[2020] UKFTT 227 (TC)

TC07713

CORPORATION TAX – mutual trading – complex insurance arrangements – whether premium element adjustment falls within mutuality exemption – discovery assessment – sufficiency of information provided to HMRC - s979 Corporation Tax Act 2009

FIRST-TIER TRIBUNAL
TAX CHAMBER

Appeal number: TC/2017/03506

BETWEEN

THE MEDICAL DEFENCE UNION LIMITED **Appellant**

-and-

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

TRIBUNAL: JUDGE ALEKSANDER
NICHOLAS DEE

Sitting in public at Taylor House, London EC1 from 1 July 2019 to 3 July 2019

Patrick Way QC and Imran Afzal, counsel, instructed by BDO, for the Appellant

James Henderson and Laura Poots, counsel, instructed by the General Counsel and Solicitor to HM Revenue and Customs, for the Respondents

DECISION

INTRODUCTION

1. The Medical Defence Union Limited ("the MDU") appeals against (i) a discovery assessment for the period ended 31 December 2007, and (ii) closure notices in respect of the periods ended 31 December 2008, 2009, 2010, 2011, and 2014, as follows:

Period ended	Corporation tax	
31/12/2007	£8,958,828.30	Discovery assessment
31/12/2008	£7,019,105.32	Closure notice
31/12/2009	£3,936,318.12	Closure notice
31/12/2010	£5,359,686.92	Closure notice
31/12/2011	£5,008,613.06	Closure notice
31/12/2014	£7,637,806.02	Closure notice

2. The substantive issue concerns the correct tax treatment of amounts paid to the MDU in respect of a premium element adjustment ("PEA") under the insurance arrangements in force during the periods under appeal.

3. For the year ended 31 December 2008, the closure notice made amendments to the MDU's corporation tax return in respect of another issue, which is no longer in dispute. It is therefore agreed that the corporation tax amount in dispute for this year should be reduced to £6,890,898.66

4. In addition, there is a dispute over the validity of the discovery assessment made for the period ended 31 December 2007. If the substantive issue is decided in favour of the MDU, the validity of the discovery assessment becomes irrelevant.

5. The burden of proof in relation to the tax treatment of the PEA rests with the MDU. The burden of proof in relation to the right of HMRC to raise a discovery assessment rests on HMRC.

6. Mr Way and Mr Afzal represented the MDU, and Mr Henderson and Ms Poots represented HMRC. We heard evidence from Charles Wander (a solicitor who represented the MDU in relation to the negotiation of the various contractual documents that are considered in this appeal), Dr Christine Tomkins (the chief executive of the MDU since 2009, and previously - since 2005 - the deputy chief executive), Maurice Gallivan (who was the finance director of the MDU at all relevant times), and Paul Bougourd (the Inspector of Taxes responsible for the making of the discovery assessment). In addition, bundles of documentary evidence were produced.

7. A large part of Mr Wander's evidence related to the interpretation and meaning of contractual documents. Mr Wander was not giving evidence as an expert, and in any event, as these were documents governed by English law, the meaning of these documents was an issue for submissions by the representatives of the parties, rather than for evidence. However, we decided to allow Mr Wander to give his evidence, but on the basis that we would attach such weight to it as we thought fit. In the end, whilst we found Mr Wander's evidence to be helpful in setting the documents in context, we placed little weight on his evidence as to the construction of the documents, as we were able to establish their meaning for ourselves.

THE PREMIUM ELEMENT ADJUSTMENT

Tax law re-write

8. The Corporation Tax Act 2009 ("CTA 2009") came in to force in relation to the MDU's accounting periods under appeal for the period ended on 31 December 2009 and the subsequent periods. We do not propose in this decision to constantly cross-refer between the pre-CTA

2009 legislation and the CTA 2009. Therefore, references in this decision to the pre-CTA 2009 legislation should be taken to include the equivalent provisions in the CTA 2009 – and vice versa.

9. Thus, references in this decision to Schedule D, Case I, or to Schedule D, Case VI in s18, Income and Corporation Taxes Act 1988 should also be taken as references to s35 CTA 2009 and s979 CTA 2009 respectively (and vice versa).

Mutuality

10. The issue in this appeal is whether the PEA represents trading (or otherwise taxable income) in the hands of the MDU, and if it does, whether that income is outside the scope of corporation tax because of the mutuality principle.

11. Profits or surpluses generated from mutual activities are outside the scope of taxation (more conveniently described in this decision as an "exemption" from tax). There is no provision in the Corporation Tax Acts which expressly takes companies trading “mutually” outside the scope of taxation, but that principle is long established. And although the Taxes Acts refer to "mutual trading" (for example s101 CTA 2009 and s1071 Corporation Tax Act 2010), there is no statutory definition of the term. The meaning of "mutual trading" and its scope are derived solely from case law.

12. The principle was originally conceived in relation to unincorporated traders. The underlying principle is that where persons carrying on a trade do so with themselves, no profits or gains are yielded by the trade for tax purposes, and therefore no assessment to tax can be made in respect of any surplus generated by the trade. Although these underlying principles relating to mutual trading were originally established in relation to unincorporated traders, the mere fact that a mutual concern is a body corporate does not destroy the element of "mutuality", and the consequential non-liability to tax.

13. It is not disputed that the MDU is a mutual association. But the mere fact that it is a mutual body does not mean that its activities are automatically exempt from tax.

14. One of the leading cases on mutuality concerned Municipal Mutual Limited, which was a company limited by guarantee established to enable local authorities to insure against fire and other risks (such as employers' liability). The effective control of the company was in the hands of the fire policy holders, who alone were entitled, in the event of a winding-up, to the surplus assets of the company. Over time, Municipal Mutual extended its business to insure virtually all other perils. It maintained separate funds for its fire business and its "other" business. The surpluses generated on both the "fire" and the "other" funds were applied to reduce the premiums payable for fire insurance (there was no reduction for premiums for insurance for "other" perils). It was conceded by the Crown that the fire insurance business was a business of mutual insurance and that the surplus arising from the fire business was not liable to tax. The point at issue was the taxability of the surplus arising from the "other" business. Municipal Mutual contended that only the surplus arising from trading with non-fire policy holders was taxable. The Crown contended that the whole of the surplus arising on the "other" fund was taxable. In his judgment in favour of the Crown in the High Court (*Municipal Mutual Insurance Ltd v Hills* (1931) 16 TC 430 at 438), Rowlatt J gave the classic definition of “mutuality”:

> …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.

15. The case was appealed, and eventually came before the House of Lords, who unanimously decided in favour of the Crown. Viscount Dunedin in the House of Lords said that the matter depended on to whom the profits went (at 441):

> 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

16. Lord Macmillan said (at 447):

> My Lords, the principle on which the surpluses arising in the conduct of a mutual insurance scheme are not taxable as profits is now well understood. The essence of the matter is that a number of persons who are exposed to some contingency, whether the inevitable contingency of' death or such possible contingencies as fire, employees' claims, marine casualties or the like, associate themselves together as contributors to a common fund on the footing that if the contemplated contingency befalls any contributor he or his representatives shall receive a compensatory payment out of the common fund proportional to his contribution. The scale of contribution or premiums is fixed on experience and estimate. If it is found to yield more than enough to satisfy the claims that emerge the contributors receive the entire benefit in the shape of bonuses, reduction of future contributions or otherwise. As the common fund is composed of sums provided by the contributors out of their own moneys, any surplus arising after satisfying claims obviously remains their own money. Such a surplus resulting merely from mis-calculation or unexpected immunity cannot in any sense be regarded as taxable profit. This was clearly laid down in the case of the *New York Life Insurance Company v Styles*, 14 App. Cas. 381 1, and is now beyond dispute.
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> 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. If this requirement is satisfied, the particular form which the association takes is immaterial.

17. As there was no complete identity of contributors and participators in relation to the "other" insurance business, it was held that the surpluses on that "other" business were taxable.

18. *Fletcher v Income Tax Commissioner* [1972] AC 414 is a decision of the Privy Council concerning the bathing beach owned by the Doctor's Cave Bathing Club in Jamaica. The club members comprised around 500 residents and three or four hotels. Originally a daily fee was paid to the club for the use of the beach by a hotel guest. But in 1963 the arrangements were changed, and the hotels became "hotel members" of the club. The hotels paid a subscription of a small fixed amount, plus a variable amount based on the number of the hotels' guests in a season. On a dissolution of the club, any surplus was divisible equally among the members (including the hotel members). The club asserted that the surplus generated from all subscriptions was not taxable on the ground of mutuality. The hotels' subscriptions for the tax year under appeal were six times the amount of the ordinary subscriptions. The Privy Council held that the disparity between the contributions of the hotels and their right to participate in

any surplus meant that the relation between the club and the hotels was an ordinary trading relationship, the profits from which were taxable.

19. Their Lordships noted "that except in the simplest cases, no single criterion is likely to be decisive." They went on to say:

> Cases in which groups of persons making contributions towards a common purpose have been held not liable for tax on any surplus over expenditure, fall under a number of heads. The expression "the mutuality principle" has been devised to express the basis for exemption of these groups from taxation. It is a convenient expression, but the situations it covers are not in all respects alike. In some cases the essence of the matter is that the group of persons in question is not in any sense trading, so the starting point for an assessment for income tax in respect of trading profits does not exist. In other cases, there may be in some sense a trading activity, but the objective, or the outcome, is not profits, it is merely to cover expenditure and to return any surplus, directly or indirectly, sooner or later, to the members of the group. These two criteria often, perhaps generally, overlap; since one of the criteria of a trade is the intention to make profits, and a surplus comes to be called a profit if it derives from a trade. So the issue is better framed as one question, rather than two: is the activity, on the one hand, a trade, or an adventure in the nature of trade, producing a profit, or is it, on the other, a mutual arrangement which, at most, gives rise to a surplus?
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> 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. The hotel members may be said, through the advantages gained for their guests, to derive current advantages commensurate with their subscriptions; but as regards any surplus, the disparity between their interest and that of ordinary members is one of substantial scale. Each hotel has one share: the hotels in aggregate have 3 (or 4) shares against 450-900 of the ordinary members. Similarly as to votes - one per hotel and one per each ordinary member. The ordinary members as a group have an overwhelmingly greater interest in the regularly earned surplus - admittedly not in practice distributed, but which could be distributed if the ordinary members wished, and which, if not distributed, goes to increase the value of property which is predominantly theirs.
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> […]
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> The ordinary members as a group were trading, for profit, with the hotels. Was then a radical transformation brought about in 1963 when the hotels became subscription paying members - paying (in addition to the house count charge) £1 10s. per annum and entitled each to one vote? In their Lordships' opinion so to conclude would amount to a distortion, if not a mockery, of the mutuality principle. The hotels may have become members in 1963; but side by side with their membership there continued the pre-existing relationship with the ordinary members which was essentially a trading relationship, similar to that with outside visitors. 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:

20. Thus, it can be seen that the mutuality principle does not rest upon the business's surplus arising from trading with its members. It is not membership (or non-membership) which

determines immunity or liability to tax – it is the nature of the transactions. It is only if the transactions have a mutual nature (namely the customers of the business being entitled to share in any surplus generated by the business) that the exemption applies.

Background Facts

21. On the basis of the evidence before us, we find the background facts to be as follows.

Move by the MDU to commercial insurance

22. The MDU is a mutual company. It provides a range of benefits to its members who are doctors, dentists, nurses, and other healthcare professionals. A significant benefit provided by the MDU to its members is assistance and indemnity relating to allegations of professional negligence. There are other services which are provided in relation to other medico-legal matters.

23. There is no automatic entitlement of members to benefits in respect of any claims arising. Instead a member has a right to have a request for assistance considered by the Board of the MDU. Because the assistance is discretionary, the MDU was held not to be an insurance company in the case of the *Medical Defence Union Limited v. Department of Trade* [1980] Ch 82. It is a requirement of registration with the General Medical Council ("GMC") that all doctors must have appropriate professional indemnity and the discretionary indemnity which is provided by the MDU is recognised as appropriate by the GMC.

24. It is accepted that the income derived from MDU membership subscriptions which accrue to the MDU's discretionary mutual fund fall within the mutuality exemption. But it is accepted by the MDU that a number of its activities (such as the provision of revision courses for medical students) fall outside the mutuality exemption, but these form only a very small part of the MDU's activities and are loss making. Also falling outside the scope of the mutuality exemption are any profits derived from the investment of its mutual fund.

25. The discretionary indemnity provided by the MDU was provided on an incident-occurred or occurrence basis. The right to request assistance extends to the estate of a deceased former member. This meant that, provided that a member had paid the subscription for a particular year, that member was entitled to request assistance in respect of any incident which occurred in that actual year notwithstanding that membership might have ceased by the time the incident was reported and the claim made. It is in the nature of allegations arising from clinical practice, and particularly for medical negligence claims, that they may be brought many years after the original incident occurred.

26. There was therefore a risk of claims arising where the indemnity, albeit discretionary, would be called upon many years after the incident had occurred.

27. During the 1990s the MDU identified that a potentially severe "funding gap" had arisen in its business model. The occurrence basis of membership meant that, although subscriptions were collected in, say, 1980, in respect of claims arising from any incidents in that year, the actual claim may not be made until many years later. Although the limitation period for medical negligence claims is three years, where there is a child involved, the limitation period does not start to run until the child reaches the age of majority. The courts also have a discretion to extend limitation, and this is not uncommon where, for example, there is mental incapacity. The implications of this became increasingly apparent in the 1980s and 1990s, with damages awards for medical negligence rising and MDU subscriptions failing to keep pace. In theory, claims arising from a particular year should have been funded by the subscriptions collected in that year, but this became impossible with liability for claims increasing at a rate greater than the rate of subscription increases. The MDU, with advice from its actuaries, recognised that its

mutual fund was likely to be insufficient to fund the claims that might come through in the years to come.

