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WEEKLY COMMENT: FRIDAY 4 APRIL 2014

1. This week I look at the Court of Appeal judgment in *Sovereign Assurance Co Ltd v C of IR* [2013] NZCA 652. I reviewed the High Court judgment in *Weekly Comment* 14 September 2012. The facts of the case are clearly set out there, together with the implications of the decision for the way the financial arrangements rules are to be interpreted. The Court of Appeal decision is primarily concerned with whether the payments were capital or revenue in nature.

The High Court decision and the basis for Sovereign's appeal

2. Sovereign Assurance Company Limited ("Sovereign") reinsured its life insurance policies with foreign reinsurers. Premiums were paid to the foreign insurers based on the "mortality risk" of Sovereign's policyholders (i.e. the risk of them dying) and claims were made as they died. This was the ordinary reinsurance part of the arrangements.

3. The reinsurers also funded, at interest, Sovereign's initial costs of issuing policies, which typically exceeded initial premiums charged, sometimes by quite a significant margin. Sovereign repaid these funds plus interest out of subsequent years' premiums. For tax purposes, Sovereign treated all of the funds received as income, and all of the funds repaid, including the interest, as tax-deductible expenditure.

4. The judge in the High Court found that the provision of the funds and their repayment were financial arrangements, and only the interest was tax-deductible. The receipt and repayment of the principal sums were non-taxable and non-deductible, respectively. This adversely impacted Sovereign because:

   (a) The income had been returned in earlier years than the expenditure;

   (b) Sovereign was in a tax loss position, so the reversal of the income returned in earlier years merely increased the tax losses;

   (c) In the intervening period there was a shareholding continuity breach and the tax losses could not be carried forward;

   (d) The reversal of the expenditure in subsequent years resulted in a substantial tax liability of around $90 million, including interest.

5. Sovereign accepted the High Court judgment that the funds flows were financial arrangements. Sovereign's appeal to the Court of Appeal concerned the tax treatment of the principal sums. Sovereign argued that:

(a) The tax treatment of the principal sums falls to be determined by other (non-financial arrangements) provisions in the Income Tax Act;

(b) The inflows were the result of sales in the ordinary course of its business and were taxable, and the corresponding outflows were costs of sales and, therefore, tax deductible; and

(c) Sovereign sold, and the reinsurers bought, through the particular funding in question, "persistency risks" relating to the life insurance business.

6. "Persistency risk" was explained as follows in the Court of Appeal judgment:

   "[16] A life insurer seeks to recover its policy set-up costs by loading the initial premiums. But, even after loading, its establishment expenses are generally two or three times the level of the first year's premium payment. Recovery of these costs usually requires about five or six years, leaving the insurer with a loss if a policy lapses or a claim arises before that break-even point. This risk is known as a lapse or persistency risk."

7. In order to prove that the funds had been received for the sale of persistency risk, Sovereign had to show that that the risk had been transferred – i.e. that the reinsurers were not entitled to be repaid if the risks materialised.

8. In support of this, Sovereign argued that it had ceded good quality life insurance contracts to cover both mortality risk and the persistency risk, and that both types of risks had been assumed by the reinsurers. The ordinary reinsurance premiums and claims related to the transfer of mortality risk and the "financial arrangements funds flows" related to the transfer of persistency risk.

The Court of Appeal decision

9. The judges in the Court of Appeal agreed with the High Court judge that the financial arrangements rules applied. Sovereign was the issuing party for the financial arrangement. In calculating its gross income or expenditure the company was required to take into account:

   (a) First, all amounts relating to the financial arrangement – that is the commission repayments spread over time (mortality risk reinsurance premiums which related to the contract of insurance were excluded); and

   (b) Second, the acquisition price of the financial arrangement – all the commissions and other payments made by the reinsurer under the treaty (but again for the same reason excluding other receipts such as mortality claim payments).

10. The Court of Appeal was also of the view that the funds from the reinsurers were not received as sale proceeds for anything that was sold by Sovereign. No property was transferred under the financial arrangement so it was not necessary to treat the acquisition price as the value at which property was transferred. The financing part of the reinsurance treaties simply provided financing.

11. However, as an additional measure, the Court of Appeal addressed the possibility that the transactions fell for consideration under the ordinary provisions of the Income Tax Act. In this regard, the focus of Sovereign's appeal was on whether the commission payments made by the reinsurer constituted income. If not, the commission repayments made by the company were not deductible expenditure.

