TR 93/11 - Income tax: assessability of income on an accruals basis: when professional fees are derived

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Taxation Ruling
Income tax: assessability of income on an accruals basis: when professional fees are derived

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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:

(a) when fees are 'derived' under subsection 25(1) (income according to ordinary concepts) of the *Income Tax Assessment Act 1936* (ITAA) by those professional persons whose income is assessable on an accruals basis; and

(b) the effect of a statutory impediment to commencing legal proceedings for the recovery of professional fee income.

2. This Ruling deals only with those cases where, on the facts, the fees 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.

Ruling (a) When fee income is derived

Each case on merits by reference to contract or arrangement

3. The question of when professional fee income is derived under subsection 25(1) of the ITAA needs to be determined by reference to the facts of each case, and especially by reference to the terms of the contract or arrangement entered into between the professional person and the client. In particular, it is necessary to determine when, on a proper construction of the contract or arrangement, a recoverable debt is created such that the professional person 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. An exception

to the position that the fee income is assessable when a recoverable debt arises can apply if the fees income is received in advance of the work to which it relates (see paragraph 8 below).

Contracts or arrangements referred to are only indicative

4. Contracts or arrangements for professional work take many forms. Although many are in writing, many are not. The contracts or arrangements referred to in paragraphs 5 to 8 below are only indicative of the types that exist; they are not an exhaustive listing.

Recoverable debt only on billing client

5. The proper construction of the particular contract or arrangement may be that a recoverable debt for the professional work done is created only when the professional person bills the client. This is the most common arrangement for professional work, particularly if the terms of the contract or arrangement are not in writing. In these circumstances, the fee income is derived in the income year in which the professional person presents the bill to the client. This is so even if the bill allows additional time for payment.

Recoverable debt when work wholly completed (including quantum meruit*)*

6. Under the contract or arrangement a recoverable debt may be created, with the professional person not needing to bill the client, once the work is wholly completed. If this is the case, the fee income is derived in the income year in which the work is in fact wholly completed. However, if the professional work is terminated prematurely (for instance, because of the dismissal or resignation of the professional person), he or she may have an action in *quantum meruit* for the work already done. The professional person in these circumstances derives the fee income (being the amount of the *quantum meruit* claim) in the income year in which the professional work ended early.

Recoverable debts arising progressively

7. The legal effect of the contract or arrangement may be that recoverable debts arise, with the professional person not needing to bill the client, for work completed by the end of particular (say, three month) periods or on the happening of some specifically

nominated actions or events. In these cases, the professional person derives the fee income in the income year or years in which each of the particular periods ends or in which each of the specifically nominated actions or events happens.

Receipt of fee in advance of work done

8. A professional person will sometimes receive fee income in advance of the work to which it relates. If the contract or arrangement requires that the fee be paid in advance, the fee income is derived in the income year in which the professional person completes the work (or the part of the work) to which the fee relates. On the other hand, if the client simply pays early, the fee income is derived when a recoverable debt arises or would have arisen if the client had not paid early (see paragraphs 5 to 7 above).

Subsection 25(1) test for 'derived' not linked to subsection 51(1) test for 'incurred'

9. When the client has 'incurred' the fee for claiming any allowable deduction under subsection 51(1) (the general deduction provision) of the ITAA is not relevant for determining when the professional person has 'derived' the fee income under subsection 25(1) of the ITAA.

(b) Statutory impediment to debt recovery

10. A statutory impediment to a professional person commencing legal proceedings for recovery of fees does not defer the time at which he or she derives the income.

Date of effect

11. 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

(a) When fee income is derived

12. 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). A fee is 'recoverable' in the relevant sense even if time to pay has been allowed (*Henderson's Case* per Barwick CJ 119 CLR at 651; 70 ATC at 4020; 1 ATR at 601). An exception to the position that income is derived when a recoverable debt arises can apply if amounts are received or receivable in advance of goods being supplied or services being provided - see paragraph 8 above (*Arthur Murray (NSW) Pty Ltd v. FC of T* (1965) 114 CLR 314; (1965) 14 ATD 98).

(b) Statutory impediment to debt recovery

13. Some professional persons are subject to statutory provisions which limit the commencement of legal action to recover fees. In some Australian jurisdictions, legislation relating to certain professions provides for the passing of a specified period before the professional person can begin an action to recover fees. Examples of these provisions are:

(a) section 61 of the *Supreme Court Act 1986* (Vic.), which provides that a solicitor cannot commence or maintain an action for the recovery of fees, charges or disbursements until the expiration of one month after the delivery by the solicitor to a client of a detailed bill of costs; and

(b) 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.

