NO. 1350—COURT OF SESSION (FIRST DIVISION)—
20TH JUNE AND 20TH JULY, 1944

HOUSE OF LORDS—25TH FEBRUARY AND 29TH MARCH, 1946

AYRSHIRE EMPLOYERS MUTUAL INSURANCE ASSOCIATION, LTD. *v.* COMMISSIONERS OF INLAND REVENUE[1]

Income Tax, Schedule D—Mutual insurance company—Whether profits arising from transactions with members chargeable to Income Tax—Finance Act, 1933 (23 & 24 *Geo.* V, *c.* 19), *Section* 31.

The A.E.M.I. Association was incorporated under the Companies Acts as a company limited by guarantee to insure on the mutual principle and indemnify its members (who were all colliery owners), and its members only, against loss and damage in respect of their liability to make compensation for injuries, fatal or otherwise, to their workmen and others, and for this purpose it had powers to accumulate funds. There were no shareholders, but each member of the Association was liable to contribute a sum not exceeding £20 in the event of its being wound up.

The funds of the Association were built up from (i) *ordinary premiums paid by members monthly at rates fixed annually based on the amount of wages paid to their workers, and* (ii) *special premiums, i.e., calls made on members consequent on any extraordinary disaster or to make up the assets of the Association to meet any deficiency in the ordinary income. The directors were required to set aside sums not exceeding £10,000 in all as a reserve fund to meet extraordinary accidents and other contingencies, and the income accruing thereon was to be credited to the members' accounts in the proportion in which each member had contributed to the invested fund. A separate account was kept for each member which was cleared annually; the premiums paid by him and his share of income from invested funds were credited and the compensation actually paid and estimated as required to settle claims arising against him during the year and his share of the Association's expenses were debited. Half of any surplus of the premiums paid over the amounts debited was returned to him; the other half, plus his share of income from invested funds, was taken to "deficiency account", the balance on that account being transferred to the Association's "general" "suspense account". In the event of a winding up, the surplus assets were divisible among the members in proportion to the amounts standing to their respective credits. A member could withdraw from the Association on three months' notice if he had paid his premiums and gave a guarantee for the payment of his share of the amount required to meet the Association's liabilities; on the other hand, if the directors ascertained that the Association's assets, including the reserve fund, then exceeded its liabilities, he was entitled, unless giving up business, to be paid one-half the amount contributed by him to such excess assets. The directors on three months' notice could terminate a member's insurance and membership, in which case all liability for accidents to the member's employees ceased and he must account to the Association for his share of its liabilities. In the event of the termination of the insurance or of a member withdrawing owing to giving up business, he was to be paid the whole amount contributed by him to the excess assets.*

[1] Reported (C.S.) 1944 S.C. 421; (H.L.) 1946 S.C. (H.L.) 1.

The transactions of the Association with its members in some years resulted in a surplus, and the Association was assessed to Income Tax under Case I *of Schedule D for the year* 1935–36 *on the footing that such surplus was a profit chargeable to Income Tax by virtue of Section* 31(1) *of the Finance Act,* 1933. *On appeal, the Special Commissioners decided that the assessment was correct in principle.*

Held, *that the surplus arising from transactions of insurance of the Association with its members was not assessable to Income Tax by virtue of Section* 31(1) *of the Finance Act,* 1933.

CASE

At a meeting of the Commissioners for the Special Purposes of the Income Tax Acts held on 11th March, 1943, Ayrshire Employers Mutual Insurance Association, Ltd. (hereinafter called " the Association ") appealed against an assessment to Income Tax for the year ended 5th April, 1936, on the sum of £13,492.

I. The following facts were admitted or proved:—

(1) The Association was incorporated on 30th June, 1898, as a company limited by guarantee under the Companies Acts, 1862 to 1890. It has no share capital.

(2) The principal objects of the Association as stated in clause 3 of its memorandum of association are, *inter alia*:—

" (1) To insure on the mutual principle and indemnify Members " against loss and damage in respect of their liability " to make compensation for injuries, fatal or otherwise, " to their workmen and others, and to relieve Members of " all claims by workmen and others or their dependents, " and all proceedings and costs therein in connection with " accidents or alleged accidents.

" (2) To contract for and issue policies of indemnity and relief, " subject to such qualifications and conditions and in " respect of such considerations as may from time to time " be deemed expedient . . .

" (5) To effect and obtain such re-insurances of the risks of the " Association as may seem expedient to the Association, " with full power to become a Member of or subscriber to " any other indemnity or Insurance Company whether " mutual or not . . .

" (9) To accumulate capital for any of the purposes of the " Association, and to appropriate any of the Association's " assets to specific purposes, either conditionally or un- " conditionally.

" (10) To invest and deal with the moneys of the Association " not immediately required, upon such investments and " securities and in such manner as may from time to time " be determined."

(3) By clause 4 of the memorandum it is provided:—

" Every Member of the Association undertakes to contribute " to the assets of the Association in the event of the same being " wound up during the time that he is a Member, or within one " year afterwards, for payment of the debts and liabilities of the " Association contracted before the time at which he ceases to be

" a Member, and the costs, charges and expenses of winding up " the same, and for the adjustment of the rights of the contri- " butories amongst themselves, such amount as may be required, " not exceeding £20."

All the members of the Association are colliery owners although some have associated businesses.

(4) The provisions of the articles of association which show the working of the Association may be summarised as follows:—

Business (*arts.* 4–6).

(5) The business is to be carried on by or under the management of the directors, subject only to such control of meetings as is provided by the articles.

Membership (*arts.* 7–9).

Application for membership has to be made in writing, and admission is on such terms as the directors decide. Members have the rights and privileges and are entitled to the special aid, insurance, or indemnity, and are subject to the liabilities specified in the policies issued by authority of the directors.

In fact no policies have been issued, but members are provided with a certificate of insurance in order to comply with the requirements of the Workmen's Compensation (Coal Mines) Act, 1934 (24 & 25 Geo. V, c. 23), Section 2.

Termination of Membership (*arts.* 10–15).

