IN THE HIGH COURT OF NEW ZEALAND
AUCKLAND REGISTRY

CIV-2005-404-6802
CIV-2005-404-6803
CIV-2008-404-2609
CIV-2009-404-6443
[2012] NZHC 1760

UNDER	the Tax Administration Act 1994
BETWEEN	SOVEREIGN ASSURANCE COMPANY LIMITED First Plaintiff
AND	ASB BANK LIMITED Second Plaintiff
AND	SOVEREIGN SERVICES LIMITED Third Plaintiff
AND	CBA ASSET FINANCE (NZ) LIMITED Fourth Plaintiff
AND	CBA FUNDING (NZ) LIMITED Fifth Plaintiff
AND	CBA DAIRY LEASING LIMITED Sixth Plaintiff
AND	COMMISSIONER OF INLAND REVENUE Defendant

Hearing:	23, 24, 26, 27, 30 April 2012 1, 2, 3, 4, 7, 8, 9, 10, 11, 14, 15, 16, 21, 22, 23, 24 May 2012
Counsel:	L McKay, R G Simpson, M McKay and B R Miles for plaintiffs D J Goddard QC, H W Ebersohn and R A Hearn for defendant
Judgment:	19 July 2012

RESERVED JUDGMENT OF DOBSON J

This judgment was delivered by me on 19 July 2012 at 11.30am
pursuant to r 11.5 of the High Court Rules.

Registrar/Deputy Registrar

Solicitors:
Bell Gully, DX CP20509, Auckland for plaintiffs
Crown Law, PO Box 2858, Wellington for defendant

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Nature of the dispute

[1] The issue in this case is the appropriate treatment for tax purposes of components of reinsurance contracts (the Treaties) entered into by the first plaintiff (Sovereign) with three reinsurers of life insurance risks, each domiciled in Germany. Nothing turns on the identity of the reinsurers. They were referred to in the proceedings as Gerling, Hanover Re and Cologne Re. Throughout the proceedings, the terms concluded between Sovereign and Gerling were treated as representative of all of Sovereign's relevant reinsurance contracts.

[2] The Treaties provided for two sets of money flows between Sovereign and the reinsurers. First, Sovereign paid premiums to reinsure defined proportions of the mortality risk[1] it had assumed under defined tranches of life insurance policies it had issued. In return, the reinsurers accepted liability to meet the cost of the defined proportions of claims made under those policies. There is no dispute over the manner in which Sovereign accounted for the money flows in both directions on the reinsurance of those mortality risks.

[1] The risk that the life assured would die during the current period of the policy.

[3] The second component of the Treaties involved reinsurers agreeing to pay Sovereign refundable commissions that were quantified as a multiple of the initial premiums received by Sovereign on the life insurance policies it issued. Sovereign had a financing need because the initial costs of establishing life insurance policies substantially exceed the initial premiums paid by the policyholders. Life insurers generally plan to recover those establishment costs out of premiums to be paid by the policyholders over a number of years. Accordingly, payment of the refundable commissions by the reinsurers eased the strain on cash flow for Sovereign.

[4] Sovereign was obliged to repay the refundable commissions in stipulated portions out of the subsequent years' premiums, so long as the policies on which the reinsurers had paid the commissions remained in force. To the extent that premiums were not received by Sovereign from the policyholders, the terms of the Treaties were taken to free Sovereign of any obligation to "pass on" the remaining instalments in repayment of the refundable commission. The amount to be repaid included an interest component to compensate the reinsurers for the time value of the amounts of the commissions they had paid to Sovereign.

[5] Although on an individual policy basis Sovereign was relieved of the obligation to repay the refundable commission if the policy lapsed, the overall arrangements between Sovereign and each reinsurer were moderated by the operation of a memorandum account (variously referred to as a Deficit Account or a Bonus Account, and which I will refer to as the Bonus Account). The Bonus Account kept track of the total money flows in both directions, and its ultimate purpose was to enable calculation of any profit share to which Sovereign would become entitled if the Bonus Account was in credit, after payment of all amounts outstanding to the reinsurer. On reinsurance of the mortality risk, reinsurance premiums paid by Sovereign were credited to the Bonus Account, and claims paid by the reinsurer were debited to the Bonus Account. On the refundable commissions, amounts paid to Sovereign were debited to the Bonus Account and repayments of the commissions to the reinsurer were credited to the Bonus Account. The interest charge on outstanding amounts of commissions was also debited to the Bonus Account.

[6] This meant that so long as the totality of business between Sovereign and a reinsurer got to the point where payments by Sovereign from all sources were sufficient to make up any deficit from lapsed[2] policies, and also for any negative balance between reinsurance premiums paid to the reinsurers and claims met by the reinsurers, then the reinsurer would be paid back all of the refundable commissions plus interest.

[7] Apparently since inception of the Treaties, and certainly for many years, Sovereign had accounted for this second set of money flows, comprising the refundable commissions received, and repayments of them plus interest, on the basis that the refundable commissions were treated as income in the years they were receivable, and repayments of commission plus interest were treated as expenses in the years that they were payable. However, the defendant (the Commissioner) has assessed Sovereign, relevantly for the 2000 to 2006 income tax years, on the basis that the refundable commissions and their repayment amount to a financial arrangement to which the accruals rules in Part E Subpart H of the Income Tax Act 1994 (the Act) apply. The consequence is that the Commissioner treats the refundable commissions as a non-taxable receipt (effectively of working capital), and only the portion of repayments in excess of the amount received by Sovereign (in effect the interest cost on use of the "principal") are treated as deductible, in a manner spread over the life of the arrangement as required by the accruals rules.

[8] Sovereign's primary rejoinder is that all money flows under the Treaties are excepted from the application of the accruals rules because they all constitute components of a contract of insurance, and that the two sets of money flows cannot be "unbundled". Alternatively, if they have to be separately analysed, the components are each contracts of insurance.

[9] Sovereign also challenged the assessments on further alternative grounds. If, contrary to its primary position, the accruals rules do apply to the treatment for income tax purposes of the portion of repayments representing "interest", then the remainder of those money flows still have to be dealt with under the core provisions

[2] "Lapse" in this sense includes both decisions by policyholders not to continue with the policy, and cases where the life assured dies, generally resulting in a claim under the policy.

in the Act. Sovereign's position is that applying first principles, the refundable commissions offset the expenses incurred in initiating the insurance policies and have the character of income. Then, as a matter of consistency, the commission repayments are expenses (and accordingly deductible for income tax purposes).

[10] For his part, the Commissioner's fall-back position is that if the accruals rules do not apply, then the character of the refundable commissions and commission repayments still has to be determined. On the Commissioner's analysis, the commissions cannot be treated as income "earned" where there is an obligation to repay them, and those money flows accordingly comprise advances and repayments essentially of a capital nature that are not assessable income or deductible expenses. Sovereign attributes to the analysis for the Commissioner on this argument, a necessity to treat the refundable commissions as loans or analogous to loans. Sovereign argues that they lack such a character, so that the Commissioner's argument is misconceived.

[11] Sovereign is a member of a group of companies under common ownership that are grouped for the purposes of their income tax returns. In the relevant years, the tax calculations for each of the remaining plaintiffs included reliance on losses for tax purposes originally generated by Sovereign. The assessments by the Commissioner have disallowed losses to Sovereign, with the consequence that the parts of those losses applied by the remaining plaintiffs have also been disallowed. Accordingly, the remaining plaintiffs have no independent arguments and the outcome of their respective challenges to the consequential re-assessment of their returns is dependent entirely on the outcome of the challenge by Sovereign.

[12] Sovereign's claim that the refundable commissions were assessable income is the first half of what would then be consistent treatment for the full extent of repayment of the commissions as being deductible. The Court was spared the details of the finite amounts involved in the assessments, and the parties agreed that the proceedings can be confined to resolution of the status of the money flows in these commission arrangements for income tax purposes. It was also agreed that, if the Commissioner's approach is correct, it would nonetheless be appropriate for there to be a further amendment to the current assessments to reflect adjustments that have

been identified between the parties in the course of preparing their arguments for trial.

[13] A taxpayer challenging the correctness of an assessment by the Commissioner generally has to establish not only that the assessment by the Commissioner is wrong, but also by how much it is wrong.[3] Given the final position of the parties in their closing submissions, I have taken these proceedings as not extending to this latter issue of quantification of any error. Where the accruals rules do apply to a financial arrangement, the Act provides for a range of methods of calculating gross income deemed to be derived, or expenditure deemed to be incurred, by the taxpayer over the life of the relevant transactions, beginning with the yield to maturity method.

[14] The ultimate alternative provides for a method "that results in the allocation to each income year of an amount that, having regard to the tenor of [alternatives to the yield to maturity method] is fair and reasonable".[4] Sovereign accepts, at least in principle, that this alternative would apply if the Commissioner is correct in assessing under the accruals rules, and I was assured that the parties would co-operate on fine-tuning the numbers in that event. It would therefore follow that if Sovereign's challenge to the application of the accruals rules is upheld, then in this case the Commissioner's assessments could be declared to be wrong without my having to find the extent by which that is so.

[15] A separate part of the tax dispute as it arose originally and which had been included in the proceedings was settled shortly before trial, and need not be addressed. The overall consequence of the parts of the Commissioner's assessments that are still being disputed result in additional tax liabilities for the plaintiffs of some $47.5 million. Because of the lapse in time since the years in which the additional tax liabilities arise, there is also use of money interest assessed against the plaintiff companies of some $45 million at the time of the hearing.

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3 Tax Administration Act 1994, s 138P, and, for example, *Ben Nevis Forestry Ventures v Commissioner of Inland Revenue* [2008] NZSC 115 at [171], [2009] 2 NZLR 289.

4 Income Tax Act 1994, s EH 1(2) and (6).

[16] The practical effect of the differences in approach to tax treatment of the money flows involved is a matter of the timing of recognition of contributions respectively to assessable income and deductible expenses. Because the receipt of amounts as refundable commissions and later repayment of those amounts essentially net off, in some situations such timing differences for income tax purposes might not give rise to meaningful disputes. However, in the present case, re-allocation of tax losses to the years in which they would be available on the basis of the Commissioner's assessment of Sovereign would not be available to the plaintiffs because of a break in the continuity of ownership of Sovereign that arose when all of its shares were acquired by ASB Bank Limited in 1998.[5]

[17] In the case for the Commissioner, the second set of money flows comprising the payments by the reinsurers of refundable commissions and Sovereign's subsequent repayment of them were described as the "financing component" or "financing arrangement" provided for in the Treaties. That term reflects the Commissioner's analysis that those money flows comprise the provision of finance for Sovereign and a financial arrangement for the purposes of the accruals rules.

[18] It is common ground that the effect of those money flows was to provide financing for Sovereign. There were numerous references, from the time that the arrangements were put in place, that treated the second set of money flows as "financing".[6] That characterisation was also adopted in an actuarial review conducted by William M Mercer, as at 31 March 1997, which commented in the context of any need for a reinsurance repayment reserve:[7]

> The Company has received financing from reinsurers to fund the acquisition of new business and the company is liable to repay the financing with a predetermined portion of future policy premiums.

[19] However, in arguing Sovereign's case, Messrs McKay and Simpson were concerned to resist any suggestion that labels attributed to any aspects of the money flows should influence the analysis of their status for income tax purposes. I have had no difficulty relegating the significance of labels, but that caution may

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5 Constraint in s IF 1 of the Act.

6 For example, 7 December 1992 Sovereign letter to Gerling "…financing is repaid over about 5 years" (ABD3/134/540) and the July 1988 memorandum (ABD2/68) described in [32] below.

7 ABD25/639/6155 (document provided post-hearing).

nonetheless be appropriate.[8] I have adopted Sovereign's use of "commission arrangements" as the term used to describe the money flows comprised in the reinsurers' payment of refundable commissions, and Sovereign's repayment of them plus interest.

[20] Similarly, the arguments for the Commissioner lend themselves to describing the extent of the refundable commissions paid to Sovereign as the principal component, with the additional component repaid by Sovereign beyond that as "interest". To neutralise the analysis, I will refer to the amounts advanced as refundable commissions by the reinsurers as the "base component", when it is necessary to distinguish that from the additional amount intended to be repaid by Sovereign, which I will refer to as the "additional component".[9]

Sovereign as a start-up insurer

[21] Sovereign was incorporated as an insurance company in the late 1980s. The driving force appears to have been the two initial senior executives, Messrs Coon and Hendry who had proprietary interests, and both of whom had experience in overseas life insurance markets, including connections with European reinsurers. I infer that the experience of Messrs Coon and Hendry provided them with contacts with the German reinsurers that led to negotiation of reinsurance treaties, the relevant ones of which took effect from 1 April 1992.

[22] Initially, Sovereign reinsured 95 per cent of the value of life insurance it had underwritten, up to a maximum of $200,000 per policy. By the 2002 income year, the five per cent retention had been increased to 25 per cent through proportionate reductions in the reinsurers' level of participation.

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8 There was similar sensitivity about the label of "refundable" commissions when that adjective did not appear in the terms of the relevant treaty itself, but only in annexures where the formulae for calculating the rate at which they were to be paid was specified. Nothing will turn on using the adjective, which is convenient for identification purposes, even although there were limits on Sovereign's obligations to "refund" commissions received.

9 An example frequently cited for Sovereign was of refundable commission received of $100, and repayment of $150. In this example, $100 is the base component, and $50 is the additional component.

