IN THE COURT OF APPEAL OF NEW ZEALAND

CA506/2012
[2013] NZCA 652

BETWEEN	SOVEREIGN ASSURANCE COMPANY LIMITED First Appellant
	ASB BANK LIMITED Second Appellant
	SOVEREIGN SERVICES LIMITED Third Appellant
	CBA ASSET FINANCE (NZ) LIMITED Fourth Appellant
	CBA FUNDING (NZ) LIMITED Fifth Appellant
	CBA DAIRY LEASING LIMITED Sixth Appellant
AND	COMMISSIONER OF INLAND REVENUE Respondent

Hearing:	3, 4 and 5 September 2013
Court:	Harrison, White and Miller JJ
Counsel:	L M McKay and M McKay for Appellants D J Goddard QC and H W Eberesohn for Respondent
Judgment:	17 December 2013 at 11.30 am

JUDGMENT OF THE COURT

A The appeal is dismissed.

B **The appellants are to pay the respondent costs for a complex appeal on a band B basis and usual disbursements. We certify for two counsel.**

REASONS

Harrison and Miller JJ [1]
White J [128]

HARRISON AND MILLER JJ

(Given by Harrison J)

Table of Contents

	Para No
Introduction	[1]
Commercial context	[11]
Gerling reinsurance treaty	[22]
Article 1	[23]
Article 2	[24]
Articles 4 and 5	[26]
Article 9	[34]
Article 20	[35]
Article 21	[36]
Supplementary documents and agreements	[37]
Issue one: Accruals regime	[42]
Issue two: Legal nature of the base component – capital or revenue?	[61]
Principles	[63]
Contractual analysis	[71]
(a) Cession of shared mortality and persistency risks	[75]
(b) Finding of transfer of lapse risk	[84]
(c) Transfer of future cash flows	[88]
(d) Extreme lapse risk	[98]
(e) Original terms reinsurance	[104]
(f) Miscellaneous factors	[108]
Conclusion	[116]
Result	[126]

Introduction

[1] In its formative years as a life insurer Sovereign Assurance Co Ltd needed two distinct types of financial assistance. The first was of a contingent but orthodox nature, to secure reinsurance against its risks on claims made under life policies. The company was able to satisfy this requirement by entering into treaties with well resourced reinsurers whereby it ceded or passed on most of its insured risks.

[2] Sovereign was able through the same treaties to satisfy its second financial requirement – to fund its costs of establishing the policies. The parties employed a financing mechanism which was well established in the reinsurance industry. The reinsurers agreed to make advances to Sovereign by paying commissions on policies ceded under the treaties; and the company agreed to pay the reinsurers commission repayments in amounts equal to the commission payments (the base component) plus an interest component (the excess component).

[3] What is at issue on this appeal is the correct taxation treatment of these reciprocal but unequal commission flows. To use Mr McKay's simple example, Sovereign assessed its taxation liability by treating (a) every $100 of commission received as income in the year of receipt; and (b) every $150 of commission repayments – that is, the aggregate of the base ($100) and excess ($50) components – as deductible expenditure in the year of payment.

[4] However, the Commissioner reassessed that liability for the 2000 to 2006 years. She treated Sovereign's $100 receipt as non-taxable and its payment of the equivalent $100 base component as non-deductible. By this means she effectively offset or disregarded the two commission flows to the extent that they were equal. As a result, only the remaining $50, the excess component, was allowed as a deductible expense.

[5] Following a six week trial in the High Court, Dobson J agreed with the Commissioner.[1] His primary finding that the Commissioner was entitled to reassess

[1] *Sovereign Assurance Co Ltd v Commissioner of Inland Revenue* [2012] NZHC 1760 [High Court decision].

Sovereign's liability to tax under the accruals rules in subpt EH of the Income Tax Act 1994 (the ITA) is not challenged.

[6] Sovereign's appeal is limited to the Judge's subsequent findings that (a) the commissions when received and the base component of the commission repayments when paid were not respectively assessable income and deductible expenditure under the ordinary or non-accrual provisions of the ITA; and (b) both items were of a capital nature, with the result that the commissions were not earned as income on receipt. The focal point of Sovereign's argument on appeal was whether the latter finding was correct. While directly engaging on that argument, the Commissioner argues that Dobson J's finding that the accruals rules govern Sovereign's liability to tax is decisive against its appeal.

[7] What, it may be rhetorically asked, does the dispute matter when on both approaches Sovereign was entitled to a net deduction against its liability to tax of $50? The issue is one of timing. If its challenge fails, Sovereign faces a potential liability of up to $90 million including use of money liability. The company was in a tax loss position before its acquisition by ASB Bank Ltd in December 1998. The effect of the Commissioner's reassessments is to reallocate and increase its losses in that period. Sovereign's change of ownership means that these losses are unavailable to shelter its increased liabilities to tax from 2000.

[8] The fiscal effect of the Commissioner's reassessments is reflected by reference to Sovereign's liability to tax in two successive income years. In 2001 the Commissioner disallowed Sovereign's claim for deductions for commission repayments of $55.564 million and removed from the company's gross income commissions of $31.917 million, increasing the level of taxable income derived by $23.647 million. In 2002 the Commissioner disallowed Sovereign's claim for deductions of $38.223 million for commission repayments and removed commissions of -$1.773 million, increasing taxable income by $39.997 million.

[9] Before addressing the merits of Sovereign's appeal we record some introductory points. One is that the focus of the company's objection to the Commissioner's reassessment has retrenched significantly following the

abandonment of its primary challenge to the Commissioner's application of the accruals rules. In the result, what were relatively subsidiary questions before Dobson J are now at the forefront of Sovereign's appeal. Another is that the positions adopted by the parties before us are inconsistent with those adopted by each at earlier stages of the reassessment and disputes process; and also with the stances traditionally taken by the Commissioner and a taxpayer on disputes about whether an item is received or paid on capital or revenue account. And another is that we are required to determine this appeal primarily by reference to a contractual instrument drafted by actuaries steeped in insurance practice, not by lawyers, and originally recorded in the German language but later translated into English.

[10] The treaties and supplementary instruments governed the relationship between Sovereign and its reinsurers and the character of the underlying financial transactions. The company's appeal against the finding that the commissions were of a capital rather than revenue character will be determined primarily by our construction of the provisions of what is agreed to be a representative treaty. For that reason, we shall first outline the factual or commercial matrix, before summarising the treaty's relevant terms and conditions, Dobson J's findings and the applicable legal principles. Our analysis will then follow.

Commercial context

[11] There is no dispute about the relevant facts which are set out comprehensively in the High Court judgment.[2] They can be summarised more briefly for the purposes of this appeal as follows.

[12] Sovereign was founded by Messrs Chris Coon and Ian Hendry and commenced business in New Zealand as a life insurer in 1989. Mr Coon had qualified as an actuary in the United Kingdom and had considerable life insurance experience. Sovereign was in immediate competition with more established players – either mutual life companies or United Kingdom owned proprietary companies which enjoyed significant capital reserves and stable portfolios of business.

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2 At [1]–[42].

[13] As a new and privately owned company with relatively little capital, Sovereign faced three discrete financing strains. The first strain arose from a life insurer's core business of undertaking a liability to indemnify another party against the adverse financial consequences of a defined risk imposed through the medium of a policy of insurance. The defined or insured risk for a life insurer is the risk of mortality, or more particularly an obligation to make certain payments on the death of a life assured.[3] Life insurers frequently cover themselves against this contingent financial liability by transferring a large part of their legal obligations to well-resourced reinsurers. The cost of reinsuring is determined in accordance with the same pricing methodology which governs the original contract of insurance. Like the life assured, the insurer pays to the reinsurer a premium representing a price calculated by reference to the insured risk in return for the reinsurer's undertaking to meet its proportionate share of claims made against the insurer.