(10) A member may withdraw on three months' notice in writing if, on the expiry of such notice, he has paid the premiums (ordinary and special) due by him, and given a satisfactory guarantee for the payment of his share, assessed in proportion to his premium, of such amount as may be ascertained by the directors to be required to meet the Association's liabilities at the date of the expiration of the notice. If, on the other hand, the directors ascertain that the assets, including the reserve fund, then exceed the liabilities, such member, unless he is giving up business shall be paid half the amount contributed by him to such excess assets.

In fact no payments have ever been made to a retiring member under this article as the directors have not been satisfied that there were excess assets.

(11) The directors may by similar notice terminate any member's insurance and membership, and all liability in respect of accidents to the member's employees after the expiry of the said notice then ceases. Such member must account to the Association for his share of the liabilities of the Association.

(12) In the event of the termination of the insurance or of a member withdrawing owing to his giving up business, he is to be paid the amount contributed by him to the excess assets, payment to be made as provided in article 10.

No repayment has ever been made under this article.

(13) Any member may with consent of the directors, and on their terms, transfer his interest to any person acquiring his business.

(14) The executor of a member is entitled to continue his interest.

(15) If a member becomes notour bankrupt, or suspends payment, his insurances are to expire on the fourteenth day after notice to that effect has been sent to him by the secretary, unless certain guarantees are given.

Premiums, Ordinary and Special (*arts.* 16–29).

(*16*) The Association's income derived from (1) ordinary premiums at rates fixed from time to time by the directors and paid monthly, and (2) special premiums, i.e., calls on members consequent upon any extraordinary disaster, or to make up the assets of the Association to meet any deficiency in the ordinary income (art. 26).

The ordinary premiums are fixed annually at the general meeting in September and run from the month of October in each year.

The ordinary premiums are based on the wages paid to different classes of workers (art. 16) with a minimum (art. 17) and members are to furnish the Association monthly with a statement showing the wages paid (art. 18).

(*23*) The directors are to set aside such sums not exceeding £10,000 *in cumulo* at any time as they think proper as a reserve fund to meet extraordinary accidents and other contingencies.

(*24*) The revenue accruing from the investment of the reserve fund is to be credited to the member's separate account in the proportion in which each member has contributed to the invested fund.

At 31st October, 1942, the reserve fund amounted to £10,158.

(*28*) A separate account is to be kept for each member to show the amount of premiums paid by him, the revenue accruing to him from the invested fund under article 24, the amounts paid or payable to his employees or others and his proportion of the management expenses. The account is to show in what proportion, if at all, he has contributed to the reserve fund and surplus assets.

(*29*) All management and other expenditure of the Association is to be paid out of the common fund of the Association and charged to each member in proportion to his premiums paid.

Bonuses (*arts.* 30–32).

(*30*) The account of each member is balanced each year, and if, in respect of the year, he has paid in ordinary premiums a sum in excess of the amount paid or estimated as requiring to be paid for him by the Association, including his proportion of the amount carried to reserve and a rateable proportion of expenses, a bonus equal to 50 per cent. of the excess is to be declared in his favour. The amount of the bonus is payable after the next annual general meeting.

Winding up (*arts.* 90–91).

(*90*) The Association is to be wound up voluntarily whenever an extraordinary resolution is passed to that effect, and (art. 91) in that event the surplus assets are divisible among the members in proportion to the amounts standing to their credit.

A copy of the memorandum and articles of association is annexed hereto, marked " A ", and forms part of this Case[1].

(5) The reserve fund has fluctuated round the sum of £10,000. The articles were interpreted by the Association to mean that all income from investments, of which the reserve fund was a small part, should be allocated to members in proportion to their holding in the reserve fund. When a new member is admitted he is allocated a portion of the reserve fund according to the amount of wages paid.

[1] Not included in the present print.

(6) In terms of article 28 each member has an account with the Association, and this account is cleared annually. A specimen attached (marked " B ", and forming part of this Case(1)) shows that the credit side of the account is composed of premiums paid and the member's share of revenue from the invested funds. The debit side is made up as follows:—

(i) Compensation paid on behalf of the member in respect of claims arising during the year.

(ii) His proportion of the Association's expenses.

(iii) Suspense account, which is the Association's estimate of the amount required to settle claims against the member which have arisen during the year, and are continuing claims at the end of the year.

(iv) Bonus account, which represents half the surplus arising on the member's account, excluding the proportion of the revenue from invested funds (article 30), i.e., half the difference between (*a*) the premiums and (*b*) the total of items (i), (ii) and (iii), and

(v) Deficiency account: the figure here is the other half of the surplus plus the proportion of the revenue from invested funds. The balances on members' accounts whether debtor or creditor are taken to the deficiency account and the balance on that account is then transferred to the general suspense account.

(7) A copy of a general suspense account is attached hereto, marked " C ", and forms part of this Case(1). It shows the balance transferred from deficiency account and its allocation among certain members. The allocation is made according to an estimate of liabilities and claims in future arising from (*a*) claims at present outstanding for which inadequate provision has been made, and (*b*) claims which might arise.

(8) A copy of an individual member's suspense account is also attached hereto, marked " D ", and forms part of this Case(1). This deals with compensation paid during the year on claims from a previous year for which provision had been made in the past. It shows on the credit side:—

(i) The balance brought forward, being the provision already made for claims.

(ii) General ledger: this is the member's proportion of the estimate of claims against the member arising during the year and unsettled at the end of the year. It is a cross-entry from the member's account (" B ").

(iii) Special premiums, if any, paid by the member during the year, and

(iv) Suspense account. This is the allocation from the general suspense account " C " referred to in the preceding paragraph.

The debit side shows the compensation paid during the year, and the balance is the provision at the end of the year for claims carried into the succeeding year.

(9) The amount of a member's claim against the Association is not limited to the estimate made by the directors or to the credit in the individual suspense account. The whole funds of the Association are available for any claim irrespective of any allocations made in the Association's books.

(10) The transactions of the Association with its members in some years result in a surplus, and the assessment under appeal was made on the footing that such surpluses were profits chargeable to Income Tax by virtue of Section 31 of the Finance Act, 1933. The Association admitted that it had transactions with its members from which surpluses arose, but did not admit

(1) Not included in the present print.

TAX CASES

Vol. XXVII—Part VII

Errata

Page 336, paragraph IV.

