TR 94/D41 - Income tax: insurance registers

Draft Taxation Ruling
Income tax: insurance registers

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IT 2408

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What this Ruling is about

1. An insurance register records which policyholders of an insurer were introduced, and are serviced by, a particular insurance agency and the right to any commission that is payable in respect of those policies.

2. An insurance agency has access to those policyholders on its register. They may be a source of new business for the insurer and, thus, more commission for the agency. Registers therefore have an intrinsic worth and from time to time are bought and sold by insurance agency businesses.

3. This Ruling discusses the taxation consequences of buying an insurance register and selling an insurance register. The Ruling applies to both general and life insurance agencies.

4. An 'agency business' may be conducted by an individual or a company and an 'agency' may be, and may receive commission as, a sole trader, a partner or a trustee of a trust estate. For the purposes of this Ruling the terms 'agent', 'agency' and 'agency business' are used interchangeably.

Ruling

5. Insurance companies enter into insurance contracts (usually called a 'policy') where, in exchange for the payment of a premium or premiums, the company promises to pay a named party a mutually agreed sum of money in the event of the risk that has been insured. Insurance companies have a network of commission agents to introduce insurance business and to 'service' existing policyholders with a view to maintaining the insurer/policyholder relationship.

6. Access and commission rights in respect of an insurer's policyholders arise under the insurance agency agreement that is entered into between an insurer and its agents. It is these rights that an agency business has under the agency agreement that are the basis of an insurance register. They are 'assets' for the purposes of Part IIIA of the *Income Tax Assessment Act 1936*.

Purchase

7. By purchasing some, or all, of an insurance register an insurance agency is adding to the client base of the agency business and hence to the profit-making structure of that business. Consideration given by an agency for the acquisition of the rights of another agency under an agency contract i.e., the consideration for an insurance register, is an outgoing of capital. It is not a deductible outgoing under subsection 51(1).

8. If the purchaser has an insurance agency business pursuant to an agency agreement entered into before 20 September 1985, its insurance register will have been acquired before that date i.e., it will be a 'pre-CGT register'. Adding more policyholders to its register by purchasing some, or all, of another register is not creating a new business asset but, rather, enlarging an existing asset. If the purchaser has an insurance agency business pursuant to a contract entered into on or after 20 September 1985, its register will be a 'post-CGT register'. The consideration paid will form part of the cost base of the insurance agency's register if it is later disposed of by the insurance agency.

Sale

9. Consideration in respect of the sale of an insurance register is received in respect of the disposal of an asset and is a capital, not a revenue receipt. Subject to the operation of subsection 160P(6), if the register formed part of an insurance agency business pursuant to an agency agreement entered into before 20 September 1985, the relevant rights are not subject to the capital gains and capital losses provisions. If the vendor has an insurance agency business pursuant to an agency agreement entered into on or after 20 September 1985, the rights disposed of are an asset for capital gains tax purposes and the amount of any gain or loss is calculated in the normal way.

10. Subsection 160P(6) deals with capital improvements on or after 20 September 1985 to an asset (other than a periodic roll-over asset) acquired on or before that date. Adding new policyholders to a pre-CGT register by acquiring another register on or after 20 September 1985 is an improvement of a capital nature to the pre-CGT asset. If an

improved pre-CGT register is later disposed of and the value of the improvement is greater than $50,000 (as indexed in accordance with section 160Q) and greater than 5% of the consideration in respect of the disposal of the improved register, the improvement is deemed to be a separate asset from the pre-CGT register and will be subject to the ordinary operation of Part IIIA.

11. Apart from Part IIIA, no other provisions of the Act operate to include the consideration received in the assessable income of the vendor agent unless the vendor sells a register in the course of a business of buying and selling insurance registers.

Roll-over relief

12. If an insurance agency business was being conducted by a sole trader and the business is incorporated on or after 20 September 1985, roll-over relief is available in respect of the assets of the business transferred to the new company provided the provisions of section 160ZZN are satisfied.

13. Section 160ZZN deems the shares in, and the assets of, the new company to be pre-CGT assets. Similarly, roll-over relief may also be available under section 160ZZO when an insurance agency business is transferred by a company to a related company.

Transfer to a family trust

14. We accept that a right to commission under an agency agreement is similar in nature to the taxpayer's right to be paid royalties in *Shepherd v. FC of T* 14 ATD 127. When an agency assigns part of its right to commission (i.e., only the right to renewal commission), the part assignment, while not effective at law, is effective in equity. The result for income tax purposes is that the renewal commission is income in the hands of an assignee and will be part of the net income of a trust when the assignee is a trustee of a trust estate.