28. In view of this, the Board of the MDU decided to change the way in which its members were protected. The MDU introduced an insured "claims made" indemnity to sit alongside the discretionary protection provided from the mutual fund. The members were provided with an insurance policy as part of the benefits of membership and, importantly, the insurance cover would be for clinical negligence claims notified in the particular policy year. This meant that MDU members would have both the benefit of a contractual policy of insurance together with the continuing discretionary benefits of membership in respect of matters falling outside the terms of the policy.

29. The MDU was also looking for a deal which included insurance for itself against any deterioration of its own financial position. This was termed "shortfall insurance/reinsurance". The MDU bought reinsurance cover each year for those risks through MDU Reinsurance Limited ("MDU Re"- a Guernsey subsidiary of the MDU which is authorised as an insurer by the Guernsey FSC).

30. By restricting the MDU's exposure to "long tail " risks (primarily claims against former and retired members), the insurance arrangement would enable the MDU over time to transfer risk from its discretionary mutual fund to commercial insurers. At the same time, the balance of members’ subscriptions, after payment of insurance premiums, would remain to accrue to the mutual fund.

31. The period during which insurance policies were provided to members ran from 2000 until 2013 (although this appeal only relates to the year ended 31 December 2007 and later years). By 2013, the circumstances in which MDU was operating, including the financial environment and relevant government policy, had changed considerably and the MDU found it appropriate to revert to providing the membership exclusively with a discretionary indemnity and the insurance arrangements ceased.

32. Although this Appeal does not extend to the initial periods for which insurance arrangements were in place, it is helpful to describe how the arrangements were originally established, and the changes made to those arrangements over time.

Original arrangements with Zurich

33. The MDU started discussions with several insurance groups. Ultimately detailed negotiations were held with Zurich Re (a division of Zurich Insurance Company – “Zurich”). It was agreed that a joint venture company, MDU Services Limited ("Services"), was incorporated for the purposes of administering the arrangements. Services would take over the MDU's assets (other than the mutual fund itself) and its trading liabilities, and would assume the employment contracts of the MDU's employees. The shares of Services were owned by the MDU and by Zurich (although in December 2007, the MDU acquired all the shares in Services).

34. Definitive agreements were signed in April 2000, which included:

(1) a subscription and shareholders' agreement in respect of Services ("the SSA"). This regulated the relationship between the MDU and Zurich, as shareholders in Services, and the basis on which Zurich would provide professional indemnity insurance to the MDU members;

(2) sale documentation for the "hive down" of the MDU's assets and liabilities to Services;

(3) various ancillary documents such as property licences and brand/trademark licences from the MDU to Services;

(4) the shortfall insurance/reinsurance.

35. The precise details of the insurance contracts and the identity of the insurer(s) changed over time (in the latter years of these arrangements there were joint insurers), but the principal features of the arrangements remained much the same:

(1) The insurers offered professional indemnity insurance, in an agreed form, to each MDU member.

(2) Each member was issued with an individual professional indemnity policy ("PI Policy") by the insurers. The insurance offered was not issued to the MDU members as a group.

(3) The insurers retained the right to refuse to issue a PI Policy to particular individuals.

(4) The PI Policy operated on a "claims made" basis: a claim was covered if it was made in the year in which the PI Policy was written, even if the incident giving rise to the claim occurred many years earlier, so long as the individual had been a member of the MDU at the time of the incident.

(5) Services dealt with the issue and administration of the PI Policies on behalf of the insurers.

(6) Insurance premiums were (as explained below) collected by Services from the MDU members as agent for the insurers.

(7) Services provided various administrative and support services in respect of the PI Policies, including claims handling, and providing related advice to MDU members.

(8) Each MDU member paid an annual amount to Services ("the Individual Subscription"). The Individual Subscription included the premium payable by the member in respect of the PI Policy ("the Individual Premium").

(9) Services received all of the Individual Subscriptions as agent on behalf of the MDU and the Insurers (when aggregated, "the Subscriptions"). The Subscriptions comprised:

(a) The aggregate of the Individual Premiums, which was collected by Services on behalf of the Insurers.

(b) An element which Services retained, and which covered Services' own management costs ("the Management Costs Element"). The MDU became the sole shareholder of Services from December 2007, and Services ceased to collect and retain the Management Costs Element after April 2008.

(c) The balance of the Subscriptions, which, broadly, was collected by Services on behalf of the MDU ("the MDU Element").

Premium Element Adjustment

36. One of the key concerns for the MDU was the level of premiums to be charged to members for the PI Policy. Dr Tomkins in her evidence says that the PEA was an integral and necessary part of the arrangements, and its purpose and effect was to ensure that the total premiums paid collectively over time by members for insurance cover were kept to the minimum amount that the MDU was able to negotiate with insurers.

37. In his evidence, Mr Gallivan said that the MDU was anxious to minimise the cost of the insurance to its members, and in achieving this aim, the MDU was assisted by its strong

bargaining position – the opportunity for Zurich to generate very substantial total premiums from over 80,000 MDU members was very valuable commercially, as was the prospect of marketing other Zurich products to MDU members.

38. Mr Wander's evidence was that although the aggregate amount of the premiums for the PI Policies was agreed for the first year, the MDU was concerned that Zurich would be able to set the premiums in subsequent years at a level that was higher than the amount the MDU might consider to be appropriate or reasonable for its members. The setting of insurance premiums is based on actuarial assessment of a wide range of factors and on a subjective assessment by the insurer of its exposure to risk. The MDU had over 130 years' experience of dealing with clinical negligence claims and it considered that its estimates of claims costs were more likely to turn out to be correct than the estimates of the insurers. The agreements reached with the insurers therefore include a mechanism to ensure that if the MDU's estimates proved to be right, the MDU members would not have overpaid the insurers for the provision of the PI Policies.

39. Accordingly, it was agreed that the premiums payable for each policy year were subject to a review, looking back at the actual claims outcome for notifications made during the relevant year. To the extent that the premiums paid for the policy year under review turned out to have delivered the insurer more than its required return on capital, after claims were paid, half of this excess was credited against the premiums payable for the following year (this is the Premium Element Adjustment - PEA). Because negligence claims take many years from first notification to reach a conclusion, the review was undertaken on a cumulative basis for all years over an extended time period. Indeed, often the notification will merely be of circumstances which may lead to a claim, but the actual claim may not necessarily result in a claim, or may only manifest itself years later.

40. Zurich accepted that it would take the risk (as underwriter) on underpricing the premiums. This is because a two-way adjustment would mean that there was no transfer of risk, and create (in essence) a "moral hazard" for the insurer, as there would have been no transfer of risk because the insurer would know it would always be paid more if the claims experience was higher than it had anticipated.

41. The PEA worked, broadly, as follows:

(1) the adjustments started at the fifth anniversary of inception of the first annual policy period, and continued each year (and would carry on, without any time limit, until all claims from the policy period were finally settled);

(2) the PEA was 50% of what was described as the "actual insurance operating return" ("IOR"), minus the amount of the premium multiplied by the "goal IOR%". The goal IOR is derived from the insurer's return on equity goal, and the SSA gives an example of goal IOR of 9%;

(3) the PEA is accumulated over all annual policy periods, and the PEA as at each adjustment date is the sum of the PEAs for each policy period that is the subject of a PEA;

(4) at each adjustment date, the PEA is the accumulated PEA minus the previous accumulated PEA;

(5) if the PEA adjustment is positive, the premiums payable are reduced by this amount. If the PEA is negative, the premiums are increased by this amount;

(6) although, because there was no two-way adjustment, the PEA is only applied if the accumulated PEA is greater than zero.

42. If it transpired from the review that Zurich that the PEA was positive, the PEA would be applied by a reduction of the premiums payable for the next policy year after the recalculation. It could never increase the Premium Element retrospectively in respect of a prior year. We consider the terms of the SSA dealing with the PEA in more detail below.

Demerger of Zurich Re

43. In December 2001 Zurich Re was demerged from Zurich as Converium. Under the demerger arrangements, Zurich Re's relationship with the MDU transferred to Converium. Converium was not at that point authorised by the (then) FSA to issue UK insurance policies, so Zurich "fronted" the policies. In essence, the insurance policies were issued by Zurich, but the polices were reinsured by Zurich with Converium. In consequence, Converium assumed the economic consequences of the underlying risks, and were responsible for setting the level of the premiums. This provided an opportunity for the MDU to renegotiate some of the terms.

44. Zurich transferred its shares in Services to Converium and a new shareholders' agreement was concluded, and the SSA was terminated. The new agreement contained many of the same provisions as the SSA, but included a new right for the MDU to terminate the joint venture and buy out Converium's shares in Services if there was a change of key management at, or a change of control of, Converium.

45. The provisions for the pricing and issue of the PI Policies to MDU members were henceforward governed by a Professional Indemnity Insurance Supply and Services Agreement with Zurich ("PIISSA", the PIISSA signed in December 2001 being the "2001 PIISSA"). The terms of the PEA were governed by the PIISSA. Although the PI Policies were issued by Zurich (or, in the case of Irish MDU members, by an Irish subsidiary of Zurich), because of the fronting arrangements, it was Converium which dealt with the setting of Premium Element.

46. The PEA in the 2001 PIISSA was essentially the same as in the SSA, and it:

(1) clarified that the accumulated PEA was always subject to a minimum of zero; and

(2) adjusted the return on equity goal to include the internal rate of return for Converium's reinsurance of the policy. There is an example in the 2001 PIISSA of a goal IOR of 12.8%.

2002 Stockmarket crash

47. There was a severe downturn in the stockmarkets in 2002, and this had had an adverse effect on the value of the MDU's mutual fund. The MDU was concerned about the potential for an unfunded shortfall in its mutual fund. It agreed the following with Converium to address the risk of a shortfall:

(1) the annual cover under the shortfall insurance/reinsurance was increased to £80 million;

(2) the PEA calculation was revised so that:

(a) the PEA calculation would cease after termination of the PIISSA; and

(b) if a claim were made under the shortfall insurance/reinsurance between 2005 and 2009 in excess of the experience account balance, the amount of this excess would be offset against the PEA;

(3) an option was granted, allowing the MDU (through its subsidiary MDU Investments Limited) to require Converium to invest £20 million in preference shares; and

(4) the MDU agreed to commute an Adverse Loss Development policy (which had been underwritten in 1998), with a return premium of £8 million.

Converium's authorisation by the FSA

48. In 2003, Converium's subsidiary Converium Insurance (UK) Limited ("CIL") was authorised by the FSA to issue insurance policies in the UK and terms were reached for it to take over the underwriting of the PI Policies. In consequence:

(1) the PIISSA with Zurich was terminated (although Services would continue to provide claims handling (and some other services) for policies that had been previously issued by Zurich);

(2) a new PIISSA (the "2003 PIISSA") was concluded with CIL, which among other things allowed CIL to include a fronting fee of up to 2.5% in its calculation of the premiums. The PEA was unchanged;

(3) variation of the shareholders' agreement with Converium to include references to the insurance being underwritten in future by CIL and to reflect negotiated changes to the PIISSA terms; and

(4) some changes were made to the shortfall insurance/reinsurance agreements and to the brand and database licences, to reflect that CIL would now be the insurer.

SCOR takes over Converium

49. In 2007, Converium was acquired by SCOR, a large French reinsurer. This triggered the MDU's right to terminate the joint venture.

50. By this time, the MDU's finances had become considerably stronger, and there was no longer any need for its balance sheet to have the support of the preference share option. The MDU wanted to continue the underwriting relationship with SCOR/Converium, but saw this as an opportunity to take full control of Services, to improve the way in which premiums were set (and to establish the accrued position of the PEA) and to be allowed the opportunity to bring in one or more co-insurers with a view to creating some competition in premium setting. It was also able to negotiate commutation of the shortfall insurance/reinsurance, and its replacement by shortfall insurance/reinsurance on revised terms.

51. Eventually revised terms were agreed with SCOR/Converium and new agreements were signed on 27 December 2007 as follows:

(1) A new PIISSA (the "2007 PIISSA") was concluded which included changes in the way premiums were set, including the ability to have a deposit premium, and some changes to the way in which the PEA was calculated (see below), and the ability to bring in co-insurer(s) on an increasing basis;

(2) A deed of amendment was agreed to act as an overarching agreement, which set out the basis for agreeing the future arrangements for Irish MDU members; and which confirmed continuation of the shareholders' agreement in relation to Irish members of the MDU (this is discussed in more detail below);

(3) An agreement for the sale of Converium's shares in Services to the MDU.

52. The PEA was amended so that it then operated broadly as follows:

(1) the "Priced Loss Ratio" ("PLR") is calculated. This is the actuarial best estimate of claims costs divided by the premiums (as a percentage), both taken from the pricing correspondence from Converium/SCOR which set out the basis for the calculation of the premiums for the policy period;

(2) at the relevant calculation date, the Ultimate Claims are determined using the available data and taking account of cases where not enough information has been reported;

(3) the Ultimate Claims divided by the Premium Element for the period gives the Ultimate Loss Ratio ("ULR");

(4) the PEA is then calculated from the difference between the PLR and the ULR. If the PLR exceeds the ULR, there is a PEA. If the ULR is greater than the PLR, the PEA is zero;

(5) the PEA is banded, with amounts ranging from 50% to 100% deducted from the premiums for the next policy period; and

(6) each policy period stands on its own (so there was no longer any cumulation).