Line 3. *Delete* : (1)

Line 6. *Delete* :—

in *Jones* v. *South-West Lancashire Coalowners' Association, Ltd.*, *and insert* :—

giving rise to profit was assessable to Income Tax. We held that

that such surpluses were chargeable to Income Tax by virtue of the said Section. The assessment under appeal was made on the basis that the surpluses are chargeable to Income Tax. The amount of the assessment is an estimated one and will be subject to adjustment if the question of law is answered in the affirmative.

II. It was contended on behalf of the Association:—

(1) that the Association carried on the trade of mutual insurance and that its transactions with its members did not give rise to a profit or surplus assessable to Income Tax (*Jones* v. *South-West Lancashire Coalowners' Association, Ltd.*, [1927] A.C. 827; 11 T.C. 790);

(2) that if those transactions were entered into by the Association with non-members their effect would be to make non-members parties to mutual trading and no profit or surplus assessable to Income Tax would arise;

(3) that the wording of Section 31 (1) of the Finance Act, 1933, was inapt to charge the profit or surplus arising from transactions with members.

III. It was contended on behalf of the Commissioners of Inland Revenue:—

(1) that the transactions of the Association with its members did give rise to a profit or surplus which was chargeable to Income Tax under Case I of Schedule D by virtue of Section 31 (1) of the Finance Act, 1933, and

(2) that the assessment was properly made in principle.

IV. We, the Commissioners who heard the appeal, were of opinion that where a mutual insurance concern existed then, in accordance with the decision in *Jones* v. *South-West Lancashire Coalowners' Association, Ltd.*(1), the effect was that the members acted both as insurers and insured. On the other hand a non-member could only be insured and a transaction of insurance with him ~~in *Jones* v. *South-West Lancashire Coalowners' Association, Ltd.*, the effect~~ of the said Section 31 (1) was to assimilate transactions of insurance with members to transactions of insurance with non-members, and that the assessment was properly made in principle. The basis of valuation of unsettled claims has not yet been agreed.

V. The representative of the Association expressed to us his dissatisfaction with our determination as being erroneous in point of law and having duly required us to state and sign a Case for the opinion of the Court of Session as the Court of Exchequer in Scotland, this Case is stated and signed accordingly.

VI. The question of law for the opinion of the Court is whether the surplus arising from transactions of insurance of the Association with its members is assessable to Income Tax by virtue of the said Section 31 (1) of the Finance Act, 1933.

H. H. C. GRAHAM, N. ANDERSON, } Commissioners for the Special Purposes of the Income Tax Acts.

Turnstile House, 94/99 High Holborn, London, W.C.1.
13th March, 1944.

H. H. C. GRAHAM, N. ANDERSON, } Commissioners for the Special Purposes of the Income Tax Acts.

The case came before the First Division of the Court of Session (the Lord President and Lords Fleming, Moncrieff and Carmont) on 20th June, 1944, when judgment was reserved. On 20th July, 1944, judgment was given unanimously against the Crown, with expenses.

The Dean of Faculty (Mr. J. G. McIntyre, K.C.) and Mr. A. M. M. Williamson appeared as Counsel for the Association, and the Lord Advocate (Mr. J. S. C. Reid, K.C.) and Mr. J. F. Gordon Thomson for the Crown.

I.—INTERLOCUTOR

Edinburgh, 20th July, 1944. The Lords having considered the Case on Appeal and having heard Counsel for the parties, Sustain the Appeal: Answer the Question of Law submitted for the opinion of the Court in the Negative: Reverse the determination of the Commissioners and Decern: Find the Appellants entitled to the expenses of the Case on appeal and remit the Account thereof, when lodged, to the Auditor to tax and to report.

(*Signed*) W. G. NORMAND, I.P.D.

II.—OPINIONS

Lord Fleming.—The Appellants' association is a company limited by guarantee and is incorporated under the Companies Acts, 1862 to 1890. It has no share capital and no shareholders. The name indicates the general character of its business, but for the decision of the question submitted to us it is necessary to understand its structure and the methods by which it carries on its business.

Its principal object is described in its memorandum of association as being: "To insure on the mutual principle and indemnify the Members against loss "and damage" in respect of claims against them by workmen or others for injuries arising out of accidents or alleged accidents. A person becomes a member of the Association by making an application, and admission is made on such terms as the directors decide. Its income is derived from (1) ordinary premiums paid by members at rates fixed from time to time and paid monthly, and (2) special premiums, i.e., calls on members consequent on any extraordinary disaster, or to make up the assets of the Association to meet any deficiency in the ordinary income. The premiums are based on the amount of wages paid to different classes of workers, with a minimum of £25. The directors are required to set aside such sums, not exceeding £10,000 *in cumulo*, as they think proper as a reserve fund to meet extraordinary accidents and other contingencies, and the revenue accruing therefrom is to be credited to the members' accounts in the proportion in which each member has contributed to the invested fund. A separate account is to be kept for each member showing the premiums paid and the revenue accruing to him from the invested funds. The account is debited with the amount paid to his employees or others, and his proportion of the management expenses, and with a sum under the name of "Suspense Account" which represents the estimated amount of liability for continuing claims against the member which have arisen in the course of the year. If after these items have been debited there is a balance in favour of the member, so much of it as is derived from his proportion of the income from invested funds is deducted, and one-half of the remainder is returned to him as a bonus payable after the next general meeting. The other half, plus his proportion of income from invested funds, is taken to "Deficiency Account" and the balance on that account is then transferred to the "General Suspense Account". In the event of a winding up, the surplus assets are divisible among the members in proportion to the amounts standing to their respective credits. A member is bound to contribute to the assets of the Association—in the event of its being wound up while he is a member, or within one year thereafter, for payment of its debts contracted before he ceased to be a member and the costs of the winding up

(Lord Fleming.)

and for the adjustment of the rights of the contributories amongst themselves—such amount as may be required, not exceeding £20. A member may withdraw from the Association on three months' notice if he has paid his premiums and given a satisfactory guarantee for payment of his share, assessed in proportion to his premium, of the amount required to meet the Association's liabilities. If, on the other hand, the directors ascertain that the assets exceed the liabilities, the member, unless he is giving up business, is to be paid half the amount contributed by him. No payment has ever been made under this provision as the directors have not been satisfied that there were excess assets. The directors may by similar notice terminate a member's insurance, and all liability for accidents to the member's employees thereupon ceases, and he must account to the Association for his share of its liabilities. In the event of the termination of the insurance, or of a member withdrawing owing to his giving up business, he is to be paid the amount contributed by him to the excess assets. The transactions of the Association with its members in some years resulted in a surplus, and the assessment was made on the footing that such surpluses were profits chargeable to Income Tax by virtue of Section 31 of the Finance Act, 1933.