12. The Court of Appeal discussed the following principles, based on the leading cases, relating to whether to characterise a payment or receipt as capital or income in nature:

    (a) First, when considering the application of a specific taxation provision the focus is on the legal structure the parties have created, not on its economic effect or consequences. So what is required is an objective determination of the parties' respective rights and obligations as if the Court were deciding a dispute about the meaning and effect of certain contractual provisions. The relevant documents must be construed in their commercial context. An appreciation of the factual matrix is essential.

    (b) Second, the inquiry is concerned with what from a practical and business point of view the receipt of funds was intended to effect "... rather than upon the juristic classification of the legal rights" used by the parties but, for the reason stated above, practical business considerations do not exclude a contractual analysis.

    (c) Third, and of central importance in this case, the necessity of earning is inherent in the circumstances of receipt if a payment is to qualify as income. While the recipient may become the beneficial owner of funds on receipt, the payment will lose the quality of income derived if it is subject to a contingency that the whole or any part may have to be repaid. In that situation it cannot be said that the payment was earned. In connection with this point, the High Court of Australia decision in *Arthur Murray (NSW) Pty Ltd v Commissioner of Taxation of the Commonwealth of Australia* [1965] HCA 58, (1965) 114 CLR 314 was cited with particular approval.

    (d) Fourth, the presence of certain indicia or factors may assist in conducting the inquiry. But they are not decisive and their relevance will vary according to the circumstances and by fact and degree. What is required is a common sense appreciation of the guiding circumstances. Some of the relevant criteria include the occasion calling for the receipt, whether the sums are used for fixed or circulating purposes; whether the sums were of a once and for all nature, creating assets or advantages of enduring benefit, the treatment of the payments on ordinary principles of commercial accounting, and whether the payments were applied to the business structure or part of the process for earning income - i.e. the factors discussed in *BP Australia Ltd v Commissioner of Taxation of the Commonwealth of Australia* [1965] UKPC 23, [1966] AC 224 (PC).

13. The Court of Appeal then performed a contractual analysis. It was noted that the consistent theme running through the various descriptions of the payments put forward by Sovereign were of "monies advanced to and repayable by an insurer for the purpose of financing its policy establishment costs".

14. The Court held there was no agreement to share liability for Sovereign's "lapse" or "persistency" risk – refer to paragraphs 5 to 8 above. The Court of Appeal approved the observation by the High Court that lapse risk cannot logically be the subject of a contract of insurance because it cannot give rise to a contingency, which might adversely affect the assured.

15. Sovereign could not successfully argue that the receipts were income because they reimbursed costs. The Court of Appeal stated "there is a subtle but important distinction between the parties' assessment of commission payments according to the insurer's underlying premium allocation to expenses and a calculation based on reimbursing actual costs".

16. An underlying commercial risk does not represent a transfer of lapse risk under a contact of insurance. An underlying commercial risk is a frequent feature of lending transactions for which the insurer is normally compensated by an appropriate interest rate. That fact does not change the essential legal character of the transaction.

17. Sovereign's alternative primary argument was that its contractual obligation was limited to passing on to the reinsurer agreed proportions of premiums if and when they were received, and the underlying transaction was one of a sale, assignment or transfer of funds. However, the Court of Appeal found that the consideration for reinsurers' agreement to pay was Sovereign's promise to repay the same amounts with interest at a later date, not a promise to sell its stock in trade.

18. Importantly, as Sovereign's need for outside financing abated, the amount of commission flows diminished. The fact that the cash flows were steadily shrinking to the point of extinction in November 2004 did not sit easily with what was said to be a commercial agreement to sell them.

19. Sovereign was unable to point to any express contractual provision or anything in the commercial matrix to support its argument. The Court noted:

    "[103] … It is unsurprising that the treaty made no reference to what is now said to be its primary purpose".

20. Where money has been received conditional on the recipient's performance, or subject to an obligation to repay, it is not normally earned for income tax purposes. Sovereign received the money subject to an obligation to repay it.

21. Finally, the Court of Appeal noted that:

    "[115] … accounting treatment cannot prevail over a principled contractual analysis. Rather, as the evidence confirms, it should follow legal substance to reflect a true and fair view. In the circumstances, we do not think it can safely be concluded that accounting practice required that the commission payments be treated as income."

Arun David, Director

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