14. The decision of the Full Federal Court of Australia in *Barratt v. FC of T* 92 ATC 4275; (1992) 23 ATR 339 is authority for the view that a statutory impediment to commencing legal proceedings for recovery of a debt does not defer the time at which fees 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 (NSW). The

Federal Court rejected the view that an amount cannot be derived unless it is presently recoverable by action.

15. It is necessary to distinguish between the coming into existence of a debt and the operation of an impediment on the recovery of an already existing debt (*Re Pollack; Ex parte DFC of T* 91 ATC 4925 at 4930; (1991) 22 ATR 670 at 677). Statutory impediments such as those imposed by subsection 35(2) of the Medical Practitioners Act (NSW) and section 61 of the Supreme Court Act (Vic.) do not stipulate a condition precedent to the existence of the debt. Rather, they are an impediment on the recovery of an existing debt.

Examples

(a) When fee income is derived

Recoverable debt only on billing client (paragraph 5 above)

Example 1

16. A radiologist is one of several partners in a radiology practice, the income of which is assessable on an accruals basis. The radiologist consults with a patient on the last day of an income year and bills the patient on the following day. The fee income is derived in the income year in which the bill issues.

Example 2

17. A pathologist is one of several partners in a pathology practice, the income of which is assessable on an accruals basis. The pathologist consults with a patient on the last day of the income year and bills the patient on the same day. The bill indicates that the amount due is payable within 30 days. The fee income is derived in the income year in which the bill issues (not the income year in which the fee is payable).

Recoverable debt when work wholly completed (paragraph 6 above)

Example 3

18. A large firm of chartered accountants, the income of which is assessable on an accruals basis, enters into a contract to audit a trading trust's accounts. Under the contract, a recoverable debt for the fee arises (without a bill needing to issue) at the end of the entire audit process. The fee income is derived in the income year in which the audit process is completed.

Quantum meruit *claim (paragraph 6 above)*

Example 4

19. A solicitor whose income is assessable on an accruals basis agrees to do the conveyancing on the sale of a client's home for a fee of $700 plus disbursements due on completion of the work. After the solicitor has begun to prepare the contract documents, the client decides to withdraw the property from sale and terminates the solicitor's services. The solicitor has an action in *quantum meruit* for the work already done. He derives the fee income (being the amount of the *quantum meruit* claim) in the income year in which his services are terminated.

Recoverable debts arising progressively (paragraph 7 above)

Example 5

20. A firm of accountants, the income of which is assessable on an accruals basis, is contracted as external auditors of a large company. The contract provides that payment is due (without the accountants needing to bill the company) at three monthly intervals for work done during the preceding three months. The fee income for work done in a particular three month period is derived in the income year in which that three month period ends.

Receipt of fee in advance of work done: contractual requirement (paragraph 8 above)

Example 6

21. A firm of architects, the income of which is assessable on an accruals basis, requires a $750 up-front payment before commencing work on drafting plans. The fee income of $750 is derived in the income year in which the plans are completed.

Receipt of fee in advance of work done: early payment (paragraph 8 above)

Example 7

22. An accountant whose income is assessable on an accruals basis quotes a fee of $100 to prepare a client's income tax return, but offers a 5 % discount if payment is made in advance. The client decides to pay in advance to obtain the discount. The fee income of $95 is derived in the income year in which the income tax return is completed.

Example 8

23. An engineer whose income is assessable on an accruals basis quotes a fee of $5 000 for engineering work to be completed within two months. The fee is due (without the need for a bill to issue) when the engineer completes the work. The client pays the whole $5 000 fee before the engineer begins work even though there is no obligation or financial advantage to do so. The fee income of $5 000 is derived in the income year in which the engineering work is completed.

(b) Statutory impediment to debt recovery

Example 9

24. A solicitor whose income is assessable on an accruals basis practises in Victoria. She confers with a client and sends out a detailed bill of costs. Two weeks later, at the end of the income year, the bill remains unpaid. The fee income is derived in the income year in which the solicitor bills the client. Although section 61 of the Supreme Court Act (Vic.) means that she will be unable to commence legal action to recover the fees until one month after the delivery of the detailed bill of costs, this does not defer the time at which the fee income is derived.

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- Supreme Court Act 1986 (Vic.) 61

case references
- Arthur Murray (NSW) Pty Ltd v. FC of T (1965) 114 CLR 314; (1965) 14 ATD 98
- FC of T v. Australian Gas Light Co. 83 ATC 4800; (1983) 15 ATR 105
- Barratt v. FC of T 92 ATC 4275; (1992) 23 ATR 339
- 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
- Re Pollock; ex parte DFC of T 91 ATC 4295; (1991) 22 ATR 670