[14] To give context to what follows, it is appropriate to summarise the legal nature of a contract of reinsurance. As the authors of *MacGillivray on Insurance Law* state:[4]

> The object of reinsurance is to indemnify the reinsured against liability which may arise on the primary insurance. The reinsurance is a separate contract from the original insurance, so that there is no privity of contract between the insured and the reinsurer. ... It is neither an assignment nor transfer of the original insurance business from one insurer to another, nor is it a relationship of partnership or agency between insurers. It is essentially an independent contract of insurance whereby the reinsurer engages to indemnify the reinsured wholly or partially against losses for which the latter is liable to the insured under the primary contract of insurance.

[15] Sovereign's second financial strain arose from a related commercial risk, described as the risk of a policy ceasing to generate premium revenue, most commonly because the life assured elects to discontinue the policy. Insurers incur substantial one-off costs in writing a new life policy. Included are commission payments to agents (typically commissions paid by Sovereign equalled or exceeded the first year's premium), medical examination expenses and administrative fees.

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[3] See further at [75]–[83] below.

[4] John Birds, Ben Lynch and Simon Milnes *MacGillivray on Insurance Law* (12th ed, Sweet & Maxwell, London, 2012) at [34-002].

[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.

[17] As between these two strains, insurers usually allocate about 50 per cent of the underlying premium to the mortality risk and 40 per cent to the persistency risk. The remaining 10 per cent is allocated to a profit component.

[18] The third financial strain, unique to a newly established life insurer, is the need to establish balance sheet reserves for potential future liabilities. This new business strain can inhibit an insurer's ability to use cash flows to write policies and grow its business. As Dobson J recited:

> [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, 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.
>
> (Footnote omitted.)

[19] While borrowings may meet the company's cash flow strains arising from policy establishment costs, they could not relieve its solvency or capital strains. However, as Mr McKay emphasised, a contract qualifying for accounting and actuarial purposes as a contract of reinsurance could meet both cash flow and solvency pressures.

[20] Sovereign entered into treaties with German reinsurers in October 1993 with effect from 1 April 1992. By consent, its treaty with Gerling-Konzern Globale (Gerling) is to be treated as the representative arrangement.

[21] Sovereign was an apparent success. Its operations expanded throughout the 1990s. It acquired Metropolitan Life NZ Ltd and in December 1998, after listing on the New Zealand Stock Exchange, it was purchased by ASB Bank, part of the Commonwealth Bank of Australia group. By 2000, the commencement of the period of the Commissioner's reassessments, Sovereign was a dominant and profitable participant in the New Zealand life insurance industry. And by then as a result of its acquisition by ASB Bank the company was able to finance its new business and solvency strains from that source. The treaty was closed to new business from 1 January 2001 and by December 2004 Sovereign had ceased making commission repayments.

Gerling reinsurance treaty

[22] The relevant provisions of Sovereign's reinsurance treaty with Gerling are as follows.

Article 1

[23] Article 1 described the treaty's scope as referring "to all life policies issued by [Sovereign] in its domestic market within the [specified] product range ..." listed in an annexure.

Article 2

[24] This article materially provided that:

> [Sovereign] will cede and [Gerling] is bound to accept the following participations in the policies:
>
> A 38 per cent quota share of the sum at risk on all policies issued by [Sovereign] to any one life, up to a maximum of NZ $200,000 original sum at risk in total on any one life at inception, where the sum at risk per life shall be the difference between the total death benefit insured and the funded value of units allocated to the policy.

[25] Reinsurance by treaty is a mechanism for insuring a large number of risks either by class or by way of whole account.[5] A quota share cession of the type

[5] Robert Merkin *Colinvaux's Law of Insurance* (9th ed, Sweet & Maxwell, London, 2010) at [17-001].

adopted by Sovereign is a process whereby an insurer passes to the reinsurer on a group or portfolio basis an agreed proportion of all risks accepted immediately the policies are written. As has been noted, treaty reinsurance is:[6]

> [A]n agreement for reinsurance, at least in principle, for a number of risks. By this method insurer and reinsurer agree that all risks of the insurer of a certain type or types, and potentially the entirety of the insurer's book of business, will be reinsured by the reinsurer. Individual risks are not assessed by the reinsurer and premiums are decided in advance, reducing administrative costs and ensuring certainty of reinsurance cover simultaneously with the direct insurance being placed. The central distinguishing feature of the treaty method of reinsurance is that the insurer is obliged to cede to the reinsurer such risks as he has agreed to cede under the treaty and the reinsurer is obliged to accept those risks. It is the predominant method of reinsurance.

Articles 4 and 5

[26] Article 4 stated:

> [Sovereign] shall pay to [Gerling] the risk premium and the commission repayments on the basis stated in Annex No. 2.
>
> [Sovereign] will continue to pay the required risk premium payments as long as the cessions are in force. The commission repayments will be paid as long as no payments from [Gerling] to [Sovereign] are due under the Bonus Account Agreement.

[27] Article 4 divided Sovereign's liability to pay Gerling into two amounts, allocated separately to the risk premium and commission repayments, and related them to a bonus account. The risk premium was calculated by reference to actuarial tables based solely on annual mortality rates. It was roughly equal to the mortality component or 50 per cent of the underlying premium.

[28] Article 5 provided that:

> For each new poilicy [sic] under this Agreement, [Gerling] shall pay an initial reinsurance commission as stated in Annex No. 3.
>
> No renewal commission, no taxes and no proportion of any procuration or renewal expenses will be paid by [Sovereign].
>
> A bonus will be returned to [Sovereign], the basis of which is stated in the Bonus Agreement.

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6 Colin Edelman and Andrew Burns *The Law of Reinsurance* (2nd ed, Oxford University Press, Oxford, 2013) at [1.50] (footnote omitted).

[29] The annexure described the commission as "refundable", assessed as a percentage of the reinsured proportion of the annualised gross premium and payable as to 85 per cent at inception, with the balance of 15 per cent payable a year later.

[30] The bonus account agreement was a separate one page document which was effectively incorporated within the reinsurance treaty, obliging Gerling to pay to Sovereign:

> 75 per cent of profits emerging after 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 $).

[31] In combination, arts 4 and 5 and the bonus account agreement were designed to provide what is known as deficit account financing to fund Sovereign's second financial strain – its lapse or persistency risk. Both parties accept this statement as an accurate summary of its operation:[7]

> With risk premium reinsurance ... it is possible to provide financing by so-called deficit account financing. Under this arrangement the business is split into tranches (e.g. monthly or quarterly new business). These tranches are all covered by a single treaty, split into two distinct sections:
>
> - Risk premium reinsurance.
> - A cash advance that is typically related to the direct writer's initial commission payments.
>
> The risk premium reinsurance is typically on a quota share basis. This means the same block of business is reinsured under both portions of the Deficit Account Financing, e.g. 30% financing is provided in conjunction with a 30% quota share of the mortality risk.
>
> The cash advance for each tranche of business is debited to a deficit account, established for that tranche, when it is paid to the direct writer. Each deficit account is credited periodically with reinsurance financing premiums, which are an agreed percentage of the reinsured proportion of the office premiums. It is also credited with the reinsurer's share of any clawback of agent's commission. The account is charged interest at an agreed rate on the outstanding financing. The percentage of the reinsured portion of the office premium is normally equal to the margins built into the direct writer's premiums for initial administration expenses, initial commission and profit margin.

[7] Paul Brett and Alex Cowley *Fin Re* (paper presented to the Staple Inn Actuarial Society, 5 October 1993) at 8.

> Once the balance of the deficit account is zero the financing element of the reinsurance arrangement is recaptured by the direct writer, i.e. any subsequent margins are retained by the direct writer. In the final period of each deficit account, it is likely the reinsurance financing premiums payable will be more than is required to repay the outstanding financing. This excess is refunded to the direct writer by the use of an experience refund.

[32] Dobson J aptly described the broad effect of the bonus account agreement and its various money flows in this way:

> [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 ... . 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.