15. We understand that in most cases little, if any, consideration is received by the assignor in relation to the transfer of the rights to a trustee of a trust. If an asset is disposed of, or a part of an asset is disposed of, for no consideration or for consideration less than its market value and the parties to the transaction are not dealing with each other at arm's length in connection with the disposal, the consideration for the disposal is deemed to be the market value of the asset at the time of the disposal. See subsection 160ZD(2). An assignor agent will have little or no indexed cost base in respect of the rights disposed of unless the relevant rights were acquired from

another person. This may be, for example, where what is assigned previously formed part of another register acquired for valuable consideration by the assignor agent. Accordingly, the capital gain resulting from such an assignment will generally be the market value of the rights to the renewal commission at the time of the assignment.

Goodwill

16. The sale of an insurance business *in toto* involves the disposal of the assets of the insurance business including the insurance register. We accept that one of the assets that is disposed of is the goodwill of the insurance agency business. To the extent that the consideration in respect of the disposal includes an element of goodwill, section 160ZZR may apply to reduce the amount of any capital gain that would otherwise arise.

17. If a part, or all, of an insurance register is sold but the agency agreement is not terminated i.e., the agency business continues in existence, no part of what is transferred to the purchaser is goodwill for the purposes of Part IIIA.

Multi-agents

18. Many insurance agency businesses are multi-agents i.e., they have an agency agreement with more than one insurer. If a particular agency agreement is entered into on or after 20 September 1985, any register that is attributable to that agreement will be acquired on or after that date and will be a post-CGT register. If a post-CGT register associated with the particular agreement is disposed of, a capital gain may arise in the normal way. If some, or all, of a post-CGT register is disposed of but the relevant agency agreement continues, no part of what is disposed of is goodwill for the purposes of Part IIIA.

19. Even if one of the agency agreements is terminated and the associated post-CGT register is disposed of, the insurance agency business still continues and, therefore, no part of what is disposed of is goodwill for the purposes of Part IIIA.

20. In some cases an insurance agency may terminate an agency agreement it has with one insurer and enter into a new agency agreement with another insurer. This involves the cessation of one business and the commencement of a new business. No rights under the agency agreement with the former insurer can be transferred to the new business. Nor can the goodwill, if any, associated with the former business. If the agency agreement that was terminated was entered into before 20 September 1985, the register is a pre-CGT register and, subject to subsection 160P(6), no capital gains implicatons arise in

respect of the disposal of that register to another agency business associated with the former insurer. If the agency agreement that was terminated was entered into on or after 20 September 1985 the transfer of the register to another agency business associated with the former insurer may give rise to a capital gain in the normal way. Goodwill associated with the former agency business may be transferred with that register. If the agency agreement with the new insurer is entered into on or after 20 September 1985 i.e., a post-CGT register is to be created, a capital gain may arise in respect of any later disposal of some, or all, of that register.

Lapses

21. There are no capital gains implications for an insurance agent when a client on a register lapses i.e., discontinues with an existing policy. We do not consider an agency's rights in respect of each policy a separate asset such that there is a disposal of that asset when a lapse occurs.

Accreditation

22. We understand that an agency is not able to sell particular insurance products without being properly accredited to sell that product. An agency business may initially be accredited to sell only one or two particular products. As the business grows and the principal becomes more experienced, product accreditation may increase. We do not see any income tax implications in simply increasing or abandoning accreditation in respect of a particular insurance product.

Date of effect

23. This Ruling applies to years commencing both before and after its date of issue. However, the Ruling does not apply to taxpayers to the extent that it conflicts with the terms of a settlement of a dispute agreed to before the date of issue of the Ruling (see paragraphs 21 and 22 of Taxation Ruling TR 92/20).

Explanations

Background

24. The relationship between an insurance company and its agents is governed by an agency agreement entered into by the parties. The relationship is that of principal and agent and the agency agreement covers such things as insurance proposals, the payment of commission, the conduct of the agent, advertising, receipt of monies, claims, agent's expenses, accounting procedures and so on. The parties to the agency agreement recognise and acknowledge that the purpose and function of the agency business is to facilitate the sale of the insurer's insurance products.

25. Various kinds of commissions may be received by an agency. The right to receive the commission arises under the agency agreement. The particular policy 'sold' generates either a single premium or regular premiums to the insurer and commissions are calculated having regard to the type of contract sold by the insurance agent. Different companies have different names for the commissions they pay but some generic terms are:

initial commissions;

renewal commissions;

CPI commissions;

persistency bonuses;

production volume bonuses;

overriding commissions; and

deferred commissions.

26. When an insurance agency first sells a policy, the insurance company records the agency's name against the policy as the originating agency. The record of an agency's name as an originating agency constitutes what has become known as an 'insurance register' i.e., an originating agency has recorded against its name all the policies sold as an originating agency. In addition, the register may include details of orphan policies allocated to the particular agency. Orphan policies are ones where there is no longer an originating agency and are allocated by insurance companies to other agencies.

27. An insurance register is really an administrative record of the policyholders of an insurer that have been 'sold' a policy, and are being serviced by, an insurance agency. From time to time the sale occurs of an insurance register by one agency to another agency or agencies. What is being sold is the right to renewal commission based on the expectation that those clients will continue their existing policies. It is also hoped that those clients will provide a source of additional income for the agency by entering into new insurance contracts with an insurer.