[23] Without significant start-up capital, a new life insurer such as Sovereign incurs cash flow strain because the costs of initiating life insurance policies are substantially greater than the first year's premiums able to be charged. An insurer in Sovereign's position has to pay commissions to agents or brokers who sell the policies to policyholders, in addition to other expenses such as the cost of medical examinations of the lives assured, and an allocation for its own office and promotional overheads. These initiation costs were put at between two and three times the first year's premium.[10]

[24] In addition, life insurers are required to hold certain minimum levels of capital to provide financial capacity to meet future claims payable to policyholders on adverse assumptions as to the occurrence of claims. Those obligations were not reflected in statute until capital requirements were promulgated by the Reserve Bank in 2011,[11] which issued pursuant to the Insurance (Prudential Supervision) Act 2010. However, before that time industry standards still required independent actuarial confirmation of capital adequacy. Those requirements place limits on the extent to which working capital can be funded by borrowings that need to be recognised as debt in a life insurance company's financial statements.

[25] In Sovereign's case, all its shares were acquired by the ASB Banking Group in 1998 so that its capital requirements changed once it had the support of an established bank. The Gerling reinsurance treaty was closed to new business in 2001, so that thereafter the dealings with that reinsurer were confined to the "run off" of business undertaken before then.

The reinsurance treaties

[26] Life insurers routinely reinsure various portions of the liabilities they assume when contracting to make payments on the death of a life assured. The classic form of reinsurance (referred to in the proceeding as "original terms reinsurance") involves a reinsurer contracting to meet a set proportion of claims arising under a

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10 A worked example provided in Mr Perera's evidence suggested initiation costs plus the cost of maintaining the policy in its first year at 240 per cent of the first year's premium: Perera first brief at [60].

11 Reserve Bank of New Zealand 2011 Solvency Standard for Life Insurance Business.

portfolio of life insurance policies, in return for reinsurance premiums paid by the insurer to the reinsurer. Because the reinsurer has not incurred any of the establishment costs, the reinsurer also pays the insurer a commission, intended to reimburse part of the costs of initiating the policy. Thereafter, the insurer accounts to the reinsurer for a defined proportion of all future premiums on the policy, for as long as it continues. The level of that on-going payment also reflects recovery over time of the commission paid by the reinsurer to the insurer, when the policy is initiated.

[27] The effect of such reinsurance is to transfer the mortality risk from the insurer to the reinsurer, to the extent of the portion of the portfolio of policies to which the reinsurance relates. In this way, the insurer and reinsurer share the risks, including the length of the period during which premiums will continue to be received. In insurance industry parlance, the concept is described as "ceding" portions of the risks underwritten by the insurer. Hence reference to a direct insurer in Sovereign's position as the "ceding insurer" or the "cedant".

[28] Because recovery of the initial costs incurred by an insurer in establishing a life policy is spread over a number of years, the insurer is exposed to the discrete risk that the policy will lapse before the establishment costs have been fully recovered. That risk is recognised in the insurance industry as "lapse", or "persistency" risk. In original terms reinsurance, the lapse risk is shared in the same way as mortality risk is re-allocated.

[29] Sovereign's case is that by negotiating to include the second set of money flows within the reinsurance treaties, it addressed this lapse risk. The inclusion in the reinsurance treaties of this arrangement meant that the reinsurers effectively funded a substantial portion of the establishment costs of the relevant policies and, within the terms of the Treaties, the reinsurers were dependent on continuation of those policies for instalments repaying that outlay.[12] Sovereign and the reinsurers

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[12] Payment of the refundable commission on some types of policies was split, 85 per cent at outset and 15 per cent in the 13th month of the policy. For others, payment was of 100 per cent at the outset.

treated the arrangement as transferring lapse risk from Sovereign to the reinsurers, to the extent of the refundable commissions, and their subsequent repayment.[13]

[30] The evolution of various forms of "financial reinsurance" (Fin Re) was addressed in a paper prepared for the United Kingdom Actuarial Society in October 1993 by Messrs Paul Brett and Alex Cowley.[14] The authors interpreted Fin Re as any form of reinsurance that does not simply cover the pure risk that the original insurer is ceding to a reinsurer, but also contains a financial element. There are numerous references in the paper to the reinsurer, via the Fin Re device, providing financing for the original insurer. In the context of an educational purpose within the actuarial profession, the paper described positive features which the authors attributed to each of original terms reinsurance, deficit account reinsurance, and surplus relief. Deficit account reinsurance is an alternative description of what is referred to in this judgment as Bonus Account reinsurance. Surplus relief describes the concept where a reinsurer make an advance (likely to be a further advance) to the direct insurer in respect of a block of policies that are already in force, in contrast to the Bonus Account or original terms reinsurance that involve money flows reflecting the writing of new business by the direct insurer.

[31] The Brett and Cowley paper characterised money flows such as the refundable commissions in this case, as the provision of financing for the insurer. Their paper also treats that component as providing capital for the insurer.[15] Although conscious of attributing consequences to labels when that is not justified, a consideration of the whole of the Brett and Cowley paper leads inevitably to the conclusion that those respected actuaries treated the refundable commissions component of a reinsurance arrangement such as occurred in this case, as the provision of finance by the reinsurer to Sovereign, and that the purpose of doing so was the provision of a form of working capital.

13 Phyel brief at [28].
14 ABD4/154.
15 See, for example, at 14 "…the capital provided is directly related to the amount of new business strain and is given when the new business strain arises". And at 36, the conclusion that "Fin Re is a cost effective form of 'capital' with a risk management element."

[32] The Treaty documentation is unusually brief for potentially long-term, relatively complex international contractual commitments that involved tens of millions of dollars. The documentation between Sovereign and Gerling began with a "Memorandum on Discussions" held in July 1988 between their representatives. The single page memorandum recorded preliminary agreement on the extent of reinsurers' expenses that might be allowed for, the rate of interest at which "the outstanding financing balance" would be carried forward, and the basis on which Sovereign would get a 75 per cent profit share after amortisation of the Bonus Accounts.[16]

[33] The treaty itself comprised just 13 pages of double-spaced provisions, with a further eight pages of annexures recording details of types of policy, formulae for calculation of the various payments and schedules of rates. The treaty was completed in October 1993 but recorded that it was to take effect from 1 April 1992. The treaty provided that Sovereign would cede a 38 per cent share of the sum at risk on all policies issued by Sovereign, up to a maximum of $200,000 on any one life at inception.[17]

[34] By article 4 of the treaty, Sovereign was committed to paying the reinsurer risk premiums and commission repayments on the basis specified in an annexure to the treaty. The commitment to pay the required risk premium payments was stated to continue as long as the ceded policies were in force. The commission repayments were to continue so long as no payments were due from the reinsurer to Sovereign under the Bonus Account agreement. There was no express recognition recorded in the Gerling treaty that Sovereign's obligation to repay instalments on the refundable commissions would cease in respect of a particular policy, when that policy lapsed. Apparently such a provision was explicit in another of the Treaties. The parties agreed to determine the issues on the basis that such a provision did apply.

[35] By article 5 of the treaty, the reinsurer was committed to pay reinsurance commissions to Sovereign in accordance with formulae set out in an annex to the treaty. The relevant annexure specifying the formulae for calculating the amounts

16 ABD2/68.
17 ABD1/17. Percentages agreed with the other reinsurers meant that Sovereign initially ceded a total of 95 per cent of the risks insured.

payable by the reinsurer described them as “refundable commissions”, and related to percentages of the premiums Sovereign charged the policyholder. Article 5 also committed the reinsurer to returning a bonus to Sovereign, on the basis stated in the Bonus Account agreement.

[36] Article 6 of the treaty specified that the reinsurers’ liability was to commence and cease simultaneously with that of Sovereign, and that the reinsurer would, in every respect, follow the underwriting fortune of Sovereign in proportion to its share.

[37] Article 8 of the treaty required Sovereign to account to the reinsurer for a proportionate part of commissions actually recovered from its agents or brokers, in cases where policies had lapsed. This provision reflected the arrangements that Sovereign had with the agents or brokers selling its life insurance policies, for Sovereign to be reimbursed for portions of the commission paid to the agents/brokers for signing up the policyholder, in the event of an early lapse of the policy. The agents’ obligations to repay commissions are graduated, so that smaller portions become repayable as the policy remains in force for longer. The evidence suggested that life insurance companies have variable levels of success in enforcing such repayment obligations, when policies have lapsed.

[38] The Treaties also contained a further provision that might be characterised as the last resort for the reinsurers to recover the refundable commissions.[18] If any winding up or bankruptcy proceedings were pursued against Sovereign, or it lost its licence to transact life insurance, or came under the managerial supervision of the government or any other authority, all outstanding amounts in the Bonus Account would become immediately repayable, with the reinsurer having priority immediately after the claims of policyholders. Depending on circumstances, that crystallising of the reinsurer’s right to be paid all outstanding amounts may have a bearing on the character of the risk assumed by the reinsurers in advancing the refundable commissions.

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[18] See, for example, articles 20(4) and 21(3) of the Gerling treaty.

[39] A Bonus Account agreement had been completed as a separate document in March 1989, to relate to a predecessor of the treaty completed in 1993. The totality of its operative terms was as follows:[19]

> One bonus account shall be maintained with respect to all Reassurance Agreements between the CEDING OFFICE and the REINSURER, which refer to a bonus payable by the REINSURER, where the bonus is calculated as follows:
>
> The REINSURER pays to the CEDING OFFICE 75 per cent of profits emerging after the amortization of total loss carried forward, bearing interest based on the current 2-year New Zealand government bond rates plus 4 per cent and after reinsurance expenses of 2 per cent (not less than 30,000 NZ $ and not more than 300,000 NZ $).

[40] There was a similar structure of annexures providing details, and then a series of addenda to the Bonus Account agreement to reflect alterations in the arrangements between the parties. For instance, in February 1993, the parties agreed to operate a second Bonus Account that was to be maintained in Deutschmark. The apparent purpose of that second account, which was to reflect in Deutschmark all entries in the original Bonus Account maintained in New Zealand dollars, was to share between the parties any currency rate losses incurred by the reinsurer. Subsequently, the parties elected not to enforce that arrangement.

[41] Then in February 1994, but purporting to have backdated effect to 1 April 1992, the parties agreed to split the Bonus Account into two components, respectively for all business written up to 31 March 1992, and for all business written after 1 April 1992. Again, it appears that the division between the two categories of business was also not maintained in the practical operation of the Bonus Account.

[42] Although the majority of the refundable commissions were paid by reference to the volume of new business underwritten by Sovereign, on a small number of occasions it also negotiated with Gerling for payment of additional lump sums. The evidence instanced a $3.7 million advance in or about early 1994. This was described as "surplus relief" and was treated as providing further compensation to Sovereign in respect of the establishment costs of existing business. Sovereign's

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19 ABD1/3.

initial commitment was to repay such surplus relief by a proportionate increase in the portion of on-going premiums received by Sovereign, that it would on-pay to the reinsurer. As with the refundable commissions themselves, the extent of those repayment obligations constituted a debit to the Bonus Account. An actuarial review of Sovereign as at 31 March 1997 completed by William M Mercer in May 1998 recorded what that review described as "additional reinsurance financing" at $13.0 million.[20] The case was argued on the basis that such surplus relief arrangements were not directly relevant to the years being assessed in that all such payments to Sovereign had been repaid by 2000.

The evidence

[43] Only two witnesses of fact were called in the case, and even with those two, their evidence extended to matters of opinion.

Witnesses for Sovereign

[44] The first was Mr Ian Perera, who is the chief financial officer of Sovereign's parent company, having previously been employed by Sovereign as an actuary since March 1999. Mr Perera provided background to Sovereign's life insurance business, and the intended purpose and effect of the Treaties. He also provided his actuarial analysis of the impact of the Treaties, and in particular his opinion on the transfer of lapse risk to the reinsurers effected by the commission arrangements.

[45] The second witness of fact was Dr Pyhel, a long-standing officer with Gerling, and more recently employed in a senior management role within a group of companies linked by ownership with Gerling. Dr Pyhel described the process by which reinsurers such as Gerling negotiate reinsurance treaties, how the reinsurers perceive the allocation of risk involved in various forms of reinsurance of life insurance business, and how Gerling accounts for the money flows involved in the treaty with Sovereign.

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20 ABD25/639/6159 (document provided post-hearing).

[46] Sovereign also called expert evidence from three actuaries and three accountants. The first actuary was Mr Bharat Bhayani, who qualified and worked as an actuary in England in the late 1980s and into the 1990s. He was seconded to work as an actuary at Gerling for 18 months beginning in March 1993, and had a range of experience as an actuary before becoming a partner of accounting services firm, Deloitte, based in Cologne, from where he is responsible for co-ordinating Deloitte's actuarial practices in continental Europe.

[47] The second actuary was Mr Stuart Davies who had previously worked as an actuary for insurance companies before joining the accounting services firm, Ernst & Young. He is a partner in that firm and leads its life reinsurance activity in Europe.

[48] The third actuary was Mr Grant Peters who is currently a partner of Ernst & Young in Australia. Mr Peters was called in reply principally to respond to criticisms of a model used by Mr Perera that was intended to demonstrate the nature and extent to which lapse risk had been transferred to the reinsurers under the commission arrangements.

[49] The first of the accountants called by Sovereign was Mr Stuart Wilson who is a partner of Ernst & Young in London. His expertise includes application of the United Kingdom accounting standards to money flows of the types provided for under the Treaties.