[33] So, in summary, the bonus account regulated four distinct cash flows. The first two were those attributable to cession of Sovereign's mortality risk – its payment of risk premiums and Gerling's settlement of claims – and do not raise any taxation issues. The second two were the commission payments and repayments.

Article 9

[34] This article governed liability between the parties for settlement of claims. Sovereign agreed to advise the reinsurer following receipt of any claims notification together with full details. Gerling's agreement was a precondition to the insurer's right to settle claims, the reinsurer's liability being calculated on the sum at risk for which the premium has been paid.

Article 20

[35] This article covered the commencement and duration of the agreement, with either party entitled to terminate with immediate effect if the other fell into arrears of payments or otherwise breached its obligations.

Article 21

[36] Significantly, this article provided for automatic termination of the agreement upon commencement of winding up proceedings against Sovereign. In that event:

(a) Gerling would immediately be discharged from all liabilities to Sovereign under the treaty, while Sovereign would be entitled to set off outstanding balances due from Gerling (under art 21(3)(a)); and

(b) any claims by Gerling "to repayment of sums paid ..." by it to Sovereign "... in excess of amounts paid by [Sovereign] to [Gerling] together with interest on the excess at 9 per cent per annum" were to be preserved and rank immediately after claims of policyholders (under art 21(3)(b)).

Supplementary documents and agreements

[37] Mr Goddard QC emphasises a number of related documents. Some fell within the factual background to the treaty. One was a memorandum of preliminary negotiations between Sovereign and Gerling representatives on 20 July 1988. The document records their preliminary agreement on the extent of allowance for reinsurer's expenses, the rate of interest at which the outstanding financing balance would be carried forward and the basis for Sovereign's right to a 75 per cent profit share after the bonus account was amortised.

[38] Also relevant is a letter from Mr Coon to Dr Pyhel, a Gerling director, on 7 December 1992. In it Mr Coon referred to Sovereign's proposal that "reassurance commission and refunds" are to be treated separately from risk premiums and claims. He also noted that "[w]hen commission has been refunded with interest the repayments cease ..." unless necessary to cover other areas of business where amortisation has left an amount outstanding; and that "[w]e do not share in mortality profits".

[39] The parties signed a supplementary agreement in May 1995. Mr McKay does not dispute Mr Goddard's observation that during the financial year ending 31 March 1995 Sovereign had identified a need for additional working capital of $3.7 million. Relevantly the agreement provided that:

(a) by art 1 Gerling agreed to pay what was called an "additional commission of $3.7 million to Sovereign" – that is, an amount in excess of commissions already paid by Gerling on existing cessions;

(b) by art 2, Sovereign agreed to pay Gerling an "additional reinsurance commission refund", consisting of cash flows plus the company's profits above an agreed level; and

(c) by art 11, payments were to continue until what was called the "commission memo account" was amortised.

[40] Similarly, Mr McKay does not dispute Mr Goddard's summary of the operation of the memorandum account for this transaction, which we adopt. The account was debited with $3.7 million as at 31 March 1995 together with interest on a quarterly basis under the aegis of a quarterly reinsurance fee; and it was credited with all reinsurance commission refunds and "any additional down payments" made by Sovereign at its discretion. Mr Goddard observes that the cash flows available to make repayments were not limited to specific policies but included a wider funding pool.

[41] Finally, a report completed by Mr Coon on the tax treatment of the reinsurance arrangements dated 19 February 1993 noted:

> The reinsurance commission is effectively split into support for commission and expenses. If a policy lapses in the first 18 months, the part notionally covering commissions is refunded to the reassurer, provided that we are successful in clawing back the broker commission. On lapse the reassurer does not recover the expense support.
>
> The amortization schedule of reassurance commission refunds allows for the reassurer losing on lapses and the time cost of money. When the commission has been fully amortized, the refund level is reduced.

Issue one: Accruals regime

[42] The primary issue at trial in the High Court was whether the Commissioner had correctly relied on the accruals rules to reassess Sovereign's liability for the 2000 to 2006 income tax years:[8]

> ... 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.

[43] As Dobson J noted:

> [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.

[44] A great deal of argument and evidence was directed towards this primary issue. The Judge found that the accruals rules in subpt EH of the ITA applied to both the commission payment and repayment features of the treaties. He severed these commission arrangements from the balance of the cash flows under the reinsurance treaties. Thus the essential components of the treaty could be separated into, first, the mortality reinsurance provisions which constituted a contract of insurance and were thus an "excepted financial arrangement", and, second, the commission arrangements which did not constitute a contract of insurance and were not separately "excepted". They were the two distinct parts for the purposes of the accruals regime.

[45] As a consequence, s EH 2 applied to all cash flows under the composite financial arrangement which were not solely attributable to the excepted financial arrangement; that is, it applied to the commission payments and repayments. They had to be spread over the relevant period and as they cancelled each other out, only

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[8] High Court decision, above n 1, at [7].

the interest flows were left as deductible. So, to revert to Mr McKay's example, only the $50 excess was deductible.

[46] Sovereign has not appealed Dobson J's findings that the two distinct parts of the treaty should be unbundled and that the accruals rules applied. Nevertheless, as in the High Court, Mr McKay submits that those findings are not decisive. He says the taxation status of the $100 base component of the commission flows must be determined on first principles. In his submission, the finding that the $50 excess is deductible as interest does not determine the legal character of the underlying arrangement irrespective of the application of the accruals rules.

[47] Mr Goddard contends that the Judge's conclusion on the accruals rules is decisive. He says the Commissioner was correct to treat the accruals regime as requiring matching and spreading of refundable commissions and the commission repayments, with only the excess or interest component as net deductible expenditure. He points to the central purpose of the accruals regime as being to eliminate the orthodox distinctions, based on form rather than substance, between capital and revenue where financing is provided. As the regime takes into account all cash flows, it determines their tax treatment including the limited circumstances in which the distinction between capital and revenue might apply.

[48] We agree with Mr Goddard. In this Court, as in the High Court, Mr McKay accepts that the commission transactions fell within the broad definition of a financial arrangement.[9] The financing component of the treaty was an arrangement whereby Sovereign obtained money from Gerling (the commission payments) in consideration for promising to pay money in the future (the commission repayments). This element of deferred consideration is central to the rules. So, too, is the regime's inherent dilution of the orthodox distinction between capital and revenue, ensuring a neutral tax treatment regardless of form. The focus is on the economic effect of the transaction – in this case the commissions and other repayments.

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[9] Income Tax Act 1994, para (b) of the definition of "financial arrangement" in s EH 14.

[49] For the purpose of s EH 1, it cannot be disputed that the commission cash flows were subject to the accruals regime for the purposes of calculating gross income or expenditure. In terms of s EH 1(1)(b), Sovereign was the issuing party for the financial arrangement. In calculating its gross income or expenditure the company was required to take into account, 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, second, the acquisition price of the financial arrangement – all the commissions and other payments made by Gerling under the treaty (but again for the same reason excluding other receipts such as mortality claim payments).

[50] In this respect we note the observation of the authors of *New Zealand Accrual Regime – A Practical Guide* as follows:[10]

> The accrual regime is fundamentally different from the rest of the income tax regime, which operates on traditional legal/accounting principles. It has moved to a regime where the Act operates more on economic principles. Within the area in which the accrual rules apply, income and expenditure are measured in terms of gains and losses resulting from benefits received and provided under financial arrangements. For each taxpayer and for each financial arrangement, all benefits received and all benefits provided are generally taken into consideration. There is no exception for capital benefits provided or received.

[51] In summary, there is apparently now no dispute between the parties that:

(a) All aspects of the commission payments and repayments were within the definition of "financial arrangement" in s EH 14(b) (as set out above at [48]).

(b) The commission payments and repayments did not constitute an "excepted financial arrangement" as defined in s EH 14. In particular, the payments did not constitute a "contract of insurance" (at [44]–[46] above).

