

TR 96/D11 - Income tax: derivation of commissioner income by real estate agents



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Draft Taxation Ruling

Income tax: derivation of commission income by real estate agents

other Rulings on this topic

IT 2626; TR 93/11

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What this Ruling is about

Class of person/arrangement

1. This Ruling considers when commission income is derived under subsection 25(1) of the *Income Tax Assessment Act 1936* (ITAA) by real estate agents from the sale/purchase of property.
2. The Ruling deals only with those cases where, on the facts, the commission income is assessable on an accruals, rather than a cash, basis. It is not concerned with the threshold issue of which of the two methods is correct in any given situation.

Background

3. In a typical real estate sale/purchase transaction the real estate agent and client enter into an agency agreement for the sale/purchase of the property. When the property is sold a deposit is paid and held by the agent in trust on behalf of the vendor and purchaser. This deposit is held in trust by the agent until instructions are received from the relevant party that the moneys may be released and the agent may deduct commission. If the agent does not receive any formal instructions the deposit moneys will not be released until the date of settlement or some time thereafter. The agent will deduct the commission and forward on the net amount of the deposit to the vendor. The amount retained by the real estate agent is not transferable from the trust account until it becomes due and payable. The time the commission becomes due and payable is usually stipulated in the agency contract to be when settlement occurs. The

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time of settlement on the sale is determined by the terms of the contract and would usually be 60 or 90 days after the property is sold.

Ruling

When commission income is derived

Reference to the terms of engagement

4. The terms of the engagement between the real estate agent and a client under which the commission is payable determine when the commission income is derived under subsection 25(1) of the ITAA. In particular, it is necessary to determine when, on a proper construction of the engagement, a recoverable debt is created such that the agent is not obliged to take any further steps before becoming entitled to payment. A fee is 'recoverable' in the relevant sense even if time to pay has been allowed.

5. The law of real property in Australia differs from State to State. Allowing for these variations, commission income is derived by a real estate agent when it becomes a legally recoverable debt irrespective of when it is actually received.

Conditional contracts

6. Some sales contracts are entered into subject to certain conditions, for example, subject to the purchaser obtaining finance. In such cases, the conditions must be satisfied before the contract becomes binding on all parties and the agent has a legally recoverable debt.

Impediments to collection

Operation of a trust account

7. Deposit moneys held in trust by real estate agents are held until instructions are received from the relevant party that the moneys may be released and the agent may deduct commission. If the agent does not receive any formal instructions the deposit moneys will not be released until the date of settlement or some time thereafter. This has no impact on the timing of the derivation of the agent's commission fee income.

Invoicing

8. Invoicing or billing a client is an indication that a commission fee has been derived. However, the determinative factor in establishing the time of the derivation is not the rendering of an invoice but the point at which the debt becomes legally recoverable. The time of invoicing or the absence of invoicing procedures has no impact on the timing of the derivation of the commission fee income.

Commission fees 'due and payable'

9. Many contracts stipulate that the agent's fee is due and payable on completion of the sale, i.e., at settlement. Depending on the terms of the contract this could be some time after the time of income derivation for income tax purposes. Although this constitutes a contractual impediment to actual receipt or collection of the commission income, it has no impact on the timing of the derivation of that income.

Commission repaid or never collected because of industry practice

10. Where an amount included as income is repaid, or never collected because of industry practice, this amount may be excluded from the assessable income of the year in which the commission fees were included (subject to the objection and amendment provisions of the ITAA and the *Taxation Administration Act 1953*).

Commission fees from engagements to purchase property

11. In some instances real estate agents are also engaged to purchase property. The principles expressed in this Ruling also apply to these engagements.

Previous Rulings

12. This Ruling replaces Taxation Determination TD 92/D212 and has been written having regard to each State and Territory's legislation and standard form contracts.

Date of effect

13. This Ruling applies to years commencing both before and after its date of issue. However, the Ruling does not apply to taxpayers to

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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

When commission income is derived

Reference to the terms of engagement

14. The Australian courts have held that income assessable on an accruals basis is 'derived' under subsection 25(1) of the ITAA when a recoverable debt is created such that the taxpayer is not obliged to take any further steps before becoming entitled to payment: *Farnsworth v. FC of T* (1949) 78 CLR 504; (1949) 9 ATD 33; *Henderson v. FC of T* (1970) 119 CLR 612; 70 ATC 4016; (1970) 1 ATR 596; *FC of T v. Australian Gas Light Co* 83 ATC 4800; (1983) 15 ATR 105.

15. When the service is so far performed that, according to the agreement of the parties, the commission has been earned then it will be income derived in the period of time in which it has become recoverable. Barwick CJ said in *Henderson's* case, at ATC 4020; ATR 601 that:

'I have used the word "recoverable" to describe the point at which income is derived by the performance of services ... fees would be relatively recoverable though by reason of special arrangements between the partnership and the client, time to pay was afforded.'