28. Agency agreements normally require the insurer's approval for the transfer between agencies of rights and obligations in respect of existing clients. Insurance companies themselves may also acquire a 'register' from an agency and distribute clients on that register to other agencies. While approval of the insurance company is necessary for a sale between agencies, it is rarely withheld. Where a sale of a register occurs, the purchaser becomes entitled to be paid some or all of the renewal and any other applicable commissions that would have been paid to the vendor agency had the sale not occurred.

29. There may be a number of reasons why an agency sells a register (or a part of it). Most commonly, retirement from the insurance industry is the reason for the sale. However, transfer to another locality, change or reorganisation of the agency structure or change in accreditation of the agency may be the reason.

30. An insurance agency business is able to exist only by virtue of the agency agreement. The business profits are generated from 'selling' policies to clients on a commission basis. Agencies build up their business over time and the value of the business is generally enhanced by selling policies to an increasing number of clients. From time to time an agency is able to acquire access to more clients and increase the potential for sales by acquiring from another agency some, or all, of that other agency's client base or register. The register has, therefore, an intrinsic worth which is reflected in the price an agency is prepared to pay to acquire it.

31. Because of the circumstances giving rise to the payment of these commissions, Taxation Ruling IT 2408 drew the conclusion that an insurance register is an income producing asset in its own right and is capable of being property the subject of a trust. The Ruling indicated that income arising from the ownership of an insurance register is not income from personal exertion whereas initial commissions, production volume bonuses, overriding commissions and recruiting commissions are income from personal exertion. (A full discussion of personal exertion income is contained in Taxation Ruling IT 2639.)

32. We have been asked to indicate our view on the taxation consequences of buying some, or all, of an insurance register and selling some, or all, of an insurance register. The matter to be determined is whether the consideration is of a capital or revenue nature.

Purchasing a register - capital gains implications

33. As indicated above, the agency contract is the business contract without which the profits of the business could not be generated. For

taxation purposes, the rights that are created under that business contract are 'assets' within the meaning of that term in section 160A.

34. When an agency acquires access to a greater number of clients there is no change in the terms of the agency agreement and the nature of any rights that an agency has as against an insurer do not change. The reality of the situation is that the purchasing agency adds to its existing list of clients a new group of clients in respect of whom the agency has servicing rights and obligations, and in respect of whom commissions are paid if their existing policies are renewed.

35. In some cases when the vendor agency remains in business the purchaser may only acquire rights in respect of renewal commissions on existing policies. The right to write new business for those clients may remain with the vendor agency. The situation can be the reverse as well i.e., the purchaser may only acquire servicing rights in relation to new business. More likely, the purchaser acquires both the servicing rights and the renewal commissions. In any event the purchaser is adding to his or her existing business the potential for an increased cash flow. It can readily be accepted, given the nature of the arrangements in the insurance industry, that by expanding the client base, the purchaser is enlarging the potential of the agency business, if not the size of that business.

36. If the purchaser has an insurance agency business pursuant to an agency agreement entered into before 20 September 1985, those rights that constitute the insurance register will have been acquired before that date. The register will be a pre-CGT register. By purchasing some, or all, of an insurance register an insurance agency is adding to the profit-making structure of the insurance agency business and enhancing its rights under the agency agreement. No new asset is being created but, rather, an existing asset is being enhanced.

37. If the purchaser has an insurance agency business pursuant to an agency agreement entered into on or after 20 September 1985, its insurance register will have been acquired on or after that date i.e., it will be a post-CGT register. No new asset is being created but the consideration paid will form part of the cost base of its post-CGT register if it is later disposed of by the insurance agency.

Purchasing a register - is it a deductible outgoing?

38. Subsection 51(1) provides that all losses and outgoings to the extent to which they are incurred in gaining or producing the assessable income, or are necessarily incurred in carrying on a business for the purpose of gaining or producing such income, shall be allowable deductions except to the extent to which they are losses or

outgoings of capital, or of a capital, private or domestic nature, or are incurred in relation to the gaining or production of exempt income.

39. It can readily be seen that there is a positive test that needs to be satisfied before a deduction is allowable but, having satisfied that test, the character of a particular loss or outgoing may be such that it is not deductible because of the exclusory provisions (the so-called negative test) in the subsection.

40. However, the subsection presupposes that a loss or outgoing incurred in gaining or producing the assessable income or in carrying on a business for that purpose may nevertheless be a loss or outgoing of capital. See Dixon CJ in *John Fairfax & Sons Pty. Ltd. v. Federal Commissioner of Taxation* 11 ATD 510 at page 511.