[50] The second accountant was Mr William Wilkinson who has recently retired as a partner of the accounting firm, KPMG in Auckland. He has had experience in New Zealand and elsewhere in accounting for insurance entities and provided largely consistent evidence with that of Mr Wilson in relation to the accounting treatment he contended for, in relation to the money flows under the Treaties.

[51] The third accountant was Mr Keith Nicholson who is a recently retired partner of KPMG in London, and is currently a director of life insurance companies in the United Kingdom. His evidence, which was called in reply, addressed his opinion that the components of the Treaties ought not to be "unbundled" for

accounting purposes, and other technical issues on the appropriate accounting treatment for such money flows.

Witnesses for the Commissioner

[52] The Commissioner called five expert witnesses - three actuaries and two accountants. Each of the actuaries was based in the United Kingdom and they all had experience in actuarial work in relevant areas in the United Kingdom and Europe.

[53] The first actuary called was Mr Paul Bispham. Mr Bispham had previously worked for another of the reinsurers with whom Sovereign contracted, Cologne Re, and had been involved in the development, design and pricing of a range of structures that he generically described as "financing reinsurance". Mr Bispham questioned whether management of lapse risk was a commercial objective of arrangements of this kind which he saw as predominantly for the purposes of providing finance. He was critical of the model Mr Perera had produced to demonstrate the transfer of lapse risk.

[54] The second actuary was Mr Harvey Duckers, who is currently the chief insurance actuary at the United Kingdom's Government Actuary's Department. Mr Duckers had some prior experience within the reinsurance business. Mr Duckers had critically analysed Mr Perera's model and suggested a different analysis of the transfer of lapse risk in his own models.

[55] The third actuary called was Mr Roger Laker, who had worked as an actuary for various life insurance companies for relatively substantial periods, and has more recently been a consulting actuary. He opined as to the substantive character of the risks involved in the reinsurance arrangements.

[56] The first accountant called for the Commissioner was Professor Michael Adams from the University of Bath in the United Kingdom whose specialty was in the accounting, finance and economic aspects of insurance and risk.

[57] The second accountant called was Mr John Hagen, a senior New Zealand accountant and former chair of the Accounting Standards Review Board.

[58] There was no material dispute as to what had occurred and the differences in the evidence focused instead on how transactions ought to be characterised in the accounting sense, and how the contractual arrangements ought to be characterised for actuarial purposes relative to the allocation and transfer of insurance risk. It is unnecessary to review the content of the evidence from each of the witnesses at this stage, and I will acknowledge the relevant components of their evidence on a topic by topic basis as I consider the issues.

The accruals rules – overview

[59] The provisions of the Act invoked by the Commissioner are in Part E (Timing of income and deductions), Subpart H (Financial arrangements). Subpart H is arranged in two divisions, and it is Division 1 that would apply here, because the money flows provided for in the Treaties, if subject to the rules, constitute financial arrangements entered into on or before 20 May 1999.

[60] Both parties cited numerous extracts from a text on the accrual regime.[21] That text comments on the purpose of the accruals rules, and their objective, in the following terms:[22]

> Their purpose is to ensure that all returns on financial arrangements are brought to tax on a progressive basis over the term of the financial arrangement concerned. The term "financial arrangement" is very broadly defined and includes virtually any arrangement where there is a deferral of the passing of consideration.

And:[23]

> The objective that emerged gradually over the original consultative process was the dilution of the capital/revenue distinction, so that all financial arrangements would receive neutral tax treatment regardless of their form.

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[21] Susan Glazebrook and others *New Zealand Accrual Regime – a Practical Guide* (2nd edition, CCH, Auckland 1999).

[22] At [100].

[23] At [102], p 7.

> ...
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> The theory behind the change is that, although financial arrangements differ in form (for example, futures contracts as against debt instruments), in many cases they have the same economic effect. Thus although in economic terms gains from those financial arrangements are the same, under the old income tax law some gains from some financial arrangements were classed as capital and non-taxable while others were classed as income and taxable.

[61] In terms of the scope of application of the accruals rules, the authors of the text also observed:[24]

> The definition of financial arrangement is so wide that it could include numerous everyday transactions which lack any element or indicia of lending. When interpreting the accrual regime provisions, the prudent approach is to assume that all transactions which result in a timing delay in the exchange of benefits are 'financial arrangements' in this wide sense. The inquiry should then be whether exceptions and exemptions apply and, if not, whether there are, as a result of an arrangement being a 'financial arrangement', any accrual rule consequences. A good rule of thumb is to assume everything is a financial arrangement or has some relationship to a financial arrangement until the contrary is definitively proved.

[62] Section EH 14 contains definitions that apply to Division 1 of Subpart EH. These include:

> **"financial arrangement" means**
>
> (a) any debt or debt instrument, and
>
> (b) any arrangement (whether or not such arrangement includes an arrangement that is a debt or debt instrument, or an excepted financial arrangement) whereby a person obtains money in consideration for a promise by any person to provide money to any person at some future time or times, or upon the occurrence or non-occurrence of some future event or events (including the giving of, or failure to give, notice), and
>
> (c) any arrangement which is of a substantially similar nature (including, without restricting the generality of the preceding provisions of this subparagraph, sell-back and buy-back arrangements, debt defeasances, and assignments of income),
>
> but does not include any excepted financial arrangement that is not part of a financial arrangement:

[63] The definition of "excepted financial arrangement" lists a variety of forms of arrangement in 22 separate paragraphs that are excepted from the scope of financial

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24 At [205].

arrangements to which the accruals rules will apply. Paragraph (b) of that definition is:

> a contract of insurance or membership of a superannuation scheme;

[64] The scope of the qualification at the end of the definition of "financial arrangement", specifying that "financial arrangements" do not include "any excepted financial arrangement that is not part of a financial arrangement" is to be read with s EH 2 which is in the following terms:

> **EH 2 Excepted financial arrangement that is part of financial arrangement**
>
> The amount of the gross income deemed to be derived or the expenditure deemed to be incurred by a person in respect of a financial arrangement under the qualified accruals rules shall not include the amount of any income, gain or loss, or expenditure, that is solely attributable to an excepted financial arrangement that is part of the financial arrangement.

Sequence of issues

[65] By the end of the hearing, it was accepted for Sovereign that the Gerling treaty included a financial arrangement within the very broad definition of paragraph (b) of that expression. The Commissioner's reliance on that broad definition obviates the need to review arguments that had previously been exchanged on whether the commission arrangements would constitute a debt or debt instrument within the narrower definition in paragraph (a) of that expression.

[66] Accordingly, the first issue is whether the two sets of money flows provided for under the treaty, namely the reinsurance of mortality risk, and the commission arrangements, can be separated for analysis as to the application of the accruals rules.

[67] Depending on whether the commission arrangements can be separated, the next issue is whether, either the whole of the treaty if its components cannot be separated, or alternatively the commission arrangements if they can be separated, constitute a contract of insurance so as to come within the exclusion for excepted financial arrangements.

[68] If the analysis underlying the Commissioner's assessments is correct in respect of the ability to consider the commission arrangements separately, and that on such separate consideration they do not constitute a contract of insurance, then the outcome would be the application of the accruals rules to the additional component of the commission arrangement money flows. In that event, the next issue would be whether Sovereign is correct in contending that the core provisions of the Act would still apply to the base component of the money flows in the commission arrangements, in which event Sovereign would argue that the refundable commissions received by Sovereign are still to be treated as assessable income, and the repayment of those amounts are to be treated as deductible expenses for the purposes of assessing Sovereign's taxable income, in the years in which the repayments were payable. The Commissioner disputes this characterisation, arguing that if the accruals rules do apply, then the treatment for income tax purposes of the additional component is all that should be reflected in assessing Sovereign's income tax obligations.

[69] The arguments for the Commissioner in resisting any residual issues for income tax purposes if the accruals rules do apply is complementary to the ground covered in the Commissioner's alternative argument. That is, if the Commissioner was wrong to invoke the accruals rules, then the base component in the money flows for the commission arrangements is nonetheless to be ignored for income tax purposes because it is capital in nature, and only the additional component of the payments Sovereign made to the reinsurer would fall to be treated as deductible expenses in the years they became payable.

[70] In the course of argument, both parties sought to attack the present position of the other, by identifying reversals of stances previously relied on by the opposing party that are consistent with the analysis now advanced for the criticising party. None of these changes of position give rise to any suggestion of estoppel, and the parties are not constrained in any way by the terms of previous arguments, from advancing at the hearing the analysis they consider best reflects their position in what is a relatively arcane area. During closings, counsel were inclined to agree with

my reaction that no significance should be attributed to positions previously adopted on behalf of the parties that are inconsistent with the arguments now advanced.[25]

Can the commission arrangements be analysed separately?

[71] The Commissioner's assessments proceed on the basis that the Treaties are able to be separated into two components for the purposes of applying the accruals rules. First, the reinsurance of the mortality risk, and secondly, the commission arrangements. On the basis that these two components should be analysed separately, the Commissioner has treated the commission arrangements as a "financial arrangement" within the broad definition of that expression in s EH 14(b). He submitted that the arrangement does not constitute an insurance contract so it does not qualify as an "excepted financial arrangement" as defined in s EH 2.

[72] Sovereign argued that this approach is wrong. It contended that the two components of the Treaties are indivisible, were treated by the parties to them as such and cannot be deconstructed in the way that the Commissioner contended. Sovereign argued that its position is supported by the relevant accounting standards, which require companies to account for all money flows in an unbundled form.

[73] Further, Sovereign argued that the commission arrangements do involve a material transfer of insurance risk and therefore qualify as a contract of insurance, irrespective of whether the two components of the Treaties are treated as indivisible or are analysed separately.

[74] To ascertain the scope of what might constitute a "financial arrangement", it is appropriate to begin with the terms used in s EH 14 of the Act. "Arrangement" is defined in the Act as meaning:[26]

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25 Compare *Medical Defence Union v Department of Trade* [1979] 2 WLR 686 at 698E per Megarry VC: "...a contention on a point of law may be equally sound or unsound whether it is the product of first thoughts, or second thoughts, or no thoughts at all".

26 Section OB 1 of the Act, the application of that general definition to the more specific definition of "financial arrangement" being confirmed in *Commissioner of Inland Revenue v Dewavrin Segard (NZ) Ltd* (1994) 16 NZTC 11,048 at 11,051.

> …any contract, agreement, plan or understanding (whether enforceable or unenforceable), including all steps and transactions by which it is carried into effect.

[75] Sovereign argued that the emphasis in this definition is on aggregating steps and transactions, rather than separating them. However, the approach to recognition of "an arrangement" will depend on context.

[76] Here, it is clearly intended that a financial arrangement may be a part or component of a larger arrangement. The words in s EH 14 "… (whether or not such arrangement includes an arrangement that is a debt or debt instrument, or an excepted financial arrangement)", where they appear near the beginning of para (b) of the definition of "financial arrangement", refer to an (implicitly larger) arrangement that may contain a debt or debt instrument, or an excepted financial arrangement. Consistently, at the end of that definition there is an exclusion for excepted financial arrangements where they are not part of a financial arrangement.

[77] When the initial reference in parentheses and that exclusion are read together with s EH 2 (which confines the exclusion of gross income deemed to be derived or expenditure deemed to be incurred to those items that are "*solely* attributable" to an excepted financial arrangement that is part of the financial arrangement), they point to a process for deconstructing component parts of wider arrangements, so as to apply the accruals rules either to the financial arrangements within a larger arrangement, or to the components of a financial arrangement that qualify. It is only where the money flows are solely attributable to an excepted financial arrangement that they are excluded.

[78] Mr Goddard emphasised the connotations of "a part" as necessarily being a component of some larger entity. The accruals rules do not need the arrangement to have status as a stand-alone transaction for other purposes. These rules require, in appropriate circumstances, analysis of a component (part). There is a very wide range of circumstances in which a deferral of consideration will feature as an aspect of all manner of commercial arrangements. Accordingly, the rationale for isolating the consequences of deferral of the consideration that is to pass from the other

features of a transaction would be frustrated if such separate analysis for income tax purposes was not available to the Commissioner.

[79] The references in s EH 2 to "income deemed to be derived" and "expenditure deemed to be incurred" are also suggestive of a process of recasting actual money flows. It may reflect no more than the process of accrual accounting in which the incurring of obligations to pay, and entitlements to be paid, trigger the requirement to account for the activities, rather than awaiting the inwards and outwards cash movements. However, the use in s EH 2 of the concept of "deemed" income and expenditure is consistent with the analysis of financial obligations, when dealing with the timing of transactions for income tax purposes, by deconstructing and reconstructing the manner in which such transactions may have been recorded in a different form for other purposes.

Marac Life Assurance Ltd v Commissioner of Inland Revenue

[80] An important element of Sovereign's arguments against separate consideration of the reinsurance of the mortality risk and the commission arrangements was its reliance on the Court of Appeal decision in *Marac Life Assurance Ltd v Commissioner of Inland Revenue*.[27] In a different context, that decision required the components of a contract, one of which constituted an insurance contract, to be treated as indivisible. The outcome was that the other, investment, component of the contract was treated as sharing the character of an insurance contract.

[81] In *Marac*, the status of certain "life bonds" issued by the company was considered for the purposes of the Income Tax Act 1976, as well as the Life Insurance Act 1908 and the Securities Act 1978. The life bonds had been designed as investment products so that the return to the investor was characterised as "bonuses" in return for a payment characterised as a "premium". This meant that the return on the money paid to Marac was characterised as being tax free because the income tax legislation at the time treated bonuses payable on a policy of life insurance as not being assessable for income tax purposes.