Ireland

53. The arrangements for the issue of insurance policies extended to MDU members in both the UK and the Republic of Ireland. The PI Policies in Ireland were issued by an Irish subsidiary of Zurich.

54. Although CIL issued UK members' PI Policies from 2003, it did not do so for Irish members. The Irish subsidiary of Zurich continued to issue the PI Policies for Irish members. A Professional Indemnity Insurance Supply and Services Agreement specifically for Irish members was agreed and dated 1 April 2005 ("Irish PIISSA"). The Irish PIISSA would terminate on 31 December 2009, and the December 2007 deed of amendment (and the PIISSA entered into on 27 December 2007) expressed an intention to agree terms for a new PIISSA for Irish business with SCOR and provided a fall-back position in case these negotiations failed.

55. SCOR and the MDU agreed that it was desirable that Zurich continue to underwrite policies for Irish members until 31 December 2009, when the Irish PIISSA terminated. There was an expectation that, by that point, terms would have been agreed for SCOR to underwrite policies for Irish members going forward. But, in the end it was decided not to provide Irish members with insurance once the Zurich underwriting finished.

56. The Irish PIISSA included a provision that it would terminate immediately on the termination of the December 2001 shareholders' agreement. It was decided that, rather than involve Zurich in the negotiations with SCOR that were going on at the end of 2007, the 2001 shareholders' agreement would be deliberately left in force (recognising that its terms would, to all intents and purposes, become irrelevant and spent once Converium transferred its shares in Services to the MDU).

International Insurance Company of Hannover ("Hannover")

57. It took many months of negotiation before the terms of the new agreements between the MDU and SCOR/Converium were agreed. The eventual agreement with SCOR provided for the introduction of co-insurers. During this time, the MDU was in negotiations with Hannover (and its parent, Hannover Re) to act as co-insurers. In January 2008, the MDU entered into agreements with Hannover and Hannover Re, which included a PIISSA (on similar terms to the one concluded with SCOR) (the "Hannover PIISSA") and a shortfall insurance/reinsurance agreement.

58. The PEA in the Hannover PIISSA was constructed differently to that in the 2007 PIISSA, although the objective was the same (to ensure that any excess above an agreed level of reasonable return for the insurer was "returned" for the benefit of the MDU's members):

(1) "PEA I" is calculated following the end of each policy period, by taking the underwriting outcome for the period, and this is calculated by totalling "income" items from the period (broadly, the paid premium element and investment income on the same, along with the opening loss reserve from the prior period) and deducting the

"outgo" (broadly, the paid claims and closing loss reserve, with Hannover's cost of capital);

(2) a negative outcome is carried forward;

(3) a positive outcome is known as PEA I and 40% of this is applied to reduce the premiums for the following policy period;

(4) a cumulative calculation is carried out after five policy periods, and the cumulative outcome (if positive), minus PEA I credits, is called PEA II and 75% of this is applied to reduce the premiums for the following policy period;

(5) negative differences to previous PEA II credits can be "debited to" the premiums, but not for a greater amount than previous PEA II credits;

(6) there was a "special PEA" agreed for 2010/11, which recognised that the agreed premium for 2010 included an element that would be returned to the MDU's members if the experience was more favourable than had been priced. This special PEA would be deducted from the subsequent year's premiums, and be calculated prior to the "standard" PEA.

59. The agreement with Hannover allowed MDU Re to participate in the insured risk if it so desired. Under the 2011 arrangements, MDU Re reinsured a small part of Hannover's insurance of the MDU's members, and then retroceded this to another insurer, Signal Iduna.

60. The 2007 PIISSA was amended by an agreement dated 30 October 2009. One of the amendments was to substitute SCOR UK Company Limited ("SCOR UK") for CIL as the insurer of the PI Policies.

Termination of commercial insurance

61. The MDU decided to discontinue offering insurance and move back to only providing discretionary indemnity, and termination of the insurance arrangements took effect on 31 March 2013. For membership renewals after that date the PI Policy was no longer provided as a benefit of MDU membership and no element of the Subscriptions was paid to the insurers as insurance premium.

62. Because the PEA was calculated retrospectively, a PEA adjustment was made in 2014, even though the insurance arrangements had terminated. But, unlike prior years, the PEA amount was paid to the MDU by the insurers.

The actual operation of the arrangements by the parties

63. We focus on the arrangements governed by the PIISSA dated 27 December 2007 as amended in 30 October 2009 (the "2009 PIISSA" - noting that the amendments had no material impact on the operation or interpretation of the 27 December 2007 PIISSA). Extracts from this PIISSA are set out in Appendix One to this Decision.

64. We have decided to focus our analysis on the 2007 PIISSA and the 2009 PIISSA, as these cover most of the periods under appeal, and the ancillary documentation (such as the documents given to individual MDU members) included in the bundles primarily relate to these PIISSAs. Whilst there are differences between these PIISSAs and the Hannover PIISSAs, these primarily relate to the calculation of the PEA, and we find that there is nothing in the differences which would affect the analysis of the taxability of Hannover's PEA. The differences between the 2007 PIISSA and the 2003 PIISSA (and the Irish PIISSA) are more extensive (particularly the change in the calculation of the PEA so that each year stood on its own, and the new provisions for deposit premiums). However, we find none of these differences are such as to affect the analysis of the taxability of the PEA.

65. For all the periods under appeal, the "Policy Period" (the period for which the individual PI Policies are issued) started on 1 April in one year, and ended on 31 March in the following year.

66. The process for agreeing the "Premium Element" for each Policy Period is set out in Clause 8.1 of the 2009 PIISSA.

67. During October, in advance of the commencement of the Policy Period, the MDU provided SCOR with the data SCOR required to calculate its proposal for the Premium Element. By no later than 20 December, a meeting was held between SCOR UK and the MDU to discuss the data and other factors relevant to calculating the Premium Element for the following Policy Period. By no later than 20 January (or such other time as might be agreed between SCOR UK and the MDU, each of SCOR UK and the MDU simultaneously communicated their respective proposals for the Premium Element.

68. There would then be negotiations between the MDU and SCOR UK which might result in an agreed Premium Element ("the Agreed Premium").

69. If the parties could not reach agreement by 31 January, then the mechanism for a Deposit Premium in clause 9 of the 2009 PIISSA would come into effect. Under this mechanism, the Premium Element was determined according to a formula. The Premium Element was recalculated on the third anniversary of the commencement of the Policy Period, taking account of claims made and other data. If the recalculated Premium Element was greater than the Deposit Premium, the Premium Element for the Policy Period following the recalculation would be increased by the excess (or, if the agreement had terminated, by settlement in cash). If the recalculated Premium Element was less than the Deposit Premium, then the adjustment would be addressed in the PEA (it was not refunded).

70. The Agreed Premium or the Deposit Premium, as the case may be, was the "Premium Element".

71. It is worth noting the following:

(1) The Premium Element (whether the Agreed Premium or the Deposit Premium) did not represent the amount that SCOR UK actually received, nor is it the aggregate amount that the MDU members actually paid, for the PI Policies. It is an amount which is used to calculate the “Insurance Premium Percentage” (which is discussed below);

(2) Clause 8.1(f) and Clause 9.1 of the 2009 PIISSA refer to the Agreed Premium and the Deposit Premium as constituting the Premium Element “as adjusted in accordance with clause 11” (the clause dealing with the PEA). However, as discussed below, in practice, neither the Agreed Premium nor the Deposit Premium actually take into account the amount of PEA to be applied in that Policy Period; and

(3) For the Policy Periods where there was a co-insurer, the Premium Element was reduced in line with SCOR UK’s share of the insured risk.

72. Clause 10 of the 2009 PIISSA dealt with the practicalities of the collection of premiums from MDU members. In February, the MDU calculated the "Insurance Premium Percentage" for the Policy Period. This was the Agreed Premium (or if applicable the Deposit Premium) divided by the Subscriptions which the MDU expected to charge its members for the Policy Period (expressed as a percentage). The amount used in this calculation was not the amount that the MDU actually collected in Subscriptions from members, but the amount that the MDU expected to charge. The actual amount collected would differ, depending on the extent of renewals and new membership. The MDU set the Individual Subscriptions on the advice of

consulting actuaries and aimed to raise enough to cover the insurance premiums (adjusted for PEA), overheads, and foreseeable discretionary payments and legal costs.

73. It is worth noting that the insurers were not involved in the setting of the Individual Subscriptions. There were different levels of Individual Subscriptions set by the MDU, and the amount of a particular member's Individual Subscription would, broadly, depend upon the nature of their practice (e.g. GP or specialist, and in the case of specialists, their particular speciality), and the number of GP sessions worked or the level of their non-NHS income. As the Individual Premium was a fixed percentage of the Individual Subscription (the Insurance Premium Percentage), the amount of the Individual Premiums was effectively determined by the MDU when it set the Individual Subscription levels. The insurers were only concerned with the determination of the Premium Element on an aggregated basis, which then fed through to the determination of the amount they received for providing the totality of PI Policies to all MDU members.

74. The Agreed Premium (or Deposit Premium) and anticipated Subscriptions were determined based on the information and estimates available to the MDU and SCOR UK in advance of the Policy Period. At the point when these amounts were determined, neither the MDU nor SCOR knew how many members would renew or new members would be recruited,

75. The MDU members paid their Individual Subscriptions to Services each month.

76. Services collected the Individual Subscriptions from the MDU members as agents for SCOR UK and the MDU, and was required (clause 10.3 of the 2009 PIISSA) to:

> […] 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) […]

77. HMRC, in their submissions, say that the 2009 PIISSA is not sufficiently precise in its usage of the defined terms "Subscriptions" and "Premium Element", and submit that sometimes these terms are used to refer to the amounts used in the calculation of the Insurance Premium Percentage, and sometimes to refer to the amounts actually collected from MDU members. We disagree with HMRC in relation to the use of the term "Subscriptions", as the 2009 PIISSA refers to "anticipated Subscriptions" (and not just "Subscriptions) in the provisions relating to the calculation of the Insurance Premium Percentage. But, we find that HMRC are correct in relation to the use of the term "Premium Element", which is defined in clause 8.1 to be either the Agreed Premium (if agreement is reached) or the Deposit Premium (if there is no agreement) – in other words it is a notional amount which is used in the calculation of the Insurance Premium Percentage. But the defined term is used in clause 10.3 to refer to the product of the Subscriptions and the Insurance Premium Percentage – in other words, this is a reference to the actual amount collected by Services on behalf of SCOR UK (subject to adjustment for the PEA). In practice, it is clear from the context whether the term is used in reference to a notional amount (used for the calculation of the Insurance Premium Percentage), or is a reference to the actual amounts payable to SCOR UK (subject to adjustment for the PEA).

78. We find that the reference to Premium Element in clause 10.3 is a reference to the product of the Insurance Premium Percentage and the Subscriptions (which is consistent with the evidence given by the MDU's witnesses). We find that in each month Services paid to SCOR UK:

(1) an amount equal to the Insurance Premium Percentage of the Subscriptions received in that month;

(2) adjusted in accordance with clause 11.1.

79. Clause 11.1 refers to the PEA, which is defined to be an adjustment to the Premium Element as calculated in accordance with Schedule 3. Paragraph 8 of Schedule 3 deals with the mechanics of the PEA. For positive adjustments, paragraph 8 provides:

> 8.1 On the first Adjustment Date, SCOR UK will deduct any PEA as calculated at the first Adjustment Date from Premium Element payable by the MDU for the next Policy Period.
>
> 8.2 On subsequent Adjustment Dates, the difference between the PEA calculated at current Adjustment Dates will be compared with the PEA calculated at the previous Adjustment Date.
>
> 8.3 If the current PEA is greater than the previous PEA SCOR UK will allocate the difference to the MDU by way of reduction in Premium Element payable by the MDU for the next Policy Period.

80. As noted above, clause 8.1(f) and clause 9.1 of the 2009 PIISSA refer to the Agreed Premium and the Deposit Premium being "adjusted in accordance with clause 11". But clause 11 (which brings paragraph 8, Schedule 3 into operation) provides that it is the Premium Element (which we find, from the context, to be a reference to the product of the Subscriptions and the Insurance Premium Percentage) that is adjusted by deducting the PEA - in other words, under clause 11, the PEA is not taken into account in the calculation of the Insurance Premium Percentage (which uses notional figures), but is taken into account by deduction from the amount otherwise payable to SCOR UK, being the Insurance Premium Percentage of the actual Subscriptions collected from MDU members.

81. Logically, adjusting the Premium Element (rather than the Actual Premium or Deposit Premium) is consistent with the way in which the PEA is determined under Schedule 3, which calculates a fixed number. If the PEA was used to adjust the Agreed Premium (or Deposit Premium), the adjustment ultimately credited to the MDU (or its members) might be an amount larger or smaller than the amount of the calculated PEA (depending on whether the actual Subscriptions collected were greater or smaller than the anticipated level of subscriptions used in the calculation of the Insurance Premium Percentage). Further, the effect of the adjustment for co-insurers would have the effect of reducing the credit given to the MDU (or its members) for the PEA.

82. HMRC's worked illustration of the calculation for 2008 (which followed paragraph 8 of Schedule 3, rather than clauses 8.1(f) and 9.1) was put to each of the MDU's witnesses, who agreed that the calculation was correct. We therefore find that the PEA was an adjustment to the actual Premium Element, rather than to the notional Agreed Premium or Deposit Premium.