I have set out the facts of the case in detail because if they are compared with the facts in *Jones* v. *South-West Lancashire Coal Owners' Association, Ltd.*, [1927] A.C. 827; 11 T.C. 790, as stated in the headnote and in the report of the same case before Rowlatt, J., and the Court of Appeal, it becomes clear that this case is indistinguishable from *Jones* and that the Crown's claim for tax must be rested entirely upon Section 31 of the Act of 1933. This indeed was not disputed by the Crown, and it is implied in the terms of the question submitted to us and also of the Crown's contention. But, for the determination of the question of whether Section 31 has the result of making the Appellant's transaction liable to tax, the cases in which prior to the Act of 1933 companies carrying on a business of mutual insurance have been held not to be assessable to the tax require to be examined.

The leading case is *New York Life Insurance Company* v. *Styles*, 14 App. Cas. 381; 2 T.C. 460. The company there carried on the business of life insurance. It had no shareholders and no shares. The only members were the holders of participating policies each of whom was entitled to a share of the assets and liable to all losses. An account was annually taken and the greater part of the surplus of premiums over the expenditure referable to these policies was returned to the policy holders as bonuses, either by addition to the sums insured or in reduction of future premiums. The remainder of the surplus was carried forward as funds in hand to the credit of the general body of the members. In view of the provision of Section 31 of the Act of 1933 it should be mentioned that, in addition to the participating policies with its members, the company had transactions of a non-mutual character with non-members, and it was admitted that profits arising from such transactions were taxable. The House of Lords held by a majority of 4 to 2, reversing the decision of the Court of Appeal and the Queen's Bench Division, that no part of the premium income received under participating policies was liable to be assessed to tax. The ground of decision was that the members had associated themselves together for the purpose of mutual insurance, and had contributed to a common fund on the basis that, if it ultimately exceeded what was required, the surplus would be returned to them, but that if it turned out to be insufficient they would require to make good the deficiency. Both Lord Herschell and Lord Macnaghten appear to me to have regarded the circumstance that the participators in the mutual scheme of insurance were members of the company as not being an essential

(Lord Fleming.)

feature of it. The passages in their speeches in which they deal with this matter will be found in Lord Chancellor Cave's speech in *Jones*(1). In that case the company was a purely mutual concern, every person indemnified by the Association being a member and every member being indemnified by the Association. The same kind of indemnity was given to the members as in the present case, and the structure and frame of the two companies is formed upon the same pattern. The decision again was that the company was a mutual trading concern, and the Lord Chancellor laid emphasis on the point that the annual surplus returned to the members. He said: "Sooner or "later, in meal or in malt, the whole of the company's receipts must go back "to the policy holders as a class, though not precisely in the proportions in "which they have contributed to them; and the association does not in any "true sense make a profit out of their contributions. It may be added that "in that case", i.e., the *New York Life Insurance Company's* case(2), "as "in this, some part of the receipts of each year was carried forward as funds "in hand. It was argued that this view gives no effect to the well established "distinction between a company and its members, and that, although the "members may make no profit, a profit may still accrue to the company. "The same point arose in the *New York Life* case, and was disposed of in "the speeches of Lord Herschell and Lord Macnaghten(3)."

Though it was not brought to our notice, the House of Lords case of *Municipal Mutual Insurance, Ltd.* v. *Hills,* 16 T.C. 430, seems to require consideration. The appellant company was formed by the representatives of various local authorities primarily for the purpose of enabling local authorities and other public bodies by co-operation to insure against fire on favourable terms. The fire policy holders alone were entitled in the event of winding up to the surplus assets, but they were not members of the company. In course of time the company undertook, in addition to fire insurance, an extensive business in employers' liability and miscellaneous insurance. The Crown admitted that the fire insurance business was a business of mutual insurance which did not attract liability to assessment for Income Tax. On the other hand, the company admitted liability to tax in respect of profit from employers' liability and miscellaneous business with persons who were not fire policy holders, but contended that it was not liable in respect of any surplus arising from employers' liability and miscellaneous business done with fire policy holders. The decision on the last-mentioned point was in favour of the Crown, but the principles upon which the judgment proceeded support the Appellant's contention. The significance of the case is that it is an instance of mutual trading though the associated persons were not members of the company; Lord Thankerton observing that, though not members, their rights were such as to make them in effect such(4). Lord Dunedin formulated the principle as follows: "Any person, or set of persons, or company, carry- "ing 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, there 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, as was found in the two cases, 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(5)." Lord Warrington,

(1) 11 T.C. 790. (2) 2 T C. 460. (3) [1927] A C., at p. 832; 11 T.C., at pp. 838/9.
(4) 16 T.C., at p. 446. (5) *Ibid.*, at p. 441.

(Lord Fleming.)

Lord Thankerton and Lord Macmillan took the same view. Lord Macmillan, in dealing with the grounds for granting tax immunity in respect of mutual insurance, summed up the matter thus: " 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 be- " tween the contributors and the participators. If this requirement is satisfied, " the particular form which the association takes is immaterial(1)."

I now turn to Section 31 of the Act of 1933 which the Crown relies upon as the warrant for assessing the Appellant. If what is immaterial is omitted and what is necessary to give effect to the definition clause is added, the Section reads as follows: " In the application to any incorporated company " or society of any provision or rule relating to profits or gains chargeable " under Case I of Schedule D (which relates to trades) . . . any reference " to profits or gains shall be deemed to include a reference to a profit or " surplus arising from transactions of the company or society with its mem- " bers which would be included in profits or gains for the purposes of that " provision or rule if those transactions were transactions with non-members, " and the profit or surplus aforesaid shall be determined for the purposes of " that provision or rule on the same principles as those on which profits or " gains arising from transactions with non-members would be so determined." The Section does not say that the profits arising from all transactions between an incorporated company or society and its members are to be taxed. But it does say—reading it short—that for Income Tax purposes those transactions are to be treated as if they had been with a non-member. The question of liability for tax accordingly depends upon whether the transaction in question would have attracted tax if it had been made with a non-member. If that question is answered in the affirmative, there is liability for tax; if in the negative, there is not. I take it that the word " non-member " has its ordinary signification and includes a person who is not a member according to the constituting documents of the company or society, even though he may have under these documents or under a policy of insurance or under any other kind of contract a right to participate in the assets of the company.

