FTT should have applied the principles we have distilled from the authorities to address the following questions:

> (1) Whether the payment from the Insurer should be regarded as derived from a different category of activity from the mutual activities of the MDU

(applying the approach in *The Carlisle and Silloth Golf Club v Smith* and *Walter Fletcher v Income Tax Commissioner*).

(2) Whether any contribution to surplus arising from the payment of the PEA should be regarded as made by the Insurer or by individual MDU members, such that there was the necessary identity between the contributors to the common fund and participators in it.

(3) Whether it makes any difference that MDU members held individual PI Policies and that Services collected subscriptions as agent of the Insurer as well as the MDU, rather than (for example) the MDU holding a group policy.

66. In its analysis at [149], the FTT did not apply the correct principles as set out in the authorities. Instead, it made observations to the effect that the PEA could be seen as allocating some of the profits derived from PI Policies back to the MDU, that there was no "miscalculation" of the kind set out in *Municipal Mutual*, that the PEA had some similarities with revenue generated from the "other" business in *Municipal Mutual*, and referred to the extent of the commercial negotiations between the MDU and the Insurer.

67. In our judgment, the FTT's compressed reasoning in paragraph [149] of the Decision included an error of law consisting of a failure to follow the correct approach. In particular, we consider the FTT's reliance on the outcome of the *Municipal Mutual* case to be misplaced. As we have noted, the difficulty for the taxpayer in that case was that fire policy holders who bought "other" insurance policies were contributing to the surplus in their capacity as holders of those "other" policies, but benefiting from it in the capacity of holders of fire policies. *Municipal Mutual* did not, therefore, give any direct guidance as to how the questions set out at [65] above should be approached. We will, therefore, set aside the FTT's conclusion as relating to 2014 and remake it by applying what we consider to be the correct approach.

68. The FTT's findings of fact demonstrate that the MDU asked the Insurer to provide PI Policies to its members for precisely the same reasons that the MDU used subscriptions from members to maintain a mutual fund: to ensure that MDU members had cover against the risk of professional negligence actions. Obtaining protection for that risk was a mutual objective. The MDU was, because of its strong bargaining position, able to ensure that, if an Insurer had a favourable claims experience, it would adjust the aggregate premiums that it had received, and would do so by payment to the MDU if the PIISSA had been terminated. The MDU could then add any such payment to its mutual fund to provide discretionary cover for its members against future claims.

69. This was not a situation analogous to the investment return generated on an investment of the MDU's mutual fund which derives from a separate investment activity (a return which it is not disputed is taxable). Rather, it involved a payment back of part of the very sums that had originally been paid over to the Insurer by the members. The MDU's dealings with the Insurer did not, in our judgment, result in it undertaking a separate activity with the Insurer. Instead, because the claims outcome, and therefore the return to the Insurer, could not be forecast with certainty at the outset, the PEA provided a mechanism to adjust the aggregate premium paid at a later date to arrive at an agreed level of return.

70. The question of whether the payment of the PEA in 2014 represented a contribution to the surplus on the common fund made by the Insurer or by the MDU's members is more difficult than the position for earlier years. Clearly it is significant that the payment itself was made by the Insurer. However, it would be wrong to lose sight of other relevant factors.

71. First, the payment in 2014 reflected the fact that the Insurer's contractual entitlement to premiums under the PIISSA was always subject to the PEA adjustment mechanism. The payment the Insurer made in 2014 was not, therefore, some new act, unrelated to past events. But for the termination of the contract that adjustment would have taken the form of a reduction in the Premium Element paid to the Insurer for one or more subsequent periods. The payment ensured that, overall, the Insurer received and retained the agreed level of return in respect of earlier periods, and no more.

72. Second, it is significant that the payment of the Premium Element to the Insurer pursuant to the PIISSA was necessarily to be funded entirely out of subscriptions that MDU members paid. All the money subjected to the scheme of the PIISSA came from MDU members by way of subscription. The level of subscriptions charged was set by the MDU alone: the Insurer was not involved in that process (see the Decision at [73]). A lower Premium Element would mean that the MDU's mutual fund would be augmented to a greater extent than it would be if the Premium Element was higher. The payment in 2014 simply meant that, once all necessary adjustments in respect of the PEA had been made, the MDU was able to retain a greater proportion of those subscriptions than had at first been thought.