Accordingly, a fee is 'recoverable' in the relevant sense even if time to pay has been allowed. See *Henderson's* case; *J Rowe and Son Pty Ltd v. FC of T* (1971) 124 CLR 421; 71 ATC 4157; (1971) 2 ATR 497; *Australian Gas Light Co* case. See also paragraph 19 of Taxation Ruling IT 2626 and paragraph 3 of Taxation Ruling TR 93/11.

Conditional contracts

16. The authority for conditional contracts is *Trotter v. McSpadden and Another* [1986] VR 329. In this case, Gobbo J found that a contract cannot be binding until all conditions are fulfilled. He found, at 331-332, that the case facts were:

'...consistent with *dicta* in two other cases, namely *Gerlach v. Pearson* [1950] V.L.R. 321 and *Reid v. Bennett* [1955] V.L.R. 505. In the first case Dean J. expressed the view that, where there had been a sale subject to finance, there was no binding agreement. Accordingly, the agent was not entitled to

commission. His Honour, at p.[325], said as follows: "In the present case, it becomes important to determine what is the precise event upon which commission has been promised. If it be upon securing a person who makes a binding agreement, and so becomes a purchaser, that event has not occurred. The document signed is not a binding and enforceable contract for two reasons. In the first place, it is subject to a condition and is not to become binding unless that condition is fulfilled - *McCallum v. Hicks*, [1950] W.N. 190; *Comley v. Wellman* (1948), 65 W.N. (N.S.W.) 268; *Marks v. Board* (1930), 46 T.L.R. 424; *Henry v. Buxton* (1904), 4 S.R. (N.S.W.) 264..."

In *Reid v. Bennett* Sholl J. spoke in terms of indefeasible entitlement when discussing agent's commission. A conditional contract would not bring about such entitlement.'

17. In *Barratt v. FC of T* 92 ATC 4275; (1992) 23 ATR 339 Gummow J stated, at ATC 4281-4282; ATR 346, that:

'No doubt a debt that is presently recoverable by action generally will be an amount "derived" in the relevant sense by the creditor. The creditor will have a present right to receive the amount in question, something both earned and quantified, without the presence of any element of contingency or defeasibility. At the other end of the scale, where the right of the taxpayer is contingent, there will be no derivation before the contingency is satisfied: see Parsons, "*Income Taxation in Australia*" 11.49.'

18. In the case of real estate transactions, the debt is both earned and quantified without the presence of any element of contingency or defeasibility when the contract becomes unconditional.

Impediments to collection

19. The decision of the Full Federal Court of Australia in *Barratt's* case is authority for the view that an impediment to commencing legal proceedings for recovery of a debt does not defer the time at which fee income is derived under subsection 25(1) by a professional person whose income is assessable on an accruals basis. *Barratt's* case concerned subsection 35(2) of the *Medical Practitioners Act 1938* (NSW), which provides that no action for the recovery of medical fees can be commenced until the expiration of six months after a bill for services rendered has been served on the patient. The Federal Court rejected the view that an amount cannot be derived unless it is presently recoverable by action.

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Operation of a trust account

20. In the case of real estate transactions, an example of an impediment to receipt of commission fees from moneys held in trust is section 24 of the *Sale of Land Act 1962* (Vic). That section states:

'Any deposit moneys received by a solicitor or estate agent in the course of a transaction for the sale of land shall be held by that solicitor or estate agent as stakeholder until-

- (a) in the case of a cash transaction the purchaser becomes entitled to a transfer or conveyance of the land, or
- (b) in the case of a terms contract, the purchaser becomes entitled to possession or to the receipt of rents and profits - at which time the deposit monies may be paid to the vendor in his own right or as the vendor directs.'

21. Impediments such as those imposed by that section do not constitute a condition precedent to the existence of the debt. Rather, they are an impediment to the recovery of an existing debt.

Invoicing

22. In many cases real estate agents do not invoice the vendor for commission due until some time after they have fully completed their contractual obligation under the terms of the agency agreement. In other instances they do not invoice for commission due at all. In most cases the agent is paid their commission fee from the deposit monies held in trust for the sale/purchase of the property. The time of invoicing or the absence of invoicing procedures has no impact on the timing of the derivation of the commission fee income.

23. In the *Australian Gas Light Co* case it was held that until a number of conditions were satisfied, no debt had come into existence. The Full Federal Court said, at 83 ATC 4805; 15 ATR 112:

'The registration of a customer's gas meter is prima facie evidence of the quantity of gas supplied and determines the quantitative basis on which he is obliged to pay. The reading of the meter and the giving of notice to the customer of what is registered are more than mere procedure. They are conditions precedent to the making of demand for payment.'

24. In the case of real estate transactions, and in contrast to the *Australian Gas Light Co* case, the amount of the commission fee and the time when the commission fee is earned and accordingly derived are determined from the sale/purchase agency contract and the contract of sale of the property. Accordingly, the time of invoicing or the absence of invoicing procedures has no impact on the actual timing of

the derivation of the commission fee income, as it is not a condition precedent to the making of the demand for payment.