(c) The payments were not excluded from the application of the accruals rules under s EH 11 (discussed further below at [57]).

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10 Susan Glazebrook and others *New Zealand Accrual Regime – A Practical Guide* (2nd ed, CCH, Auckland, 1999) at [301].

[52] Sovereign's acceptance of the two points in [51](a) and (b) is inevitable given the exhaustive nature and breadth of para (b) of the definition of "financial arrangement" in s EH 14 which provides:

> (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) ...

[53] The breadth of this definition is evident in the expansive definitions of "money"[11] and "arrangement",[12] together with the reference to a future time, and the last element of the definition relating to its application to wider or composite financial arrangements.[13]

[54] As a consequence of Sovereign's concessions, s EH 10 is of central importance in this appeal but it is also the primary obstacle to Mr McKay's argument. It materially provides as follows:

> **EH 10 Relationship with rest of Act**
>
> **Qualified accruals rules override**
>
> (1) *Notwithstanding any other provision in this Act*, gross income or expenditure in an income year in respect of a financial arrangement under the qualified accruals rules shall be calculated under those rules.
>
> **Property transfer price**
>
> (2) Where
>
> (a) property is transferred under a financial arrangement, and
>
> (b) the property or the consideration given for the property is relevant under any provision of this Act other than the qualified accruals rules for the purpose of determining any amount of gross income or allowable deduction of a person,

11 "Money" in paragraph (b) of the definition of financial arrangement is defined expansively in s EH 14 as including "money's worth, whether or not convertible into money, and the right to money, including the deferral or cancellation of any obligation to pay money whether in whole or in part".

12 A wide definition of "arrangement" is provided in s OB 1, namely: "any contract, agreement, plan, or understanding (whether enforceable or unenforceable), including all steps and transactions by which it is carried into effect".

13 See Casey Plunket "Tax Accounting: Accruals" in Garth Harris and others *Income Tax in New Zealand* (Brookers, Wellington, 2004) 657 at [15.3.1]–[15.3.4] and [15.3.6].

> the property shall be treated for the purpose of that provision as having been transferred under the financial arrangement for an amount equal to the acquisition price of the property.
>
> (Emphasis added.)

[55] This provision is concerned with the calculation of income and expenditure in a given year. In particular:

(a) Under s EH 10(1) gross income or expenditure in an income year in respect of a financial arrangement under the qualified accruals rules is to be "calculated" under those rules, notwithstanding any other provision in the Act. Therefore wherever a financial arrangement exists as defined its tax treatment will be determined by the qualified accruals rules.

(b) Under s EH 10(2) where the requirements of paras (a) and (b) are met the property is to be treated for the purpose of any provision other than the qualified accruals rules as having been transferred under the financial arrangement for an amount equal to the acquisition price of the property. The accruals rules do not contain a discrete definition of property for the purposes of s EH 10(2) and accordingly the word must be given its ordinary meaning.

[56] The purpose and scope of s EH 10(2) is to provide a mechanism that avoids double taxation (or double deductions) where an arrangement provides more than just financing because it also provides for the transfer of property. As noted, it is common ground that under a transaction of this kind, the financing component of the payments made falls to be considered under the accruals rules. The treatment of the acquisition price for the property excluding the financing component is determined by the other relevant provisions of the Act.[14] We note that this interpretation of s EH 10(2) is consistent not only with the text but also with the purpose of the accruals rules themselves (as outlined above at [47]–[50]).[15] The accruals rules do

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14 See generally Glazebrook and others, above n 10, at [400].

15 See also Plunket, above n 13, at [15.2.1].

not contain a discrete definition of property and accordingly the word must be given its ordinary meaning.

[57] Mr McKay accepts what he calls the paramountcy of s EH 10. Its primacy is confirmed by the limited category of specific exceptions provided by s EH 11 where the accruals rules do not apply. However, Mr McKay seeks to circumvent its application by arguing that the transaction falls within s EH 10(2). That section effectively excludes from the scope of the rules the components of the transaction attributable to the transfer of property. Mr McKay's essential proposition is that the base component of the commission repayments is attributable to a sale of property, leaving the interest component to be treated for taxation purposes according to orthodox principles.

[58] We do not accept that argument. For reasons which we shall explain more fully later in this judgment (below at [88]–[103]), we agree with Mr Goddard that the commission flows did not constitute a transfer of property. It is apparent from our analysis that s EH 10(2) has no application as no property was in fact transferred. As Mr Goddard submits, the financing part of the reinsurance treaties simply provides financing. In exchange for receipt of certain sums, the equivalent amount plus interest must be repaid. No property or anything else is sold or transferred or supplied.

[59] In essence, Sovereign received the commission payments to fund its working capital costs and repaid the same amount plus interest. Sovereign's references to "sales of cash flows" cannot obscure this point. The agreement was not structured as a sale of cash flows, and there is no evidence to support Mr McKay's submission that that was how the agreement was understood by the parties. As no property was sold, s EH 10(2) does not assist Sovereign.

[60] We are not satisfied that the commission arrangements fell within an excepted category allowing for taxation consequences external to the accruals rules. The Commissioner's application of them here is lawful, and decisive of Sovereign's appeal. However, against the contingency that we have erred, we will now address

Mr McKay's main submission that irrespective of the application of the accruals rules the transactions fell for consideration under the ordinary provisions of the ITA.

Issue two: Legal nature of the base component – capital or revenue?

[61] Dobson J also dismissed Sovereign's alternative grounds of objection to the Commissioner's reassessments. The company's notice of appeal challenges his finding that the relevant commission flows of payments and repayments were not respectively assessable income or deductible expenditure under the ordinary provisions of the ITA.[16] Mr McKay submits that the Judge erred in finding that:

(a) it was necessary for the base components of the cash flows, when taken in isolation, to give rise to a form of taxable activity before they might give rise to tax consequences under the ordinary provisions of the ITA;[17]

(b) if there was such a requirement, the base components did not satisfy it but amounted simply to a "cheque swap ... devoid of other relevant commercial purpose";[18] and

(c) once the accruals rules are applied to the excess component, the base component "becomes irrelevant for income tax purposes".[19]

[62] Sovereign also challenges the Judge's related finding that the base components were capital in nature because the commissions were not earned by Sovereign when received. As this finding is of decisive effect, it was the primary focus of argument before us.

Principles

[63] Sovereign's appeal must be determined according to the allowable deduction provision, s BD 2 of the ITA, which materially provides as follows:

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16 High Court decision, above n 1, at [201].
17 At [185]–[186].
18 At [201].
19 At [215].

BD 2 Allowable deductions

Definition

(1) An amount is an allowable deduction of a taxpayer

...

(b) to the extent that it is *an expenditure or loss*

(i) *incurred by the taxpayer in deriving the taxpayer's gross income*, or

(ii) *necessarily incurred by* the taxpayer in the course of carrying on a business for the purpose of deriving the taxpayer's gross income ...

Exclusions

(2) An amount of expenditure or loss is not *an allowable deduction of a taxpayer to the extent that it is*

...

(b) incurred in deriving exempt income under Part C (Income Further Defined), D (Deductions Further Defined) or F (Apportionment and Recharacterised Transactions), or

...

(e) *of a capital nature*, unless allowed as a deduction under Part D (Deductions Further Defined) or E (Timing of Income and Deductions) ...

(Emphasis added.)

[64] In order to qualify as deductible expenditure in terms of s BD 2(1)(b) Sovereign's base component commission repayments to Gerling had to be incurred in deriving its gross income and not be of a capital nature. As Richardson P said for this Court in *A Taxpayer v Commissioner of Inland Revenue*:[20]

> ... Income is a complex concept. In the absence of a comprehensive statutory definition those concerned with its interpretation and application must seek to determine the statutory purposes and the policies underlying the legislation. As a matter of economic theory and reflecting an assumed ability to pay, income is conventionally described in terms of an increase in economic power, that is the ability to command goods and services between two points of time; and so, in broad terms, as the net accretion in wealth plus consumption during the period in question ... income recognition for tax

[20] *A Taxpayer v Commissioner of Inland Revenue* (1997) 18 NZTC 13,350 (CA) at 13,355.

