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# WEEKLY COMMENT: FRIDAY 14 SEPTEMBER 2012

1. The recent case *Sovereign Assurance Company v Commissioner of Inland Revenue* [2012] NZHC 1760 serves to underline the breadth and depth of the financial arrangements rules. The case concerned the New Zealand tax treatment of a series of cash flows between Sovereign and foreign reinsurers recorded in a "Bonus Account".

2. This week I look at:

   - The facts of the case;
   - The tax treatment by Sovereign;
   - The accounting treatment;
   - The Commissioner's view; and
   - The decision: the implications for the financial arrangements rules

**Facts of the case**

3. Sovereign issued life insurance policies and reinsured the mortality (i.e. death) risk with the foreign reinsurers. Sovereign paid premiums and the reinsurers paid out on claims by Sovereign.

4. The premiums and the claims paid were recorded in the Bonus Account ("the Account"). The premiums resulted in credits to the Account and the claims paid by the reinsurers resulted in debits to the account.

5. But there was a second series of cash flows that were also recorded in the Account. These were the payment to Sovereign of refundable commissions by the reinsurers that resulted in debits to the Account, and the repayment by Sovereign of the refundable commissions that resulted in credits to the Account. The refundable commissions were a type of financing. Sovereign's initial costs upon issuing a life insurance policy exceeded the initial premiums received. So the reinsurers financed Sovereign by paying a multiple of the initial premiums as refundable commissions. Sovereign repaid the refundable commissions out of subsequent years' premiums. The amount repaid included an interest component to compensate the reinsurers for financing Sovereign's initial insurance costs. The interest charge also resulted in debits to the Account.

6. In essence, therefore, the Account recorded the payments by Sovereign to the reinsurers as credits, and the payments by the reinsurers to Sovereign as debits. Any excess credit balance constituted a profit share to which Sovereign became entitled.

**The tax treatment by Sovereign**

7. Sovereign treated the receipt of the refundable commissions as income and the repayments as deductions. Sovereign's basis for this treatment was that the refundable commissions formed part of the reinsurance arrangements and were therefore excluded from being financial arrangements under the exclusion for insurance contracts as excepted financial arrangements.

8. Central to Sovereign's treatment was the contention that the refundable commissions were an integral part of the insurance contracts and could not be "unbundled". Sovereign maintained that the receipt and repayment of the refundable commissions could not be separated from the payment of premiums and the receipts in respect of claims relating to the reinsurance of the mortality risk. In other words, the cash flows relating to the refundable commissions could not be separated out and have a different tax treatment applied to them.

9. In support of its adopted position of not treating the refundable commissions separately, Sovereign relied on the Court of Appeal decision in *Marac Life Assurance Limited v Commissioner of Inland Revenue* [1986] 1 NZLR 694 (CA). That case concerned the status of certain "life bonds" issued by Marac that contained both investment and life insurance components. The Court of Appeal held that the investment component should not be separated out, and that the entire life bonds were a form of life insurance, receipts in relation to which were exempt from income tax under the rules that applied at the time.

10. It should be noted, however, that in *Marac* there was a single undifferentiated premium paid, a factor that proved to be important in the decision in Sovereign's case.

11. Sovereign's tax treatment of the repayments of the refundable commissions as deductible expenditure resulted in tax losses that were made available to other companies in the tax group to which Sovereign belonged.

**The accounting treatment**

12. Sovereign adopted NZ IFRS 4 earlier than required so that it applied to its 2006 accounting year. That standard restricts the categories of transaction that can be treated as insurance contracts to those that involve a significant insurance risk. Furthermore, if a contract qualifies as an insurance contract, then it remains such until all rights and obligations are extinguished, or expire. In effect, once an insurance contract, always one.

13. In Court, Sovereign argued that the refundable commissions were part of its reinsurance arrangements for accounting purposes. Sovereign resisted any separation of the reinsurance premium/claim and refundable commissions/repayment components in reliance on the provisions in NZ IFRS 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.

14. In terms of the specific accounting treatment accorded the refundable commissions, 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 an accounting sense there was no impact on the profit and loss account.

15. The expert witness for the Commissioner, Mr. Hagen was firmly of the view that a true and fair view required Sovereign to treat the refundable commissions as a financing arrangement, and that such treatment was required to comply with NZ IFRS 4.

**The Commissioner's view**

16. The Commissioner maintained that the refundable commissions were a financial arrangement. Therefore, the receipts were not income and the payments were deductible only to the extent of the interest element.

17. From Sovereign's view this was significant because a shareholding change meant that deductions available in earlier years due to the receipts not being income could not be carried forward and used.