The Section speaks of *those* transactions, i.e., the transactions actually made with the members, and the hypothetical transactions which we have to consider must be, at least in substance, the same as those actually made with the company except that the person who enters into the transactions is not a member of the company. We must assume that the premiums are the same and that the other terms of the contract with the company, including the financial provisions, are the same. Premising as we must that, apart from the Act of 1933, the transaction as made with the member does not attract tax, we must consider whether the same transaction if made with a non-member would be taxable. The question may also be put in this form. It being conceded that a non-taxable scheme of mutual insurance can be carried on through the medium of an incorporated company of which the participators are members, on the lines adopted in the *New York Life Insurance Company* case(2), and in subsequent similar cases, is it an indispensable feature of the immunity from tax given to such transactions that those who participate should be members of the company or society? I answer both these questions in the negative.

(1) 16 T.C., at p. 448. (2) 2 T.C. 460.

(Lord Fleming.)

Taking the test as laid down in *Jones*(1) and *Muncipal Mutual Insurance*(2), I see no difficulty in an incorporated company or society making contracts with a number of persons under which they would participate in a scheme of mutual insurance, in all respects the same as those made between the Appellant Company and its members, without it being made a condition of the contracts that the persons participating were to become members of the company or society. In the *New York Life Insurance Company* case(3) the contract was made by the issue of a policy by the company which, *inter alia*, had the effect of making the shareholder a member. But supposing that provision to be omitted, I do not see any reason why the policies should not be framed so as to give the policy holders all the rights and privileges and subject them to the liabilities which are essential to constitute a relationship of mutuality among them, and in particular to ensure that all "surpluses" were to be returned to them or otherwise applied for their benefit. Nor can I understand why such a relationship should not be constituted among the policy holders without making them members of the company. In *Municipal Mutual Insurance, Ltd.*, which was prior to the Statute of 1933, transactions similar to the actual transactions now in question were conceded by the Crown to be non-taxable though the participators in the scheme were not members of the company. Assuming that concession to be right, as I think it was, it follows that, the hypothetical transactions we have to consider if they had been actual transactions which had occurred prior to the Act of 1933, would not have been taxable, and that necessarily leads to the result that the actual transactions of the Appellant taking place after the Act are not taxable.

I think the whole case may be summed up thus. Section 31 of the Act of 1933 applies to those kinds of mutual trading in which membership of the company or society is an indispensable requisite for obtaining immunity from taxation. Remove it and tax, *ipso facto*, is attracted. I do not doubt that there may be cases of that character. But, in my opinion, this is not one of them. I therefore think the quesion put to us should be answered in the negative.

Lord Moncrieff.—I am of the same opinion. In the fourth speech the learned Lord Advocate proposed to argue that, in view of the forfeiture by retiring members of half the sum standing to their credit in the "Deficiency" Account", the Association must be regarded as one which was making gains and profits; and that the case could thus be distinguished in its circumstances from the earlier cases which were the subject of decision in *Jones* v. *South-West Lancashire Coal Owners' Association, Ltd.* (11 T.C. 790) and *New York Life Insurance Company* v. *Styles* (2 T.C. 460). I do not think any such argument was open. This appeal Case has, in my opinion, been so framed as to allow of trial only of the single question which the Special Commissioners have entertained and decided, viz: On the assumption that the decision would otherwise have been ruled by the case of *Jones* v. *South-West Lancashire Coal Owners' Association*, does Section 31 of the Finance Act, 1933 (as subsequently enacted), now require that a different decision should be arrived at?

In determining that single question two considerations must be kept in view. First, that as now decided the Association, while it may or may not make profit, is in either event equally engaged in trade. Although Lord Watson, when giving the leading opinion in *New York Life Company* v.

(1) 11 T.C. 790. (2) 16 T.C. 430. (3) 2 T.C. 460.

(Lord Moncrieff.)

Styles, asserts a directly opposite view(1), and while the passage asserting that view is relied on as affording a ground of judgment for the decision in 1927 of the related case of *Jones*(2), the opinion that such an association was engaged in trade was affirmed as matter of express decision in 1926 in the immediately intervening case of *Commissioners of Inland Revenue* v. *Cornish Mutual Assurance Co., Ltd.*, 12 T.C. 841. Second, that the immunity from Income Tax was conceded in the cases of *Jones* and *Styles* on the ground that, on a proper analysis of the transaction, the association although engaged in trade did not make profits or gains; and not on what would seem to be the irrelevant consideration that, while in fact making profits and gains, it did so only as a mutual association of traders.

As now enlightened by the reasoning underlying the decisions which I have cited, I have difficulty in seeing on what ratio the immunity from tax which was granted by their Lordships could have been withheld. The surplus was in each case in the hands of the association in respect and in respect only of an overpayment of premiums; which overpayment immediately fell to be placed on suspense account pending repayment to the contributors, albeit subject as among them to certain readjustments which the noble and learned Lords regarded as negligible. If such a surplus should have been held to represent profits subject to tax, a mere alteration of the method of bookkeeping in use by the association would have resulted in the disappearance of the surplus. By the use of ordinary banking facilities the amount falling to be yielded by premiums prepaid could have been adjusted at a figure which would have resulted year by year in a deficit and not in a surplus, while the balance required in each year could have been left to be obtained by subsequent calls for the exact amount. It is of primary importance to note that, upon this analysis, no profits or gains are made by an association trading on these lines, and to recognise that this must be equally true whether the contributors be members or be not members of the association. It is of scarcely less importance that, whether the contributions be made by members or by non-members, they equally are received by the association in the course of carrying on a trade; and that, accordingly, the Finance Act of 1933 cannot be regarded as having for the first time imprinted a trading character upon associations which theretofore had not been traders.

