Mutual trading: the four key conditions

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Mutual trading relies on historic case law, and advisers must ensure that all conditions are met to prevent unexpected taxation of surpluses.

Key Points

What is the issue?

Mutual trading is a narrow, case-law driven exception to the normal trading rules, with no statutory definition and principles derived almost entirely from historic court decisions that HMRC still relies on today.

What does it mean to me?

Advisers dealing with members' clubs, mutual insurers and similar organisations need to go beyond establishing that a trade exists and assess whether mutuality

genuinely applies, as failures can unexpectedly expose surpluses to tax.

What can I take away?
For mutual trading to apply, all four conditions must be met in substance as well as form, with close attention to contributors, beneficiaries, control, surplus attribution and governing documents to avoid quiet but costly failures of mutuality.

The concept of what constitutes a trade is a fundamental question in UK tax law, forming the basis of many disputes between taxpayers and HMRC since tax was first levied on profits. In many cases, tax advisers can apply commercial common sense: some activities are clearly trading, others clearly not. Most of us can recall a client who insists, hand on heart, that their loss-making side venture – which also happens to be a longstanding weekend passion – is a genuine business activity rather than an attempt to claim sideways loss relief.

Where matters fall into the grey areas, however, the legislation offers surprisingly little assistance. Income Tax Act 2007 s 989 and Corporation Tax Act 2010 s 1119 define a trade only as something that ‘includes any venture in the nature of trade’. Advisers are therefore left to rely on the badges of trade and a long line of case law.

Ordinarily, once it has been established that a trade exists, the analysis ends there. But there are circumstances where advisers must go a step further. One of the most important – and most easily misunderstood – is mutual trading. This article examines what mutual trading is, how the courts have developed it over time, and why it continues to present practical risks for advisers.

What is mutual trading?

The core principle of mutual trading is often expressed simply as the notion that ‘a person cannot trade with themselves’ – although this does require closer examination.

Where an organisation is established and operated by its members for their mutual benefit, trades only with those members, and any surplus ultimately belongs to them collectively, that surplus is not considered taxable income. Mutual trading most commonly arises when dealing with members’ clubs, mutual insurers, co-operatives and similar organisations.

Crucially, mutual trading does not prevent an activity from being a recognised trade. This was established in the case of *CIR v The Cornish Mutual Assurance Co Ltd* [1926] 12 TC 841, where a mutual insurance company insuring only its own members was nonetheless found to be trading. Mutuality instead determines whether the surplus arising from that trade is taxable.

Any activity carried on with non-members or third parties remains a normal taxable trade.

From informal arrangements to mutuality

To illustrate how mutuality arises in practice, consider a familiar situation. I have had the (mis)fortune of organising a private seven-a-side football group. This involved booking the pitch, ensuring that there were sufficient players each week, bringing the kit and – importantly – handling the money.

The pitch was booked for ten weeks. I tracked attendance and asked players to pay for each week they played. I rounded up the charge to the nearest 50p, and it was agreed that any small surplus would be retained to buy replacement balls, goalkeeper gloves and similar items as needed. Few would suggest that this arrangement constituted a taxable trade, or that it would be of any interest to HMRC. No one was seeking to profit; the group was simply pooling its own money for a shared purpose.

But what if the arrangement were formalised? What if members wanted any surplus returned to them, memberships issued and rules drafted? And what if, instead of a small group of colleagues, this was scaled up to be a large, nationally recognised organisation hosting professional events? At that point, the question of mutual trading becomes highly relevant.

An entirely case-law concept

Despite its practical importance, mutual trading has no statutory definition. Various definitions – including Corporation Tax Act 2009 ss 1 and 655, Corporation Tax Act 2010 s 1070 and Income Tax (Trading and Other Income) Act 2005 s 104 – refer to aspects of mutual trading, but none explain what it actually is. The concept has instead been developed over many decades through case law, most of which

predates modern legislation. HMRC itself acknowledges this, stating in its Business Income Manual (BIM 24025):

‘There is no statutory definition of mutual trading… Our understanding of the concept of mutual trading derives from case law. The majority of the cases predate such legislation as exists… The body of case law should be seen in the context of a process leading (not always sure-footedly) to the current state of affairs.’

One of the earliest relevant cases is *Last v London Assurance Corporation* (1884) 2 TC 100, which established that payments made as a return to policy holders could not be deducted as expenses in computing profits. This was followed by *Styles v New York Life Insurance Company* (1889) 2 TC 460, which determined that income received from mutual sources was not assessable to tax, although income from non-mutual sources – whether trading, property, investment or capital gains – would be.

Over time, the courts have distilled a set of four conditions that must **all** be satisfied for mutual trading to exist.

The four conditions for mutual trading

1. Any surplus must be paid to contributors only

The case of *Jones v The South-West Lancashire Coal Owners’ Association Ltd* [1927] 11 TC 790 establishes that arrangements must exist for any surplus to be paid to contributors, and no one else. The South-West Lancashire Coal Owners’ Association Ltd was a mutual insurance association limited by guarantee, established to insure colliery owners against accidents involving their employees.

The inspector of taxes argued that the surpluses arising each year were taxable profits, as they were not paid out to contributors. The association countered that surpluses were accumulated solely to meet future claims from members, or to be distributed on a winding up.

The dispute reached the Court of Appeal, which agreed with the association. The surplus was not retained as profit but was held in a common fund for the eventual benefit of the contributors. The arrangements ensured that the surplus was not held as taxable profit, but instead formed part of the common fund for members’ benefit – and were sufficient to satisfy the requirement of mutuality.