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[27] *Marac Life Assurance Ltd v Commissioner of Inland Revenue* [1986] 1 NZLR 694 (CA).

[82] The life insurance element comprised of Marac's commitment to pay the full interest return for the term of the bond (up to 10 years for the longest on offer) on the event of an earlier death of the life assured. On Marac's own accounting for this component of the transaction, it allocated 0.5 per cent of the "premium" to cover the risk that the full extent of bonuses would be payable on an investor's death prior to maturity.

[83] Sovereign relied on the Court of Appeal's analysis that treated the life bonds as an indivisible set of arrangements. The Court did not consider separating out the investment and life insurance components. The Commissioner's rejoinder in relation to this was that there had been no argument in *Marac* that the contracts for the life bonds ought to be bifurcated in any way, and that the whole argument had proceeded on the basis that, assessed overall, it was either a contract of life insurance, or not.

[84] In Richardson J's analysis:[28]

> Each sum payable by Marac is a single unsubdivided sum as is the premium payable by the investor and there is no warrant for attributing to the parties alternative contractual arrangements for the investment of the premiums paid.

[85] Given that in *Marac* there was a single undifferentiated "premium" paid, it is understandable that the challenge to its status was on an "all or nothing" basis. It was argued for Sovereign that it would be highly unlikely to have been determinative if the premium in *Marac* had been separated into two components. It was speculated that respect for form would still have dictated the same outcome, namely accepting the contract as one of insurance. That point is not borne out by the analysis, which relied on the undifferentiated form in which the contract was undertaken. It seems inevitable that the Court's analysis would have been different, and require a quite different rationale, if differentiated payments would still have led to the same outcome.

[86] Mr McKay also emphasised the finding in *Marac* that the contract amounted to one of life insurance notwithstanding the statistically insignificant portion of the amount invested in each bond that was allocated to cover the extent of life insurance

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[28] At 706.

risk assumed. That approach reflected the Court's respect for the form in which the transaction had been undertaken. He cited the observation from Richardson J:[29]

> Investors are free to enter into whatever lawful financial arrangements will suit their purposes. They cannot be treated as having entered into a different arrangement which would or might have achieved somewhat similar economic advantages and whether or not they ever had that alternative in contemplation. If Marac life bonds are policies of life insurance that is the end of the inquiry.

[87] That observation was immediately followed in Richardson J's judgment by the following:[30]

> The true nature of a transaction can only be ascertained by careful consideration of the legal arrangements actually entered into and carried out: not on an assessment of the broad substance of the transaction measured by the results intended and achieved or of the overall economic consequences.

[88] That approach of apparent strict adherence to legal form was qualified later in the same paragraph with the observation that there may be a statutory provision that mandates a broader or different approach.

[89] Mr McKay submitted that *Marac* remains good law, in part in reliance on the more recent Court of Appeal decision in *Commissioner of Inland Revenue v Gulf Harbour Development.*[31] That case involved the issue of redeemable preference shares which carried with them the rights to membership of a golf club operated by the taxpayer. The taxpayer treated the supply of preference shares as exempt for the purposes of the Goods and Services Tax Act 1985 (GST), being a form of financial service. However, the Commissioner contended that the shares included the supply of membership rights to the golf club which were a taxable supply for the purposes of the GST assessment. He argued this on the basis that the substance of the transaction was the supply of the membership rights, or alternatively that there were two separate supplies, the first of the preference shares being an equity security and therefore GST exempt, and the second the supply of membership rights which were subject to GST.

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[29] At 705-706.
[30] At 706/51-54.
[31] *Commissioner of Inland Revenue v Gulf Harbour Development* (2004) 21 NZTC 18,915.

[90] The Court of Appeal adopted the approach reflected by that Court in *Marac*. It rejected the prospect of analysing the substance of the transaction for the purposes of liability for GST and also rejected the prospect of separating it into component parts.

[91] In contrast to *Marac*, the present case does involve two separately identifiable series of money flows that reflect different and discrete (if overlapping) commercial dynamics. Sovereign could conceivably have contracted just for the mortality reinsurance, or could have obtained the two components from different reinsurers.[32] The outcome on each component reflected different circumstances, with prospects for each of mortality risks and lapse experience to perform differently from the other over time. Their interdependence arose in calculating an overall outcome of the dealings between Sovereign and the reinsurer, but that by no means made their performance inseparable.

[92] Notwithstanding the consistent application of its approach to liability for GST, I am satisfied that the approach adopted by the Court of Appeal in *Marac* is distinguishable, and should not apply in the present circumstances to prevent separation of the two components where the accruals rules clearly contemplate that. Unlike the potentially relevant taxing provisions in *Marac*, the accruals rules do require analysis of transactions on a basis that will reflect their economic substance over time, rather than reflecting the form in which money flows occur. So, too, in *Gulf Harbour*, the taxing provisions provided no mandate to separate components of a contract, and respect for contractual form was determinative. As Mr McKay submitted, for the Commissioner to succeed in *Gulf Harbour* would require putting the contract to one side. Here, the accruals rules do not require the Treaties to be ignored, but do mandate an analysis of their components to identify deferred consideration elements that may constitute a financial arrangement.

[93] Mr McKay sought to bolster Sovereign's challenge to the ability to separate the money flows under the treaty by inviting an analogy with what he treated as the unreasonable or unrealistic outcome that would ensue if the same approach applied to other forms of excepted financial arrangement. He instanced annuities, which are

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32 See [102]-[104] below.

a separate category of excepted financial arrangement. Where they are for a term contingent upon human life or an annuity to which s CM 2 applies, (ie an annuity for a term certain where they are issued by a life insurer), Mr McKay argued that an infinite breakdown of the components of some forms of annuity could lead to the identification of deferred consideration that could be carved out of the rest of the annuity arrangement to fall outside an "excepted financial arrangement". In this regard, Mr McKay cited an Australian decision of the Full Federal Court in *Australia and New Zealand Savings Bank Ltd v Federal Commissioner of Taxation*[33] where, in an approach consistent with that in *Marac* and *Gulf Harbour,* the Court decided as a matter of form rather than on substance whether payments under particular arrangements styled as annuities were an instalment of an annuity or part repayment of capital with interest. In the absence of any complaint that the form of transaction was a disguise for some other or different transaction, the Court had to look at the transaction as entered into, and invocation of the doctrine of substance was rejected.[34] Mr McKay invited the analogy that, once the relevant contract had the status of one category of excepted financial arrangement, then it was inappropriate to drill down further to attempt a different attribution to components of it.

[94] For the Commissioner, Mr Goddard countered with the illustration of how the accruals rules apply to the taxation of convertible notes. They constitute hybrid instruments which generally involve a commitment by the issuer to pay interest on the subscription amount for the note, and then converting the note into a share, either mandatorily or at the investor's option. Such arrangements are therefore treated as having debt and equity components. They are subject to the accruals rules so that the equity component is recognised as an excepted financial arrangement. The gain or loss on the investment of the money will be treated as subject to the accruals rules for the investor. Mr Goddard argued that considering the separation of components in convertible note arrangements, the separate treatment of the commission arrangements under the accruals rules can be achieved relatively more easily.

33 *Australia and New Zealand Savings Bank Ltd v Federal Commissioner of Taxation* 93 ATC 4370.

34 At 4389 per Hill J.

[95] Neither analogy is particularly helpful. The approach of the Australian Court in respecting the form of transactions structured as annuities is similar to the approach in *Marac* and *Gulf Harbour*, in that the Court was not dealing with a taxing provision that mandated separate analysis of components of larger transactions for the purpose of identifying deferred consideration.

[96] On the other hand, the apparent approval of the authors of the text on the accruals regime, for the approach to taxing convertible notes as advanced for the Commissioner,[35] does provide a measure of support for the Commissioner's approach to the separate analysis of the components under the Treaties.

[97] A further argument for Sovereign about the indivisibility of the two sets of money flows was that both had their origins in the premiums received by Sovereign in respect of underlying policies, that both related to elements that inhered as components of the policies, that both transferred risk to the reinsurers and that there was a degree to which the commission arrangements were subject to mortality risk as well as lapse risk.

[98] I am not satisfied that these features can avail Sovereign in preventing separate analysis of the money flows in the commission arrangements, for the purposes of the accruals rules. It is inconsistent with other aspects of Sovereign's case to treat its commission repayments as having their "origins in the premium received by Sovereign in respect of the underlying policy" when the extent of the refundable commission received by Sovereign is a reflection of the amount of the initial premium paid by the policyholder whereas subsequent repayments to the reinsurer are dictated by the receipt of subsequent periodic premium payments. Certainly, premiums received by Sovereign have components to pay for the mortality risk insured, and to recover the expenses incurred in underwriting the policy, but those two components remain separately identifiable. I deal subsequently with the extent to which insurance risk is transferred to the reinsurers in respect of lapse risk.[36]

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35 *New Zealand Accrual Regime – a Practical Guide* at [904], p 200.
36 See [147]-[175] below.

[99] As to the further argument that a measure of mortality risk was inherent in the commission arrangements and that that risk was also transferred to the reinsurer, this was said to occur because adverse mortality experience in the underlying portfolio of policies would reduce the premium money flows received by Sovereign and therefore adversely affect the timing of commission repayments to the reinsurers. That analysis of cause and effect is literally correct. However, I do not accept the analysis as affecting the ability to bifurcate the two sets of money flows for the purposes of the accruals rules. That is because adverse mortality experience is reflected in the mortality reinsurance money flows and the absence of premiums paid because of lapsed policies is analysed irrespective of whether the lapse has been caused by death of the life assured, or a decision by the policyholder to discontinue their policy. It would therefore be somewhat artificial to double up the respects in which adverse mortality experience is seen as affecting the position between Sovereign and the reinsurer.

[100] It was also argued that because mortality losses are debited to the Bonus Account, that would prolong the period over which the reinsurer was exposed to non-repayment of the refundable commissions. However, that is an incidental consequence of the mortality experience and cannot be treated as establishing a connection between the two sets of money flows that would render it inappropriate to analyse them separately.

[101] The Brett and Cowley paper described the risk premium reinsurance, and the "cash advance" ("…that is typically related to the direct writer's initial commission payments") [ie the commission arrangements in the present case] as being covered by a single treaty, but "…split into two distinct sections".[37] I am satisfied that that description accurately describes the inter-relationship between the two components of the on-going financial dealings between Sovereign and its reinsurers. It also accords with the characterisation proposed by Mr Coon when he corresponded with Dr Pyhel at Gerling in December 1992, for reassurance commissions and refunds to be separate from the risk premiums and claims.[38] Dr Pyhel confirmed that each

[37] ABD4/154/656.
[38] ABD3/13/540.

component was priced separately to reflect market rates, so that there was no cross-subsidy between the mortality risk reinsurance, and the commission arrangements.[39]

[102] As to the attitude of the parties to the treaty, Dr Pyhel was firm in his view that Gerling would not have undertaken the commission arrangements, without the reinsurance of mortality risk. Gerling looked to have a long-term relationship in reinsuring mortality risk, and a shorter term provision of financing support whilst Sovereign was getting established.[40]

[103] In contrast, Mr Bispham, one of the actuaries called for the Commissioner, expressed the view that some reinsurance companies are prepared to provide financing similar to the commission arrangements here, without also reinsuring a portion of the direct insurer's mortality risk.[41]

[104] These approaches are reconcilable, and depend on matters of business judgement by different reinsurers. The point is that both approaches accommodate the separation of the two elements. As noted, on Dr Pyhel's evidence Gerling would not provide the commission arrangements without the mortality risk reinsurance, he saw Gerling exiting the commission arrangements after Sovereign's start-up phase but remaining in the mortality risk reinsurance long-term, and each set of money flows was costed independently of the other.

[105] In the operational sense, Sovereign characterised the two components of the Treaties as being heavily interdependent. Periodic calculations of the balance in the Bonus Account require money flows on both components to be taken into account, so that the on-going balance is a reflection of the interaction between all four sets of money flows. In addition, the interdependence may be material in spreading the risks to which Sovereign's business was exposed. It will be necessary to consider separately the nature and extent of transfer of the lapse risk,[42] but this consideration overlaps in the operational sense because Mr Perera gave the impression that

39 Phyel brief at [69], [70], T637/12-30.
40 T638/16-34.
41 Bispham brief at [93], T1159/12-24.
42 See [147]-[175] below.

management of Sovereign's business involves monitoring the company's on-going experience on both mortality and lapse risk.

[106] Ultimately, the characterisation for Sovereign of the close interdependence of the different components of the Treaties may, in large part, be a matter of its commercial perception. Mr Perera accepted that Sovereign could not analyse its performance on mortality or lapse risk unless it addressed the performance on each set of money flows separately. However, it could not determine how it was performing under the treaty relative to any entitlement to a share of the profits, without combining the results on both components.[43] There are likely to be different responses to adverse trends in mortality experience on the one hand and the rate of lapse of certain types of policies on the other, so that prudent management of Sovereign's on-going business will involve discrete management of the matters under its control that are relevant to each of these aspects of Sovereign's business.

[107] Sovereign's business includes widespread reliance on projections of future behaviours by others. Life insurers are reliant on actuarial analyses for much of their business planning. Life insurance business is treated as involving long-term transactions, so that the accounting standards also require, on numerous aspects of the business, actuarial projections of future events. Given that feature of the business, it is less material to claim that artificiality or uncertainty created by separating the money flows involved in the two components of the Treaties in some way conflicts fundamentally with the manner in which Sovereign operates it business.[44]

[108] More importantly, reporting for tax purposes reflects past performance during a tax year, and it is not difficult to detail each of the money flows recorded during the year, at the end of it.[45] I am not persuaded that the form of the contractual commitments, or the manner in which Sovereign operated its business, could provide any material impediment to separate analysis of the money flows under the commission arrangements, for the purposes of the accruals rules.