83. We find that in practice, the PEA was taken into account as follows:

(1) prior to the start of the Policy Period, Services estimated its anticipated Subscriptions, and the amounts that would be collected by way of Subscriptions for each month (for various reasons, the level of Subscriptions collected from MDU members varied from month to month),

(2) the PEA, a fixed amount known before the start of the Policy Period, was spread across the Policy Period roughly *pro rata* to the Subscriptions that were anticipated for each month,

(3) the PEA allocated to any particular month was deducted by Services from the Premium Element collected in that month, and Services paid the net amount into the bank account that it held for SCOR UK.

84. All subscriptions received by Services from MDU members were paid into an "aggregate" bank account in the name of Services. Towards the end of the month following receipt (that is, around six weeks after receipt), Services transferred the "Premium Element" (namely the product of the Subscriptions received and the Insurance Premium Percentage) less the PEA into a separate account(s) held in Services' name for the benefit of the insurers. The balance (less Services' own costs) was paid into a separate account held in Services' name for the benefit of the MDU. The amounts in the segregated accounts were subsequently paid to the insurers and the MDU, respectively.

MDU members

85. An individual renewing their MDU membership would receive a renewal letter 6 weeks in advance of their renewal date. The letter would set out their Individual Subscription for the renewal period. Included in the bundles was an example of a renewal letter issued in respect of the 2008/09 Policy Period. There were no examples of renewal letters for the other periods under appeal, but there was no suggestion that renewal letters for other periods did not follow a similar format. The following statement (referring to the PI Policy) was included in the renewal letter immediately after the subscription payment details for the renewing member:

> 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.

86. 55.71% was the Insurance Premium Percentage for the 2008/09 Policy Period. Renewal letters issued for other Policy Periods would have a different percentage figure, reflecting the Insurance Premium Percentage for the period in question.

87. Mr Gallivan explained in his evidence that at the time the renewal letters were circulated, the amount of the PEA would not necessarily be known, and it was for this reason that the renewal letters referred to the gross amount of the Individual Premium, without taking account of the PEA. But he had also stated that the PEA would be calculated around February, as was the Agreed Premium, with the consequence that the MDU could take account of the PEA when setting its subscription levels for the subsequent Policy Period.

88. An individual who wanted to join the MDU would have an initial discussion with someone at the MDU. They would be asked for details of their practice, which would be used to set the level of their Individual Subscription. They would then be sent an Application Guide and an Application Form. The Application Guide included a copy of the terms of the PI Policy, and named SCOR and Hannover as the underwriters. Although no examples of policy schedules were included in the evidence, it is not disputed that the policy schedules would have named SCOR and Hannover as the insurer and the individual as the insured.

89. The MDU would insert the amount of the applicant's Individual Subscription into the appropriate section of the Application Form that was sent to the applicant. The amount of the Individual Subscription would depend on the applicant's area of speciality, (for GPs) the number of sessions, and (for other practitioners) their income (excluding work which was covered by other indemnifiers, such as the NHS). Unlike the renewal letter, neither the Application Guide nor the Application Form state the percentage of the Individual Subscription that was payable as the premium for the PI Policy.

90. The start of the "Declaration and agreement" on the Application Form was as follows:

> I hereby apply for membership of the [MDU] […] and apply to [SCOR] and [Hannover] for professional indemnity insurance.

91. 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).

92. All the MDU's witnesses confirmed during cross-examination that the PEA did not retrospectively adjust the amount of the Individual Premium paid by any individual member for their PI Policy. Mr Gallivan in his evidence said that it would be impractical to allocate the PEA to individual members, although he acknowledged that to do so was something of a mathematical exercise, and was possible, although they had never thought it was appropriate – and considered that the PEA was "better off in the mutual pot".

93. Mr Way during his submissions acknowledged that the PEA was not allocated in any way to individual MDU members. Rather the benefit of the PEA accrued to the MDU's discretionary mutual fund, and the individual MDU members (and some former members) benefited (indirectly) from the PEA because of their entitlement to participate in that fund.

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).

2008 Worked Illustration

95. HMRC prepared a worked illustration of the calculations for the 2008/09 Policy Period starting on 1 April 2008 and ending on 31 March 2009. The worked illustration is set out in full in Appendix Two to this decision. The worked illustration was put to each of the MDU's witnesses during cross-examination, and each of them confirmed that the calculation was correct. We therefore find that this worked illustration correctly illustrates the calculations for the 2008 Policy Period.

96. SCOR UK insured 75% of the risk in the 2008/09 Policy Period, and Hannover insured the balance (25%).

97. In Table 1, the amounts for the Premium Elements are taken from the 2007 PIISSA and the Hannover PIISSA (and were carried forward into the 2009 PIISSA). As this was the first policy period governed by the 2007 PIISSA and the Hannover PISSA, the parties agreed the amounts for the Premium Element and the PEA, and these amounts were set out in the contractual documents as the amounts to be used in the 2008/09 Policy Period. The amount for the Anticipated Subscriptions was set by the MDU. The difference between the respective 100% Premium Elements reflects the commercial negotiations between the insurers and the MDU.

98. The amounts in Table 2 are the Premium Elements in Table 1, adjusted to reflect the risk percentages assumed by SCOR UK and Hannover, respectively. It can be seen that the total Premium Element is 55.71%, which corresponds to the percentage shown in the renewal letter for the 2008/09 Policy Period.

99. Table 3 sets out the Subscriptions actually received, and the amounts actually paid to SCOR UK. These are different to the amounts in Table 2, as a result of new members joining, and some members leaving. But it can be seen that the estimates made in Table 2 were reasonable ones.

100. The PEA to be applied by SCOR UK in the 2008/09 Policy Period was agreed to be £23,001,000. We note that clause 11.1 of the 2007 PIISSA (which was carried forward into the 2009 PIISSA) provides that the PEA for the 2008/09 Policy Period is to be £23m, but the table in Schedule 2 (to which clause 11.1 refers) gives an amount of £23,001,000, which was the amount actually applied. The reason for the difference is not wholly clear, it may just be a rounding effect.

101. Of course, there was no PEA for Hannover for the 2008/09 Policy Period, as this was their first year of underwriting the PI Policies.

102. In the 2008/09 Policy Period, Services accounted to SCOR for the product of the Subscriptions Received and the Insurance Premium Percentage (shown in Table 3 as the SCOR UK Premiums) less the PEA.

MDU's submissions

103. Mr Way, for the MDU, acknowledges that if the MDU was trading with a third party it would be subject to tax on the income from that trade, because that would not be part of its mutual trade. But he submits that the relationship between the MDU and the insurers is not one that produces income in the hands of the MDU. Rather the operation of the PEA is simply a method for determining how much of the Subscriptions passes by way of insurance premiums and how much is received by the MDU from its members, either initially or ultimately, as a contribution to its mutual fund.

104. Mr Way argues that for the MDU to have a liability to tax in respect of the PEA, the starting point must be that that there has to be either a trading activity (taxable under s35 CTA 2009), or, alternatively, there must have been an activity which gives rise to income taxable under s979 CTA 2009 (charge to tax on income not otherwise charged). In other words, there must be some kind of "source" for the income. He submits there is no such source.

105. We were referred by Mr Way to the decision of the Court of Exchequer in *AG v Black* (1871) 1 TC 54 which concerned Brighton Corporation's liability to income tax on a statutory levy on coal brought into the town. It was held that this was income (chargeable to tax) that fell within the former Schedule D. In his judgment Martin B lists the various Schedules under which income tax was charged at that time. He then went on as follows:

> Now, all these Schedules taken together would seem a sufficiently large net to include every description of property; but to prevent any doubt we have section 100, which imposes a duty on every description of property or profit not contained in the foregoing schedules. In fact, the care displayed in embracing every possible source of profit is, I may say, carried to an almost ludicrous extent, it is practically impossible to escape the operation of the Act.
>
> […]
>
> I am therefore of opinion, that this is a "property or profit," coming within the meaning of 5 & 6 Vict. c. 35, and consequently that the corporation of Brighton must pay income tax upon it.

106. However, the broad scope given to the meaning of "property or profit" by Martin B was narrowed on appeal (1871) 1 TC 54. In his judgment Blackburn J said:

> The words of 5 & 6 Vict. cap. 35. ss. 60, and 100 are very wide, but I do not think that they attach to everything. I think they would not apply to a borough

> rate or to a highway rate. I do not consider the latter analogous to the classes of property alluded to in section 60, Schedule A., and in Section 100, Schedule D. […]

107. Accordingly, Mr Way submits that not all amounts received by a company are liable to tax. For a receipt to be liable to corporation tax, it must give rise to profit of an income nature.

108. He then referred us to *Spectros International plc (in liquidation) v Madden* (1996) 70 TC 349 (at 375) where Lightman J says:

> The law respects the freedom of the parties to a transaction to frame and formulate their agreement as they wish and to suit their own legitimate interests (taxation and otherwise) and, so long as the form adopted is genuine, and not a sham, honest, and not a fraud on someone else, and does not contravene some established principle of public policy, the Court will give effect to the method adopted. But as a corollary to this freedom, where the parties have chosen one method, it is not open to them to invite the Court to treat as adopted some other method because it is more advantageous to them, because it leads to the same practical and economic result and because it is the more obvious and sensible method to have adopted. If the question is raised what method has been adopted and the transaction is in writing, the answer must be found in the true construction of the document or documents read in the light of all the relevant circumstances. If the terms of the documents are clear, that is the end of the question. If however there is any doubt or ambiguity upon the language used read in its proper context, it may be possible to resolve that doubt or ambiguity by reference to the inherent probabilities of businessmen entering into the transaction in one form rather than another.

109. Thus, says Mr Way, absent tax avoidance, artifice or fraud, the court must respect the form of the contractual relationships agreed by the taxpayer in determining the taxpayer's liability. Mr Way submits that the contractual documents in this case speak for themselves, and do not demonstrate any kind of trading relationship between the MDU and the insurers. All they demonstrate is a method for apportioning on an annual basis the Subscriptions received from the MDU members between the insurers (as consideration for the PI Policies), and the MDU (as a contribution to its discretionary mutual fund). Mr Way submits that there is no element of tax avoidance or artifice which would require the Tribunal to adopt a more aggressive form of purposive application of the legislation (as seen in cases such as *Collector of Stamp Revenue v Arrowtown* [2003] HKCFA 46 or *Barclays Mercantile Business Finance v Mawson* [2004] UKHL 51).

110. And there is no receipt of the PEA by the MDU (save in the final year), and in the absence of receipt, there can be no taxation.

111. In summary, he submits that there is no activity carried on by the MDU which gives rise to any income in its hands. Although not determinative, he says that there is nothing in the contractual documents that has the flavour of trading – the arrangements do not have the "look" of a commission, profit-sharing, or an introduction arrangement – they do not include the kinds of standard provisions that one might expect in those kinds of contracts. What Mr Way says that the contractual documents look like, are precisely what they say they are - namely a mechanism for ensuring that there was not an overpayment of premiums by the MDU's members.

112. But, continues Mr Way, even if the PEA is income in the hands of the MDU, that income is outside the scope of corporation tax because of the mutuality principle. This is because the PEA is paid only because previously the premium that had been received and charged by the insurers was too high. Had the correct amount been charged at the outset then all that would

have happened would have been that a smaller part of the Subscriptions will have been paid to the insurers and a larger amount would have been paid to the MDU. In such circumstances there would be no doubt that the increased MDU element would have been within the mutuality principle. Another way of putting the same point is that the origin of the PEA payments is the premiums paid by the members to the insurers. The PEA is a mechanism for reducing the insurance premiums payable by MDU members to the extent that they are excessive, and this excess ends up in the MDU's mutual fund (for the benefit of the members).

113. For the final year (period ended 31 December 2014), the mechanics had to change, because the insurance arrangements had been terminated and there was no premium payable by MDU members that could be reduced. Instead what happened was the payments pursuant to the PEA were paid by the insurer to the MDU. Nevertheless, says Mr Way, the PEA still falls within the scope of the mutuality principle. There is no different analysis to that which applies in the earlier years; it is still money that should have initially gone from the members to the MDU – and following the application of the PEA that is exactly what happen, it starts with the members and it ends up being paid into the MDU's mutual fund, and on that basis the position is the mutuality principle still applies.

114. Once the PEA has been unravelled it can be seen that it makes its way into the mutual fund, and so it has the quality of a payment from the MDU members into their mutual fund.

115. Mr Way submits that there is no business-like activity carried on by the MDU in exchange for the payment of the PEA. HMRC assert the MDU was entitled to the PEA in exchange for giving insurers the ability to provide insurance to the MDU members, and in terms of a taxable activity, they contend that the PEA arose in the context of business of arranging insurance or, alternatively, in the context of a wider business of protecting the financial interests of healthcare practitioners. But, submits Mr Way, the documentation does not support HMRC's analysis. Rather the rationale for the PEA was to ensure that there were not overpayments of premiums to the insurer, and that the MDU could be sure, acting as the guardian of its members' interests, that there was no overpayment.

HMRC's submissions

116. HMRC's case is that the PEA amounts were profits of an income nature, taxable under either the former provisions of Schedule D, Case I, or Schedule D, Case VI (or the equivalent provisions in the CTA 2009), and are not taken outside the scope of corporation tax by the mutuality principle.