Turning now to the short but conclusive question of the proper construction and application of the Finance Act of 1933, two conflicting interpretations were proposed. For the Appellants it was maintained to have been the statutory assumption that the transactions, whether with members or with non-members, were to remain the same; and that on this assumption, as little profit could be found, upon a proper analysis of the transactions, to have been ingathered in the one case as in the other. The mere substitution of non-members for members as contributors did not result in the creation of a profit. It was contended on the other hand on behalf of the Commissioners that, since the passing of the Act of 1933, all transactions of a mutual association with its members (although not yielding profits) were to be notionally regarded and treated for purposes of Income Tax as being the entirely different transactions which non-mutual insurers are in use to enter into for the express purpose of making profits; and that the non-profitable surplus of the one class of traders, although the transactions were entirely different, was hereafter to be made subject to tax as though it had been an actual profit such as the other class of traders are in use to make. I do not

(1) 2 T.C., at p. 471. (2) 11 T.C., at p. 837.

(Lord Moncrieff.)

hesitate to affirm the former and to reject the latter of these two alternative constructions of the enactment; and can only suppose, from the eleven years which have been allowed to elapse before the latter construction was proposed, that it is an afterthought, and an afterthought moreover such as does not perhaps entirely evidence the greater wisdom imputed by the familiar adage. It would seem moreover that the suggested result might very readily have been achieved, if any such result had been in view, by following the phrasing of Section 53 (2) (*h*) of the Finance Act of 1920; or even perhaps by terminating Section 31 (1) of the Finance Act of 1933 itself with the word " members ", as occurring in the ninth line of the Section. With such alternatives at call, I cannot suppose that the statutory Section as framed can have been intended to operate as an obscure enactment of a liability to tax which might have been so unmistakably enacted.

Lord Carmont.—I also agree with the opinion of Lord Fleming.

The Lord President (Normand).—It is conceded that there is no liability to Income Tax apart from Section 31 (1) of the Finance Act, 1933, because any surplus resulting from the excess of premium payments over claims is returnable to the members who are both insurers and insured. In brief no profits can arise from an arrangement by which a number of persons form an association for the purpose of sharing their losses. Section 31 (1) of the Finance Act, 1933, shortly read, makes surpluses arising from the transactions of an incorporated company or society with its members taxable as if those transactions were transactions with non-members. But if the transactions in this case had been with non-members, the result would have been precisely the same as regards profits. Instead of members sharing losses, non-members would have been sharing losses, and no profit could have resulted. The Special Commissioners have avoided this result by holding that non-members could only be insured and could not be insurers. I think they were influenced by the consideration that non-members transacting as both insurers and insured would be in effect members whether called so or not, and they therefore construed " non members " as the equivalent of persons not having the right which members enjoy to the return of surplus contributions. On that view the surplus would go to persons who had not contributed to it and would, therefore, be profit. But, while it is almost meaningless to speak of non-members participating in the actual transactions of this Company, because such participation would in effect make them members, the wording of the Sub-section does not seem to warrant a construction which involves a hypothetical modification of the actual transactions as well as the hypothetical substitution of non-members for members as the parties to those transactions.

My conclusion is, therefore, that since those transactions could beget no profit, whether the parties to them were members of the Company or not, there is no hypothetical profit within the meaning of the Sub-section. My opinion is thus in agreement with the opinion delivered by Lord Fleming. But I have thought it right, at the risk of some repetition, to say so much, because I feel great difficulty in stating more positively the intention of the Sub-section, and in defining its ambit. It is not wholly satisfactory to me to say that this Company and others like it lie outside the ambit, while confessing my uncertainty about what companies or societies fall within it. For, take any kind of association of persons whose transactions *inter se* were outside the scope of Income Tax till 1933, because in the nature of things they could yield no taxable profit, how could a hypothetical profit spring into being from the mere supposition that the same transactions took place between non-members instead of between members of the association? Yet it appears to me that the underlying assumption of the enactment is that somehow the

(The Lord President (Normand).)

substitution of non-members for members would have just that miraculous result. I seem in the end to be driven to that last refuge of judicial hesitation when confronted with a difficulty of interpretation, the doctrine that no tax can be imposed on the subject without words in an Act of Parliament clearly showing an intention to lay a burden on him. It might be some consolation to reflect that that is a doctrine which might be allowed special force against the Crown's contention that the Act entitled it to treat as profits sums which in reality are not profits at all and which a modification of the Company's book-keeping for future years would entirely eliminate, were it not that, in Income Tax questions, complete equity is mere error unless it is based on a sound construction, however difficult to arrive at, of the statutory provisions.

The Crown having appealed against the decision in the Court of Session, the case came before the House of Lords (Lords Thankerton, Macmillan, Wright, Simonds and Uthwatt) on 25th February, 1946, when judgment was reserved. On 29th March, 1946, judgment was given unanimously against the Crown, with costs, confirming the decision of the Court below.

The Attorney-General (Sir Hartley Shawcross, K.C.), the Lord Advocate (Mr. G. R. Thomson, K.C.), Mr. Reginald P. Hills and Mr. J. F. Gordon Thomson appeared as Counsel for the Crown, and Mr. R. P. Morison, K.C., and Mr. C. J. D. Shaw for the Association.

JUDGMENT

Lord Thankerton.—My Lords, this appeal arises out of an assessment to Income Tax made on the Respondent Association for the year ended 5th April, 1936, on the sum of £13,492, being the estimated surplus arising in that year from the transactions of the Association with its members. It is not disputed that the assessment was made on the footing that such surplus constituted profits chargeable to Income Tax by virtue of Section 31 of the Finance Act, 1933, and could not otherwise be justified. On appeal the Special Commissioners affirmed the assessment, and, on the requisition of the Association, stated a Case for the opinion of the Court of Session, the question of law being: " Whether the surplus arising from transactions of " insurance of the Association with its members is assessable to Income Tax " by virtue of the said Section 31(1) of the Finance Act, 1933." The case was heard by the First Division of the Court of Session, by whose Interlocutor dated 20th July, 1944, the appeal was sustained and the question of law submitted for their opinion was answered in the negative. Hence the present appeal by the Crown.