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43 T454/27-32.
44 See Perera first brief 391, reference to FRS-34.
45 Perera T495/23-30, Davies T788/31-34.

The accounting standards

[109] It was submitted for Sovereign that the correct accounting for the money flows under the treaty for financial reporting purposes ought to be highly influential in determining whether the money flows under the commission arrangements ought to be separated for the purposes of the accruals rules. Mr Simpson pointed in particular to the fact that those standards are substance-based and are intended to optimise "representational faithfulness" in presenting a true and fair view of the financial status of the entity being reported upon. He relied on accounting standards as supporting Sovereign's arguments on two distinct issues. First, that the two sets of money flows under the treaty should not be "unbundled" to enable separate analysis of the commission arrangements. Secondly, in characterising either the whole of the treaty, or if necessary the commission arrangements, as a contract of insurance.

[110] Sovereign cited the observation of Cooke J in *CIR v National Bank of New Zealand* to the effect that income for tax purposes is to be ascertained according to relevant accounting principles and commercial practices, except so far as the statutory provisions require otherwise.[46] The issue in that case was the treatment for tax purposes of interest accruing on the bank's loan exposures that were treated as doubtful debts. The judgment acknowledged that the appropriate treatment for such interest amounts was one area in which it is recognised that the statutory taxing provisions do require treatment that does not follow accounting principles.

[111] Sovereign also cited the Court of Appeal decision in *CIR v Farmers Trading Company Ltd* to the same effect, in that Richardson J recognised the importance, in administering income tax legislation, of applying generally accepted accounting principles in computing business income, "...so far as the statutory language permits".[47]

[112] Mr Goddard disputed as a general proposition that the treatment of money flows under the commission arrangements in financial statements could shed

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[46] *CIR v National Bank of New Zealand* (1976) 2 NZTC 61,150 (CA) at 61,159.
[47] *CIR v Farmers Trading Company Ltd* (1982) 5 NZTC 61,200 (CA) at 61,205.

determinative light on how they were to be treated for the purposes of the accruals rules. He also made the particular submission that because the accruals rules contemplate an unbundling of money flows at a low threshold, the higher the threshold for unbundling under relevant accounting standards, the less likely that that test would be useful in determining the appropriate treatment of the money flows for the purposes of the accruals rules.

[113] A significant change to the form of accounting standards occurred during the period to which the present assessments relate. At the beginning of the period, in 2000, financial statements in New Zealand were subject to financial reporting standards that endeavoured to reflect the trend of international practices but were expressed in standards set peculiarly for New Zealand (FRS). Then during the years to which the assessments relate, New Zealand adopted internationally promoted standards, namely IFRS.

[114] A component of the former standards, FRS 34, had been issued in November 1998 to govern the financial reporting for life insurance businesses. It applied to the preparation of financial statements for the 2000 to 2005 income years. A component of the later standards, NZ IFRS 4, was issued in November 2004 in relation to financial reporting by insurance businesses on the basis that it would be mandatory for reporting periods commencing from the beginning of 2007 and could be applied at a reporting entity's discretion, from the beginning of 2005. Sovereign elected to adopt NZ IFRS 4 earlier than required, so that it applied to Sovereign's 2006 accounting year.

[115] The prospect of treating money flows differently for financial reporting on the one hand, and for accounting for income tax purposes on the other, as recognised in the caveat acknowledged by the Court of Appeal in both the *National Bank* and *Farmers Trading* cases, is inevitable. Effecting the purpose of the Income Tax Acts may require treatment of money flows in a manner that is different from presentation of those items in a manner intended to optimise the true and fair view of the financial state of the reporting entity.

[116] No single proposition can govern the various circumstances in which it will be appropriate to apply an accounting for transactions different from that applying under the accounting standards. The presentation of financial statements conforming with the accounting standards should be respected, except to the extent that taxing provisions clearly require a different presentation. In that case, the extent of different presentation ought to reflect the rationale for that difference. The rationale should be apparent from the context and terms of the taxing provision itself.

[117] Here, it seems unlikely that the accounting standards could be determinative in any event, or even substantially influential in determining, first, whether the components should be unbundled, and secondly, if they are unbundled, how the commission arrangement money flows should be treated for the purposes of the accruals rules. This is in part because the statutory terms of the accruals rules remained constant throughout the years to which the relevant assessments relate, but the accounting standards relied on were changed. It would be obtuse to adopt accounting standards that might produce different results in different years, when the accruals rules, if they applied, ought to require consistent results.

[118] For the 2000 to 2005 years, the FRS provisions did not contemplate any circumstances in which component money flows in arrangements like the Treaties would be separated. The provisions of those standards contemplated that the character of a contract as one of insurance would be assessed overall, and money flows generated by the arrangements accounted for accordingly.

[119] FRS 34 provided for accounting for life insurance business, and para 7 of that standard addressed reinsurance. The standard and commentary on it required contracts that might be characterised as reinsurance to be assessed on their substance. That is, whether they provided for the transfer of risk against loss or liability from the ceding insurer to the reinsurer. Provided that substantive requirement was met, premiums paid by ceding insurers were to be recognised as an asset by the ceding insurer and a liability by the reinsurer.

[120] Later in this judgment I will consider whether the commission arrangements effected a transfer of any significant risk.[48] It was common ground that the reinsurance of a portion of the mortality risk did constitute a contract of insurance. In any context where the components of the treaty could not be unbundled, then the reinsurance of mortality risk would be likely to bestow the status of a contract of insurance over the whole arrangements.

[121] Mr Simpson urged me to consider the effect of the FRS provisions as foreshadowing, or having implicit in them, the more extensive provisions on accounting for insurance contracts in NZIFRS 4. I am not satisfied that that approach would be appropriate. That is particularly so considering the limited extent to which any provision in the accounting standards that might raise an argument against separation can override the statutory intention, as evident from the accruals rules, that separation should occur.

[122] So far as the 2006 assessment was concerned, Sovereign resisted any separation of the two components of the Treaties in reliance on the provisions in NZIFRS 4, and in particular a provision in para 10(c) of that standard that prohibits unbundling if an insurer cannot measure a "deposit component" separately. That provision relates to insurance contracts that contain both an insurance component and a "deposit component". Where transactions of that type are undertaken, the standard requires the insurer to undertake an analysis of whether the deposit component can be separately measured.

[123] Sovereign argued, in reliance on para 10 of NZ IFRS 4, that the standard contemplated unbundling only where an insurance contract included a deposit component, and that it was a deposit component that could be separately quantified.[49] However, I agree with the preponderance of opinions from witnesses addressing the point that no part of the commission arrangements came within the definition of "deposit component". For instance Mr Hagen confined the notion of "deposit component" to the forms of insurance contract that include an investment component so that the "deposit" is received by the insurer other than to meet the

48 See [147]-[175] below.
49 This approach was supported by, for example, Nicholson reply brief at [44] and Wilson reply brief at [19].

costs of providing life insurance cover.[50] Such components contribute to some form of investment, being held by the insurer and invested by it on behalf of the policyholder. Hence use of the word “deposit” which connotes payment for some purpose intended to provide a return, being distinguishable from payments for assumption of insurance risk.

[124] As with the position prior to application of the NZIFRS standards, this example of circumstances in which unbundling of component parts might occur is not helpful in determining the appropriateness of separating the sets of money flows for the purposes of applying the accruals rules. Accordingly, I treat that part of NZ IFRS 4 as simply having no application.

[125] In terms of the accounting standards, Mr Hagen remained firmly of the view, after thorough testing on cross-examination on these points, that a true and fair view required Sovereign to treat the refundable commissions received as a financing arrangement, so that they could not be reported as part of the revenue received. Consistently, he considered that the periodic repayments of those commissions by Sovereign to the reinsurer could only be treated as expenses to the extent of the additional component, treated on Mr Hagen’s analysis as interest paid to the reinsurer. Mr Hagen did not accept that there was any difficulty of quantification in separating the money flows, and that the supposed interdependence of the outcomes of the mortality risk reinsurance premiums offset against mortality claims in no way precluded the treatment for which he contended.

[126] On Mr Hagen’s analysis, separate treatment of the commission arrangements was required in any event to comply with NZIFRS, and indeed its predecessor FRS34. Mr Hagen was concerned that ignoring the “obvious financing element embedded in the reinsurance arrangements” would allow form to prevail over substance, and not fairly present the economic effect of the transaction.[51] It follows that, on Mr Hagen’s analysis, financial statements in a form that accounted separately for the commission arrangements would then be applicable to account for the income tax consequences under the accruals rules.

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[50] For example, T1594/32-1595/5, and too, Nicholson reply brief at [56] and Wilkinson reply brief at [11]-[13].

[51] Hagen brief at [60].

[127] In contrast, a majority of the remaining experts and Dr Pyhel gave materially consistent evidence that Bonus Account treaties such as those in these proceedings are not accounted for on an "unbundled" basis in Europe.[52] The evidence was to the effect that in the United Kingdom and Europe, for both regulatory and income tax purposes, particularly reinsurers but also insurers are left to account for the components of such treaties together. There was no evidence to suggest that this occurs despite taxation provisions like the New Zealand accruals rules.

[128] It is unnecessary to choose between these contrasting views in order for the accruals rules to apply as in the Commissioner's assessments. I am satisfied that a separate analysis of the commission arrangements is required by the accruals rules, and that this requirement applies independently of whether the accounting standards would require the same treatment in any event.

[129] Accordingly, I am not satisfied that any of the grounds raised by Sovereign are sufficient to resist the approach adopted for the Commissioner, in considering the status of the money flows in the commission arrangements separately from the remaining components of the Treaties.

Do the commission arrangements constitute a contract of insurance?

[130] It is accepted that the commission arrangements come within the very broad definition of financial arrangement for the purposes of the accruals rules. Accordingly, the next issue is whether they amount to an excepted financial arrangement by virtue of being a contract of insurance.

Common law definition

[131] There is no definition of "contract of insurance" in the Act, or any other relevant statutory source. In those circumstances, the parties agreed that the definition of this concept applying more generally at common law should be used, and for Sovereign it was submitted that the concept should be determined by

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[52] Bhayani (re reinsurers' accounting) brief at [105-[109], Davies reply brief at [38] and [39], Nicholson reply brief at [35]-[42], Laker T1490/26-34 (components of such treaties … "tend to be left together").

reference to ordinary legal and business conceptions. The accrual regime text also recommends the application of the common law definition of "contract of insurance". The text states:[53]

> In general, an insurance contract will be any contract which provides a benefit on the happening of an uncertain event where the purpose of the benefit is to compensate the insured party for loss or prejudice resulting from the event.

[132] The case for the Commissioner is that, at common law, the nature and form of the commitments made are determinative. Both parties referred to what may be the classic formulation, now almost a century old, from *Bunyon on Life Assurance*.[54] This has been cited, for instance, by Cooke J in *Marac* where he included the following extract from page 1 in the text:[55]

> The contract of insurance has been defined by Tindal CJ to be that in which a sum of money 'as a premium is paid in consideration of the insurer's incurring the risk of paying a larger sum upon a given contingency'... The contract of life insurance may be further defined to be that in which one party agrees to pay a given sum upon the happening of a particular event contingent upon the duration of human life, in consideration of the immediate payment of a smaller sum or certain equivalent periodical payments by another. This consideration in money is termed the premium or premiums, and is paid either in one sum, when it is termed a single premium, or by a succession of periodical instalments ...

[133] Cooke J then observed that despite the age of the definition, there was not "...the slightest reason to suppose that in any of the three acts the New Zealand Parliament had anything but the traditional definition in mind". Those acts included the Income Tax Act 1976. That confirmation of currency of the definition is itself now 26 years old. Mr Simpson argued that there has been substantial evolution in the nature and sophistication of insurance products, so that it was timely to give the notion of a contract of insurance a more expansive definition to recognise wider forms of arrangement where there is a transfer of defined risks not necessarily structured in a way that required the recipient of cover for the risk to make a payment at the outset that was labelled as a premium.

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53 *New Zealand Accrual Regime – a Practical Guide* at [209], p 35.
54 *Bunyon on Life Assurance* (5th ed, 1914).
55 *Marac Life Assurance Ltd v Commissioner of Inland Revenue* [1986] 1 NZLR 694 (CA) at 697.

[134] A further definition addressed in argument was that from the Appendix to NZ IFRS 4, where "insurance contract" was defined as:[56]

> A contract under which one party (the insurer) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder if a specified uncertain future event (the insured event) adversely affects the policyholder.

[135] Neither this definition for use in the accounting standards nor the suggested scope of "insurance contracts" in the text on the accruals regime makes explicit reference to any requirement for a premium. Appendix C to NZ IFRS 4, which deals with accounting for life insurance entities, does provide for the manner of accounting for premiums and claims by a life insurance entity. Mr Goddard submitted these provisions implicitly required a premium to be received by the insurer as an implicit element of what will constitute an insurance contract.[57]

[136] Given that insurance contracts will arise in a commercial context, it is reasonable to imply that assumption of the risk by the insurer would be undertaken for consideration. That implication does not necessarily require the consideration to be labelled as a premium. Nor is it critical that it is paid to the insurer at the outset. However, it is the essence of the commercial bargain that the extent of consideration passing to the insurer is defined and reflects the costs of arranging the contract, plus an actuarial projection of the extent of circumstances in which the insurer is likely to have to meet claims on the subsequent happening of defined uncertain events.