41. Accordingly, there may be two questions that need to be answered when determining deductibility under subsection 51(1). The first is whether the relevant outgoing is incurred in gaining or producing the assessable income or in carrying on a business for that purpose. If the answer to that question is in the negative the second question does not arise because the loss or outgoing is not deductible. If the answer is in the affirmative, we then have to ask whether the loss or outgoing is nonetheless not deductible because it falls within the exclusory parts of the subsection.

42. In the case of consideration paid to acquire an insurance register we think the answer to both questions is in the negative.

43. In *John Fairfax*, (supra), the taxpayer entered into a merger arrangement with Associated Newspapers Ltd. Part of the arrangement involved an acquisition by the taxpayer of certain unissued shares in Associated Newspapers Ltd. The taxpayer incurred legal costs in defending its title and that of its nominees as the registered holders of those shares. Menzies J said (at page 519):

> 'To make a payment to acquire or defend the acquisition of a favourable position from which to earn income or to enter into arrangements that will yield income is not in general an outlay incurred either in gaining or in carrying on business for the purpose of gaining assessable income; such a payment in the case of a trading company, occurs at a stage too remote from the receipt of income to be so regarded. To be deductible an outlay must be part of the cost of trading operations to produce income, i.e., it must have the character of a working expense.'

44. By applying the same principles to the cost of acquiring access to a greater client base and potential income flow, we have concluded that the expenditure is not incurred in gaining or in carrying on a business for the purpose of gaining, assessable income. The payment

occurs at a stage too remote from the receipt of income and it does not have the character of a working expense

45. That being the case, it is not strictly necessary to consider the second question. However, in the circumstances, we consider it is appropriate to say why we think the consideration in respect of the acquisition of an insurance register is expenditure on capital account.

46. In determining whether expenditure is capital or revenue in character, an authoritative starting point is the decision in *British Insulated and Helsby Cables v. Atherton* [1926] A.C. 205. Lord Cave set out the basic principle at pp. 213-4 where he said:

> 'But when an expenditure is made, not only once and for all, but with a view to bringing into existence an asset or advantage for the enduring benefit of a trade, I think that there is a very good reason (in the absence of special circumstances leading to an opposite conclusion) for treating such expenditure as properly attributable not to revenue but to capital.'

47. In *Sun Newspapers Ltd. v. Federal Commissioner of Taxation* 5 ATD 87 the taxpayer paid an amount to buy out threatened opposition. The Full High Court determined that the payment was an outgoing on capital account and was not deductible for income tax purposes. In deciding whether the amount was a capital or revenue outgoing, Latham J pointed to a number of features of the payment. In particular, he indicated that the payment produced a situation of advantage to the taxpayer, the agreement proved profitable to the business of the taxpayer and the expenditure was a large non-recurrent and unusual event made for the purpose of obtaining an advantage for the enduring benefit of the taxpayer's trade. These features are also to be found when consideration is given for the acquisition of an insurance register.

48. It might be argued that expenditure in acquiring a register is not an outgoing of capital. When acquiring a client base the expenditure would be expected, but not guaranteed, to produce the results alluded to by Latham J in *Sun Newspapers*. Despite the existence of that purpose or effect, one could argue that there is no necessary enduring benefit to an agency business because the expected, or hoped for, result may not eventuate. Indeed, some or all of the new clients may not renew their existing policies and it may be that they do not take out any new policies at all. While this is most unlikely, the response to such an argument is, again, to be found in *Sun Newspapers*. Latham J said (at p. 90):

> 'It is true that the payments did not result in a new capital asset of a material nature, but they did obtain a very real benefit or

> advantage for the companies, namely, the exclusion of what might have been serious competition. *When the words permanent or enduring are used in this connection it is not meant that the advantage which will be obtained will last forever. The distinction which is drawn is that between more or less recurrent expenses involved in running a business and an expenditure for the benefit of the business as a whole*.' (emphasis added)

Selling a register - is there a capital gain?

49. The most usual case in which an insurance agency disposes of an insurance register is when the principal of an insurance agency business wishes to retire i.e., the agency agreement with the insurer is brought to an end and the business is sold to another agency. One valuable part of that business is the insurance register. It is usually sold *en bloc* to another agency but may be broken up. We think that this is a sale of an integral part of the business structure, or organisation, of the profit-earning enterprise. The transfer can only be to a person or company with an agency agreement with that insurer and the new 'owner' has either some, or all, of the rights as against the insurer and other agencies in repect of those clients that the former agency had.

50. In most cases the purchaser has an existing agency contract and new clients are added to the existing base in respect of which the owner had rights and obligations flowing from the existing agency contract. This is not a novation of the original contract because it isn't a tripartite agreement whereby a contract between two parties is rescinded in consideration of a new contract being entered into on the same terms between one of the parties and a third party. If a new agent was to buy a register at the commencement of his or her agency business, it would not affect this conclusion because the agency agreement would not have been entered into by the insurer in consideration of the transfer of the register to the commencing agent.

51. As set out in paragraph 33 above, the rights being disposed of by a vendor of an insurance register are assets for the purposes of the capital gains and capital losses provisions. Accordingly, the consideration received may give rise to a capital gain if the insurance register was created or acquired on or after 20 September 1985.