18. As a fall back, the Commissioner argued that the underlying transaction was capital in nature so the receipt was not income in any event, and the repayments were deductible only to the extent of the interest element.

19. The disallowance of the deductions would result in a tax liability of $45m as well as interest of around the same amount.

**The decision: the implications for the financial arrangements rules**

20. Dobson J held that the refundable commissions and the repayment thereof amounted to a financial arrangement and the repayments were consequently deductible only to the extent of the interest element. In doing so he made some key observations about the operation of the financial arrangements rules.

21. **First, he noted that the scope of the rules is extremely broad**. He quoted paragraph [205] from Susan Glazebrook and others *New Zealand Accrual Regime – a Practical Guide* (2nd edition, CCH, Auckland 1999) as follows:

    "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."

22. **Second, His Honour decided that a single agreement, such as the reinsurance treaties at issue, could be separated into two (or more) components for the purposes of applying the accruals rules**. His reasons were as follows:

    (a) Paragraph (b) of the definition of "financial arrangement" in s. EH 14 of the Income Tax Act 1994 is couched in very broad terms, and includes:

    "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)…"

    His Honour noted at para [76] that the words in brackets "refer to an (implicitly larger) arrangement that may contain a debt or debt instrument, or an excepted financial arrangement.

[Note: the corresponding definition in s. EW 3(2) of the Income Tax Act 2007 does not contain the phrase in brackets "(whether or not etc.)" but there is no basis for concluding that the definition in the 1994 Act has been constrained in any way.]

(b) S. EH 2 of the Income Tax Act 1994 dealt with an excepted financial arrangement that is part of a financial arrangement and stated that:

"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 accrual 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."

[The corresponding provision in the Income Tax Act 2007 is s. EW 6(2).]

(c) His Honour noted at para [77] that the following features "*point to a process for deconstructing component parts of wider arrangements, so as to apply the accrual rules either to the financial arrangements within a larger arrangement, or to the components of a financial arrangement that qualify*" (emphasis added). It is only where the money flows are solely attributable to an excepted financial arrangement that they are excluded:

(i) The definition of "financial arrangement" contains an exclusion for excepted financial arrangements where they are not part of a financial arrangement; and

(ii) The definition of "financial arrangement" contemplates the inclusion of an excepted financial arrangement in an "arrangement", then excludes an excepted financial arrangement that is not part of a financial arrangement; but

(iii) The exclusion under s. EH 2 is limited to those items that are "*solely* attributable" to an excepted financial arrangement that is part of a financial arrangement.

(d) His Honour noted further at para [78] that:

"*The accrual 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." (emphasis added)

(e) Finally, His Honour noted that the concepts of "deemed" income and expenditure are consistent with separately identifying and dealing with financial arrangements for tax purposes. He stated at para [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*." (emphasis added)

23. **Third, Dobson J concluded that the prescribed tax treatment under the financial arrangements rules overrides any accounting treatment adopted by the taxpayer.**

    (a) He referred at para [121] to:

    "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."

    (b) Further at para [128] he stated:

    "I am satisfied that a separate analysis of the commission arrangements is required by the accrual rules, and that this requirement applies independently of whether the accounting standards would require the same treatment in any event."

    (c) His reasons included the following:

    (i) The prospect of treating money flows differently for financial reporting and accounting purposes was recognised by the Court of Appeal's caveats in both *CIR v National Bank of New Zealand* (1976) 2 NZTC 61,150 (CA) at 61,159 and *CIR v Farmers Trading Company Ltd* (1982) 5 NZTC 61,200 (CA) at 61,205, to the effect that accounting principles should apply "except so far as the statutory provisions require otherwise".

    (ii) 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.

    (iii) The statutory terms of the accrual 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 accrual rules, if they applied, ought to require consistent results.

    (iv) 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.

24. **Fourth, whether or not a component of a financial arrangement is an excepted financial arrangement needs to be considered in terms of the statutory definition of the particular excepted financial arrangement, if there is one, or if not, the definition of the concept applying more generally at common law should be used**. In Sovereign's case, there is no definition of "contract of insurance" in the Act, so the common law definition applied. Dobson J found that at some point the transference of risk had lapsed to a point where it was no longer significant. He also found that there was no significant timing risk in relation to the timing of the repayments to be received by the reinsurers.

25. **Fifth, it is possible that the underlying components of the financial arrangement may remain taxable under ordinary (non-financial arrangements rules) taxing provisions**. For example, a sale of revenue account property for a deferred consideration would give rise to tax implications in terms of both the financial arrangements rules and under general tax provisions. However, that did not apply in Sovereign's case, as the receipt of the commissions

and the repayment thereof without a deferral would have merely amounted to a cheque swap with no general tax consequences.

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