> purposes is pre-eminently an area requiring a careful balancing of principle and pragmatism.

[65] The real focus of Sovereign's appeal is thus on whether the commission payments made by Gerling constituted income in its hands; if not, the commission repayments made by the company were not deductible expenditure. The leading cases outline a number of criteria which guide the decision whether to characterise any given payment or receipt as income or capital in nature.[21] To the extent that they have arisen, judicial differences have focused less on the relevant principles than their application to the facts.

[66] It is necessary to identify the principles which apply directly to Sovereign's appeal. 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.[22] 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.[23] The relevant documents must be construed in their commercial context. An appreciation of the factual matrix is essential. For that reason, some but limited assistance is available from analogous cases.

[67] 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[24] but, for the reason just given, practical business considerations do not exclude a contractual analysis. The absence of enforceable rights is not decisive of the revenue character of a business

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21 *Regent Oil Co Ltd v Strick (Inspector of Taxes)* [1966] AC 295 (HL); *BP Australia Ltd v Commissioner of Taxation of the Commonwealth of Australia* [1966] AC 224 (PC) at 397 and 399; *Commissioner of Inland Revenue v McKenzies (NZ) Ltd* [1988] 2 NZLR 736 (CA) at 740; *Reid v Commissioner of Inland Revenue* [1986] 1 NZLR 129 (CA) at 136; *Birkdale Service Station Ltd v Commissioner of Inland Revenue* [2001] 1 NZLR 293 (CA); and *Fullers Bay of Islands Ltd v Commissioner of Inland Revenue* (2006) 22 NZTC 19,716 (CA).

22 *Ben Nevis Forestry Ventures Ltd v Commissioner of Inland Revenue* [2008] NZSC 115, [2009] 2 NZLR 289 at [46]–[47], citing *Commissioner of Inland Revenue v Renouf Corporation Ltd* (1998) 18 NZTC 13,914 (CA) at 13,919.

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

24 *BP Australia Ltd*, above n 21, at 264, applying Dixon J in *Hallstroms Pty Ltd v Federal Commissioner of Taxation* (1946) 72 CLR 634 at 648.

receipt.[25] However, there will be cases where it is unnecessary to go beyond the rights and obligations assumed under the contract.[26]

[68] 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.[27]

[69] Of particular relevance is this statement of the High Court of Australia in *Arthur Murray (NSW) Pty Ltd v Commissioner of Taxation of the Commonwealth of Australia*:[28]

> As Dixon J observed in *Carden's Case*[29]: "Speaking generally, in the assessment of income the object is to discover what gains have during the period of account come home to the taxpayer in a realized or immediately realizable form".[30] The word "gains" is not here used in the sense of the net profits of the business, for the topic under discussion is assessable income, that is to say gross income. But neither is it synonymous with "receipts". It refers to amounts which have not only been received but have "come home" to the taxpayer; and that must surely involve, if the word "income" is to convey the notion it expresses in the practical affairs of business life, not only that the amounts received are unaffected by legal restrictions, as by reason of a trust or charge in favour of the payer – not only that they have been received beneficially – but that the situation has been reached in which they may properly be counted as gains completely made, so that there is neither legal nor business unsoundness in regarding them without qualification as income derived.

[70] 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.[31] Some of the relevant criteria include the occasion calling for the receipt; whether the sums are used for fixed or

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25 *FCT v South Australian Battery Makers Pty Ltd* (1978) 140 CLR 645 at 662.

26 *Commissioner of Taxation v Firth* [2002] FCA 413, (2002) 192 ALR 542 at [66].

27 *Arthur Murray (NSW) Pty Ltd v Commissioner of Taxation of the Commonwealth of Australia* (1965) 114 CLR 314.

28 At 318.

29 *Commissioner of Taxes (SA) v Executor Trustee and Agency Co of South Australia Ltd* (1938) 63 CLR 108 [*Carden's Case*].

30 At 155.

31 *BP Australia Ltd*, above n 21, at 264.

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.[32]

Contractual analysis

[71] It is now common ground that in terms of the income tax legislation the treaty was a contract of reinsurance with a financing component. However, the legal character of that financing component cannot be determined in isolation from the other contractual provisions. The instrument must be construed as a whole.

[72] In construing the relevant contractual terms we bear in mind Mr McKay's caution against placing undue weight upon labels or terms used by the parties. That is because, as the evidence confirmed at trial, usage and terminology may differ between offices and jurisdictions. Also, insurance agreements rely more upon good faith than the precise words used. Mr McKay gives the example of the phrase "commission repayments". Other treaties refer to it as an "expense recovery component", a "commission amortisation component", a "commission refund" and a "financing premium". We must observe, however, that the consistent theme running through these phrases is of monies advanced to and repayable by an insurer for the purpose of financing its policy establishment costs.

[73] Mr McKay's primary proposition is that Sovereign earned the commission payments as income at the time of receipt because they were part of an arrangement with Gerling either to share risks or transfer future cash flows. His arguments in support frequently overlap and repeat themselves in various manifestations and are heavily influenced by reasoning by analogy – either with other types of reinsurance or financing arrangements. While that approach has its place, it does not assist where it is advanced at the expense of a fact-specific contractual analysis in a unique commercial setting. The treaty and supplementary memoranda must be the decisive

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32 *McKenzies (NZ) Ltd*, above n 21, at 740, applied in *Commissioner of Inland Revenue v Fullers Bay of Islands Ltd* [2005] 2 NZLR 255 (HC), affirmed on appeal in *Fullers Bay of Islands Ltd*, above n 21.

instruments where the inquiry, as Mr McKay accepts, requires a determination of the parties' respective rights and obligations.

[74] We have isolated out and will address what we understand are Mr McKay's primary arguments as follows.

(a) Cession of shared mortality and persistency risks

[75] Mr McKay's principal submission is that, when the treaty is read as a whole in its commercial context and consistently with the underlying contractual notion of risks shared between the parties, Sovereign was to receive the advances on no more than an expectation that the instrument "would permit recovery by the reinsurer, in present value terms ...". What was ceded under art 2 was an aggregate proportion of Sovereign's mortality and persistency risks. Both were passed to Gerling, not just a share of Sovereign's mortality risks.

[76] Viewed commercially, Mr McKay says, Sovereign had to cede sufficient good quality contracts to ensure the financially viable performance of the portfolio as a whole. The policies would not only have to perform to their terms but also yield sufficient to meet losses on lapsed contracts. Any loss suffered absolutely or in present value terms and whether arising either through adverse mortality or persistency experience in terms of the portfolio as a whole was that of the reinsurer to the ceded extent.

[77] The text of art 2 answers Mr McKay's argument. There was no agreement to share liability for Sovereign's lapse risk on ceded policies. In particular:

(a) A quota share treaty obliges the insurer to cede to the reinsurer a fixed proportion of all risks falling within its scope. By art 2, Sovereign ceded "a 38 per cent quota share of *the sum at risk* on all policies" (emphasis added). The risk is the insured danger, peril or event or the possibility of a loss occurring giving rise to the insurer's liability. Its occurrence triggers the insurer's contractual obligation to indemnify the insured person or his or her beneficiary. The insurer is "at risk" when it is exposed to that contingency.

(b) Sovereign's policies were not produced or discussed in argument but it was common ground that the company insured the risk of mortality. One internal document described its business as writing "regular premium life assurance". The sum for which the company was at risk on a policy was the sum insured – its defined financial exposure to a third party on the occurrence of the death of the life assured.