It had been settled in a series of cases in this House, beginning with *New York Life Insurance Co.* v. *Styles* (1889), 14 App. Cas. 381 (2 T.C. 460), and ending with *Municipal Mutual Insurance, Ltd.* v. *Hills* (1932), 16 T.C. 430, that the surpluses arising out of transactions of purely mutual insurance between an association and its members, or between an association as insurers and the policy holders as the insured, were not assessable to Income Tax. The ground of these decisions is well summarised by my noble and learned friend Lord Macmillan in the *Municipal Insurance* case (16 T.C., at page 448) as follows: " 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

(Lord Thankerton.)

" which the association takes is immaterial "; and earlier on the same page he stated: " 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." It may be added, however, by way of contrast, that such surpluses were held liable to be included in computing profits for the purposes of Corporation Profits Tax, by virtue of the express provisions of paragraph (*h*) of Sub-section (2) of Section 53 of the Finance Act, 1920, the material part of which provides: " Profits shall " include in the case of mutual trading concerns the surplus arising from " transactions with members . . . "

The Crown concedes that the Respondent Association is a typical mutual insurance society, indemnifying its members in respect of claims by their workmen for injuries arising out of accidents or alleged accidents, its members being the only contributors and the only participators, and that the surpluses arising on its transactions would not have been assessable to Income Tax in view of the decisions already referred to; but the Crown maintains that such liability is imposed by the provisions of Section 31 of the Finance Act, 1933, the material part of which enacts as follows:—

" 31.—(1) In the application to any company or society of any " provision or rule relating to profits or gains chargeable under Case I " of Schedule D (which relates to trades) . . . any reference to profits " or gains shall be deemed to include a reference to a profit or surplus " arising from transactions of the company or society with its members " which would be included in profits or gains for the purposes of that " provision or rule if those transactions were transactions with non- " members, and the profit or surplus aforesaid shall be determined for " the purposes of that provision or rule on the same principles as those " on which profits or gains arising from transactions with non-members " would be so determined . . .

" (3) It is hereby declared that in computing, for the purposes of " any provision or rule mentioned in sub-section (1) of this section, any " profits or gains of a company or society which include any income " which is chargeable to tax by virtue of the foregoing provisions of this " section, there are to be deducted as expenses any sums which—

" (*a*) represent a discount, rebate, dividend, or bonus granted " by the company or society to members or other persons in respect " of amounts paid or payable by or to them on account of their " transactions with the company or society, being transactions which " are taken into account in the said computation; and

" (*b*) are calculated by reference to the said amounts or to the " magnitude of the said transactions and not by reference to the " amount of any share or interest in the capital of the company or " society . . .

" (7) In this section the expression ' company or society ' means " any incorporated company or society whether incorporated in the " United Kingdom or elsewhere . . . "

On behalf of the Appellants the Attorney-General submitted three points on the construction of Sub-section (1) of the Section. He maintained, in the first place, that the word " members ", once used in the Sub-section, should not be construed as confined to members of the company or society in the strict sense, but should be held to include contributor-participators in an exclusively mutual transaction of insurance, such as was the case in ***Municipal***

(Lord Thankerton.)

Mutual Insurance, Ltd. v. *Hills*(1), in which members of the company were not parties to the mutual insurance, nor entitled to participate in any surplus arising thereon. In the second place the Attorney-General contended that the phrase " if those transactions were transactions with non-members " did not mean that the two sets of transactions could be treated as identical, but only involved that, though the Respondent Association had no transactions with non-members, the transactions with their members were not to be treated as mutual transactions and any surplus arising from them would be taxable profit. In the third place the Attorney-General contended that, on a proper construction, the Sub-section provides that the surpluses are to be deemed to be profits.

The first contention of the Attorney-General appears to me to be completely negatived by the definition of " company or society " in Sub-section (7), which limits the members referred to in Sub-section (1) to members of an incorporated company or society, and cannot include contributor-participators in an exclusively mutual insurance scheme, who are not members of the incorporated company or society who are the insurers. These contributor-participators would, accordingly, be included among the non-members referred to in the Sub-section, and this would apparently create havoc in the second contention. In other words, the class of mutual insurance concerns exemplified by the *Municipal Mutual Insurance* case will remain exempt from liability to assessment to Income Tax, and their transactions would fall to be included among " transactions with non-members ", and the companies or societies who are struck at by the Sub-section would hardly object to having their transactions treated as if they were transactions of that class of non-members.

It was hardly surprising that the learned Attorney-General stated that if he was wrong in his first contention as to the meaning of " members " he was not prepared to say that he could succeed in the appeal. Accordingly I find it unnecessary to deal further with his contentions, and I am of opinion that the appeal fails and should be dismissed with costs, the judgment of the First Division of the Court of Session being affirmed.

Lord Macmillan (read by Lord Simonds).—My Lords, the Respondent Association was assessed to Income Tax on a sum of £13,492 for the year ended 5th April, 1936. This sum represented the surplus arising from the Association's transactions of mutual insurance with its members. The question of law for determination is formulated in the Case stated by the Special Commissioners as follows: " Whether the surplus arising from transactions " of insurance of the Association with its members is assessable to Income " Tax by virtue of . . . Section 31 (1) of the Finance Act, 1933." The Special Commissioners answered the question in the affirmative, but their decision was reversed by the First Division of the Court of Session on appeal. The Crown is now in turn the Appellant in your Lordships' House.

The Association was incorporated in 1898 as a company limited by guarantee. It has no share capital, and its transactions are exclusively with its own members. Its purpose is to insure its members on the mutual principle against liability for injuries to their workmen. The constitution of the Association is typical of mutual insurance companies, and its familiar provisions are fully set out in the opinion of Lord Fleming(2). In a series of well-known cases before the enactment of the Finance Act, 1933, this House held that a mutual insurance company was not liable to be taxed in respect of a surplus arising from the excess of premiums contributed over claims met.

(1) 16 T.C. 430. (2) *See* page 337 *ante*.

(Lord Macmillan.)

The ground of these decisions was that such a surplus was not profit within the meaning of the Income Tax Acts, but merely represented the extent to which the contributions of those participating in the scheme had proved in experience to have been more than was necessary to meet their liabilities. The balance or surplus was the contributors' own money and returnable to them. Nothing had been earned and nobody had made a profit. Section 31 (1) of the Act of 1933 was passed after these decisions and no doubt in consequence of them.

