

## The Sovereign Assurance Case

This case is interesting for two reasons. First it entails about \$100m of tax. Secondly, it is an example of the IRD challenging (thus far successfully) tax treatments taken by Sovereign that at least on its face appeared both appropriate and conservative.

The facts. Sovereign incurred commissions with its brokers as and when it wrote life policies. These commissions were payable before Sovereign could expect to achieve recovery of these costs via collection of premiums from the associated policies.

To shelter against this result, Sovereign entered into an arrangement with its reinsurer in tandem with offloading the insurance risk under the policies, as is ordinarily done with reinsurance. These arrangements were called "Treaties" and entailed Sovereign receiving cash up front from the reinsurer. This cash was by way of "refundable commissions" and restored Sovereign's cash position in the year it wrote its policies and paid out commissions. It was required to refund its reinsurer only out of premia received, so Sovereign achieved a desirable cash result via this route.

Tax wise, Sovereign accounted for the cash received from its reinsurer in the year it received these "refundable commissions". It claimed a deduction in the year it repaid them. This, on its face, did not appear in any way objectionable.

The IRD however took a different view (and it will soon be apparent why). The IRD argued that Sovereign was not required to recognise the income from these "refundable commissions" immediately in the year of receipt. Instead, the IRD said Sovereign was required to spread this income across the year of receipt and later years. This would seem to give Sovereign a better tax result, wouldn't it?

In part the answer to that question is yes. By applying the IRD's methodology, the result is a loss for Sovereign in the early years (the commission costs being greater than the premia received) and income in later years (when the refundable commissions were to be treated as income).

All this would have had no adverse result for Sovereign, but for one key event. That key event was the change in shareholding upon it being acquired by ASB. This meant (because tax laws work this way) that any losses that sat with Sovereign at the time of the shareholding change were forfeited.

By requiring Sovereign to account for income regarding the cash from its reinsurer in a later year (and not in the year of receipt), Sovereign ended up with losses in the early years. With the shareholding change these were forfeited and therefore could not be offset against the income derived in later years. All up this meant a very sizeable tax bill for Sovereign and is a good reason to use a limited partnership (not being subject to these changes in ownership rules) if possible. This case is on appeal.