117. Mr Henderson submits that it is important for the Tribunal to focus on an analysis of the contractual arrangements, rather than merely consider the overarching intention of the parties and economic effect at a high level. But even if we were to consider the business economics of the PEA at a high level, the PEA was not just about "getting the premiums right". Rather it was a commercial "carve up" negotiated between the parties (the MDU and the insurers), as can be seen from the fact that the insurer did not pay the MDU all amounts in excess of the agreed return of capital figure - initially the PEA was 50% of the excess over that figure, but subsequent negotiations changed that percentage to a ratchet formula. This shows, says Mr Henderson that the PEA was included in the arrangements by dint of a commercial negotiation between the MDU and the insurers, whereby the insurers agreed to pay something to the MDU for the opportunity that had been provided to it by the MDU. This is not a case of a scientific analysis of the insurers' return on capital, which can be seen by the fact that it gets renegotiated by virtue of the negotiating position and the relative bargaining strength of the MDU Limited and the different insurers at different times.

118. Mr Henderson also submits that the MDU's submissions that the PEA is merely an adjustment to the premiums paid for the PI Policies are also incorrect. It was acknowledged by

all the MDU's witnesses and by Mr Way that the PEA did not effect a retrospective adjustment to the premiums paid by MDU members. Indeed, there is no contractual entitlement of the MDU members to the PEA - the PEA is not mentioned in the terms of the PI Policies or in any of the ancillary documents relating to either joining the MDU, or renewing membership. Rather the PEA are amounts due from the insurers to the MDU, which have the effect of supplementing the MDU's mutual fund.

119. Mr Henderson argues that although the MDU was not carrying on the business of an insurance broker, it was carrying on a business-like activity analogous to that of an insurance broker - as it was arranging insurance for its members. The MDU was contractually entitled to the PEA, which arose from a very business-like activity – namely negotiating with the various insurers. Accordingly, says Mr Henderson, the PEA is taxable as income in the hands of the MDU.

120. Mr Henderson asked us to consider what would have been the position if Services was not interposed as an agent for the MDU and the insurers. In that case, the MDU member would pay two separate amounts, one to the insurer in the form of the commercial premium for the PI Policy and one to the MDU as his contribution to the mutual fund. Separately the insurers would pay a separate amount to the MDU Limited if any PEA were due. And Mr Henderson notes that this is in fact what happened in respect of the accounting period ended on 31 December 2014.

121. And Mr Henderson submitted that even if the MDU did not have a legal entitlement to the PEA, that does not prevent the PEA from being trading income in its hands, and cited the decision of the Upper Tribunal in *Pertemps Recruitment Partnership v RCC* [2011] STC 1346 in support of this submission. But even if the activities of the MDU did not amount (at least in this respect) to trading, it did not prevent the PEA amounts from being taxable income, instead it would be taxable as miscellaneous income under Schedule D, Case VI (or the equivalent provisions in CTA 2009) In support of this contention Mr Henderson referred us to the cases of *Hugh v Rogers* (1958) 38 TC 270, *Brocklesby v Merricks* (1934) 18 TC 576, and *Norman v Evans* (1964) 42 TC 188.

122. *Hugh v Rogers* concerned a taxpayer who had originally registered himself as an agent of the Phoenix Assurance Company for the purpose of obtaining life insurance for himself at a more advantageous premium (he did not introduce anyone else to the Phoenix). His employer wanted to organise a pension plan for employees, and (knowing that he was insured with the Phoenix) he was asked to write to the Phoenix to obtain their terms for providing pension policies. It turned out that the Phoenix's terms were the best, and the employer contracted with them. The Phoenix then paid the taxpayer commission on these policies, which (with the knowledge and consent of his employer) he retained. The issue before the High Court (on appeal from the General Commissioners) was whether the commission was taxable under Schedule D, Case VI. Harman J said:

> Were the Commissioners then not entitled to come to the conclusion that the Phoenix Company paid him the commission under the contract? I think they could have come to no other. But it is said, and I am inclined to accept this, that one must also see on what terms the taker takes the money. Well, it is true he was surprised to be offered it, it is true he half suggested that his employers should have it, but it is also true that he put it in his pocket. It seems to me to be the obvious inference that he accepted the statement of the Phoenix Company that it was due to him as commission; in fact I do not see any other one. I think it was both paid and accepted as commission, and it is only when assessments are made on him and he applies to the lawyers for the first time, he having had apparently no assistance of a legal kind before the

> Commissioners, that doubts are raised whether it was not a free gift on the grounds that in fact he had never done anything to earn it. He had not, but commission is often paid to agents on transactions with which they have had nothing to do. It cannot have been from the point of view of the company a free gift, unless I am to assume that the company is acting ultra vires, which I certainly am not. I think the Commissioners were entirely entitled to hold that the reason he accepted the money was because he was an agent, so to call it, of the Phoenix Assurance Co., though they do not know any more than I do what the terms of the agency were. He accepted it in that capacity, and I do not see any other capacity in which it could be suggested he received it. There is no suggestion anywhere in writing, or indeed in any evidence that I can see recited in the Case, that the insurance company suggested it was a pure present. This seems to me, if I may say so, to be a lawyer's afterthought, a very plausible one but not in my opinion justified. Consequently, I hold that the Commissioners rightly found that this money was not a voluntary payment, but was paid as commission by the company and received as commission by the taker, the Appellant. If that is the case there is no reason to doubt that commission under an agency agreement is a subject-matter for tax under Schedule D, Case VI, and that the assessment was rightly made, and the Commissioners reached a proper conclusion.

123. *Brocklesby v Merricks* concerned a fee paid to an architect to negotiate the sale of a plot of land that he had helped his client to acquire. Although the architect did not assist in any way regarding the sale, the client nonetheless paid the fee, and the architect was assessed to tax on the fee under Schedule D, Case VI. The assessment was upheld in the High Court. The judgment of Finlay J in the High Court was approved unanimously by the Court of Appeal. In his judgment, Finlay J said:

> He was paid this sum, because he had an enforceable right to get it, and that enforceable right was based on this, that he had got a contract in respect of which, for certain services to be rendered by him specified in the contract, he was to be entitled to remuneration. I repeat, and the Appellant is entitled to any benefit he can get from it, that I think, surveying the facts, it is reasonably certain that the contract would not have been entered into, anyhow would not have been so favourable to the Appellant, if it had not been for the fact that he had rendered this exceedingly important voluntary service to the company; but that does not, to my mind, prevent the contract, when it is entered into, from being, as indeed it is expressed to be, a contract for remuneration in respect of services. The case, therefore, is not of the nature of the cases which depend upon well-known and rather elementary principles to which Mr. King referred. It is not a case where there has been a purely voluntary service rendered and then something given in respect of that. It is a case in which, induced very probably by the voluntary service, the parties chose to enter into a contract for remuneration in respect of services. I think that that was the conclusion at which the Commissioners arrived. I think they rightly thought that this was a café (*sic*) assessable under Case VI, and accordingly it results that the appeal, in my opinion, fails and must be dismissed.

124. *Norman v Evans* concerned the lease by a breeder of racehorses. The leasee undertook to pay all racing expenses and to pay the breeder half of any prize money. The breeder was assessed to income tax under Schedule D, Case VI on the payments received by him under the lease. Buckley J says the following in his judgment:

> It seems to me, therefore, that the Crown here are justified in saying that the sums which the Respondent received in respect of the horses which were under these leases were sums that he received in consequence of a contract contained in each of the leases. If that is so, do those sums retain any character

of being race winnings, or are they casual profits of a kind which fall to be taxed under Case VI? Now, in the case of an owner who races his own horse under his own colours in circumstances in which it is reasonable to say that in so doing be is not doing it as part of a trade or business, I understand that it is the practice of the Revenue to treat any profits that such owner may make as being casual profits of a kind which are not caught by the Income Tax Acts, not being profits of a trade and not being profits or gains of any other kind referred to in any of the charging provisions of the Act; but the case may be different if the moneys in question are not moneys which result from the taxpayer's own activities in that respect. Case VI of Schedule D charges tax in respect of any annual profits or gains not falling under any other Case of Schedule D and not charged by virtue of Schedules A, B, C or E. It has not been contended in this case that these profits or gains are not "annual" profits or gains. Perhaps I should say that it has not been contended that they are not chargeable because they are not "annual" profits or gains, and I say that they are annual profits or gains within the meaning of Case VI. If the leases are treated as being something not incidental to the Respondent's business of breeding horses, then it seems to me that the moneys received by the Respondent as the result of those leases and under those leases are annual profits or gains not falling under any other Case of Schedule D, and they certainly do not fall under any of the other Schedules mentioned. In my view they are not profits which arise merely from a recreational activity, that is to say an activity of a kind which does not attract liability to Income Tax; they do not arise from any recreational activity of the Respondent; they in fact arise from a businesslike transaction entered into between the Respondent and the lessees, and therefore, in my judgment, they are profits or gains which give rise to a liability to tax.

125. Mr Henderson submits that when a person carries on a business-like activity, then *prima facie* the receipts are taxable unless there is a clear reason to the contrary. In this appeal the activity carried on by the MDU was that of arranging the PI Policies and negotiating complex commercial contracts. Mr Henderson submits that the evidence was that this was carried on in a business-like way. Therefore, he submits, there is nothing, particularly in the case law cited relating to Schedule D, Case VI, that prevents the PEA from being taxable.

126. And, continued Mr Henderson, the fact that the provisions relating to the PEA in the various contracts may not look like the sort of provisions relating to an insurance commission or some sort of profit share is irrelevant to the tax analysis. The PEA payments fundamentally have the nature of income arising from the insurers and paid to the MDU.

127. Mr Henderson goes on to submit that the mutuality exemption does not apply to take the PEA income out of the scope of corporation tax.

128. Mr Henderson submits that, in the light, for example, of the decision of the Privy Council in the *Fletcher* case (cited earlier) one cannot take the high level approach adopted by the MDU as to the application of the exemption. There is a need to look at the detail.

129. We were first referred also to the judgment of the Court of Appeal in *The Carlisle And Silloth Golf Club v Smith* (1913) 6 TC 198 which held that green fees paid by non-members for the use of the club's facilities were outside the mutuality exemption, and taxable under Schedule D.

130. We were also referred to the *Municipal Mutual* case. Mr Henderson submits that the PEA in this appeal is not analogous to a surplus arising from a miscalculation or unexpected immunity of the kind Lord Macmillan mentions in his speech in the House of Lords (cited previously). Mr Henderson's submission is that what Lord Macmillan was considering is

simply that more money has been put into the fund than necessary, whereas in this case, HMRC submit that the PEA arises from something outside the mutual trade, namely: the insurance contracts between the MDU members and the insurers, and from the PIISSAs. There is no sort of blanket rule that any sort of miscalculation somehow brings the mutuality principle into play. In any event, HMRC do not accept that this is just a miscalculation; rather, the PEA is a payment from the insurers to the MDU for providing them with the business and as a result of the commercial negotiations.

Discussion

131. In matters of tax, it is usually the case that "the devil is in the details", and we find that to be especially true in this appeal. The answer to the question of whether the MDU is liable to corporation tax on the receipt of PEA payments follows from a detailed analysis of the contractual arrangements.

Source

132. Mr Way submits that there is no "source" of income on which the MDU can be taxed, as the PEA is merely a mechanism for adjusting the proportion of the Subscriptions paid by MDU members between the insurers and the MDU (for the benefit of its mutual fund).

133. We disagree and find that there is a "source" of income for the following reasons.

134. First, to state the obvious, this is not a situation where there is a gift to the MDU, or anything similar where there is no taxable source as there is no property from which the income arises.

135. And we disagree with the contention that the PEA is merely a mechanism for allocating Subscriptions paid by MDU members between the MDU and the insurers.

136. It is accepted by all parties that the PEA does not retrospectively adjust the premiums paid by members. This must follow from the timing of the PEA payments, which are paid in Policy Periods subsequent to the Policy Period to which they refer back – and therefore benefit (if that is the right expression) a different set of MDU members to those that originally paid the premiums (as some members will have retired, and new members will have joined in the intervening time).

137. But of greater significance is the fact that there is no reference to the PEA in any of the documents sent to new or renewing members. The contract between the insurers and the individual members for the PI Policy is created through the MDU's application form, which provides that the applicant applies to the insurers for professional indemnity insurance on the terms set out in the application guide. Neither the terms and conditions of the PI Policy included in the guide, nor anything else in the guide, refers to the PEA. Indeed, the only way in which an MDU member could find out about the PEA is on a very close reading of the MDU's annual accounts – and even then the references do not disclose the mechanism used to give effect to the PEA. It is the MDU, and not its members, which is contractually entitled to the benefit of the PEA.

138. Further, the renewal letters state expressly that (in the case of the 2008/09 Policy Period) 55.71% of the subscription income is applied in paying the insurance premium, and it was acknowledged by each of the MDU's witnesses that the 55.71% percentage did not take account of the PEA. Mr Gallivan explains this by saying that at the time the renewal letters were sent out, the PEA was not known, and so could not be addressed in the letters. But this is incorrect, as the amount of the PEA was agreed at the same time as the Individual Subscriptions were set – indeed the evidence is that in setting the anticipated Subscriptions, the MDU took the amount of the PEA into consideration.

139. And the way the PEA is calculated reinforces the analysis that the PEA is not merely an adjustment to the allocation of Subscriptions between the MDU and the insurers. There is no underlying scientific basis that ensures that the PEA equals the excess over a stated capital return achieved by the insurers – rather that excess is split in a negotiated manner. Initially the excess is split 50:50 between the MDU and the insurers, but in later years the split is based on a ratchet, and is determined separately for each year, rather than on a cumulative basis. The PEA is determined as a fixed number of pounds. In contrast the insurance premiums payable by members is calculated as a percentage of Subscriptions. If the aggregate Subscriptions increase or decrease (because, for example, of retirements or recruitment of new members), then the level of the premiums paid to the insurers will increase (or decrease) in proportion. But no matter what the level of the premiums paid to the insurers, the amount of the PEA remains the same.

