

TR 93/36 - Income tax: assessability of commissions paid by investment funds to intermediaries



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Taxation Ruling

Income tax: assessability of commissions paid by investment funds to intermediaries

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IT 2536

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*This Ruling, to the extent that it is capable of being a 'public ruling' in terms of Part IVAAA of the **Taxation Administration Act 1953**, is a public ruling for the purposes of that Part. Taxation Ruling TR 92/1 explains when a Ruling is a public ruling and how it is binding on the Commissioner.*

What this Ruling is about

1. This Ruling considers the assessability under Division 6 of the *Income Tax Assessment Act 1936* (ITAA) of a commission that is not in the nature of an initial service fee or entry fee paid by an investment fund to an intermediary (e.g. an investment adviser, accountant or solicitor) in relation to the capital of an investor where the intermediary is under an obligation to pass on the amount to the investor. Such an obligation may arise in several ways. For example, there may be a fiduciary relationship between investor and intermediary or a covenant may be required by paragraph 7.12.15(6)(h) of the Corporations Regulations (the Regulations).
2. This Ruling does not consider the assessability to an investor of a partial or full refund of the service fee or entry fee into an investment product. That is considered in Taxation Ruling IT 2536.

Ruling

3. If an intermediary is legally entitled to receive a commission from an investment fund in relation to the capital of an investor but is under an obligation to pay that commission to the investor, the commission is received on behalf of the investor. In those circumstances, the commission is trust income and is subject to the provisions of Division 6.
4. Such an amount is income of a trust estate whether the intermediary pays the amount to the investor, deals with it on the investor's behalf, or deals with it other than on the investor's behalf.

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5. Generally, if the investor is not under a legal disability and is presently entitled to the amount, the assessable income of the investor under section 97 includes the amount of the commission less all allowable deductions, such as fees paid by the investor to the intermediary in respect of the collection and administration of the commission.

6. Fees and commissions charged by the intermediary to the investor in respect of the collection and administration of the amounts received on the investor's behalf are income of the intermediary according to ordinary principles and are assessable to the intermediary under section 25.

Date of effect

7. 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

General

8. If an investment product does not involve the payment of entry fees when the initial investment is made, the whole amount invested by the investor is applied by the investment fund to the investment product. In other words, there is no reduction in the capital amount invested. Commissions payable by the investment fund to the intermediary on the investment are an operating expense of the investment product and are withheld by the investment fund before it allocates the return on the investment to the investor's account. Generally, such commissions are paid by the investment fund to the intermediary on a regular basis, for example monthly in arrears. Attachment A describes the flow of investment funds and commissions in the case of an investment product not requiring the payment of an entry fee. It is this case which is covered in this Ruling.

9. Attachment B describes the flow of investment funds and commissions in the case of an investment product requiring the payment of an entry fee (Taxation Ruling IT 2536 applies to this type of investment product). This Ruling does not deal with the issues raised by that type of arrangement.

Obligation on the intermediary to pass on the commission to the investor***The Corporations Law***

10. The *Corporations Act 1989* (the Corporations Law) provides a system of regulation of dealings in company securities. It also regulates dealings with the public in many investment products other than company securities. The Corporations Law refers to these investment products as "prescribed interests".

11. In broad terms, a prescribed interest is identifiable by an investor investing a sum with another party on the basis of receiving a return by relying on that other party to perform the management function required to earn that return. A cash management fund is an example of a prescribed interest.

12. Under the Corporations Law, prescribed interests may only be offered to the public by a public company or its agent under seal. The company is called the management company and promotes the investment product.

13. Another requirement is that before offering the investment product for public subscription, the company must obtain from the Australian Securities Commission approval of the deed governing the investment product. Section 1069 of the Corporations Law specifies certain covenants which must be included in the deed including, at paragraph 1069(1)(n), such other covenants as are prescribed by the Regulations.