[137] Mr Goddard responded to the proposition that payment in the nature of a premium was unnecessary by arguing that transfer of risk arose so widely in diverse contexts that are not treated as insurance, that there could be no justification for abandoning the requirement for a premium as a necessary ingredient of a contract of insurance. He instanced the contractual arrangement between Sovereign and its agents, requiring the agents to reimburse parts of the commissions paid to them for writing a new policy, in the event that the policy lapses soon after creation. That arrangement shifts part of the lapse risk from Sovereign to its brokers, but cannot be characterised as a contract of insurance.

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56 ABD23/633/5498.
57 Appendix C, paras 5.1, 5.2 and 5.2.2, ABD23/633/5516, 5517.

[138] A second example was a form of limited resource loan where a lender advances, say, $10 million, on terms requiring the borrower to repay $1 million per annum or such lesser sum as the borrower receives from, say, a defined portfolio of insurance policies it has written, in any given year. That arrangement would expose the lender to the borrower's mortality and lapse risk, but would not transform its loan to the borrower into a contract of insurance. A wide variety of financial instruments such as currency and interest rate swaps are also designed to "manage" risk, but in reallocating risk, such contracts do not come within any sensible contemplation of contracts of insurance.

[139] As commonly used, the notion of insurance has as distinctive features the payment of a smaller sum or periodic sums, in return for the payer subsequently being compensated by the payee to a higher value, on the happening of a defined uncertain event. Simplistically, the distinctive business skills of an insurer are in aggregating and therefore spreading the risk of having to meet claims out of the total premium income, and actuarially projecting the extent of claims that will have to be met so as to provide adequately for such liabilities (including by reinsurance) from the premiums charged.

[140] It is common ground that, on the basis of the *Bunyon* definition, the absence of any sum in the nature of a premium or premiums would exclude a contract from that definition of "contract of insurance". I am not satisfied that there is any basis for rejecting the definition from *Bunyon* as outdated or inapplicable in this context.

[141] A straightforward form of contract for reinsurance of the lapse risk faced by Sovereign would arise if it insured against, say, a greater than 15 per cent portion of the life insurance policies it issued lapsing in less than 24 months from the receipt of first premiums. Gerling would charge Sovereign a premium and in return pay any amount required to top up the level of premiums actually paid to Sovereign, say, by an amount that would result in Sovereign receiving the non-mortality risk components of the premiums on 85 per cent of the policies that had been on issue for 24 months. Such a policy could operate on tranches of Sovereign's new business as issued on a periodic basis.

[142] In contrast, the initial money flows in the commission arrangements flow not to, but from, the putative insurer. The quantum of the payments is a reflection of the premiums received by Sovereign, rather than any measurement of premiums not received. Thereafter, it is the putative insured that is conditionally committed to repaying a larger amount. Both sequence, and proportionality of the amounts paid and received, are the opposite of insurance contracts.

[143] There is a superficial appearance of inconsistency between the Commissioner's case, which depends upon an analysis of the substance of the commission arrangements to justify their separate analysis for the purposes of applying the accruals rules, and then adopts a legal analysis based on form in arguing for the exclusion of the commission arrangements from the definition of "contract of insurance". However, the apparently inconsistent approach is justified by the different context in which the two issues arise. Parliament is to be taken as intending to exclude from the application of the accruals rules, money flows that arise under contracts of insurance, thereby excluding from the accruals rules deferred consideration in money flows of the type that arise when the mutual commitments take the form that is reflected in a contract of insurance.

[144] In any event, I am not persuaded that the Commissioner's insistence on the payment of a premium, in return for the prospect of a subsequent payment of a larger amount depending on the occurrence of defined but uncertain events, is merely a matter of form. The components of the money flows could be given different labels, and what is material is the commercial rationale underlying the structure on which the bargain between insurer and insured depends.

[145] For the reasons outlined, I consider that a payment or payments in the nature of a premium is a necessary element of a "contract of insurance", where that type of transaction is listed as an excepted financial arrangement.

[146] In addition to the absence of any "premiums" paid by Sovereign, I am also satisfied that the commission arrangements lack other usual attributes of a contract of insurance. The putative insurer's commitment at the outset does not depend on any usual type of future uncertainty, but only on the rate at which premiums received

by the "insured" become available to repay the "refundable commission". A loss for the "insurer" would occur only if the totality of its business with the "insured" is insufficient to make up a shortfall on a particular tranche of policies, and the "insurer" does not have the prospect of making an uncertain profit out of continuing premiums that exceed projections for the costs of meeting claims.

Was there transfer of significant risk?

[147] A transfer of risk to the insurer is another central element of the common law definition of a "contract of insurance". I have found that the commission arrangements do not meet that definition because they lack a payment in the nature of a premium, and other commercial dynamics inherent in insurance contracts are lacking. However, it is appropriate to consider the additional arguments on transfer of risk in the event that I am wrong in those findings as to what is necessary for a contract of insurance that constitutes an excepted financial arrangement.

[148] In addition, the accounting standards on financial reporting for insurance companies restrict the categories of transaction that can be treated as insurance contracts to those which involve a significant insurance risk.[58] Consideration of the additional arguments on transfer of risk is also necessary in the event that I am wrong in dismissing accounting standards as not being determinative or highly influential in deciding the status of the commission arrangements for the purposes of the accruals rules. If those standards were interpreted as treating a material transfer of risk as a dominant characteristic of a contract of insurance, then their application may lead to recognition of the commission arrangements as a contract of insurance for the purposes of constituting an excepted financial arrangement.

[149] Lapse risk is recognised as an identifiable risk for insurance businesses. As a matter of logic (and as recognised in insurance practice), it cannot be the subject of a contract of insurance between the policyholder and the direct insurer because it does not relate to a contingency that would potentially affect the insured adversely. However, the insurance industry recognises that lapse risk is a risk able to be transferred between insurers and reinsurers: for some form of consideration, the

58 The definition of "insurance contract" is in Appendix A, NZ IFRS 4, ABD23/633/5498.

insurer can protect itself against the adverse financial consequences of a higher than projected rate of lapse within any defined portfolio of policies.[59]

[150] Sovereign was exposed to this lapse risk in relation to its life insurance business. The potential adverse impact of a relatively worse lapse rate experience than anticipated was most acute for it when its business was under greatest cash flow strain in its establishment years, and when the volume of business was growing rapidly. There was therefore an insurable risk which Sovereign could have transferred to the reinsurers, on appropriate terms.

[151] From the perspective of those managing Sovereign at the time, the commission arrangements concluded with the reinsurers could validly be treated as "parking" or deferring the adverse consequences of worse than anticipated lapse experience. Instead of awaiting the uncertainties of the extent of lapses in the early years of policies that Sovereign had written, it received sums from the reinsurers at the outset (and for some categories of policy, in part in the 13th month after their inception). These payments could either be seen as pre-payments by the reinsurer of subsequent premiums where there was no certainty individual policyholders would pay the premiums, or they could be treated as reimbursement of a significant portion of the expenses that Sovereign risked not recovering to the extent that a portion of the relevant tranche of policies lapsed. The expert actuaries recognised that this transfer of risk occurred, but differed over its extent.[60]

[152] There was no evidence from those involved for Sovereign at the time which characterised those arrangements as transferring lapse risk, and the correspondence about the commission arrangements treated them as financing. Sovereign's case depended on Mr Perera's ex post facto characterisation of them as having that effect.

[153] Dealing just with the terms of the commission arrangements in the treaty, Sovereign was only obliged to repay defined portions of the refundable commissions paid by the reinsurer, to the extent that Sovereign was funded to do so by on-going

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59 The distinction recognising lapse risk as an insurable risk only between insurer and reinsurer is also specified in the accounting standards: see NZIFRS4, Appendix B, para B16, ABD23/633/5502.

60 Bhayani brief at [42], Davies brief at [51], T776/24-34, compare Bispham T1239/23-1240/1, Duckers T1366/28-1368/18, Laker T1501/14-1502/30.

receipt of premiums on the policies to which the refundable commissions related. On this basis, the reinsurer bore the risk of a larger than projected portion of a relevant portfolio of policies lapsing before there had been recovery of the sums it had paid in respect of those policies. If this was the totality of the commitment to repay, then there would have been a pro-rata transfer of the lapse risk.

[154] The case for the Commissioner was that any transfer of lapse risk has to be analysed in light of the prospect that the reinsurers would, in all likelihood, still recover all of the refundable commissions, together with interest at the agreed rate, because of the way in which the Bonus Account operated. The Bonus Account included all commission repayment obligations, irrespective of whether the policies to which they related had lapsed or not. That meant that the reinsurers were not assuming the risk of higher than projected lapses on an individual policy basis, but only the risk that all amounts that Sovereign was obliged to pass through the Bonus Account would, in total, be inadequate to make up a shortfall created by worse than anticipated lapse experience in one or more tranches of policies.

[155] On this analysis, Mr Goddard argued there was no transfer of significant lapse risk and the economic effect of the commission arrangements was no more than a revolving credit arrangement, facilitating cash flow for Sovereign. Mr Goddard argued that the whole design of the commission arrangements was intended to minimise or avoid consequences of lapse risk, rather than acknowledging its existence and explicitly transferring that risk between the parties. I am not satisfied that that characterisation means that no transfer of risk was involved. Insurers of all manner of risks do not encourage the occurrence against which the insured is seeking cover, so that just as a life insurer will not seek to write policies among the terminally ill, so a reinsurer imposing a charge for assumption of lapse risk does not encourage the direct insurer to write policies being indifferent to the prospects of lapse.

[156] For reasons that I will set out as briefly as possible, had it been material, I would conclude that at the outset of the treaty arrangements, and in their early years, the commission arrangements did effect a transfer of significant lapse risk to the reinsurer. The requirement to supplement the repayment obligations by other

amounts in the Bonus Account would defer the point, if any, at which that account would reach a nil balance and therefore become a potential source of profit share payments for Sovereign. However, in its start-up phase, that would have been a less significant consideration than the substantial advantage of "parking" the short-term consequences of adverse lapse experience. I am satisfied that it constituted a meaningful deferral of that risk.

[157] However, by the beginning of the 2000 to 2006 years of direct relevance to these proceedings, the substantially more extensive sources available for repayment of the refundable commissions advanced by the reinsurers reduced the extent of lapse risk assumed by the reinsurers.

[158] Sovereign provided evidence that the risk assumed in these years was still significant. Mr Perera constructed an actuarial model as part of Sovereign's case, to demonstrate the range of circumstances in which a worse than anticipated lapse experience would cause loss to the reinsurer because the Bonus Account would not amortise. For the Commissioner, Mr Duckers constructed an alternative model, the effect of which was to demonstrate that the very limited circumstances in which the Bonus Account would not amortise were so remote as to not involve the assumption of any material lapse risk by the reinsurers.

[159] The various models adopted different assumptions. For example, the rate of lapse among policies underwritten is projected differently depending on the type of policy. If the policies only provide life cover (described by Sovereign as "rate for age" policies) where the only benefit is payment of an amount on the death of a life assured, then policies may be projected to lapse at a more or less constant rate. However, if the model assumes policies that combine an element of life insurance with an investment element (described by Sovereign as "unit linked" policies) where the policyholder builds up some residual value reflecting the investment component, and therefore had an increasing incentive to continue with the policy over a period of time, the projected lapse rate would drop over time. Accordingly, the type of policy modelled for lapse rates would influence the outcome.

[160] The different models also applied different measures of return projected for the reinsurer, with one using a projection of the present value of future profits, and the other a benchmark rate of return on capital. After debate with numerous of the experts, it was apparent that both measures may be valid, but the measure chosen will have idiosyncratic impacts on the output of the model.

[161] At its core, Mr Perera's model demonstrated that on a given annual portfolio of policies, a Bonus Account maintained for those policies would not amortise if there was an on-going annual rate of lapses among the policies of 17 per cent, and an assumed mortality rate within a realistic range. New Zealand life insurance data suggests that such a 17 per cent lapse rate is within the range experienced by New Zealand companies and, although worse than Sovereign's own rate, such a lapse rate could not be dismissed as unrealistic. The majority of the actuaries acknowledged the appropriateness, particularly for a start-up company, of adopting industry averages and then applying at least a 50 per cent, and potentially up to 100 per cent, increase on that average as an appropriate lapse rate for actuarial projections.

[162] Mr Perera's model did not include any allowance for "topping up" repayments from other tranches of policies for a number of reasons, including that the aim of the model was to illustrate the risks at the inception of the treaty when there was no in-force business.[61]

[163] Essentially, Mr Perera's modelling was confined to the consequences of lapse rate within a single tranche of policies.[62] By way of example, Mr Perera separately modelled the refundable commissions and commission repayments in relation to the 1989 tranche of Sovereign's policies that were reinsured. Having removed the figures for reinsurance premiums paid and claims made, that reconstruction demonstrated that the 1989 tranche of policies would not have amortised. The reality, however, was that in the 1989 year, there was relatively favourable mortality risk experience and once the outcome for all money flows was recombined, dealings under the treaty for the 1989 tranche of policies indeed did amortise.

61 Perera, second reply brief at [51].
62 For example, T478/22-479/5.

[164] That outcome illustrates the concern that Mr Perera's modelling could not adequately reflect the extent to which the accumulation of prior years' portfolios of policies lessened the risk that the Bonus Account would not amortise, in the event that it was maintained separately in relation to a single year's business. There is a recognised risk-spreading feature in underwriting larger volumes of similar risks, relative to the risks with smaller portfolios. Consistently with that, once the pool of policies that was able to make residual contributions to any shortfall from a current portfolio of policies became substantial, the risk of the Bonus Account not amortising reduced progressively as it was operated on a cumulative basis for all years' business.