140. Mr Gallivan's evidence was that although it would have been possible to have structured the PEA so that it was allocated between the members on a percentage basis

> "… we never thought it was appropriate. Better off in the mutual pot."

141. In other words, the MDU decided that it was better for the PEA to benefit the MDU's mutual fund, rather than reduce the premiums paid by its members.

142. Mr Way cited the case of *Spectros International plc (in liquidation) v Madden* in support of his contention that the contractual arrangements concluded by the parties had to be respected (absent artifice or fraud). But a close analysis of the PIISSAs shows, in our view, that the PEA represents a commercial agreement reached between the MDU and the insurers, and this finding is supported by the evidence of both Dr Tomkins and Mr Gallivan that the MDU used its bargaining strength to negotiate with the insurers for the best terms.

143. On any view there is a "source" – namely the PIISSAs, contracts concluded by the MDU with the insurers, which provide for regular payments to be made to the MDU, and we so find.

Taxable income

144. Mr Way submits that even if the PEA has a "source", it is only *prima facie* taxable if it falls within the scope of the taxing provisions – namely either Schedule D, Case I, or Schedule D, Case VI. He cited the case of *AG v Black* in support of the contention that only a limited category of non-trading items falls within the scope of Schedule D, Case VI.

145. But the Court of Appeal in *AG v Black* found that a statutory levy on coal payable to Brighton Corporation was taxable as income – and the examples given of the kinds of income that were not taxable under Schedule D, Case VI were local authority rates. We agree with the submissions of Mr Henderson that receipts from business-like activities are *prima facie* taxable, unless there is a clear reason to the contrary, and there is no such contrary reason in this case. There is nothing in any of the cases cited to us which would prevent the PEA from being taxable. Although the MDU are not insurance brokers, they did arrange PI Insurance for their members, and negotiated a complex suite of documents, using their considerable bargaining strength to the advantage of them and their members. This is a business-like activity, and there is no reason why income derived from that activity should fall outside Schedule D, Case VI.

146. Mr Way submits that the PEA is never actually received by the MDU, and without receipt there can be no taxation. This is an adaptation of the well-known statement in the judgment of Rowlatt J in *Leigh v. Inland Revenue Commissioners* [1928] 1 KB 73 (not cited to us), where he says:

> It is to be remembered that for income tax purposes "receivability" without receipt is nothing.

But *Leigh* was a case about the amount of income that was "receivable", rather than the amount of income that had accrued – and so is of no relevance to this appeal. In any event, we find that the MDU received the PEA as a result of the netting undertaken by Services, when it allocated funds between the bank accounts that it held for the benefit of the MDU and the insurers respectively.

147. For completeness, we would mention that we do not agree with HMRC's submission that the *Pertemps Recruitment* case supports the contention that income can be taxable, even if the recipient has no entitlement to that income. *Pertemps Recruitment* related to trading income, where it was not disputed that (a) the payments in question undoubtedly belonged to the taxpayer (although its clients had an entitlement to a claim in restitution for those amounts), and (b) the payments were properly treated as income in the company's financial statements in accordance with accounting standards. Those are very different circumstances from the facts in this appeal.

Mutuality

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.

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.

150. We find that the PEA does not benefit from the mutuality exemption.

DISCOVERY ASSESSMENT

The law

151. The law governing discovery assessments is set out Schedule 18, Finance Act 1998, the relevant provisions of which (as they apply to the assessment made against the MDU) are as follows:

> **Assessment where loss of tax discovered or determination of amount discovered to be incorrect**
>
> 41.(1) If an officer of Revenue and Customs discovers as regards an accounting period of a company that—
>
> (a) an amount which ought to have been assessed to tax has not been assessed, or
>
> (b) an assessment to tax is or has become insufficient, or
>
> (c) relief has been given which is or has become excessive,

they may make an assessment (a “discovery assessment”) in the amount or further amount which ought in their opinion to be charged in order to make good to the Crown the loss of tax.

(2) If an officer of Revenue and Customs discovers that a company tax return delivered by a company for an accounting period incorrectly states—

(a) an amount that affects, or may affect, the tax payable by that company for another accounting period, or

(b) an amount that affects, or may affect, the tax liability of another company,

they may make a determination (a “discovery determination”) of the amount which in their opinion ought to have been stated in the return.

Restrictions on power to make discovery assessment or determination

42.(1) The power to make—

(a) a discovery assessment for an accounting period for which the company has delivered a company tax return, or

(b) a discovery determination,

is only exercisable in the circumstances specified in paragraph 43 or 44 and subject to paragraph 45 below.

(2) Those restrictions do not apply to an assessment or determination which only gives effect to a discovery determination duly made with respect to an amount stated in another company's company tax return.

(2A) Those restrictions, other than the restriction in paragraph 45, do not apply so far as regards any income or chargeable gains of the company in relation to which the company has been given, after any enquiries have been completed into the return, a notice within sub-paragraph (4).

(3) Any objection to a discovery assessment or determination on the ground that those paragraphs have not been complied with can only be made on an appeal against the assessment or determination.

(4) A notice is within this sub-paragraph if it is—

(a) a notice under section 184G or 184H of the Taxation of Chargeable Gains Act 1992 (avoidance involving capital losses),

(b) a notice under section 81(2) of TIOPA 2010 (schemes and arrangements designed to increase relief), or

(c) a notice under section 232 or 249 of TIOPA 2010 (avoidance involving tax arbitrage).

Loss of tax brought about carelessly or deliberately

43. A discovery assessment for an accounting period for which the company has delivered a company tax return, or a discovery determination, may be made if the situation mentioned in paragraph 41(1) or (2) was brought about carelessly or deliberately by—

(a) the company, or

(b) a person acting on behalf of the company, or

(c) a person who was a partner of the company at the relevant time.

Situation not disclosed by return or related documents etc

44.(1) A discovery assessment for an accounting period for which the company has delivered a company tax return, or a discovery determination, may be made if at the time when an officer of Revenue and Customs—

(a) ceased to be entitled to give a notice of enquiry into the return, or

(b) completed their enquiries into the return,

they could not have been reasonably expected, on the basis of the information made available to them before that time, to be aware of the situation mentioned in paragraph 41(1) or (2).

(2) For this purpose information is regarded as made available to an officer of Revenue and Customs if—

(a) it is contained in a relevant return by the company or in documents accompanying any such return, or

(b) it is contained in a relevant claim made by the company or in any accounts, statements or documents accompanying any such claim, or

(c) it is contained in any documents, accounts or information produced or provided by the company to an officer of Revenue and Customs for the purposes of an enquiry into any such return or claim, or

(d) it is information the existence of which, and the relevance of which as regards the situation mentioned in paragraph 41(1) or (2)—

(i) could reasonably be expected to be inferred by an officer of Revenue and Customs from information falling within paragraphs (a) to (c) above, or

(ii) are notified in writing to an officer of Revenue and Customs by the company or a person acting on its behalf.

(3) In sub-paragraph (2)—

“relevant return” means the company's company tax return for the period in question or either of the two immediately preceding accounting periods, and

“relevant claim” means a claim made by or on behalf of the company as regards the period in question or an application under section 751A of the Taxes Act 1988 made by or on behalf of the company which affects the company's tax return for the period in question.”

152. The issue in this appeal in relation to the HMRC's ability to make a discovery assessment for the accounting period ended on 31 December 2007 is whether, looking at paragraph 44(1), a hypothetical HMRC officer could not have been reasonably expected (on the basis of the information made available to him) to have been aware that there was a purported understatement of tax. In relation to this, the hypothetical officer is assumed to have read the information referred to in paragraph 44(2).

Background facts

153. We heard evidence from Paul Bougourd, who was the HMRC officer responsible for the making of the discovery assessment. His evidence as regards the tax returns and other documents filed by the MDU was not controversial, and is not disputed. However, there is a difficulty with his evidence as to whether he was aware of the purported understatement of tax in the MDU's corporation tax return. This is because the reference in paragraph 44(1) is to a hypothetical HMRC officer, and not to the actual officer making the assessment. But we were content to hear Mr Bougourd's evidence on the basis that it was merely an example of what a

typical HMRC officer might be expected to make of the materials before him. However, in the end, we reached our decision without having to rely on Mr Bougourd's evidence.

154. The issue is whether the information that was made available to HMRC was such that objectively a hypothetical officer could reasonably be expected to be aware of the alleged insufficiency in tax for the accounting period ended on 31 December 2007. For these purposes the hypothetical officer must take into account information contained in the corporation tax returns, corporation tax computations, and the MDU's financial statements for the year ended 31 December 2007 and for the two preceding accounting periods years (paragraph 44(2)-(3), Schedule 18, Finance Act 1998).

155. The MDU's corporation tax computation for the year ended 2007, and the two preceding computations, include a statement in section D1 about the PEA. The statement for 2007 says:

> An amount of £36,749k has been recognised in the statutory accounts of The Medical Defence Union Ltd in respect of a Premium Element Adjustment ("PEA") receivable by way of an increased proportion of the MDU Element of subscriptions under the Professional Indemnity Insurance Supply and Services Agreement between The Medical Defence Union Ltd and Converium AG. A copy of this agreement was forwarded to HMRC on 11 August 2005. The renegotiation of the agreement has resulted in the acceleration in the timing of the receipts. Of the total amount receivable, £6,000k was received before the year end, £24,618k is shown in note 9 to the accounts under "Debtors - amounts falling due within one year" and £6,132k is shown in note 10 to the accounts under "Debtors - amounts due after more than one year." The increase for the year of £28,196k is deducted from mutual expenditure in the Income & Expenditure Account as shown by note 3 to the accounts. It is considered that the PEA is part of The Medical Defence Union Ltd's mutual income and not chargeable to corporation tax.

Discussion

156. Mr Way submits that in addition to the corporation tax returns and computations, and the financial statements, the hypothetical officer should also take into account the 2003 PIISSA, as there was a reference to its existence and to its relevance in the computations, as the D1 statement made it clear that it was pursuant to the PIISSA that the PEA arose.

157. Mr Way notes that the D1 statement in the 2007 computations refers (a) to a very large quantum of money (more than £36m), (b) to the 2003 PIISSA, pursuant to which the PEA arose, (c) to the fact that HMRC was in possession of the 2003 PIISSA, (d) to the MDU’s view of the effect of the PEA, and (e) to the MDU’s view that the PEA was not taxable and was part of the MDU’s mutual income.

158. Mr Way also notes that:

(1) There are various references in the accounts for 2007 and the preceding two years, to the fact that there were individual insurance policies for the members in their own names;

(2) The 2003 PIISSA referred to the fact that MDUSL was acting as agent; and

(3) The 2003 PIISSA also set out details of how the PEA was to be calculated and how it was to be applied. In other words, HMRC had the information from which it could determine whether or not it agreed with the MDU’s characterisation of the PEA as set out in the D1 statement.

159. Mr Way submits that there was ample information made available to HMRC from which objectively a hypothetical officer should reasonably have been aware of the alleged insufficiency in tax. In consequence, he says that the discovery assessment is invalid.

160. The leading case on the validity of discovery assessments is the decision of the Court of Appeal in *Sanderson v HMRC* [2016] STC 638. This decision concerned the provisions relating to discovery assessments in s29(5), Taxes Management Act 1970, but the underlying principles considered in *Sanderson* are equally applicable to Schedule 18. In his judgment Patten LJ (with whom the other members of the Court agree) says (at [17] to [25] and at [41]):

> [17] The power of HMRC to make an assessment under s 29(1) following the discovery of what, for convenience, I shall refer to as an insufficiency in the self-assessment depends upon whether an officer 'could not have been reasonably expected, on the basis of the information made available to him before that time, to be aware of the [insufficiency]'. It is clear as a matter of authority:
>
> (1) that the officer is not the actual officer who made the assessment (for example Mr Thackeray in this case) but a hypothetical officer;
>
> (2) that the officer has the characteristics of an officer of general competence, knowledge or skill which include a reasonable knowledge and understanding of the law: see *Revenue and Customs Comrs v Lansdowne Partners Ltd Partnership* [2011] EWCA Civ 1578, [2012] STC 544, 81 TC 318;
>
> (3) that where the law is complex even adequate disclosure by the taxpayer may not make it reasonable for the officer to have discovered the insufficiency on the basis of the information disclosed at the time: see *Lansdowne* at [69];
>
> (4) that what the hypothetical officer must have been reasonably expected to be aware of is an actual insufficiency: see *Langham (Inspector of Taxes) v Veltema* [2004] EWCA Civ 193, [2004] STC 544, 76 TC 259 (per Auld LJ at [33]–[34]):
>
>> '[33] More particularly, it is plain from the wording of the statutory test in s 29(5) that it is concerned, not with what an Inspector could reasonably have been expected to do, but with what he could have been reasonably expected to be aware of. It speaks of an Inspector's objective awareness, from the information made available to him by the taxpayer, of "the situation" mentioned in s 29(1), namely an actual insufficiency in the assessment, not an objective awareness that he should do something to check whether there is such an insufficiency, as suggested by Park J. If he is uneasy about the sufficiency of the assessment, he can exercise his power of enquiry under s 9A and is given plenty of time in which to complete it before the discovery provisions of s 29 take effect.
>>
>> [34] In my view, that plain construction of the provision is not overcome by Mr Sherry's argument that it is implicit in the words in s 29(5) "on the basis of the information made available to him" (my emphasis) and also in the provision in s 29(6)(d) for information, the existence and relevance of which could reasonably be inferred from information falling within s 29(6)(a) to (c), that the information itself may fall short of information as to actual insufficiency. Such provision for awareness of insufficiency "on the basis" of the specified information or from information that could reasonably be expected to be inferred

therefrom does not, in my view, denote an objective awareness of something less than insufficiency. It is a mark of the way in which the subsection provides an objective test of awareness of insufficiency, expressed as a negative condition in the form that an officer "could not have been reasonably expected … to be aware of the" insufficiency. It also allows, as s 29(6) expressly does, for constructive awareness of insufficiency, that is, for something less than an awareness of an insufficiency, in the form of an inference of insufficiency.'