52. The amount of the capital gain will depend on the indexed cost base of the asset disposed of. If the register is a post-CGT register built up over time there will ordinarily be no, or at best a minimal, indexed cost base for the purposes of calculating any capital gain. If consideration had been paid to enlarge a post-CGT register, that

consideration will form part of the cost base or indexed cost base on the disposal of some, or all, of the register.

53. In certain limited circumstances, disposing of a pre-CGT register will give rise to a capital gains tax liability. Subsection 160P(6) deals with capital improvements on or after 20 September 1985 to an asset (other than a periodic roll-over asset) acquired before that date. Adding new policyholders to a pre-CGT register by acquiring another register on or after 20 September 1985 is an improvement of a capital nature to the pre-CGT asset. If an improved pre-CGT register is later disposed of and the value of the improvement is greater than $50,000 as indexed in accordance with section 160Q and greater than 5% of the consideration in respect of the disposal of the improved register, the improvement is deemed to be a separate asset to the pre-CGT register and will be subject to the ordinary operation of Part IIIA. In practice this means that the part of the register acquired on or after 20 September 1985 will, when sold as part of the enhanced register, be treated as a separate asset acquired on or after 20 September 1985, and any capital gain attributable to that part of the register will be subject to taxation.

Selling a register - is it an income gain?

54. The amount of a capital gain attributable to the sale of an insurance register is reduced, by subsection 160ZA(4), to the extent than an amount has been or will be otherwise included in the assessable income of an agency in relation to the disposal of a register. Accordingly, consideration has to be given to the question whether other provisions of the Act operate to include an amount in the assessable income of an agency as a result of a sale of some or all of a register.

55. There are many occasions when selling an asset of a business will result in a revenue gain. See, for example, the discussion in the reasons for decision of the Full Federal Court in *Federal Coke Pty Ltd v. FC of T* 77 ATC 4255; (1977) 7 ATR 517, *Moneymen Pty. Ltd. v. FC of T* 91 ATC 4019; (1991) 21 ATR 1142, *Henry Jones (IXL) Ltd v FC of T*. 91 ATC 4663; (1991) 22 ATR 328 and *SP Investments Pty. Limited v. FC of T* 93 ATC 4170; (1993) 25 ATR 165.

56. Having regard to the nature and the circumstances that give rise to the sale of insurance registers, we do not think that there is any general principle of income tax law that requires the characterisation of the consideration received as income according to ordinary concepts and thus assessable under subsection 25(1). Nor do we think that there are any other provisions of the Act, apart from the provisions of Part IIIA, that operate to include the consideration in the

assessable income of a vendor agent unless the vendor sells a register in the ordinary course of a business of buying and selling insurance registers.

Roll-over relief

57. There are many cases of an individual insurance agent transferring his or her insurance business to a company which the agent controls. We accept that for all practical purposes there is a novation of the original contract between the insurer, the individual insurance agent and the new corporate agency. However, the transfer of the assets of the original agency business to the new business is a disposal of those assets. This includes any rights under the original agency agreement that are transferred to the new business. The new agency agreement encompasses the existing bundle of rights that have been rolled-over to the new company.

58. The business being transferred may be a pre-20 September 1985 business or it may be a business commenced on or after that date. Roll-over relief may be available in respect of the disposal of the assets of an agency business if the provisions of section 160ZZN are satisfied. Generally speaking, the former agent would need to receive as consideration in respect of the disposal only non-redeemable shares in the company, the market value of those shares must be substantially the same as the roll-over assets and the former agent must be the beneficial owner of all the shares in the new company.

59. Section 160ZZN deems the shares in, and the assets of, the new company to be pre-CGT assets. Similarly, roll-over relief may also be available when an insurance agency business is transferred by one company to a related company. See section 160ZZO.

Transfer of an insurance register to a family trust

60. Taxation Ruling IT 2408 accepts that an insurance register is an income producing asset in its own right and is as much capable of being property the subject of a trust as any other income producing property. What was being said was that the relevant chose in action i.e., the right to commission, can be the subject of a trust. 'Choses in action may be the subject of trusts in the same way as there can be a trust of any other category of personal property...' See Starke, Seddon and Ellinghaus (eds), *Cheshire & Fifoot's Law of Contract,* Sixth Australian Edition, Butterworth's 1992 at p. 704.

61. The situation under consideration arises when an individual insurance agent, running an insurance agency business as a sole trader, assigns his or her rights to future renewal commissions to a trustee of

a trust for the benefit of the individual's family. Normally the individual is a director of the company that is the trustee of the trust.

62. What is assigned is a contractual right that the agent has under the agency agreement to be paid renewal commission on the policies in respect of which the agent is the originating agent or which have otherwise been allocated to the agent. That right is a legal chose in action because it confers on the agent a right of proceeding in a court of law to recover pecuniary damages for the non-performance of the insurer's obligation to pay the commission.