[165] The longer a particular policy has been in force, the lower the proportion of on-going premiums that would be available to supplement under-recoveries caused by other policies lapsing. However, I find that by the years in issue, that accumulated resource was sufficient to alter the extent of any risk to the reinsurer of the Bonus Account not amortising.

[166] In the end, I am not satisfied that any of the models could provide an accurate basis for anything like an arithmetic projection of the relative likelihood of the reinsurer suffering a loss on account of worse than projected lapse experience over the entire portfolio of relevant policies, particularly as the years of accumulated older policies grew.

[167] Mr Perera's reconstruction of the theoretical assessment of the risk is to be contrasted against Mr Coon's projections, apparently carried out for Sovereign's own management purposes during its start-up years. In what appears to have been an internal review conducted at the end of March 1992 in relation to the profitability of business in force at the end of December 1991, projections were provided in relation to the Bonus Account, assuming no new business was underwritten. On two different measures of the interest rate charged, and on both standard and high lapse rate projections, Mr Coon was able to conclude that the Bonus Account would eventually be repaid "even with very poor quality business and high interest

assumptions".[63] At the end of December 1992 in the somewhat different context of correspondence with Gerling to negotiate terms for reassurance, Mr Coon proposed rates for commissions to be payable by the reinsurer, and refunds of them, for each of a range of different types of policy being sold by Sovereign with a covering comment:[64]

> In putting together my proposals, I have structured arrangements such that on expected lapse and current interest rates, financing is repaid over about five years. There would then be a margin of 10% of reassurance proportion of premiums to allow for lapse rates deteriorating or interest rates rising again.

[168] Mr Coon's projection of repayment over about five years is consistent with the tenure for Fin Re in the Brett and Cowley commentary.[65] On the other hand, Brett and Cowley did treat such arrangements as transferring lapse risk to the reinsurer. Their paper did not provide detailed analysis for the comment to this effect and it is likely to reflect the analysis of a confined series of tranches of policies, rather than a long-term accumulation of the operation of Fin Re moderated by the operation of a global Bonus Account.

[169] As to Gerling's perspective, Dr Pyhel considered that lapse risk had been transferred to the reinsurer.[66] Dr Pyhel's review of the relationship reflected that he had been "scared" about the lapse risk to which the arrangements exposed Gerling, particularly in the early years of the treaty.[67]

[170] Mr Goddard argued that if any significant risk was assumed by the reinsurer, then the parties could be expected to have negotiated the extent of consideration for doing so. At the least, the cost of assuming the lapse risk would be separately identifiable, whereas it was not. That is a valid point. Dr Pyhel was inclined to suggest that he may have undervalued the risk Gerling was assuming in this regard, and also that Mr Coon negotiated well for Sovereign on the point.

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63 ABD3/114/433.
64 ABD3/134/540.
65 ABD4/154/659.
66 Phyel brief at [28].
67 T629/9-14.

[171] Mr Goddard also argued that any risk had to be seen as a modest one, given the wide range of circumstances in which the reinsurer did not suffer any adverse financial consequences of the lapse risk experience incurred.

[172] These points do not dissuade me from the view that a significant lapse risk was transferred under the commission arrangements in the early years of the treaty. Mr Perera accepted that Mr Coon was competent and fully informed. However, I treat Mr Coon's 1992 analyses projecting (with some reservation) that the Bonus Account would amortise as being influenced by optimism when objective actuaries would more likely have weighted their projections more heavily with the prospect of adverse events.

[173] It is unnecessary to stipulate the precise point at which the extent of lapse risk was lowered to the point where it was no longer a significant one. Mr Perera accepted in cross-examination that by early 2000 the volume of in force business had accumulated to an extent that it was "very, very unlikely" that the Bonus Account would not amortise. He also accepted as unlikely that the risk of Gerling incurring a loss because of adverse lapse experience would have influenced Gerling's pricing for continuing the commission arrangements.[68] By reference to a March 2001 summary of accounting with reinsurers, Mr Perera agreed in cross-examination that the pattern of payments by then suggested repayment of commissions in about 10 quarters.[69]

[174] For the purposes of NZ IFRS 4, if a contract qualifies as an insurance contract, then it remains such "until all rights and obligations are extinguished, or expire".[70] In effect, once an insurance contract, always one. I am not satisfied that that approach should apply to the character of the commission arrangements in the present context. The requirement for consistency of treatment of transactions for the purpose of financial reporting is important because of the need for constant measures, especially in comparisons from one accounting period to another. That consideration does not arise when deconstructing a larger arrangement for the purposes of applying the accruals rules.

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68 Perera cross-examination, T481/24-30.
69 T474/22-475/8, ABD9/381/1794.
70 NZIFRS4, Appendix B, paras B29, B30, ABD23/633/5507.

[175] It would be highly artificial to treat the commission arrangements as a contract of insurance when I have found they lack essential characteristics of such a contract. Further, I am satisfied that, as a matter of commercial reality, from the outset of the relevant period in 2000 the accumulated history of the Bonus Account meant that there was no meaningful risk that it would not amortise throughout the years to which the assessments in issue related. In those circumstances, it would be highly artificial to treat the commission arrangements as an excepted financial arrangement on the basis of an historical transfer of risk when the arrangements did not involve any significant transfer of an insurance risk in the relevant period, and were in other respects a financial arrangement to which the accruals rules would apply.

Timing risk

[176] In Sovereign's closing, it was argued the transfer of a timing risk to Gerling operated in the same way as the transfer of lapse risk to justify characterising the commission arrangements as a contract of insurance. Timing risk was characterised as the uncertainty of timing of receipts from policyholders. The analysis of one of the actuaries called for Sovereign, Mr Bhayani, separated insurance risks from a timing risk.[71] Another of Sovereign's witnesses, Mr Wilson, did list the timing risk as an insurance component.[72]

[177] Experts called for the Commissioner were more cautious in their opinions. Mr Bispham accepted that there was a category of risk called a timing risk, but appeared reluctant to acknowledge it as a material form of insurance risk in relevant circumstances.[73] Mr Laker was relatively emphatic that delay in recovery of commissions paid by reinsurers was not a form of insurance risk. Merely because the risk of a delay in recovery of amounts was a consequence of two other forms of insurance risk, namely mortality and lapse risks, did not indicate to Mr Laker that the risk of delay was itself a further insurance risk.[74]

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71 Bhayani brief at [41(a)].
72 Wilson brief at [145].
73 T1206, 1207.
74 T1505.

[178] It is consistent with these opinions to treat the payment of the refundable commissions to Sovereign as removing the uncertainty for Sovereign of the time at which it would receive sums that amounted to advances on future premiums from policyholders. That arrangement also transferred to Gerling the uncertainty as to the subsequent points in time at which it would receive repayment of the amounts advanced against those future premiums. The uncertainty of *when* Gerling would receive various portions of the repayments and interest on them is not an insurable risk of the same type as *whether* Gerling would be repaid (that being a reflection of the lapse risk), or the basic mortality risk of how many lives assured would die in a given policy period.

[179] Putting to one side the increased risk that delay in repayment might increase the prospects of not being paid at all, where the assessment focuses discretely on the timing issue of when the reinsurer will be repaid, I am not satisfied, despite the opinions of some experts that it is conceptually an insurance risk, that it qualifies as such in the present circumstances. The business risk for the reinsurer as to when it will be repaid amounts advanced to Sovereign is not a readily insurable risk for the reinsurer. It is the same as a lender's financing risk, and it would be inconsistent with the purpose of excluding contracts of insurance from the scope of the accruals rules to treat such a risk as bringing the commission arrangements within the scope of a "contract of insurance", with the consequence that it would take them outside the scope of the accruals rules.

[180] I would therefore not be persuaded that the commission arrangements reflected the transfer of a significant insurance risk to the reinsurers, in respect of either the extent of any lapse risk in the relevant years, or the risk as to timing of repayments to be received by the reinsurers.

Balance of money flows under commission arrangements taxable?

[181] If, contrary to Sovereign's primary challenge, the Commissioner was correct to assess the additional component of the commission arrangements under the accruals rules, then Sovereign claimed in the alternative that the base component of those money flows remained taxable under ordinary income taxing provisions. On

Sovereign's analysis, the payment and repayment of the base component would still be returned as assessable income on the one hand, and deductible expenses on the other.

[182] The Commissioner treats the application of the accruals rules to the additional component as comprising the totality of the income tax consequences for all of the money flows under the commission arrangements. The Commissioner denies that the base component is assessable income when received, or deductible expenditure when repaid by Sovereign.

[183] It is common ground that there will be transactional situations in which the remainder of money flows, after treatment of part of them under the accruals rules, will have additional income tax consequences. To the extent they apply, the accruals rules are to be applied first. Under the heading "Relationship with rest of Act", s EH 10(1) provides:

> Notwithstanding any other provision in this Act, gross income or expenditure in any income year in respect of a financial arrangement under the qualified accruals rules shall be calculated under those rules.

[184] As the text on the accruals regime comments, calculation under the accruals rules to the extent that they apply is paramount where there is any conflict with the rest of the Act. That text then continues:[75]

> This does not, however, mean that the other provisions of the Act cease to apply. It is only income arising from the financial arrangement, that is, the deferral element, which is calculated according to Division 1. There could still be income tax consequences under other provisions of the Act. For example, with an agreement for sale and purchase of property the difference between the acquisition price and the price agreed to be paid – essentially the interest element – will be taxable under the accrual regime. The proceeds of sale may also be brought to tax under other provisions of the Act, such as s CD1 (taxation of land transactions). …

[185] For there to be any additional income tax consequences arising from the remainder of the money flows, those additional elements must constitute some form of taxable activity. In the example cited from the text, sale of a property held on revenue account would need to be accounted for as if the consideration had passed

[75] *New Zealand Accrual Regime – a Practical Guide* at [400], p 113.

contemporaneously. So, too, with the sale of any trading stock, or provision of services where they had been paid for on a deferred basis.

[186] Therefore the next issue is whether the base component of the transaction, after removal of the additional component of the money flows dealt with under the accruals rules, constitute a taxable activity. For this analysis, having dealt with the deferral aspect under the accruals rules, it is to be assumed that both parties to the transaction perform their obligations contemporaneously. For example, if the deferred consideration element of a contract for the sale of land was excluded, and the right to possession was granted contemporaneously with payment of the base component of the consideration, the issue would be whether that sale of land was a taxable activity for the vendor. Similarly, if A contracted to paint B's house for $25,000 but did not require B to pay that sum for 18 months after completion of the job, after stripping out the interest component of that consideration to identify the base component that would have been paid by B had consideration passed as soon as the painting was completed, that base component would constitute assessable income in A's hands (less the deductible expenses incurred in undertaking the job).

[187] In the present circumstances, the parties were at odds as to whether the commission arrangements constituted any independent taxable activity, if they were analysed on the notional basis that the base component payments from the reinsurer to Sovereign, and Sovereign's repayment of them, occurred contemporaneously. The Commissioner argued that there was no independent taxable activity, beyond the provision of a principal sum by the reinsurers to provide financing for Sovereign, and the repayment of that financing.

[188] Sovereign argued, particularly in light of a concession on behalf of the Commissioner that the commission arrangements did not constitute a loan, that the advance and repayment of the base components did constitute independent taxable activity. First, it was argued that the commission arrangements amounted to a sale by Sovereign of future cash flows in circumstances where those cash flows represented part of Sovereign's business and were therefore part of its taxable activity.

[189] Secondly, Sovereign argued that the refundable commissions paid by the reinsurer constituted reimbursement for the costs of initiating life insurance policies so that they constituted recovery of deductible expenses and as such should be treated as part of Sovereign's ordinary business income.

[190] As to the first of these propositions, the evidence did not contain any contemporaneous references to Sovereign or the reinsurers treating the commission arrangements as a sale of future cash flows. The characterisation suggested in the few references that there were to the nature of the refundable commissions simply reflected a recognition that they amounted to financing for Sovereign.[76] I accept that one measure of the refundable commissions the reinsurers were prepared to pay to Sovereign was a calculation of the then present value of the future cash flows to be received by Sovereign from policyholders, that being the source from which the refundable commissions would be repaid. However, that quantification cannot of itself justify an ex post facto rationalisation of the nature of the transaction as a sale of future cash flows. If they had been characterised as such, it is reasonable to expect that the parties to the transactions would have addressed their commitment to a sale and purchase of future cash flows as such at some stage but there is no evidence of that.

[191] Sovereign cited numerous cases on the factoring or sale of book debts, or the sale of unmatured bills of exchange to invite analogy with the characterisation of those transactions as confirmed by the courts.[77] One reason for citing such cases was to support Sovereign's challenge to the stance previously adopted on behalf of the Commissioner to the effect that the commission arrangements amounted to loans. Those cases addressed the discrete mischief of whether putative borrowers had undertaken transactions that were subject to money-lending legislation, with a relevant consideration being whether protection of borrowers by constraints imposed on moneylenders was justified. The cases cited for Sovereign reflect the Courts' respect for the form in which the parties undertook financing transactions, and not requiring the commercial effect of such transactions to dictate a different

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[76] See references in n6.