14. Subparagraph 7.12.15(6)(h)(v) of the Regulations provides that a management company must covenant not to pay brokerage or commission in respect of a subscription for prescribed interests to:

- the holder of an investment adviser's licence; or
- an accountant, solicitor or other person whose principal business is not the giving of advice about securities;

unless that person (i.e. the intermediary) has stated in writing that the total amount of the brokerage or commission will be passed on to the investor.

15. Therefore, under the statement required by the covenant, investment intermediaries such as an investment adviser, accountant or solicitor declare that they do not accept commissions for arranging subscriptions to prescribed interests on their own behalf.

Trust relationship

16. An intermediary who is instructed by a client in relation to the buying or selling of securities or subscription to investment products is in a fiduciary relationship with the investor/client and as such may not make an undisclosed or unagreed profit out of the fiduciary relationship. The client may agree to allow the intermediary to retain such commissions as may be paid to the intermediary provided the true legal position is explained and fully understood by the investor. Such agreement may be expressed or may be implied from the course of dealings between investor and intermediary but can only be implied where it can be shown that the client knew the legal position and by conduct agreed or assented to waive his or her rights (*Brown v. Commissioners of Inland Revenue* (1964) 42 TC 42).

17. An intermediary, having a fiduciary duty to a client, is not to take any secret remuneration or any financial benefit not authorised by the legal circumstances which create the fiduciary relationship. If the intermediary does gain or receive any financial benefit on behalf of the investor, he or she must account for it to the investor (*Brown v. Commissioners of Inland Revenue*).

18. Similar obligations may arise under specific legislation or regulations governing the professional conduct of the investment intermediary.

Whether income of the intermediary

19. If an intermediary has a legal right to receive a commission from an investment fund, but does so on the client's behalf, the intermediary has no beneficial interest in the commission but merely serves as a conduit for the passing on of the commission from the investment fund to the investor. In those circumstances, the commission received by the intermediary is income of the investor, whether the amount is passed on to the investor (for example, under the covenant required by subparagraph 7.12.15(6)(h)(v) of the Regulations) or not (*Brown v. Commissioners of Inland Revenue*).

20. In some circumstances, the commission may not be passed on. For example, the investor may instruct the intermediary to reinvest it or otherwise deal with it. In these cases, the commission is received by the intermediary on behalf of the investor and is therefore not income of the intermediary. If the intermediary simply retains the commission it will be assumed that he has done so with the agreement of the investor, i.e. it equates with the administrative cost of handling the commission. An administrative charge or fee of this nature is assessable income of the intermediary (see Example 3, paragraphs 40/41).

Whether income of the investor

21. Generally, section 97 includes certain amounts in the assessable income of a beneficiary of a trust estate, provided the beneficiary is presently entitled to a share of the income of the trust estate and is not under a legal disability.

22. 'Net income' in relation to a trust estate is defined in section 95 to mean the total assessable income of the trust estate calculated under the Act as if the trustee were a taxpayer in respect of that income and were a resident, less all allowable deductions. The question which arises is whether an amount received by an intermediary on behalf of an investor is income of a trust estate for the purposes of section 95.

23. The term 'trustee' is defined in subsection 6(1) to include, (in addition to a person appointed or constituted trustee by act of parties, by order, or declaration of a Court, or by operation of law), a person having the administration or control of income affected by any express or implied trust, or acting in any fiduciary capacity. An investment intermediary in the circumstances described above is a trustee as defined in section 6.

24. The term 'trust estate' is not defined in the ITAA and it has the same meaning as 'trust property'. 'Trust property' is described in *Halsbury's Laws of England* (3rd ed., vol.38, p.810) as 'property vested in the trustee, whether the property is a legal estate, a legal right or an equitable interest in which case the legal title will be in some other person'. The legal right includes the intermediary's contractual right to receive commission from an investment fund.