63. The agency agreement itself remains on foot but the insurer is normally made aware of the assignment and, as we understand the terms of agency agreements, could veto the assignment if it so wished. Strictly speaking, the chose in action that arises under the agency agreement is a right to receive various commissions as and when certain events occur. So, for example, an immediate entitlement to commission arises when a policy is sold by an agent. Payment of renewal commission occurs in the event that the policy is renewed i.e., at the time the policyholder pays the renewal premium to the insurer. By assigning only a part of the entitlement to commission payable in respect of each policy i.e., only the right to renewal commission, an agent is assigning only a part of the chose in action.

64. Debts and other legal choses in action are assignable at law pursuant to, for example, section 134 of the *Property Law Act 1958* (Vic.). Equivalent provisions exist in other Australian jurisdictions. An attempted assignment of part only of a chose in action is ineffective at law but can be assigned in equity: *Shepherd v. F C of T* 14 ATD 127, *F C of T v. Everett* 80 ATC 4076; 10 ATR 608. However, in Western Australia a part of a debt can be subject to a statutory assignment: *Property Law Act 1969* (W.A.), subsection 20(3).

65. In *Shepherd*, the taxpayer granted a licence to a manufacturer to manufacture castors on certain terms. One condition was that the taxpayer was to be paid a royalty of 5% of the gross sale price of castors maufactured by or on behalf of the licensee which had been sold during the preceding month. The taxpayer later purported to assign 'all my right title and interest in and to an amount equal to ninety per centum of the income which may accrue during a period of three years from the date of this assignment from royalties payable' by the manufacturer. The High Court (Barwick CJ and Kitto J, Owen J dissenting) held that what was transferred was a part of an existing chose in action and therefore the assignment was valid in equity. At 14 ATD 129 Barwick CJ said:

> 'In my opinion, if the assignment of a part of the chose in action consisting of the promise to pay royalties is complete,

> it is effective to vest the appropriate part of the right equitably in the assignee, whether or not the assignment is for consideration or by way of gift. It is only if the donee needs the assistance of equity to complete the gift, as distinct from enforcing the right given, that he can be met with the defence that equity will not assist a volunteer. Here, if there was an immediate gift of a proportion of the right to royalties, the donees need seek no assistance. If the deed upon its true construction evidences an intention presently to assign part of the right, the assignment would be complete within the doctrines of equity.'

66. We accept that a right to commission under an agency agreement is similar in nature to the taxpayer's right to be paid royalties in *Shepherd* and, accordingly, a part assignment of such a right is effective in equity. The result for income tax purposes is that the renewal commission is income in the hands of an assignee and will be part of the net income of a trust when the assignee is a trustee of a trust estate.

67. If the right to commission arose under an agency agreement entered into on or after 20 September 1985, it will be an asset for the purposes of Part IIIA. If an asset is disposed of, or a part of an asset is disposed of, for no consideration or for consideration less than its market value and the parties to the transaction are not dealing with each other at arm's length in connection with the disposal, the consideration for the disposal is deemed, by subsection 160ZD(2), to be the market value of the asset at the time of the disposal. At the same time the consideration in respect of the acquisition by an assignee of the right to renewal commission will be deemed, by subsection 160ZH(9), to be the market value of the right at the time it is acquired.

68. An assignor agent will have little or no indexed cost base in respect of the rights disposed of unless the relevant rights were acquired from another person. This may be, for example, where what is assigned previously formed part of another register acquired for valuable consideration by the assignor agent. Accordingly, the capital gain resulting from the assignment will generally be the market value of the rights to the renewal commission at the time of the assignment.

Goodwill

69. It has been suggested that the list of names on a register is the goodwill of an agency business, and hence, at least part of the consideration received on the sale of a register ought to be taxed concessionally as a result of the operation of section 160ZZR.

70. It is usual for goodwill to be classified into three categories. These are 'site' or 'local' goodwill, 'commercial' or 'name' goodwill and 'personal' goodwill.

71. In *F C of T v. Williamson* (1943) 67 CLR 561 Rich J accepted that, in a particular case, the goodwill of a business may be local or personal or partly one and partly the other. It is local to the extent to which the trade connection depends on the place in which the business is carried on. It is personal to the extent to which it is the personality, ability and good reputation of the (trader) that attract the trade and not the place where the business is carried on. At pp. 563-4 he said:

> '[T]o determine the nature of the goodwill in any given case, it is necessary to consider the type of business and the type of customer which such a business is inherently likely to attract as well as all the surrounding circumstances...the goodwill of a business is a composite thing referable in part to its locality, in part to the way in which it is conducted and the personality of those who conduct it, and in part to the likelihood of competition, many customers being no doubt actuated by mixed motives in conferring their custom.'