[77] For example, *Chow Yoong Hong v Choong Fah Rubber Manufactory* [1962] AC 209, *Olds Discount Co Ltd v John Playfair Ltd* [1938] 3 All ER 275.

characterisation. For instance, Lord Devlin for the Privy Council in *Chow Yoong Hong*:[78]

> It [the Court] must first look at the nature of the transaction which the parties have agreed. If in form it is not a loan, it is not to the point to say that its object was to raise money for one of them or that the parties could have produced the same result more conveniently by borrowing and lending money.

[192] The context of such cases is very different from the scope of application of an income tax statute. I do not find those cases helpful in attributing a character to the commission arrangements that was not articulated by the parties to them at the time. The difficulty for Sovereign is that the parties here did not document or structure their transactions as a sale of book debts, or even as an assignment of rights to future cash flows. The treaty described them as commissions, or refundable commissions, and they were calculated as a multiple of initial premiums received. The rate of repayment was notionally related to defined proportions of subsequent premiums received, with interest charged on the amounts outstanding. The reality was that that confined repayment obligation was supplemented by arrangements for monies to go to the reinsurer from sufficient other sources to cover, in most situations, for early lapse of specific policies.

[193] The second basis for treating the refundable commissions as assessable income was that they amounted to reimbursement for the establishment costs of life insurance policies, which expenses were themselves deductible. Again, there was nothing in the contemporary documentation to acknowledge that the refundable commissions were calculated by reference to the extent of establishment costs Sovereign actually incurred on the policies to which the commissions related. Nor did contemporaneous documents state that their purpose was directly to reimburse Sovereign for those expenses. This latter proposition was put to a number of witnesses, but I am not satisfied that the point was established. It is subtly different from the proposition that the extent of refundable commissions were calculated by reference to the amount of initial premiums charged on the policies initiated, in circumstances where the parties would expect the levels of premiums to be a fair proxy for the extent of the expenses incurred.

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[78] At 216.

[194] However, there is no direct connection between the two: if inefficient or unlucky, Sovereign might incur establishment costs at a greater level relative to initial premiums, than it had projected. Equally, if Sovereign's business was more efficient than projected, it might incur actual establishment costs at lower levels than projected by reference to the level of premiums charged. There is therefore a looseness in treating the level of premiums as "a proxy" for the extent of establishment costs. The witnesses who addressed this point simply established for Sovereign that the percentage of initial premiums agreed as the formula for calculating the amount of refundable commissions would, all things being equal, constitute a more or less consistent portion of the establishment costs Sovereign expected to incur.

[195] Further, there was no evidence that the reinsurers monitored the level of actual costs Sovereign incurred in establishing life policies, and nor did the terms of the Treaties afford any opportunity for the reinsurers to adjust the amount of refundable commissions they were committed to paying, by reference to fluctuations in the level of establishment costs Sovereign incurred. It is therefore artificial to treat the reinsurers as reimbursing Sovereign for a defined portion of the actual costs incurred in establishing policies.

[196] It is convenient to anticipate at this point overlapping arguments for Sovereign, in opposing the Commissioner's final alternative, namely that the base component in the commission arrangements money flows were capital in nature. In support of Sovereign's characterisation of the commissions as income, Mr McKay invited an analogy with the practice of sale of book debts by retailers, to financiers factoring book debts.[79] Mr McKay submitted that the essence of the commission arrangements amounted to a sale of book debts where the refundable commissions were paid by the reinsurers to acquire the rights to be paid future cash flows that the parties anticipated Sovereign would receive from policyholders, in the same way as a financier factoring a retailer's debts would pay an amount to acquire at least equitable property in the retailer's contractual rights to subsequent payments from the purchasers of goods acquired on deferred payment terms. Dealings in such cash flows constituted part of the retailer's business and were therefore to be treated as

[79] Cases such as those in n77 were also relied on, on this aspect of Sovereign's argument.

income, in substitution for the subsequent payments which the retailer was committed to passing on to the financier.

[197] Mr Goddard resisted any such analogy with cases on factoring of debts, including on grounds that the transactions took different forms. Whereas the retailer sold property in the contractual rights to subsequent payments from the customers to the financier, in return for which it earned the consideration of the discounted sum paid to it by the financier, Sovereign had not purported to assign to reinsurers the entitlement to receive subsequent premiums. Rather, Sovereign was receiving a refundable commission subject to a commitment to effect repayment with interest out of specified portions of subsequent premiums that Sovereign was the only entity contractually entitled to receive. Therefore whereas the structure of the transaction between the retailer and the financier in a sale of book debts entitled the retailer to treat the amount received from the financier as earned by it, Sovereign could not adopt that stance when it received the refundable commissions subject to an obligation to repay them.

[198] The difference in the respective positions of retailers who sell book debts, and Sovereign as recipient of refundable commissions, is qualified to a degree if the financier of book debts retains the right to claim amounts outstanding from the retailer in the event of default by the purchasers. That contingent liability for the retailer qualifies the entitlement to treat the factored book debts as income, but does not remove the material distinction that factoring provides a means for the retailer to realise sales income, whereas the refundable commissions are a form of financing for Sovereign.

[199] A further difference in the structure of the transactions is that factoring of book debts customarily relates to the total deferred consideration payable to the retailer for the sale of goods. In comparison, Sovereign's obligations involve apportioning future periodic payments, payable at the option of the policyholder for continuing the contract of insurance. That is, the purchaser's unconditional commitment to the retailer is different from the qualified prospect of further premiums from policyholders which may cease at any time on the policyholder's election to allow a policy to lapse, or on the death of the life assured. It is

inconsistent with Sovereign's case on the materiality of lapse risk to overlook this distinction in the circumstances of legal entitlement to, and the nature of, future cash flows from the retailer's customers when compared with the prospect of subsequent payments from Sovereign's policyholders.

[200] Sovereign's argument on this point also overlooks its insistence in other aspects of its case on the interdependence between reinsurance of mortality risk, and the provision of refundable commissions. On Dr Pyhel's approach, the reinsurer's interest is not simply in making a financial margin on its business of advancing commissions, but also in making a reinsurer's profit on the mortality risks reinsured. The prospects of achieving each of those objectives is affected by the performance of Sovereign's policyholders. That dynamic distinguishes the commission arrangements from a sale of book debts, where the retailer's customer has an unqualified commitment to pay for the goods purchased, whereas policyholders are not committed to subsequent years' premiums, and that uncertainty is material to the relationship between Sovereign and its reinsurers.

[201] Accordingly, notwithstanding strong urgings from Mr McKay that I treat the commission arrangements either as a sale of future cash flows or book debts, or as partial reimbursement for the costs of establishing the policies to which the treaty related, I am not prepared to give any of those unacknowledged characters to the commission arrangements. The payments of commissions and their repayment were in the nature of financing. If the deferral aspect of repayments is removed, there would be a contemporaneous exchange of the same amounts, namely the base component. Such a contemporaneous "cheque swap" would be devoid of other relevant commercial purpose. The money flows comprising the base component therefore do not have taxable status.

Base component of money flows capital in character?

[202] The final alternative contention for the Commissioner, in the event that the accruals rules do not apply to the commission arrangements, is that the base component is capital in character, and therefore to be disregarded for income tax purposes. This amounts to an additional basis for rejecting Sovereign's

characterisation of the base component as assessable income and deductible expenditure.

[203] In terms of core provisions in the Income Tax Act, s CD 5 of the Act, as it applied in the relevant income years, provided that the gross income of a person includes any amount that is included in gross income under ordinary concepts.

[204] Section BD 2 defined allowable deductions essentially as the extent of expenditure or loss incurred by a taxpayer in deriving the taxpayer's gross income, or necessarily incurred by the taxpayer in the course of carrying on a business for the purpose of deriving the taxpayer's gross income. Exclusions from that broad definition included, at the relevant time, amounts of expenditure of a capital nature (in s BD 2(2)(e)).

[205] Mr Goddard argued that Sovereign could not treat the refundable commissions it received as being "earned", which would be necessary for them to be treated as income. Rather, because they were refundable, they were a source of financing accommodation which required, in a capital/income distinction, that they be recognised as capital.

[206] In terms of accounting treatment, Sovereign had treated the refundable commissions as revenue, but then offset all commissions received by increasing the policy liabilities recognised for the purposes of its profit and loss account, by the same amount. Therefore in the accounting sense there was no impact on the profit and loss account, which the Commissioner treated as an additional indication that the commissions could not be treated as income. It also followed that because the profit was not increased by the receipt of the refundable commissions, on a true and fair view of the company's financial position it was wrong to treat them as income.

[207] Mr Goddard contrasted commissions of the more usual type paid to brokers or other intermediaries who sold insurance policies, in which case the commission amounted to remuneration earned by the seller of the policy and, in usual circumstances, was entitled to be retained by the broker. That entitlement is subject to the limited exception of an obligation to repay part of the commission earned in

the event of early termination of the policy by the policyholder. However, subject to the policy remaining on foot for a stipulated period, such as 18 months, those commissions represent income earned by the seller of the policy.

[208] In contrast, the anticipated position on receipt of the refundable commissions is that they would be repaid to the reinsurer with interest, either from on-going premiums on the policies to which the refundable commission payments related, or from surplus components of premiums paid on other policies. That anticipated outcome involved complete repayment of the commissions, which is antithetical to their initial receipt by Sovereign being treated as income earned by it.

[209] The commission arrangements are structured on the basis that the reinsurers will get their money back, plus interest, but subject to a risk that adverse events will prevent that happening. The purpose of those arrangements is financing of the costs of initiating policies, and they are designed to tailor the timing of repayments to Sovereign's subsequent money flows. Sovereign accepted that it is a form of financing.

[210] As to Sovereign having less than the usual unqualified commitment to repay the advances it receives, the Commissioner invited an analogy with authority which states that limits on a lender's recourse to specific assets or circumstances does not alter the status of an advance. Mr Goddard cited from an Australian decision of the Full Federal Court on appeal in *FCT v Firth*.[80] That case involved the deductibility of interest costs on borrowings undertaken to finance share investments. Interest rates incurred of between about 17.3 to 19.3 per cent per annum were treated by the Commissioner as including a discrete component of consideration in return for the lender limiting the assets to which it would have recourse for repayment of the loans, to the shares intended to be purchased with the proceeds of the loans. In upholding the taxpayer's challenge to the apportionment of interest costs, all of which had been claimed as deductible, Hill J observed for the Court:[81]

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80 *FCT v Firth* 2002 ATC 4346 (FFC).
81 At [73]-[74].

> More fundamentally, it is not in our view correct to say that a provision limiting a lender to recourse to particular funds or assets for repayment of an advance is inconsistent with the transaction being characterised as a loan.
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> …
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> It is well established that it is possible to have a contract of loan in which the parties agree that the lender is limited to recourse to particular funds or assets for repayment of the loan:
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> …
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> Where the lender's recourse is limited to particular funds or assets, the possibility that the funds or assets will be insufficient to recoup the advance in full is a risk incurred by the lender. That risk will ordinarily be reflected in the rate of interest charged on the moneys borrowed. Nonetheless, the limited recourse feature of the transaction does not alter its character as a loan.

[211] By analogy, the limitations on the financier's recourse cannot be determinative in depriving the commission arrangements of loan-like character, when analysing the base component as provision of working capital by the financier to the recipient of the finance.

[212] Here, the risk that adverse events will prevent complete repayment to the reinsurer is at least partially addressed by the finite obligation Sovereign would have to repay all outstanding amounts when any of a range of signals of financial or regulatory stress arise. Although in many contingencies, that fall-back position may not adequately protect the reinsurer's financial interests, it is relevant to the analysis of the legal position between the provider and the recipient of the financing. Its effect is that in a range of circumstances where the Bonus Account may not, or is likely not to, amortise, that risk triggers an obligation for Sovereign to repay all the amounts outstanding.

[213] In all these circumstances, I am satisfied that the base component in the money flows within the commission arrangements is capital in nature. The consequence is that, if I were wrong to treat the accruals rules as applying to the commission arrangements as a financial arrangement, then, on application of core taxing provisions, the base component in the refundable commissions received and repayments made by Sovereign would be excluded for the purposes of calculating taxable income. That conclusion coincides with my finding in rejecting Sovereign's

alternative proposition, namely that even if the accruals rules apply to the additional component of the commission arrangement money flows, then the base component is to be dealt with as constituting taxable income and assessable deductions. I have found that not to be the case.

Conclusion

[214] In summary, I have found that the commission arrangements are to be considered separately from the other components of the money flows under the treaty, and that those commission arrangements constitute a financial arrangement for the purposes of the accruals rules. They are not a contract of insurance so as to qualify as an excepted financial arrangement.

[215] Once the accruals rules are applied to the additional component representing the consideration for deferral of Sovereign's repayment of the amounts received as commissions, the base component of those money flows becomes irrelevant for income tax purposes. Sovereign is therefore wrong in its alternative contention that the commissions received and subsequent repayments should be added respectively to its assessable income and deductible expenses.

[216] Against the contingency that I am wrong in upholding the Commissioner's application of the accruals rules, then on the alternative contention for the Commissioner, the base components in the money flows comprising refundable commissions received, and repayment of the commissions by Sovereign, are capital in nature and the interest component would be the only part of the money flows that is relevant for income tax purposes.

Costs

[217] The Commissioner has succeeded in defending the assessments and is entitled to costs. If the parties cannot agree the issues as to costs, I will, in the first instance at least, receive memoranda.

[218] I am grateful to all counsel for the manner in which they focused constructively on the issues requiring determination and dealt efficiently with the relatively dense subject matter of the proceedings.

Dobson J