25. There is a view that the intermediary's commission in the present case is the "trust estate" and therefore it cannot be "the net income of" the trust estate (see *FC of T v. Everett* 80 ATC 4076; (1980) 10 ATR 608). We agree that the decision in *Everett's case* establishes that the expression "trust estate" in Division 6 refers to the trust property which gives rise to the income derived by the trustee.

26. However we do not accept that the commission as presently described is the "trust estate". As stated in paragraph 24 a legal right, such as the intermediary's contractual right to receive commission from an investment fund, can be trust property. It is also well established that a contracting party (the intermediary) may be trustee for a third party (the investor) of that chose in action which is constituted by the benefit of the contract (see Meagher & Gummow, *Jacob's Law of Trusts in Australia*, 5th ed, 1986, para 222). In this situation the trust property is the benefit of the promisor's promise, that is, the promisee's right (the intermediary's right) to sue at law for damages should the need arise.

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27. Periodical payments made in the form of a percentage on the value of business done are commissions and are income according to ordinary concepts.

28. Therefore, in the present case, if the intermediary receives a commission by reason of a right to receive the commission from the investment fund, for example under contractual arrangements between investment fund and intermediary, the commission constitutes income of the trust estate and is therefore subject to the provisions of Division 6. This is because the commission is income arising from the trust estate, i.e. from the right to receive the commission which chose in action is the trust property.

29. An amount which is received by an investment intermediary on behalf of an investor in the circumstances described above is included in the income of the trust estate, whether the amount is passed on to the investor by the intermediary or is dealt with by the intermediary on the investor's behalf and in accordance with the investor's instructions. Similarly, if the commission is not passed on by the intermediary to the investor and is not dealt with by the intermediary on behalf of the investor, the income character of the amount in relation to the trust estate does not change. The amount continues to constitute income of the trust estate because it has been received by the intermediary on behalf of the investor (*Brown v. Commissioners of Inland Revenue*).

30. As mentioned in paragraph 22, the net income of a trust is calculated by subtracting all allowable deductions from the total assessable income of the trust. In the present case, the net income of the trust is the commission received by the intermediary from the investment fund less allowable deductions relating to that income. Such deductions include fees charged by the intermediary to the investor for the collection and administration of the commission.

Examples

Example 1

31. John instructs his solicitor Anne to invest \$100,000 in the Cash Management Fund 'Growth'. A cash management fund is a prescribed interest in terms of the Corporations Regulations. Investment in the Growth fund does not involve the payment of up front charges or entry fees and the commission is charged against investors' returns.

32. The solicitor receives from the investment fund manager a monthly commission of 0.025% of the average \$ value of all her client accounts in the Growth fund, payable monthly in arrears (a trailer commission). Therefore, in relation to John's investment, she receives

a monthly commission of \$25 payable by the Growth fund manager.

33. Because of the operation of the Corporations Regulations, Anne has stated in writing that she will pass on the total amount of the commission to John. Each month, Anne passes on the commission to John. The amount of \$25 per month is included in John's assessable income under section 97.

34. Anne is the conduit for the payment of \$25 per month from the Growth fund manager to John and therefore the commission does not form part of her assessable income.

Example 2

35. George instructs his solicitor Frances to invest \$10,000 in the Cash Management Fund 'Growth' (refer to paragraph 31 for description of the fund). In relation to George's investment, the solicitor receives a monthly commission of \$2.50 payable by the Growth fund manager.

36. Because of the small amount involved, George instructs Frances to accumulate the monthly payments on his behalf. The commission is accumulated each month for George's benefit, as he has directed.

37. The commission is included in George's assessable income even though it is not received by him each month.

38. The intermediary is regarded as a conduit for the monthly payment of \$2.50 from the Growth fund manager to George. As she deals with the monies on behalf of the investor, the commission does not form part of Frances' assessable income.