(c) By contrast, Sovereign's lapse risk was not represented by a defined or quantifiable sum for which it was at risk on a policy or "on all policies". Instead, the company was exposed to a different but uninsured business risk. It was the consequential risk of early termination of a policy with the loss of Sovereign's own expenses incurred to date. As Dobson J observed, lapse risk is an identifiable risk for an insurance business.[33] But as a matter of logic it cannot be the subject of a contract of insurance because it cannot give rise to a contingency which might adversely affect the assured.

[78] Article 2's use of the settled insurance concepts of "cession", "accept[ance]" and "participation" confirms our conclusion that the provision did not operate as a sharing mechanism for both mortality and lapse risks. As the authors of *MacGillivray* note:[34]

> Risks are frequently described as being "ceded" by the reinsured and "accepted" by the reinsurer. ... "Cession" has a meaning distinct from its general meaning as a form of assignment. The reinsured will commonly retain a part of the risk reinsured for his own account, and this is referred to as his "retention". The retention provides a measure of the reinsured's confidence in the business reinsured, and an incentive to underwrite responsibly ... .

[79] *MacGillivray's* point is that an insurer which cedes risks to a reinsurer does not in law assign the rights and obligations arising under the primary policy if the insurer retains any share for its own benefit. A cession is a particular risk exposure which is transferred under a reinsurance treaty.[35] In this case, as we have found, the cessions were limited to Sovereign's mortality risk. By art 3 the company initially

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33 At [149].
34 Birds, Lynch and Milnes, above n 4, at [34-012] (footnotes omitted).
35 Edelman and Burns, above n 6, at 199.

retained a five per cent quota share. Accordingly, its cessions to Gerling were of 95 per cent of its insured liabilities, not an assignment or transfer of its policies. Later, as Sovereign's financial position strengthened, its cessions decreased to 75 per cent.

[80] "Participations" are a form of insurance which allow a policyholder to receive dividends. In its context, we are satisfied that the reference to participations reinforced the allocations of returns on the ceded mortality risks, with further returns possible if the line of ceded business proved profitable subject to the modification introduced by the bonus account's operation. There is no basis for arguing that the participations also included Sovereign's persistency risk.

[81] The unbundled regime of total cash flows provided elsewhere in the treaty also supports our construction of art 2. The actuarially assessed mortality risk premium payable by Sovereign under art 4 equated with the mortality component or 50 per cent of the underlying premiums; and the commissions payable by Gerling under art 5 equated with the proportionate share of the underlying premiums represented by the expenses component.

[82] In this Court Mr McKay submits that the commission payments "approximated" the reinsurer's share of Sovereign's policy set-up costs. His apparent purpose was to show that they were paid as reimbursement of the company's establishment costs, which were deductible, thereby indicating a symmetry between the receipts and payments. However, he does not challenge Dobson J's rejection of Sovereign's argument at trial that the commission repayments amounted to reimbursement of a defined share of its set up costs.[36] As the Judge noted, 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.

[83] In our judgment art 2 provided only for Sovereign's cession of a defined share of its insured mortality risks, and not for a separate sharing of the company's uninsured persistency risk which remained exclusively to its account.

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[36] High Court decision, above n 1, at [193]–[195].

(b) Finding of transfer of lapse risk

[84] In support of his principal submission, Mr McKay relies on Dobson J's finding that in the period before the years of reassessment under review commencing in 2000 the commission arrangements effected a transfer of a significant lapse risk to Gerling.[37]

[85] However, we are satisfied that the Judge's finding on this point was made in a different context and for a different purpose. He was determining the common law meaning of a contract of insurance for the purposes of the accruals rules, not the separate question of whether the parties agreed that Sovereign would transfer to Gerling a share of its lapse risk. He had already held that the commission arrangements did not satisfy that definition because they lacked a payment in the nature of a premium.[38] But, if the Judge was wrong in that finding, he was satisfied that in their early years the commission arrangements did effect a transfer of significant risk to the reinsurer[39] which by early 2000, the start of the reassessment period, had diminished to the point of insignificance.[40] Accordingly, the commission arrangements did not possess the character of a contract of insurance.

[86] Dobson J was concerned with whether substantively or in fact Gerling assumed an underlying commercial risk of an adverse lapse risk record on policies written by Sovereign. Plainly the insurer itself was primarily exposed to that same commercial risk, particularly in its formative years, with a consequential effect on its ability to make commission repayments. In that sense Gerling took part of the underlying financial risk. However, once Sovereign started to become financially self-sufficient through ASB's support its risk and that of Gerling as its previous financier abated.

[87] The Judge's finding simply reflects the fact that 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

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37 At [156] and [172].
38 At [147].
39 At [156] and [172].
40 At [173].

legal character of the transaction.[41] The existence of the underlying commercial risk with Gerling does not assist our construction of the relevant contractual provisions.

(c) Transfer of future cash flows

[88] Mr McKay's alternative primary argument is that Sovereign's contractual obligation was limited to passing on to Gerling agreed proportions of premiums if and when they were received. The underlying transaction was one of a sale, assignment or transfer of funds. In consideration for receiving the reinsurer's commission payments the insurer through a sale of its stock in trade provided an interest in future policy cash flows whatever their level. An interest rate applied to debits in the bonus account only because Gerling's flow of commission payments preceded Sovereign's reciprocal flow of commission repayments, thus ensuring a commercially realistic rate of reinsurer's profits – a prerequisite to Sovereign's enhanced participation in the profits. And the sole purpose of the sentence in art 4 – "The commission repayments will be paid as long as no payments from [Gerling] to [Sovereign] are due under the Bonus Account Agreement" – was to confer upon the insurer a right to 75 per cent of the profits above the agreed break-even point.

[89] While the parties expected that Sovereign would receive sufficient premiums to allow Gerling to recover the amount of commission payments (in present value terms), Mr McKay says, the company was not bound to repay if the expectation did not materialise. Sovereign only had to cede a policy to earn the commission payable on it. Nothing further was required except to act as a conduit for the premiums on receipt. And it is irrelevant that the treaty did not acknowledge his characterisation of its effect as transferring, swapping or selling interests in future policy cash flows.

[90] Mr McKay compares Sovereign's position to that of its own brokers. The company earns its commissions simply by ceding the policies, with a corresponding obligation to pass varying proportions of future premiums to Gerling. Both parties anticipate that those future and contingent cash flows will render Gerling's investment sufficiently profitable to permit the ceded portfolio to repay the

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41 *Firth*, above n 26, at [75].

investment. But the company is not obliged to ensure that result and is legally indifferent to mortality and persistency experience on the ceded policies.

[91] Mr McKay emphasises that Sovereign gave no contractual warranties about the persistency experience of any ceded life policy; and that the Commissioner accepts that art 4 is to be read subject to a condition or proviso that Sovereign would not be required to make commission repayments on a particular policy once it lapsed or was discontinued.

[92] Again, we are not satisfied that the argument survives an orthodox contractual analysis, for a number of reasons. First, it was common ground, as Dobson J found,[42] that the commission payments were advanced for the express purpose of financing Sovereign's establishment expenses and other cash flow strains.[43] The company does not challenge the Judge's finding or resile from its concession. The commission repayments were just as the parties described them – repayments of advances. They were priced separately from the risk premium payments by reference to the insurer's own proportionate allocation of the underlying premiums to its persistency risk – loaded in the early years and reducing over time. That is also how they were viewed by the main players, Dr Pyhel and Mr Coon.

[93] The supplementary agreement starkly illustrates this point (outlined above at [39]). Sovereign was short of working capital of $3.7 million to the year ending 31 March 1995 even after receiving the benefit of its existing financing arrangements with Gerling. The parties employed the same mechanism to provide the company with additional funding. It was an outright financing agreement, with a specified advance and an obligation to repay with interest. Mr McKay points out that its effect was spent by 2000. That is true but the relevance of the supplementary agreement lies in its confirmation of the real purpose of the commission arrangements.