73. It is instructive to consider the position that would have applied if the Insurer had, in each relevant Policy Period, been able to price its insurance coverage so as to give it precisely its target return, no more and no less. In that case, the augmentation of the MDU's mutual fund represented by the membership subscriptions remaining after the Insurer had been paid would have been straightforwardly outside the scope of tax because of the mutuality principle. The payment in 2014 simply put the MDU's mutual fund back in the position it would have been in if the Insurer had priced its policies precisely when first written. The only difference was that the MDU had to wait until the various adjustments contemplated by the PEA had been made before being restored to that position. We see no reason of principle why the payment in 2014 should fall outside the mutuality principle in those circumstances. Rather, in our judgment, an analysis of all the relevant factors leads to the conclusion that the payment in 2014 simply represented an adjustment to the amount of member contributions, made in previous years, that the MDU was entitled to retain. Understood in those terms, the payment in 2014 represented a contribution to the surplus made by the MDU's members, in that capacity. There was therefore the necessary identity between contributors to the fund and those entitled to it.

74. A slightly different way of looking at matters, focusing on premiums rather than member contributions and also addressing the third question raised at [65] above, is that the insurance arranged by the MDU was part of the mutual activity of obtaining protection against professional negligence claims. The subscriptions that MDU members paid included sums that were to be aggregated and paid to the Insurer. The

fact that there were individual policies, rather than a group policy, did not affect the nature of that activity. PI Policies could only be held by persons who were MDU members. MDU members could not realistically be said to be acting in a different capacity as PI Policy holders. Pricing was on an aggregate basis, and was agreed by the MDU on behalf of its members. To the extent that any PEA was determined to arise following termination of the PIISSA, that meant that (aggregate) premiums had been overpaid by MDU members collectively. The excess, being the PEA, was paid to the MDU, for the benefit of its mutual fund and thus for the benefit of MDU members. That should not give rise to a different treatment than if the PEA had been returned to members directly (and whether or not it had then been contributed by them to the mutual fund).

75. It is important to bear in mind the fact that the existence of the MDU as a separate legal entity is not determinative. It is instructive that in *New York Life Insurance Co v Styles* both Lord Herschell and Lord Macnaghten approached the question by considering what the position would have been if there had been no incorporated entity (pp.481 and 484). If the MDU had not been incorporated it is hard to see how the payment by the Insurer in 2014 could be characterised as anything other than a refund of overpaid premiums, and not a profit derived from a taxable activity.

76. We have considered whether the fact that Services collected subscriptions on behalf of the Insurer and the MDU, rather than the full amount of the subscriptions being received by the MDU and the MDU paying premiums to the Insurer, makes any difference to the analysis. The argument might be that MDU members were not contributing to a common fund when the premium element of the subscriptions was paid to the Insurer, and therefore that characterising any PEA as an adjustment to premiums cannot assist the MDU.

77. We do not consider that this feature prevents the mutuality principle applying. Premiums were paid to the Insurer on an aggregate basis, out of the common fund represented by the membership subscriptions. Again, it is instructive to consider what the position would be if the MDU did not exist as a separate legal entity. In that case premiums would also have been payable directly by the members to the Insurer, as an expense of the common fund represented by the subscriptions, and any PEA would have been returned to them in the same capacity. The nature of the mutual activity was the arrangement of insurance on terms which reflected the collective bargaining power of the MDU membership.

78. Once these points are appreciated, the remainder of the analysis set out at [63] above applies mutatis mutandis and the payment in 2014 is not subject to corporation tax by operation of the mutuality principle. Accordingly, we remake the Decision so as to allow the MDU's appeal against the closure notice for the accounting period ended 31 December 2014.

Disposition

79. For the reasons set out above, we allow the appeal. The Decision is set aside and replaced by a decision that the MDU's appeals against HMRC's discovery assessment and closure notices are allowed in their entirety.

80. Given our conclusions above, it is not necessary to consider the MDU's appeals as relating to the validity of the discovery assessment for 2007.

Signed on Original

MRS JUSTICE FALK

JUDGE JONATHAN RICHARDS

RELEASE DATE: 07 October 2021