Example 3

39. Robert instructs his solicitor Michael to invest \$10,000 in the Cash Management Fund 'Growth' (refer to paragraph 31 for description of the fund). In relation to Robert's investment, the solicitor receives a monthly commission of \$2.50 payable by the Growth fund manager. As the monthly administrative cost to Michael's firm of passing on the commission to Robert is at least \$2.50, Robert has instructed Michael to debit his account for the amount of \$2.50.

40. The monthly amount of \$2.50 is received by Michael on Robert's behalf. Michael has no beneficial entitlement to the amount. As the amount of the administrative cost is at least equal to the amount of commission received by Michael on Robert's behalf, there is no net

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income of the trust to which Robert is entitled. Therefore no amount is included in Robert's assessable income under section 97.

41. The administrative cost debited by Michael to Robert's account is a fee and is to be included in Michael's assessable income under section 25.

Commissioner of Taxation

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ATO references

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BO T90 Pt1 (Penrith)

legislative references

- Corporations Act 1989 (Cth) 1069
- Corporations Regulations 7.12.15(6)
- ITAA 25(1); ITAA Div.6; ITAA 95
- ITAA 97

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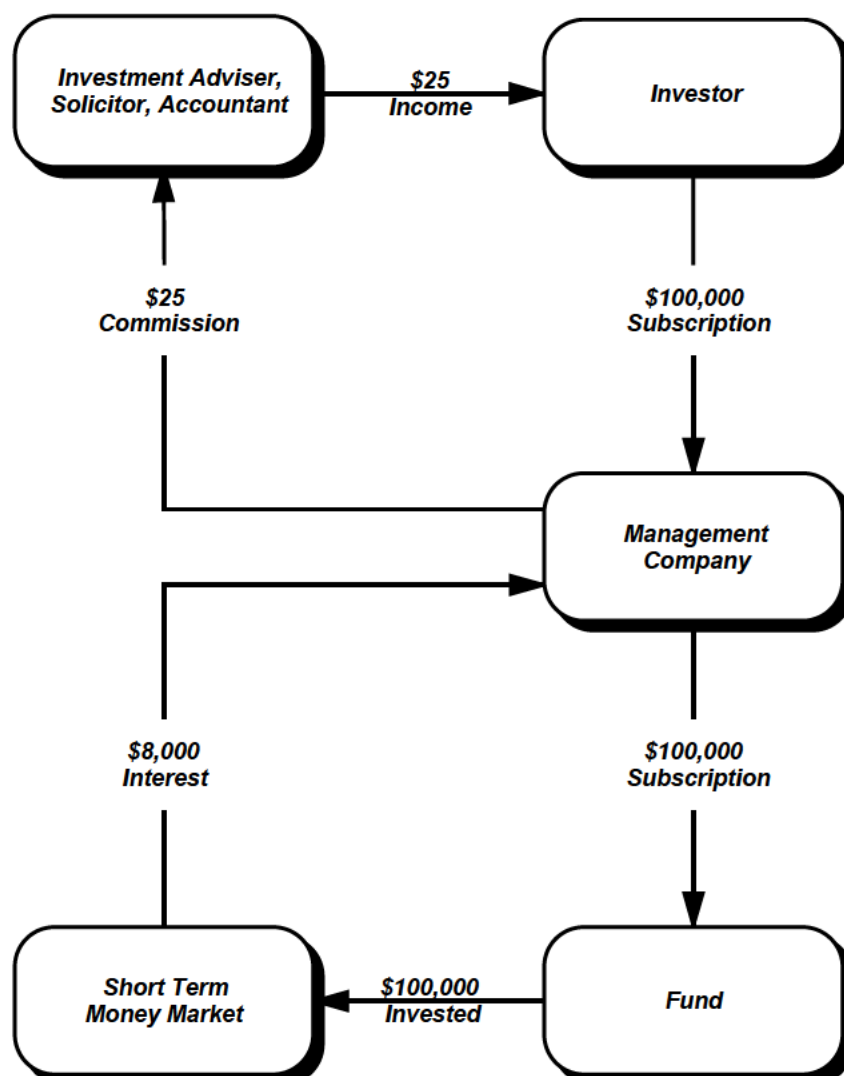
case references