(5) that the assessment of whether the officer could reasonably have been expected to be aware of the insufficiency falls to be determined on the basis of the types of available information specified in s 29(6). These are the only sources of information to be taken into account for that purpose: see *Langham v Veltema* at [36]:

> 'The answer to the second issue—as to the source of the information for the purpose of s 29(5)—though distinct from, may throw some light on, the answer to the first issue. It seems to me that the key to the scheme is that the Inspector is to be shut out from making a discovery assessment under the section only when the taxpayer or his representatives, in making an honest and accurate return or in responding to a s 9A enquiry, have clearly alerted him to the insufficiency of the assessment, not where the Inspector may have some other information, not normally part of his checks, that may put the sufficiency of the assessment in question. If that other information when seen by the Inspector does cause him to question the assessment, he has the option of making a s 9A enquiry before the discovery provisions of s 29(5) come into play. That scheme is clearly supported by the express identification in s 29(6) only of categories of information emanating from the taxpayer. It does not help, it seems to me, to consider how else the draftsman might have dealt with the matter. It is true, as Mr Sherry suggested, he might have expressed the relevant passage in s 29(5) as "on the basis only of information made available to him", and the passage in s 29(6) as "For the purposes of subsection (5) above, information is made available to an officer of the Board if, but only if," it fell within the specified categories. However, if he had intended that the categories of information specified in s 29(6) should not be an exhaustive list, he could have expressed its opening words in an inclusive form, for example, "For the purposes of subsection (5) above, information … made available to an officer of the Board … *includes any of the following*".'

[18] Where there is more scope for argument is in relation to the level of awareness that the relevant information needs to create in order for the condition to bar the right to raise a s 29(1) assessment. In the present context, for example, is it necessary for the information disclosed to lead the notional officer to conclude on the balance of probabilities that there is an insufficiency or must he be satisfied beyond reasonable doubt? Alternatively is some quite different test to be applied? The balance of probabilities test had found support in *Corbally-Stourton* and has been adopted in the Scottish case *of R (on the application of Pattullo) v Revenue and Customs Comrs* [2009] CSOH 137, [2010] STC 107.

[19] But in *Lansdowne* at first instance ([2010] EWHC 2582 (Ch), [2011] STC 372) Lewison J (at [48]) preferred to take a different and more general approach:

> '[Counsel for HMRC] said that this was the wrong test. HMRC had to know with reasonable certainty of the insufficiency in question otherwise the office could not have been “aware” of it. There is, no doubt, an epistemological debate to be had about whether you can discover or be aware of something that does not in fact exist. In the present case, for example, the commissioners decided that there was no insufficiency. Had HMRC discovered or been aware of an insufficiency before their decision that there was in fact no insufficiency? Or had they been aware of it, but then ceased to be aware of it? And now that I have disagreed with the commissioners on one of the points, are HMRC aware of it again? Or have they been aware of it throughout? But I do not consider that I need to enter into this debate. In the present case the commissioners asked whether HMRC had sufficient information to make a decision whether to raise an additional assessment. That seems to me to be the right test.'

[20] A not dissimilar test was applied in the Court of Appeal. Sir Andrew Morritt C said (at [56]):

> '… I do not suggest that the hypothetical inspector is required to resolve points of law. Nor need he forecast and discount what the response of the taxpayer may be. It is enough that the information made available to him justifies the amendment to the tax return he then seeks to make. Any disputes of fact or law can then be resolved by the usual processes. For these reasons I would dismiss the appeal of HMRC.'

[21] To the same effect, Moses LJ said (at [69] - [70]):

> '[69] … As the Chancellor points out (at [56]), awareness of an insufficiency does not require resolution of any potential dispute. After all, once an amendment is made, it may turn out after complex debate in a succession of appeals as to the facts or law, that the profits stated were not insufficient. I have dwelt on this point because I wish to leave open the possibility that, even where the taxpayer has disclosed enough factual information, there may be circumstances in which an officer could not reasonably be expected to be aware of an insufficiency by reason of the complexity of the relevant law.
>
> [70] I also wish to express polite disapproval of any judicial paraphrase of the wording of the condition at s 30B(6) or s 29(5). I think there is a danger in substituting wording appropriate to standards of proof for the statutory condition. The statutory condition turns on the situation of which the officer could reasonably have been expected to be aware. Awareness is a matter of perception and of understanding, not of conclusion. I wish, therefore, to express doubt as to the approach of the Special Commissioner in *Corbally-Stourton v Revenue and Customs Comrs* [2008] STC (SCD) 907 and of the Outer House in *R (on the application of Pattullo) v Revenue and Customs Comrs* [2009] CSOH 137, [2010] STC 107, namely that to be aware of a situation is the same as concluding that it is more probable than not. The

statutory context of the condition is the grant of a power to raise an assessment. In that context, the question is whether the taxpayer has provided sufficient information to an officer, with such understanding as he might reasonably be expected to have, to justify the exercise of the power to raise the assessment to make good the insufficiency.'

[22] It is important to emphasise that the decision in *Lansdowne* did not involve any qualification of what Auld LJ in *Langham v Veltema* identified as the question posed by the second s 29(5) condition. The hypothetical officer must, on an objective analysis, be made aware of an actual insufficiency in the assessment by the matters disclosed in the s 29(6) information. This is made clear by Sir Andrew Morritt C at [55] of his judgment in *Lansdowne*. The sole dispute in that case was whether the disclosures made by the taxpayer's accountants were sufficient to cause the hypothetical officer to conclude that there was an insufficiency.

[23] The passages in the judgments of Sir Andrew Morritt C and Moses LJ as to the level of the officer's awareness were directed to the Revenue's argument that the disclosures made required inferences to be drawn about the accuracy of the self-assessment based on certain legal assumptions and that the officer could not be expected to resolve issues of law in determining the impact of the information supplied. In the face of such uncertainties, the officer could not be taken to be 'aware' of an insufficiency. The decision in *Lansdowne* confirmed that the officer was not required to resolve (or even be able to assess) every question of law (particularly in complex cases) but that where, as Moses LJ expressed it, the points were not complex or difficult he was required to apply his knowledge of the law to the facts disclosed and to form a view as to whether an insufficiency existed. That is a matter of judgment rather than the application of any particular standard of proof. And the reference to the officer needing to reach a conclusion which justified the making of a discovery assessment has to be read in that context.

[24] Mr Sanderson's case is that the Upper Tribunal overstated the level of knowledge which needs to be imputed to the officer under s 29(5) in order to justify the making of a discovery assessment. The threshold is said to be a relatively low one and merely requires the officer to be able to justify his belief that further tax is due. Part of Mr Gordon's argument rests on eliding the requirement in s 29(1) for an officer to 'discover' that there is an insufficiency in the return with the condition in s 29(5) that the notional officer could not have been reasonably expected, on the information available, to be 'aware' of that insufficiency. Unless, it is said, the threshold of knowledge is set relatively low it would be difficult, if not impossible, in most cases for the Revenue to be able to raise an assessment under s 29(1).

[25] I do not accept that sub-ss 29(1) and (5) import the same test and that the Revenue's power to raise an assessment is therefore directly dependent on the level of awareness which the notional officer would have based on the s 29(6) information. The exercise of the s 29(1) power is made by a real officer who is required to come to a conclusion about a possible insufficiency based on all the available information at the time when the discovery assessment is made. Section 29(5) operates to place a restriction on the exercise of that power by reference to a hypothetical officer who is required to carry out an evaluation of the adequacy of the return at a fixed and different point in time on the basis of a fixed and limited class of information. The purpose of the condition is to test the adequacy of the taxpayer's disclosure, not to prescribe the circumstances which would justify the real officer in exercising the s 29(1)

> power. Although there will inevitably be points of contact between the real and the hypothetical exercises which sub-ss 29(1) and (5) involve, the tests are not the same.
>
> […]
>
> [41] I would endorse what the Upper Tribunal said in [78] - [79] of its decision in *Charlton*:
>
>> '[78] The correct construction of s 29(6)(d)(i) is that it is not necessary that the hypothetical officer should be able to infer the information; an inference of the existence and relevance of the information is all that is necessary. However, the apparent breadth of the provision is cut down by the need, firstly, for any inference to be reasonably drawn; secondly that the inference of relevance has to be related to the insufficiency of tax, and cannot be a general inference of something that might, or might not, shed light upon the taxpayer's affairs; and thirdly, the inference can be drawn only from the return etc provided by the taxpayer.
>>
>> [79] As we have described, the balance provided by s 29 depends on protection being provided only to those taxpayers who make honest, complete and timely disclosure. That balance would be upset by construing s 29(6)(d)(i) too widely. Inference is not a substitute for disclosure, and courts and tribunals will have regard to that fundamental purpose of s 29 when applying the test of reasonableness.'

161. We draw the following principals from *Sanderson*, as well as from *HMRC v Lansdowne Partners LLP* (2011) 81 TC 318 and *Langham v Veltema* (2004) 76 TC 259 (from which Patten LJ quotes):

(1) The officer is not the actual officer who made the assessment, but a hypothetical officer;

(2) The hypothetical officer has the characteristics of an officer of general competence, knowledge, and skill, which include a reasonable knowledge and understanding of the law;

(3) Where the law is complex, even adequate disclosure by the taxpayer may not make it reasonable for the officer to have discovered the insufficiency on the basis of the information disclosed at the time;

(4) It must be reasonable for the hypothetical officer to be aware of an actual insufficiency; and

(5) The fact that information contained in the return might have been sufficient to cause the officer to ask further questions is not enough to alert the officer to an actual insufficiency.

162. Mr Henderson submits that the D1 statement in the 2007 corporation tax computations is not

> information the existence of which, and the relevance of which as regards the situation mentioned in paragraph 41(1) or (2) […] are notified in writing to [an officer of Revenue and Customs] by the company or a person acting on its behalf

for the purposes of paragraph 44(2)(d)(ii). This is because, he says, the PEA is ("wrongly and categorically") stated to be "*receivable by way of an increased proportion of the MDU Element* *of subscriptions*". In other words, the tax computation invites the hypothetical HMRC officer to reach the view that the PEA amounts were non-taxable as being part of the mutual trade income. Further, from the D1 statement in the 2007 tax computation, it is not possible to understand how or why the 2003 PIISSA (provided to HMRC on 11 August 2005) remained relevant to the PEA position for this period following its renegotiation.

163. Mr Henderson further submits that even if the 2003 PIISSA were to be treated as before the hypothetical officer for the purposes of paragraph 44(2), the hypothetical officer could not reasonably be expected to be aware of the insufficiency of tax based just on the 2003 PIISSA and the corporation tax computation, particularly given the complexity of the arrangements. The relevance of the 2003 PIISSA to the insufficiency of tax was not set out in the D1 statement. It was only after reviewing in detail further documents (for example the relevant professional indemnity insurance policies, which showed that the policy of insurance was between the insurer and each individual member) and further information which had not previously been provided to HMRC that the insufficiency could be established.

164. We agree with Mr Henderson's submissions, and find that the discovery assessment was validly made.

165. We find that the hypothetical HMRC officer would not have to take account of the 2003 PIISSA, as this was not one of the documents accompanying any of the MDU's relevant corporation tax returns. And the mere fact that the hypothetical officer was on notice that the 2003 PIISSA had been previously provided to HMRC and was relevant to the taxability of the PEA is not enough to bring the document within the scope of the documents before the hypothetical officer.

166. And even if we are wrong on that point, we would have found that a review of the terms of the 2003 PIISSA would not have been enough to bring the insufficiency of tax to the attention of the officer. This is for two reasons. The first is that it would be necessary for the officer to have seen the complete suite of contractual documents to understand how the PEA interacts with the Individual Subscriptions paid by MDU members and the premiums paid by them to the insurers – in particular the fact that there was no contractual entitlement for the MDU members as regards the PEA. The second is that an HMRC officer of general competence, knowledge and skill (including a reasonable knowledge and understanding of the law) could not be expected to unravel the meaning of the complex terms that the MDU had negotiated with the insurers and which were contained in a suite of lengthy and densely drafted agreements. The fact that this is appeal has been categorised as "complex" and has generated a lengthy decision just goes to illustrate that the taxability of the PEA is far from straightforward.

167. As regards the D1 statement contained in the 2007 corporation tax computations, we agree with Mr Henderson that the information in the statement is insufficient to disclose the insufficiency of tax declared in the 2007 corporation tax return. Whilst the information might possibly have been sufficient to put the hypothetical officer on notice that further questions might be appropriate, that is not sufficient to alert the hypothetical officer to the insufficiency.

CONCLUSIONS

168. The appeal is dismissed.

169. This appeal was categorised as "complex", but the MDU elected under Rule 10(c)(ii) of the Tribunal Procedure (First-tier Tribunal) (Tax Chamber) Rules 2009 that the proceedings should be excluded from potential liability for costs. No order in respect of costs is therefore made.