The Attorney-General with engaging candour submitted that he ought to succeed because, although the Sub-section might not in terms fit the case, it was nevertheless manifest that Parliament must have intended to cover it; if it did not cover it, then he could not figure any case which it could cover and Parliament must be presumed to have intended to effect something. I can imagine what he would have said had the case been the converse one of a taxpayer pleading that, although the words of the charging enactment covered his case, it was nevertheless manifest that Parliament could not have intended to tax him. With this deprecatory preface the Attorney-General endeavoured to attack the decision of the First Division.

The structure of Section 31 (1) is quite simple. It assumes that a surplus arising from the transactions of an incorporated company with its members is not taxable as profits or gains. To render such a surplus taxable it enacts that the surplus, although in fact arising from transactions of the company with its members, shall be deemed to be something which it is not, namely, a surplus arising from transactions of the company with non-members. The hypothesis is that a surplus arising on the transactions of a mutual insurance company with non-members is taxable as profits or gains of the company. But unfortunately for the Inland Revenue the hypothesis is wrong. It is not membership or non-membership which determines immunity from or liability to tax, it is the nature of the transactions. If the transactions are of the nature of mutual insurance the resultant surplus is not taxable whether the transactions are with members or with non-members.

The argument for the Crown sought to make out that the expression " transactions with non-members " in the Sub-section meant transactions not of a mutual character, and submitted that a mutual transaction with a non-member was a contradiction in terms. But this is a misconception. There is nothing to prevent a mutual insurance company entering into a contract of mutual insurance with a person who is not a member of the company. The argument will not fit the terms of the Sub-section. It is " those transactions ", that is, mutual transactions with members, which are to be treated as if they were transactions, that is, mutual transactions, with non-members.

But it is unnecessary to elaborate the point, for I find myself in complete agreement with the opinions expressed by the Lord President and his brethren, which are as unanswerable as they are admirably lucid.

The Legislature has plainly missed fire. Its failure is perhaps less regrettable than it might have been, for the Sub-section has not the meritorious object of preventing evasion of taxation, but the less laudable design of subjecting to tax as profit what the law has consistently and emphatically declared not to be profit. I should dismiss the appeal.

Lord Wright (read by Lord Thankerton).—My Lords, I do not feel that I can add anything to the brilliant and incisive judgment of the Lord President, with which I am in complete agreement. His logic is unanswerable. I can see no escape from the conclusion at which he has arrived.

The appeal should, in my opinion, be dismissed.

Lord Simonds.—My Lords, I am so fully in accord with the view felicitously expressed by the Lord President that I should be content to do no more than state my concurrence but for the argument addressed to the House by the Attorney-General.

The case is an unusual one. The Section under discussion, Section 31 of the Finance Act, 1933, is clearly a remedial Section, if that is a proper description of a Section intended to bring further subject-matter within the ambit of taxation. It is at least clear what is the gap that is intended to be filled and hardly less clear how it is intended to fill that gap. Yet I can come to no other conclusion than that the language of the Section fails to achieve its apparent purpose, and I must decline to insert words or phrases which might succeed where the draftsman failed.

I need not restate the facts of the present case or the history of judicial decisions which led to the enactment here in question. The vital words for your Lordships' consideration are, " a profit or surplus arising from trans- " actions of the company or society with its members which would be included " in profits or gains for the purposes of that provision or rule " (that is to say, under Case I of Schedule D) " if those transactions were transactions with " non-members ". The Attorney-General argued, and there was, I think, some force in his argument, that in the passage I have cited the expression " non-members " means persons who are not contributors to and participators in a mutual insurance scheme and does not mean persons who are in the strict sense not members of a company or society according to its constitution or rules. The badge of membership, he said, for the purpose of this Section is contribution and participation in some mutual scheme. I do not think it necessary to decide this question, which may in other connections have far-reaching importance. For, assuming for this purpose that the argument is so far well founded, the Attorney-General is still faced with a difficulty which appears to me, as it did to the learned Lord President, to be insuperable. For the hypothetical profit or surplus with which the Section deals is one that is assumed to arise out of " those transactions " with " non-members ". What are " those transactions "? They are *ex hypothesi* transactions in which the element of mutuality is an integral, essential and inseparable part. How then can the two factors coalesce? On the one hand a transaction in which mutuality is essential, on the other hand a party to that transaction who by the postulated definition of non-member is excluded from any transaction which involves just that element of mutuality. It follows that, upon an initial assumption in favour of the Attorney-General, the Section becomes meaningless and the hypothetical profit or surplus indeterminable. The appeal must, in my opinion, be dismissed.

Lord Uthwatt.—My Lords, this case was dealt with by the First Division of the Court of Session and argued in this House by the Appellants upon the assumption, dictated by the form of the Case Stated, that the relevant terms of the contracts of insurance between the Company and its members were such that, apart from Section 31 of the Finance Act, 1933, no taxable profit could thereby arise to the Company. Into the validity of this assumption it is not permissible to enter.

The assumption implies that, in the case of a member, all those terms in the articles of association which secure to him rights in respect of surplus contributions, as those articles stand at the date of his contract of insurance, enter into and form part of the contract of insurance. The member therefore, as respects surplus contributions, can rely not only on his rights as a member of the company under the articles but also on his contractual rights.

(Lord Uthwatt.)

Upon the construction of Section 31 it is, in light of the definition of " company or society ", beyond dispute that the members there referred to are members of the company or society under consideration. The Sub-section brings within the compass of profits or gains for purposes of Income Tax the surplus which would arise if transactions with members were transactions with non-members. The status of membership and all that results from that status are to be ruled out. But there the Section stops.

The ruling out of the status of membership and its consequences leaves unaffected the substance of the contract and in that there is inherent the right in respect of surplus contributions. There is therefore, on the assumption made, no sum finding its origin in payments under the contract which can enter into the " profit or surplus " referred to in the Section.

I would dismiss the appeal.

Questions put:

That the Interlocutor appealed from be reversed.

The Not Contents have it.

That the Interlocutor appealed from be affirmed and the appeal dismissed with costs.

The Contents have it.

[Solicitors:—Allen & Overy, for J. & R. A. Robertson, W.S., Edinburgh, and M'Grigor, Donald & Co., Glasgow; Solicitor of Inland Revenue (England), for Solicitor of Inland Revenue (Scotland).]