- Brown v. Commissioners of Inland Revenue (1964) 42 TC 42
- FC of T v. Everett 80 ATC 4076; (1980) 10 ATR 608

subject references

- commissions
- fees
- investments
- investment advisers
- investment products
- net income
- prescribed interest
- trusts

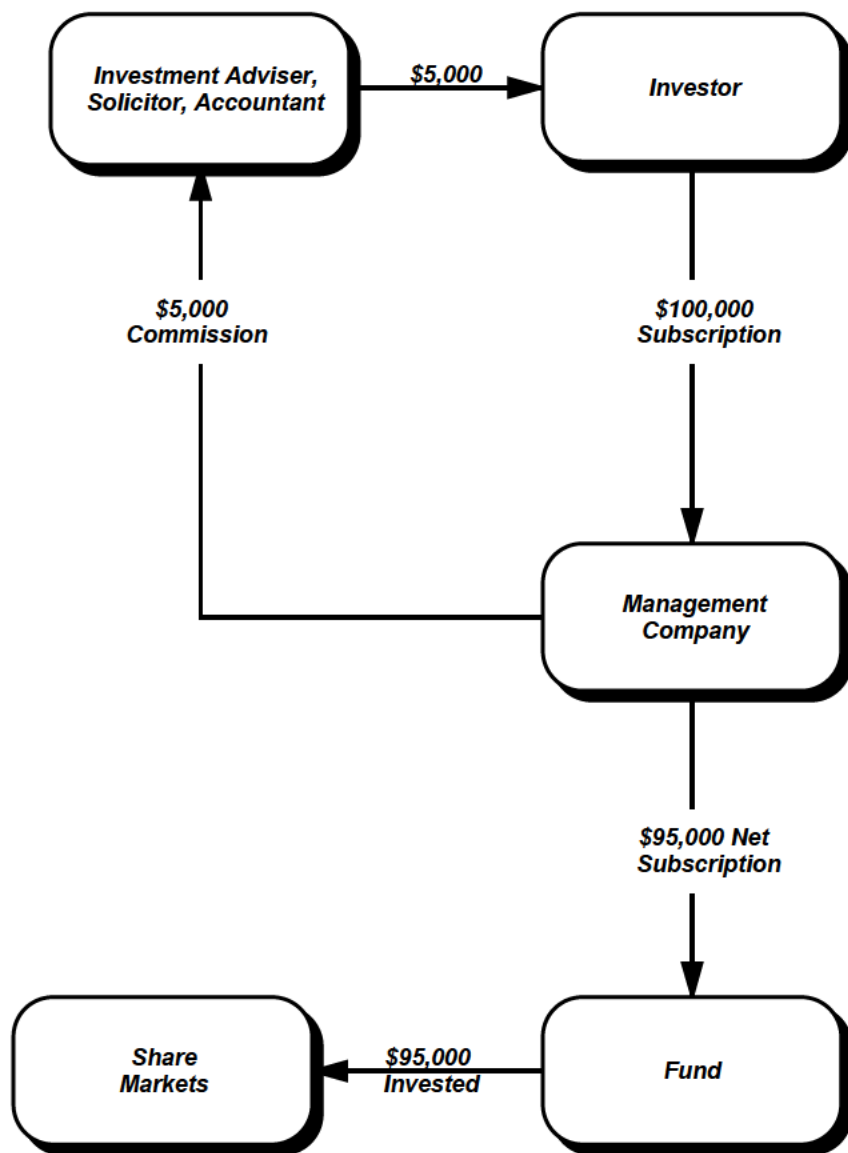
Attachment A

CASH MANAGEMENT TRUST

This flow chart illustrates an investment product with no up front payments for entry.

Attachment B

EQUITY TRUST



This flow chart illustrates an investment product with an up front service fee which is refunded to the investor - See IT 2536.