RIGHT TO APPLY FOR PERMISSION TO APPEAL

170. This document contains full findings of fact and reasons for the decision. Any party dissatisfied with this decision has a right to apply for permission to appeal against it pursuant to Rule 39 of the Tribunal Procedure (First-tier Tribunal) (Tax Chamber) Rules 2009. The application must be received by this Tribunal not later than 56 days after this decision is sent to that party. The parties are referred to “Guidance to accompany a Decision from the First-tier Tribunal (Tax Chamber)” which accompanies and forms part of this decision notice.

NICHOLAS ALEKSANDER

TRIBUNAL JUDGE

RELEASE DATE: 19 MAY 2020

Cases referred to in skeletons, but not mentioned in the decision

Mersey Docks & Harbour Board v Lucas (1883) 2 TC 25
Styles v New York Life Assurance Co (1889) 2 TC 460
CIR v Cornish Mutual Assurance Co Limited (1926) 12 TC 841
Jones v South-West Lancashire Coal Owners Association Limited (1927) 11 TC 790
Cenlon Finance Co v Ellwood [1962] AC 782
Parkin v Cattell (1971) 48 TC 462
RCC v Household Agents Limited (2008) 78 TC 705
Countrywide Estate Agents FS Limited v RCC [2012] STC 511
Charlton v HMRC [2013] STC 866

APPENDIX ONE
EXTRACTS FROM 2007 PIISSA (AS AMENDED BY AN AGREEMENT DATED 30 OCTOBER 2009)

The following are terms defined in the 2007 PIISSA:

MDUSL: Services

SCOR UK: SCOR UK Company Limited

Healthcare Practitioners means individuals, primary care groups and primary care trusts who are, or were, engaged in the provision of healthcare in the United Kingdom (including Healthcare Professionals)

Healthcare Professionals means General Practitioners, Private Practitioners, General Dental Practitioners, and other medical and dental practitioners including primary care groups and primary care trusts, who are for the time being engaged in the provision of healthcare in the United Kingdom

Old PEA means the allocation that would have been made in respect of premium element adjustments under the UK PIISSA had the same continued

PEA means an adjustment to the Premium Element calculated in accordance with Schedule 3

Policy Period means the period from 1 July 2003 to 31 March 2004, and each subsequent period from 1 April to 31 March or, if earlier, the date of termination of this Agreement

PI Insurance means fully retrospective, annual, claims made professional indemnity insurance for Healthcare Professionals

UK PIISSA means the professional indemnity insurance supply and services agreement of 28 May 2003.

DDR and *ERP* are run-off professional indemnity insurance policies for former MDU members who have (a) died, ceased to practice through disability, or have retired (DDR), or (b) subsequently obtained professional indemnity from another provider (ERP).

The following are the provisions of clauses 7 to 11 of the 27 December 2007 PIISSA (as amended):

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 any 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*). In addition, the Subscriptions shall include premiums charged to Healthcare Practitioners for DDR and/or ERP (if applicable).

8. PREMIUM ELEMENT

8.1 In advance of each Policy Period commencing on or after 1 April 2009:

(a) as soon as possible after the last Business Day in September and in any event by no later than the last Business Day in October, the MDU shall provide SCOR UK with such data as SCOR UK reasonably requires (in the form of a delivery list to be discussed between representatives of the MDU and SCOR UK) in order to calculate its proposed Premium Element for the following Policy Period (the *Premium Element Data*);

(b) by no later than 20 December, a meeting shall be held between representatives of SCOR UK and the MDU to discuss the Premium Element Data and other factors relevant to calculating the Premium Element for the following Policy Period;

(c) by no later than 20 January (or at such other time as SCOR UK and the MDU may agree), each of SCOR UK and the MDU shall simultaneously propose in good faith to the other, for the following Policy Period:

> (i) the Undiscounted Claims Costs;
>
> (ii) the Discounted Claims Costs (that first proposed by the MDU being the *MDU Discounted Claims Costs* and that first proposed by SCOR UK being the *SCOR UK Discounted Claims Costs*;
>
> (iii) the Premium Element, calculated in accordance with the methodology set out in Schedule 1 part 3 (that first proposed by the MDU being the *MDU Proposed Premium* and that first proposed by SCOR UK being the *SCOR UK Proposed Premium*); and
>
> (iv) if SCOR UK wishes to do so, any commercial proposals as to a Premium Element lower than the SCOR UK Proposed Premium and/or if the MDU wishes to do so, any commercial proposals as to a Premium Element greater than the MDU Proposed Premium;

(d) within 5 Business Days after such proposals are exchanged between SCOR UK and the MDU (or at such other time as SCOR UK and the MDU may agree), a meeting will be held between representatives of SCOR UK and the MDU (which may include actuaries or other advisers) to discuss such proposals and the data and assumptions used for their preparation, with a view to agreeing the Premium Element for the following Policy Period;

(e) the MDU and SCOR UK may continue to exchange proposals for the Premium Element but:

> (i) SCOR UK may not propose a Premium Element higher than the SCOR UK Proposed Premium; and
>
> (ii) the MDU may not propose a Premium Element lower than the MDU Proposed Premium;

(f) if agreement is reached on the Premium Element for the following Policy Period by 31 January, then such amount, as adjusted in accordance with clause 11, shall constitute the *Agreed Premium*, and if no agreement is reached by 31 January, then the provisions set out in clause 9 shall apply. For the avoidance of doubt, the capital allocation that will be applied in respect of the Agreed Premium will be 85 per cent. of the Agreed Premium.

8.2 Each of SCOR UK and the MDU shall promptly provide to the other such data or other information as the other [may] reasonably require in relation the method of calculation of the Undiscounted Claims Costs, Discounted Claims Costs, and/or Premium Element proposed by it pursuant to clause 8.l(c) in order to demonstrate that such proposed Undiscounted Claims Costs, Discounted Claims Costs and/or Premium Element has been calculated in accordance with the methodology set out in Schedule 1.

8.3 The MDU shall use all reasonable endeavours to ensure that the Premium Element Data is accurate, up-to-date, and complete in respect of the categories of information which are contained in it.

8.4 For the Policy Period commencing on 1 April 2008, the Agreed Premium shall be £100,022,433.

8.5 For the avoidance of doubt, the provisions of this clause 8 and clause 9 shall be interpreted on the basis that the SCOR UK Co-insurance Percentage is 100 per cent., but actual payments to SCOR UK shall be reduced *pro rata* if the SCOR UK Co-insurance Percentage is less than 100 *per cent*.

9. DEPOSIT PREMIUM

9.1 Where the parties have been unable to set an Agreed Premium in accordance with clause 8.1 by 31 January in advance of a Policy Period commencing on or after 1 April 2009, if the MDU so chooses the Premium Element shall (prior to any adjustment required by clause 11) be set at:

(a) the lower of (i) the mid-point between the MDU Proposed Premium and the SCOR UK Proposed Premium (for the avoidance of doubt, as both first exchanged pursuant to clause 8.l(c) and each with its own capital allocation applied), and (ii) ten per cent. above the MDU Proposed Premium; or

(b) if no proposals have been submitted by SCOR UK for the Premium Element in accordance with clause 8.1 (and accordingly there is no SCOR UK Proposed Premium), the most recent Agreed Premium from a Policy Period, adjusted for any changes in membership numbers of Healthcare Practitioners;

and shall be referred to in this Agreement as the *Deposit Premium* for the relevant Policy Period, which shall constitute the Premium Element for the relevant Policy Period adjusted as may be required by clause 11.

9.2 An illustration of the calculation of the Deposit Premium is set out in Schedule 4 part 1.

9.3 In respect of any Policy Period in which there is a Deposit Premium, upon the third anniversary of the beginning of such Policy Period, the Premium Element for such Policy Period shall be recalculated by SCOR UK in accordance with the formula set out in Schedule 4 part 2 and details of such recalculation shall be notified to the MDU. If such recalculation produces a recalculated Premium Element that is:

(a) greater than the Deposit Premium determined in accordance with this clause 9 for the relevant Policy Period, the MDU shall pay the excess (up to the SCOR UK Proposed Premium and after adjusting for the PEA) to SCOR UK:

(i) by adjustment of the Premium Element in the next Policy Period; or

(ii) if this Agreement has terminated, by settlement in cash no later than 30 days after SCOR UK has notified the MDU of the amount of the excess;

(b) less than the Deposit Premium determined in accordance with this clause 9, there shall be no refund of Premium Element, it being understood that this will be addressed in the PEA.

9.4 The recalculation pursuant to clause 9.3 will take account of clause 10.

9.5 For the avoidance of doubt, the capital allocation used in the recalculation of the Deposit Premium pursuant to clause 9.3 is 85 per cent. of the SCOR UK Proposed Premium, as first exchanged pursuant to clause 8.l(c).

10. COLLECTION OF SUBSCRIPTIONS AND PAYMENT OF PREMIUM ELEMENT

10.1 By no later than the last Business Day of February immediately preceding each Policy Period, the MDU shall calculate in good faith and notify SCOR UK of the *Insurance Premium Percentage* for that Policy Period, being the Agreed Premium (or, if applicable, the Deposit Premium) for that Policy Period divided by the aggregate Subscriptions which the MDU expects to charge in respect of that Policy Period, and expressed as a percentage.

10.2 MDUSL shall, as the agent of the MDU and SCOR UK, collect the Subscriptions from Healthcare Practitioners in accordance with clause 4.

l0.3 MDUSL shall account to SCOR UK for the Premium Element and (if applicable) the premiums charged to Healthcare Practitioners in respect of DDR and/or ERP 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:

(a) in respect of the Policy Period beginning 1 April 2008 and ending 31 March 2009, shall be adjusted by the amount set out against such payment in Schedule 2 (being an agreed calculation derived from and in substitution for the Old PEA) (the *Adjustment Amount*) as increased by an amount equivalent to interest calculated on the Adjustment Amount daily at the rate set out in clause 15.5 from the date of this Agreement to the date on which such payment is due under clause 10.3), the aggregate of the Adjustment Amounts being £23 million; and

(b) in respect of Policy Periods beginning on or after 1 April 2009, shall be adjusted, if required, in accordance with the PEA.

1l.2 SCOR UK's returns for the purposes of IPT shall, save as required by law, be made by reference to the amount of the Premium Element (and therefore after adjustments have been made in accordance with clause 11.1), and MDUSL shall account to SCOR UK for IPT on this basis. If HMRC requires payment of IPT by reference to the amount of the Premium Element prior to such adjustments having been made (and/or by reference to, or in connection with the £12 million adjustment pursuant to the terms of the Letter Agreement), giving rise to an obligation to pay an additional amount of IPT (the *Additional IPT Amount*) the MDU and MDUSL shall be jointly and severally liable to pay the Additional IPT Amount (together with related costs, interest and penalties) to SCOR UK provided that the MDU shall be entitled to require SCOR UK to take such action as the MDU may reasonably request to appeal any such requirement of HMRC and any adjudication in respect thereof (an *Appeal*) provided such request is made as soon as is reasonably practicable. SCOR UK shall submit all material proposed correspondence with HMRC and/or pleadings and other material documentation relating to an Appeal to MDUSL for its prior approval (such approval not to be unreasonably withheld or delayed).

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 this Agreement occurs and the preceding Policy Periods in accordance with Schedule 3, provided that the PEA for any Policy Period which is treated as accrued in the last annual audited accounts of SCOR UK 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.

11.4 If PEA is paid to the MDU at or after termination of this Agreement, SCOR UK shall, at the request and cost of MDU, and in accordance with the MDU's reasonable instructions, use its reasonable endeavours to recover from HMRC, and pay to the MDU immediately upon receipt, the IPT in respect of such amount.

The following are the provisions of paragraph 8.1 of Schedule 3 to the 2009 PISSA, which deals with the allocation of the PEA:

8.1 On the first Adjustment Date, SCOR UK will deduct any PEA as calculated at the first Adjustment Date from Premium Element payable by the MDU for the next Policy Period.

8.2 On subsequent Adjustment Dates, the difference between the PEA calculated at current Adjustment Dates will be compared with the PEA calculated at the previous Adjustment Date.

8.3 If the current PEA is greater than the previous PEA SCOR UK will allocate the difference to the MDU by way of reduction in Premium Element payable by the MDU for the next Policy Period.

8.4 If the current PEA is less than the previous PEA the MDU will allocate the difference to SCOR UK by way of increase in Premium Element payable by the MDU for the next Policy Period.

APPENDIX TWO
WORKED ILLUSTRATION PREPARED BY HMRC

Policy Period: 1 April 2008 to 31 March 2009
Insurers: SCOR UK as to 75%, Hannover as to 25%

Agreed Figures and Projections

Table 1

SCOR UK 100% Premium Element	£100,022,433
Hannover 100% Premium Element	£95,750,000
Anticipated Subscriptions	£177,629,000

Table 2

	Amount	**% of Total Anticipated Subscriptions**
SCOR UK Premium Element (on 75% basis)	£75,016,825	42.23%
Hannover Premium Element (on 25% basis)	£23,937,500	13.48%
Total Premium Element	£98,954,325	55.71%

PEA to be applied in the Policy Period: £23,001,000

Actual Figures

Table 3

Subscriptions Received	£177,247,094
SCOR UK Premiums (42.23% of Subscriptions Received)[1]	£74,851,448

PEA applied in the Policy Period: £23,001,000

[1] UK and Channel Islands