72. In *Box v. Federal Commissioner of Taxation* 10 ATD 71 Dixon CJ, Williams, Fullager, Kitto and Taylor JJ stated (at p. 75):

> 'Goodwill includes whatever adds value to a business, and different businesses derive their value from different considerations. The goodwill of some businesses is derived almost entirely from the place where they are carried on, some goodwills are purely personal, and some goodwills derive their value partly from the locality where the business is carried on and partly from the reputation built up around the name of the individual or firm or company under which it has previously been carried on.'

73. In *I.R.C. v. Muller & Co's Margarine Ltd.* [1901] A.C. 217 Lord MacNaughten said (at pp. 223-4):

> 'Goodwill is composed of a variety of elements. It differs in its composition in different trades and in different businesses in the same trade. One element may preponderate here another element there.'

74. The above passages describe adequately what is local and personal goodwill. Commercial or name goodwill is discussed in a draft paper issued by the New South Wales Office of State Revenue in March 1994 entitled *'Valuation of Goodwill'.* At pp. 15-16 the draft paper states:

> '...[Commercial goodwill] is associated with the name by which the business is identified, and which has arisen by

> virtue of factors not associated with the place at which the business is carried on, or the identity of its proprietor(s)...This goodwill primarily reflects many of the factors identified in the Accounting Standards as being intangible sources of the earnings of a business such as internal management, market penetration, effective advertising, benefit of licences, overall economic strength etc. In its nature, commercial goodwill is found mainly in businesses much larger than that of a sole trader, or small partnership or company. Businesses which enjoy such commercial goodwill are usually identified with well known trade or business names, brand names, trademarks, patents and other forms of intellectual property. Often they are the subject of franchised business systems...'

75. In the context of an insurance agency business, it could be expected that there would be little commercial or name goodwill except in, perhaps, the larger agency businesses. Normally this kind of goodwill is associated with insurance companies rather than the agency business that introduces clients to them.

76. We understand that within the insurance industry today there are no restrictions within a State as to the location or area within which a particular agent may attempt to generate new business. If there is any goodwill associated with an agency business, it cannot be local goodwill unless there is a clear geographical location in which the agency business operates with little or no competition from other agencies linked to the same insurer. This may arise, for example, in a country area. Given the nature of an insurance agency business, it is difficult to discern any local goodwill that attaches to an agency business conducted primarily in a metropolitan area.

77. It is arguable that there is some degree of personal goodwill associated with an agency business. While acknowledging that there is real doubt as to whether personal goodwill is a saleable asset, we are prepared to accept that it is possible to be disposed of in the circumstances under consideration, at least in the sense referred to by Rich J in *Williamson*. In that case he discussed the situation of an agreement for the sale of a business containing a covenant that the vendor agrees to introduce and recommend the proprietors and employees of the purchasing entity, thereby encouraging the existing customers to continue to deal with the new proprietors. At p. 565 he said:

> 'It might then be that the premium should be regarded as being in part paid for the acquisition of any personal goodwill enjoyed by the seller in respect of the business.'

78. What may actually be occuring, however, is that the payment for such endorsements really is associated with a restrictive covenant in

relation to the sale rather than a payment for a property right. Wallace and Zipfinger, *Australian Stamp Duties Law*, 1993, Butterworths, at para. 21.19 state:

> 'Further, it can be argued that amounts paid for endorsements...enhance the value of what has been acquired but do not effect the transfer of any property. It should not be assumed that, because a payment is made, it follows that property has been transferred.'

79. So, for example, assume that an agency acquires from another agency its company superannuation plan business that does not generate renewal commissions. The purchaser may acquire the particular *bloc* of business primarily with a view to capturing future roll-over business from the employees if and when they leave their current employers. In these circumstances, we do not think that an asset has been disposed of by the vendor that consists of goodwill if the vendor maintains the agency agreement (and hence the agency business) under which it created the company superannuation plan business that it has now sold. There has clearly been a payment for something of value but we do not think there has been a transfer of goodwill for capital gains tax purposes because goodwill can only be transferred with the business from which it emanates. (See the discussion in paragraphs 80-83 below).

Inseverability of goodwill

80. In *Bacchus Marsh Concentrated Milk Co. Ltd. v. Joseph Nathan & Co. Ltd.* (1919) 26 CLR 410 a contract between the parties purported to transfer 'the exclusive right' of using certain inventions and processes, and of selling the milk powder produced by them, from one company to the other. Isaacs J stated (at pp. 438-439):

> 'All that the "exclusive right" stipulated for could give was a personal right to exclude [the vendor] from further carrying on its business of selling dried milk in Australia. It is not, and does not purport to be, a transfer of a business, with goodwill...Goodwill is property, but, as such is inseparable from a particular "business" in the sense of a particular going concern. It is an asset of that business, and enhances its value...The identity of the concern is essential to the conception of goodwill. You cannot attach the goodwill of an old business to a new business...
>
> '[The vendor] may have thought the right to "Eclipse" trademark passed, on the ground...that the trademark indicated the method of manufacture, but unless the goodwill passed, the right to the trade mark did not, and unless "the

> business" - the definite particular commercial undertaking or enterprise which [the vendor] was in fact carrying on - was sold and passed, the goodwill did not pass.'