2. Contributors must match participators

The case of *Municipal Mutual Insurance Ltd v Hills* [1932] 16 TC 430 establishes that contributors to a mutual surplus must correspond with those who participate in it. Municipal Mutual Insurance Ltd was created by local authorities to obtain low-cost fire insurance through co-operative means. The company did not permit the distribution of profits to members, and any surplus on winding up was payable only to holders of fire policies. It also offered employer's liability and other insurance business.

It was accepted that the fire insurance activity was mutual and that income from other policies for third parties was taxable. The issue was whether surpluses arising from other policies held by fire policyholders could also be treated as mutual.

The company argued that because these additional policies were taken out by members, the resulting surpluses were also mutual income and therefore not taxable. The commissioners rejected that argument.

Surpluses arising from non-fire policies were allocated to fire policyholders. Because not all fire policyholders had contributed to those other policies, some members benefited from profits generated by others. This amounted, in substance, to a distribution of trading profits and breached the mutuality principle.

The case established that the contributors to the common fund must, as a class, be identical to those who benefit from it. While individual members may come and go, the class of contributors and participators must align.

3. Controlling the common fund

The Australian case of *Revesby Credit Union Co-Operative Ltd v Federal Commissioner of Taxation* [1965] HCA 2 establishes that contributors to the common fund must also control it.

Although an Australian case, *Revesby* is considered relevant for UK tax purposes. The credit union was established to assist members in commencing businesses, acquiring tools and similar activities. Members paid a fee and could then participate in any surplus, vote at meetings and elect the committee governing the organisation. Non-members enjoyed none of these rights.

The court emphasised that a common fund must be created for a common purpose, and that therefore control of the fund must rest with those same contributors. Where anyone who is not a contributor exercises control, the arrangement involves a transaction with a third party and the conditions of mutuality cannot be satisfied.

Control does not require every member to be involved in the day-to-day management, but the members must collectively have ultimate authority over the organisation.

4. Contributions should be linked to the distributed surplus

The case of *Fletcher v ITC* [1972] AC 414 establishes that the amount contributed to the common fund must be reasonably linked to the surplus distributed.

The case concerns the Doctors Cave Bathing club in Jamaica, which operated two distinct subscription arrangements. ‘Bathing’ subscriptions were paid by individuals, while ‘Hotel’ subscriptions were paid by local hotels for the benefit of their guests. The Commissioner sought to tax the income arising from the Hotel subscriptions, while the club argued that this income also arose from mutual trading.

Historically, hotel guests had paid individually for access. Over time, this was replaced by a structure under which the hotels paid a single subscription on behalf of their guests through the introduction of the Hotel subscription.

When reviewing the case, the Lords on the Privy Council observed that the overall structure appeared to meet many of the typical requirements of mutual trading. The fact that Hotel members paid a higher subscription than Bathing members was not, in itself, determinative. This required the Lords to look beyond the formal structure and examine how the contributions and benefits actually operated in practice.

At this point, the Lords rejected the suggestion that the Hotel subscriptions could be treated as payments made by, or on behalf of, the hotel guests as the true users of the facilities. The hotels could not be ‘looked through’ in this way and had to be regarded as the members for the purpose of the Hotel subscriptions. While the hotels enjoyed the benefits of membership, each hotel only held a single subscription, notwithstanding that it covered hundreds of guests.

That single subscription entitled the hotel to only one vote at meetings and one share of any surplus. This was clearly disproportionate when compared to the

number of individuals making use of the club's facilities under that subscription. Viewed from the opposite perspective, the Bathing members were overwhelmingly benefiting from the weighting applied to the Hotel subscriptions, effectively receiving a greater share of the surplus relative to their own contributions.

The Lords considered this arrangement to be highly similar, in substance, to the original structure under which hotel guests had paid individually – an arrangement that had already been considered as trading. The introduction of the Hotel subscription was therefore characterised as 'a distortion, if not a mockery, of the mutuality principle'.

On that basis, the Hotel subscriptions were held not to constitute mutual trading, and the income from them was taxable.

The case demonstrates that, for mutual trading to exist, any surplus – whether distributed or retained – must be reasonably attributable to the contributions made. Where contribution and benefit are fundamentally misaligned, formal mutuality will not prevent the activity from being treated as taxable trading.

Mutual trading remains a live issue

Although many of these foundational cases date back decades, mutual trading remains actively contested.

In *Medical Defence Union Ltd v HMRC* [2020] UKFTT 227 (TC), HMRC successfully relied on *Municipal Mutual* and *Fletcher*, demonstrating that these cases continue to underpin modern disputes.

Where mutual and non-mutual activities are carried on within a single entity, a further issue arises: the allocation of expenses. The courts have long required expenses to be apportioned on a reasonable basis, a point of particular relevance to members' clubs, as illustrated in *The Carlisle and Silloth Golf Club v Smith* [1913] 6 TC 48.

In conclusion

Mutual trading is a niche but important area of tax, sitting within the trading rules that are already vague in legislative terms. Unlike many areas of tax introduced for

a targeted purpose through legislation (even if not always perfect), mutual trading has developed and evolved organically over more than a century of case law.

That history makes it hard for advisers and taxpayers alike to navigate. However, each case has filled in a little more of the puzzle. As with trading generally, experience builds intuition, and you start to ‘get a feel’ for what mutual trading is and when it applies – ensuring that clients are not caught out unexpectedly. The risk for advisers is that mutuality often fails not through intention, but through drafting, governance or the quiet expansion of non-member activity.

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