42 At [18].
43 At [65] and [101].

[94] Second, as noted, what was ceded was a share of policy liabilities, not the policies themselves or the premium entitlements they carried; and what was specifically exchanged was an agreed quota share of the ceded risks for payment of premiums actuarially assessed solely by reference to the underlying mortality risk. Sovereign agreed to pay the premiums "as long as the cessions are in force".[44] Separately, Gerling agreed to pay the commissions in consideration for Sovereign's agreement to repay them "as long as no payments from [Gerling] to [Sovereign] are due under the bonus account agreement" – that is, until amortisation of "the total loss" or all of Sovereign's debit account constituted by its outstanding commission repayments. While the timing and rate of Sovereign's commission repayments were linked to its receipt of premiums, the obligation to pay them on a portfolio basis was absolute. In essence, the consideration for Gerling's agreement to pay commissions was Sovereign's promise to repay the same amounts with interest at a later date, not a promise to sell its stock in trade.

[95] Third, as Mr McKay accepts, Sovereign's cessation of its liability to make commission repayments on discontinued policies did not affect its underlying obligation to make all such repayments attributable to the portfolio as a whole. That is because, as noted, all relationships operated on a portfolio basis with the aggregate of underlying premiums received by Sovereign providing the source for its commission repayments. In effect, Mr McKay concedes Sovereign's obligation to repay all commissions subject only to the condition of its receipt of the funds designated for that purpose.

[96] Fourth, as Sovereign's need for outside financing abated, the amount of commission flows diminished. As Mr Goddard points out, Sovereign was not paying a constant percentage of premiums. The amount payable for any given policy depended on the global state of the bonus account; there was no identifiable participation in the policy cash flows by reference to percentage or duration. The fact that the cash flows were steadily shrinking to the point of extinction in November 2004 does not sit easily with what is said to be a commercial agreement to sell them.

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44 Under art 4 of the treaty.

[97] Fifth, Mr McKay is unable to point to any express contractual provision or anything in the commercial matrix to support his argument. While the factual background is not decisive, it assists in a case like this in understanding the business purpose of the commission arrangements. It was never suggested by any participant in the negotiations or in the background material relating to deficit account financing that the purpose of the commission arrangements was to provide Gerling with an additional but deferred cash flow in the form of the persistency component of the underlying premium.

(d) Extreme lapse risk

[98] To support his thesis that Sovereign was doing no more than selling or assigning future cash flows, Mr McKay postulates an extreme case. He refers to the possibility that all policies written by Sovereign in the first year of the treaty's operation lapsed. If that happened, the company's obligations to the reinsurer on those policies would have been discharged. Gerling would be entitled to look to ceded policies written in following years to recover its commission payments for the first year, but not to Sovereign itself. If Sovereign made no future cessions, for example because it entered into new treaties with other reinsurers, Gerling would never recover its original commission payments.

[99] In answer Mr Goddard provided an arithmetical example of how an increase in lapse rates would not reduce the total amount of Sovereign's liability to repay commissions. It is unnecessary to replicate his calculations here; Mr McKay does not dispute their accuracy. Mr Goddard's example simply serves to establish that a poor persistency record would have the effect of deferring the timing of Sovereign's overall repayments. Instead of taking the anticipated five years to amortise its bonus account liability, Sovereign may have required seven or eight years for that purpose.

[100] There was, of course, a theoretical possibility that Mr McKay's doomsday example might materialise. Doubtless the parties were aware of the same remote possibility. Consistently with that assumption, Mr McKay himself notes that Sovereign's commission repayments were front end loaded in the sense that higher percentages were payable in the early years, reducing over time. Plainly this regime

was designed to minimise the risks associated with Mr McKay's contingent hypothesis.

[101] Also, Mr McKay acknowledges that, while adverse mortality or persistency in the years immediately following cessions of a policy would obviously prolong reinsurers recovery of their investment in present value terms and in limited cases exclude any recovery at all, the industry expectation with this type of financing arrangement is that reinsurers will recover their investment within a five year period.

[102] Mr McKay's theoretical possibility, which he accepts was contrary to that industry expectation, is simply another example of Gerling's assumption of an underlying commercial risk for which it received compensation. In conformity with the financing arrangement, Sovereign's debit balances in the bonus account carried an interest liability at a defined rate. Its only commercial purpose was to compensate Gerling for the time value of its outstanding advances. Interest was payable at four per cent above the base government bond rate, reflecting an acceptance of a significant degree of business risk. The longer Sovereign required to amortise its debit account balance as a result of a poor lapse record, the greater its financing costs would become. And the existence of Sovereign's interest obligation was also antithetical to the notion of sale of an asset in the form of cash flows.

[103] In conclusion, in common with Dobson J,[45] we are satisfied that Mr McKay's argument that the commission arrangements constituted Sovereign's sale of or assignment to Gerling of future cash flows is a reconstruction based upon an artificial economic substance approach in substitution for a disciplined analysis of the parties' actual agreement. It is unsurprising that the treaty made no reference to what is now said to be its primary purpose.

(e) Original terms reinsurance

[104] Mr McKay makes much of a comparison between this treaty and what is known as original terms reinsurance. In essence, reinsurance of that nature entitles the reinsurer to the same proportion of the premium as its reinsured participation,

45 At [201].

allowing the reinsurer to receive the share of the underlying premium calculated to meet establishment costs even though they are incurred by the insurer. As a result, the reinsurer pays commissions to the insurer upon cession of a policy that provide funding for set up costs broadly equal to the reinsurer's proportionate participation in the policy. The financing commissions are treated for solvency or financial reporting as earned income, not as a loan or as giving rise to a debt or other liability.

[105] In effect, Mr McKay says, in the context of original terms reinsurance the reinsurer's share of the establishment costs is calculated as the present value of estimated cash flows; they are the purchase price for participating in cash flows generated by the ceded policies. By analogy, he says, the same must apply here.

[106] We reject Mr McKay's analogous reliance on original terms reinsurance. Manifestly Gerling and Sovereign contracted on quite different terms. Original terms reinsurance is based on the premise of sharing premiums and a correlative exposure on claims. Mr McKay acknowledges the material differences with quota share reinsurance. In particular, the Gerling treaty was characterised by an unbundled and separated payment structure, distinguishing between the mortality and lapse risk components. Each fulfilled a different commercial objective, as Mr Goddard submits. Also the bonus account and its function were unique. And the nature of the reinsurer's participation was markedly different.

[107] Mr Goddard observes that Sovereign is reluctant to push the original terms reinsurance analogy too far because if this was an original terms treaty, and the only cash flow from Sovereign to Gerling was in the form of premiums, payment of them would be non-deductible under s DK 3 of the ITA for the reason that they are not premiums payable under a contract of life insurance.

(f) Miscellaneous factors

[108] As we have noted, the leading appellate authorities have settled the proper approach for determining whether an item of receipt or expenditure has the character of capital or income.[46] We return to them at this point, briefly: counsel did not spend

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46 See above at [65] of this judgment.

a great deal of time on the authorities and we do not find it necessary to do so either. Our conclusions on the accruals rules are dispositive. Further, one of the considerations – earned income – settles the capital or income question in this case, even if one assumes, as we are prepared to do, that others – notably, connection to Sovereign's primary income-earning activities and regularity of flow – favour Sovereign. For example, Mr McKay emphasises that Gerling paid the commissions regularly and recurrently on a quarterly basis, and Sovereign relied upon them to meet ongoing revenue expenses.[47] However, Sovereign's frequency of receipt and use of funds did not transform their character from capital to revenue.

[109] We do address two points.