81. In *Hepples v. F C of T* 91 ATC 4808; 22 ATR 465, McHugh J said (at ATC 4837, ATR 498):

> 'It will be seen...that goodwill is the collective name for various intangible sources of the earnings of a business which are not able to be individually quantified and recorded in the accounts as assets of the business. The goodwill may be constituted by sources internally generated by the business entity or "from the combination or inter-relationship of entities or groups of assets (synergistic benefits)" or both: see the Statement of Accounting Standards AAS 18: *Accounting for Goodwill* (March 1984), para.7.
>
> 'Goodwill, therefore, is "inherently inseverable from the business to which it relates": *Geraghty & Anor v. Minter & Anor* (1979) 142 C.L.R. 177, at p. 193. It does not survive the cessation of the business and cannot be dealt with independently of that business: *Geraghty*, at pp. 81, 193;...'

82. It seems, therefore, that you cannot deal with a part only of the goodwill of a business. In *Just Jeans Pty. Ltd. v. F C of T* 87 ATC 4373; 18 ATR 775, the Full Federal Court held that a business name was only one aspect of the goodwill of a business and that goodwill as a whole can only be transferred with the business from which it emanates.

83. If the proprietor of an agency business decides to sell the business to another agency, we accept that some aspect of what is sold is goodwill for the purposes of Part IIIA. However, if just some part of a register is sold and the agency business continues, no part of what is disposed of is goodwill. If an agency relinquishes one agency agreement without selling the associated register and enters into another agency agreement with a new insurer, the former business has been disposed of and a new business has been commenced. No rights under the agency agreement with the former insurer can be transferred to the new business, including the goodwill, if any, associated with the former business.

Multi-agents

84. Many insurance agency businesses are multi-agents i.e., they have an agency agreement with more than one insurer. If a particular agency agreement is entered into on or after 20 September 1985, any register that is attributable to that agreement will be acquired on or after that date and will be a post-CGT register. If a post-CGT register

associated with that particular agreement is disposed of, a capital gain may arise in the normal way. If some, or all, of a post-CGT register is disposed of but the relevant agency agreement continues, no part of what is disposed of is goodwill for the purposes of Part IIIA.

85. Even if one of the agency agreements is terminated and the associated post-CGT register is disposed of, the insurance agency business still continues and, therefore, no part of what is disposed of is goodwill for the purposes of Part IIIA.

86. In some cases an insurance agency may terminate an agency agreement it has with one insurer and enter into a new agency agreement with another insurer. This involves the cessation of one business and the commencement of a new business. No rights under the agency agreement with the former insurer can be transferred to the new business. Nor can the goodwill, if any, associated with the former business. If the agency agreement that was terminated was entered into before 20 September 1985, the register is a pre-CGT register and, subject to subsection 160P(6), no capital gains implicatons arise in respect of the disposal of that register to another agency business associated with the former insurer. If the agency agreement that was terminated was entered into on or after 20 September 1985 the transfer of the register to another agency business associated with the former insurer may give rise to a capital gain or loss in the normal way. Goodwill assocaited with the former agency business may be transferred with that register. If the agency agreement with the new insurer is entered into on or after 20 September 1985 i.e., a post-CGT register is to be created, a capital gain may arise in respect of any later disposal of some, or all, of that register.

87. It is possible to dispose of a discrete part of an integrated business including the goodwill associated with that part of the business. In Taxation Ruling IT 2328 we give the example of a taxpayer who acquires a supermarket business before 20 September 1985 and integrates a liquor outlet acquired after that date. If the integrated business was sold the goodwill attributable to the supermarket business would not be subject to capital gains tax. Any goodwill associated with the liquour outlet would be subject to capital gains.

88. However, in the context of an insurance agency business, if an agency business associated with a particular insurer afterwards becomes a multi-agency i.e., it enters into one or more new agency agreements with different insurers while maintaining the original agency agreement, we do not think that more than one discrete business is being carried on. That being the case the later disposal of a register associated with any particular agency agreement would not contain an element of goodwill even if the relevant agency agreement

is terminated. If the relevant agreement remains in place, the disposal of the register or part of it may still occur and no part of what is disposed of represents goodwill.

Lapses

89. There are no capital gains implications for an insurance agent when a client that formed part of a register lapses i.e., discontinues with an existing policy. We do not consider an agency's rights in respect of each policy a separate asset such that there is a disposal of that asset when a lapse occurs.

Accreditation

90. We understand that an agency is not able to sell particular insurance products without being properly accredited to sell that product. An agency business may initially be accredited to sell only one or two particular products. As the business grows and the principal becomes more experienced, product accreditation may increase. We do not see any income tax implications in simply increasing or abandoning accreditation in respect of a particular insurance product.

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