Commission fees 'due and payable'

25. The time a commission fee becomes due and payable is not relevant in determining the time when a fee becomes recoverable and accordingly derived. A fee becomes 'recoverable' and accordingly is derived in the relevant sense even if time to pay has been allowed: see *Henderson's case*; *Rowe's case*; *Australian Gas Light Co case*. See also paragraph 19 of Taxation Ruling IT 2626 and paragraph 3 of Taxation Ruling TR 93/11.

Commission repaid or never collected because of industry practice

26. Subsection 51(1) of the ITAA allows a deduction for losses or outgoings incurred in gaining or producing assessable income or necessarily incurred in carrying on a business for that purpose. Commission fees derived and repaid or never collected because of industry practice are not losses or outgoings incurred in deriving that income. Such amounts represent either a repayment of income received or an amount of income not actually collected rather than an outgoing incurred in deriving that income.

27. In circumstances where amounts are repaid or never collected because of industry practice, a strict application of the law may lead to situations where the Commissioner is seeking tax in respect of those amounts. The general approach has been to use the objection and amendment provisions in the law, subject to the statutory time limits in those provisions, to exclude these amounts from the assessable income of the year in which the commission fees were included.

Illustrations of standard agency contracts

28. The following paragraphs illustrate when commission fees are considered to be derived based on the terms commonly found in each State and Territory's standard contracts for the sale/purchase of property.

Victoria

29. In Victoria the standard real estate agency contracts to sell state that the agent's fee is payable if the property is sold. The contract defines 'sold' as 'obtaining a binding offer'. Accordingly, agents are

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considered to have derived their commission income when the contract of sale/purchase signed by the two parties becomes unconditional.

New South Wales

30. In New South Wales the standard agency contracts to sell state that the agent must 'introduce a purchaser to the principal who subsequently enters into a binding contract'. In these cases agents are also considered to have derived their commission fee when the contract of sale/purchase signed by the two parties becomes unconditional.

Australian Capital Territory

31. ACT sole agency agreements state that the listing agent is entitled to a fee 'IF ANYONE (including the Owner) sells the property as a result of the introduction of a buyer to the property during the sole agency period'. In these cases agents are considered to have derived their commission fee when the contract of sale/purchase signed by the two parties becomes unconditional.

Western Australia

32. Western Australian selling agency agreements state that 'the listing agent shall be entitled to be paid a selling fee' if the agent 'introduces a prospective purchaser who subsequently enters into a binding contract for the sale and purchase of the property'. As in Victoria and New South Wales, in these cases agents are considered to have derived their commission fee when the contract of sale/purchase signed by the two parties becomes unconditional.

Tasmania

33. The standard selling agency agreement in Tasmania states that the agent will be paid if 'the property is sold'. In the absence of a definition of 'sold' we consider the time the agents have derived their commission fee is again when the contract of sale/purchase signed by the two parties becomes unconditional.

South Australia, Queensland, Northern Territory

34. Sales agency agreements in South Australia, Queensland and the Northern Territory state that agents are entitled to their commission if the following three steps are completed:

- the agent introduces a purchaser, who
- enters into a sales contract, and
- completes that contract.

In these cases it is considered that agents have not derived their commission income until the parties complete the sales contract. This would be at settlement.

Your comments

35. If you wish to comment on this Draft Ruling please send your comments by: 28 June 1996

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Commissioner of Taxation

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ISSN	1039 - 0731	- commission fees
		- fees never collected
ATO references		- income derived
NO	95/9634-8	- real estate agent
BO	96 CASSBI 001	- refunds
	AF 416/34	- time of derivation
Previously released in draft form as		<i>legislative references</i>
TD 92/D212		- ITAA 25(1)
		ITAA 51(1)
Price	\$1.00	- TAA 1953
		- Medical Practitioners Act 1938
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<i>reference number</i>		- Sale of Land Act 1962 (Vic) 24
		<i>case references</i>
<i>subject references</i>		- Barratt v. FC of T 92 ATC 4275;
- allowable deductions		(1992) 23 ATR 339

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- Comley v. Wellman (1948) 65 WN (NSW) 268
- Farnsworth v. FC of T (1949) 78 CLR 504; (1949) 9 ATD 33
- FC of T v. Australian Gas Light Co 83 ATC 4800; (1983) 15 ATR 105
- Gerlach v. Pearson [1950] VLR 321
- Henderson v. FC of T (1970) 119 CLR 612; 70 ATC 4016; (1970) 1 ATR 596
- Henry v. Buxton & Anor (1904) 4 SR (NSW) 264
- J Rowe and Son Pty Ltd v. FC of T (1971) 124 CLR 421; 71 ATC 4157; (1971) 2 ATR 497
- Marks v. Board & Ors (1930) 46 TLR 424
- McCallum v. Hicks [1950] WN 190
- Reid v. Bennett; McKinley (Third Party) [1955] VLR 505; (1956) ALR 148
- Trotter v. McSpadden & Anor [1986] VR 329