(i) Payments not "earned", because received subject to an obligation to repay

[110] Income, relevantly for present purposes, is generally taken to comprise gains received and earned during the relevant tax year. 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.[48]

[111] We have already discussed this issue when analysing the agreements at [71]–[103] above. For the reasons given there, we do not accept that Gerling's periodic commission payments were earned by Sovereign in the sense that they were received unconditionally. Although the amounts paid were determined by reference to individual policies, Sovereign received the money subject to an obligation to repay it. It is immaterial that the obligation to repay attached at a portfolio level rather than a policy level; what matters is that it did attach to the sums advanced. This consideration is sufficient in itself to establish that the commission payments were not earned income when received.

(ii) Accounting and regulatory treatment

[112] We address this consideration in deference to the submissions of counsel, both of whom referred to the appropriate accounting treatment for the commission

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47 *Reid*, above n 21.
48 *Arthur Murray (NSW) Pty Ltd*, above n 27.

flows. The subject of accounting standards also received close attention in the High Court.[49] When considering the accruals rules Dobson J set out at length the competing evidence about the correct accounting for the money flows for financial reporting purposes. However, despite his full survey of the evidence, the Judge found it unnecessary to decide on the correct accounting treatment in this case.[50]

[113] We accept that Gerling treated the arrangement as a whole as reinsurance for financial reporting purposes, relying on the rationale that both mortality and persistency risks were transferred to the reinsurer. That rationale is said to permit the parties to a reinsurance arrangement to treat commission payments as earned income for both accounting and regulatory purposes notwithstanding that the payments served a financing purpose. This mattered for regulatory purposes because the insurer's capital reserves would have been affected had the payments been treated as loans. Accordingly, reinsurance premiums and commission repayments were treated as earned income when receivable; and reinsurance claims and commissions were treated as expenses when paid.

[114] We emphasise, however, that such taxation treatment followed characterisation of the commission payments as insurance for accounting and regulatory purposes. Sovereign no longer pursues an argument that the commission payments are to be treated as insurance for the purposes of New Zealand tax law. Put another way, it no longer disputes unbundling of the money flows.

[115] Further, accounting treatment cannot prevail over a principled contractual analysis.[51] 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. We observe that the expert witnesses were not in accord with respect to New Zealand accounting treatment, although they did substantially agree that in Europe the reinsurance treaties would be treated as a single contract of reinsurance. As noted above, the Judge did not decide the correct accounting treatment, although he did appear to approve of the evidence of John Hagen, a witness for the

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49 At [109]–[129].
50 At [128].
51 *Arthur Murray (NSW) Pty Ltd*, above n 27; *Birkdale Service Station Ltd*, above n 21.

Commissioner, who opined that because the commissions were refundable a true and fair view required that Sovereign should not treat them as income.

Conclusion

[116] In the circumstances of this case the issue of whether Sovereign received Gerling's commission payments on capital or revenue account can be answered in two ways. Both lead to the same result and are mutually supportive.

[117] The first inquiry is into what, from a practical and business point of view, was the purpose of the commission payments. Mr McKay's essential proposition is that Sovereign earned the commissions as income at the point of receipt simply by the act of ceding the policies. That proposition might have been arguable but for the fact that Sovereign assumed an obligation to repay the commissions, with interest.

[118] The decision of the High Court of Australia in *Arthur Murray*, upon which Mr Goddard relies, is a case in point.[52] There a dancing studio received pre-payments of fees for lessons to be given in future years. The studio was not bound to refund the fees if for some reason the lessons were not used. The High Court agreed with the studio that the pre-payments when received were not income. The mere possibility of having to repay them, even if only on a claim for damages, was sufficient to deprive the payments of the quality of taxable income because that possibility was an inherent characteristic of the receipt itself.

[119] There was no outright financial exchange of commissions for goods or for services provided by Sovereign to Gerling. The company was not entitled to retain the funds as its own without paying the reinsurer back an equivalent amount together with interest by way of compensation for the time value of the money. Sovereign had no right to beneficial receipt of the funds, free of any obligation in Gerling's favour; and the monies were not intended to "properly be counted as gains completely made".[53]

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52 *Arthur Murray (NSW) Pty Ltd*, above n 27.
53 *Arthur Murray (NSW) Pty Ltd*, above n 27, at 318.

[120] The alternative but complementary approach is to consider the rights and obligations respectively assumed by the parties under the treaty. Mr McKay makes much of the Commissioner's equivocality on whether the commission payments were loans. He says a loan is the only financing transaction which does not require recognition of the base flows for tax purposes: as both receipts and expenditure do not result in an increase of reported profit, they are treated as being on capital account. All other cash flows must fall within the purview of revenue. Thus, if the financing arrangement was not a loan, the commissions could only have been paid on revenue account.

[121] We do not understand the Commissioner's equivocality on the legal characterisation of the commission arrangements. In the High Court she disavowed any suggestion that the commission payments were loans. Dobson J described the advances as "loan-like".[54] In his written synopsis in this Court Mr Goddard characterised the financing component as analogous to a limited recourse loan. However, before us he accepted that it was in form a loan. The only material difference was the absence of a certain date for repayment.

[122] On the Commissioner's submission the advances were loans in form and substance.[55] In our judgment that characterisation is correct. We are satisfied that Gerling agreed to pay the commissions on condition that Sovereign would repay an equivalent amount at some future time.[56] As we have found, the company was obliged to repay the advances subject only to the condition that it received the underlying premiums payable on the ceded portfolios. But this limitation on Gerling's rights of recourse did not change the essential legal character of the commission transactions as a loan.[57]

[123] Significantly, Mr McKay concedes that if Sovereign ceased making commission repayments while its balance in the bonus account was in debit, Gerling would be entitled under art 5 to pursue or enforce repayment provided Sovereign had received the underlying premiums. To this extent Mr McKay accepts that Gerling

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54 At [211].

55 *Terminals (NZ) Ltd v Comptroller of Customs* [2013] NZSC 139 at [40].

56 *Re Securitibank Ltd (No 2)* [1978] 2 NZLR 136 (CA) at 167.

57 *Firth*, above n 26, at [73]–[74].

had a contingent right of recourse. Again that right is hardly consistent with a sale or assignment of cash flows or with an unenforceable expectation that Sovereign would repay.

[124] Our construction is further reinforced by art 21(3). Its effect is unambiguous: if Sovereign was wound up and the treaty cancelled, any debit balance in the bonus account was recoverable as a debt due to Gerling ranking immediately after policyholders and attracting interest at a rate of nine per cent per annum. This is the language of debt. In the event of Sovereign's liquidation, the article plainly constituted Gerling as a creditor with a contingent right of recovery. Mr McKay accepts that analysis but says it is irrelevant because the contingency of a debt liability says nothing about the commercial or taxation character of the receipts. However, that is not the point. What is material is that art 21(3) clearly confirms the parties' common intention that the commission payments were a loan.

[125] In summary, if our inquiry was limited to the three operative provisions of the treaty together with the bonus account, we would be able to conclude that the commission payments were not derived as income. In a business and practical sense, the advances were not earned in the course of Sovereign's business as a life insurer. Consequently, the company's expenditure in the form of payments of the base component of the commission repayments was not incurred in deriving income. That conclusion is put beyond question when the treaty including the termination provisions is read as a whole, confirming the legal character of the commission arrangements as a loan.

Result

[126] The appeal is dismissed.

[127] The appellants are to pay the respondent costs for a complex appeal on a band B basis and usual disbursements. We certify for two counsel.

WHITE J

[128] I agree, for the reasons given in the judgment at [42]–[60], that the Commissioner's application of the accruals rules is correct and that Sovereign's appeal should therefore be dismissed.

[129] As the judgment recognises at [50], the purpose of the accruals rules is to eliminate the need to distinguish between the concepts of capital and income. This is made clear by s EH 10(1) of the ITA which applies in this case. I agree, for the reasons given at [55]–[59] and [88]–[103], that s EH 10(2) is not applicable.

[130] In my view therefore it is not necessary to address the submissions for Sovereign on the basis that the accruals rules did not apply to the financing transactions in this case.

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