



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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*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

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 the deposit paid is 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 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 the agency agreement

4. The terms of the agency agreement 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. Actual receipt of the commission is not necessary for there to be income derived.

5. The sale/purchase contract does not determine the entitlement to or the time of derivation of the agent's commission fee.

Commission fees contingent

6. Some agency agreements provide that commission fees are only payable in the event of a sale or upon demand where a vendor defaults. The agent fees are therefore contingent and are not derived until either settlement occurs or where payment is demanded upon vendor default.

7. Where an agency agreement provides that no agent's fee is payable unless a property is 'sold' and the word 'sold' is not defined for the purposes of the agreement, the word will take its common law meaning. In these cases a property is not sold until the contract is completed, i.e., at settlement.

Impediments to collection

Operation of a trust account

8. 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 settlement or some time thereafter. This has no impact on the timing of the derivation of the agent's commission fee income.

Invoicing

9. Invoicing or billing a client is usually an indication that the 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 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'

10. Many agency agreements 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 agreement 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

11. There is a general industry practice that in certain circumstances (e.g., where a sale falls through after a sale contract has been signed) commission may be repaid or is not sought to be collected. In these circumstances, where an amount previously included as income is repaid or is never collected, we will allow that amount to be deducted from the assessable income in the year in which the amount is repaid or the decision is made never to collect the commission.

Commission fees from engagements to purchase property

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

13. Illustrations of the position in each State or Territory are included in paragraphs 29 to 36 of this Ruling.

Previous Rulings

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

Date of effect

15. This Ruling applies to returns of income lodged after its date of issue.

Explanations

When commission income is derived

Reference to the terms of the agency agreement

16. 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. As such, actual receipt of the commission is not necessary for there to be income derived.

17. Accordingly, under the terms of an agency agreement, the commission income will be income derived at the point in time at which it can be said that the commission has become a recoverable debt in favour of the agent. It is at that time when the commission can be said to have been earned. In *Henderson*, Barwick CJ said (at CLR 650-651; ATC 4020; ATR 601):

'... only fees which have matured into recoverable debts should be included as earnings. ... I have used the word "recoverable" to describe the point at which income is derived by the performance of services. ... fees would be relevantly recoverable though by reason of special arrangements between the partnership and the client, time to pay was afforded.'

See also *J Rowe and Son Pty Ltd v. FC of T* (1971) 124 CLR 421; 71 ATC 4157; (1971) 2 ATR 497, and the *Australian Gas Light Co* case. Refer also to paragraph 19 of Taxation Ruling IT 2626 and paragraph 3 of Taxation Ruling TR 93/11.

Commission fees contingent

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

'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.'

19. 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, under the terms of the agreement, the agent is entitled to the commission fee.

20. The standard agency agreements for New South Wales, Western Australia, South Australia, Queensland and the Northern Territory include certain provisions the effect of which is that agents are not entitled to any commission fee unless the sale/purchase contract is completed or payment is demanded upon vendor default. In Tasmania, the agent is entitled to commission if the property is 'sold'. The word 'sold' is not defined in the agreement and we therefore consider that the common law meaning applies, i.e., completion of the contract. The position under the standard agency agreements for Victoria is that agents are entitled to their commission fee once the sale/purchase contract is signed by both the vendor and the purchaser. We understand that currently there are no standard agency agreements in use in the Australian Capital Territory.

21. In the absence of any provision to the contrary, a sale will not be completed until settlement of the sale contract (as for Tasmania). In *Summergreene v. Parker* (1950) 80 CLR 304 Williams J stated (at 319-320):

'It has been held in England that an agent employed to effect a sale of property does not earn his commission unless a binding contract of sale is made between the vendor and a purchaser who is not only ready and willing but able to purchase the property ... But, assuming that such an agent must prove that the purchaser is not only ready and willing but also able to perform the contract, it is sufficient if the purchaser is in the position to perform the contract at the time fixed for completion ... Accordingly, where an agent for a proposed company agrees with the vendor that the purchase shall be completed by the company performing certain acts, the vendor, in the absence of evidence that the company will refuse to do so, must wait until the time fixed for completion to see whether the company is ready and willing and able to perform these acts before rescinding the contract.'

Impediments to collection

22. The decision of the Full Federal Court 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 Full Federal Court rejected the view that such amounts cannot be derived unless they are presently recoverable by action.

Operation of a trust account

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

'Any deposit moneys received by a legal practitioner or estate agent in the course of a transaction for the sale of land shall be held by that legal practitioner or estate agent as a 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 moneys may be paid to the vendor in his own right or as the vendor directs.'

24. 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

25. 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 agents are paid their commission fee from the deposit moneys held in trust for the sale/purchase of the property. In the *Australian Gas Light Co* case the Full Federal Court held that until a number of statutory conditions were met, including the giving of a notice, no debt came into existence.

26. In our view real estate agents, as providers of professional services, are closer to the taxpayer's situation in *Henderson* rather than the taxpayer's situation in the *Australian Gas Light Co* case. In *Henderson v. FC of T* (1969-70) 119 CLR 612; 69 ATC 4049; (1969)

1 ATR 133, Windeyer J said (at CLR 636-637; ATC 4060-4061; ATR 146-147):

'... I think that services rendered for fees do not result in income derived ... until the fees are either paid or payable. This, of course, may be before an account for payment is rendered. For example, a physician may be entitled in law to be paid for attendances upon his patient before his treatment of him for his illness has been completed and he has sent him a bill. What he is thus entitled to be paid forms part of his income calculated on an earnings basis ... for work done ...

Money is not, I think, earned income until it is in law recoverable as a debt. Of course, if an amount were recoverable as a *quantum meruit* although a task was not completed, it could be said to be earned. And, as I have said, services may create debts before a bill is sent to the debtor. But services rendered do not produce taxable income until they create a debt. And it must be a debt which is in fact recoverable, not a bad debt.'

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'

27. 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 is derived in the relevant sense even if time to pay has been allowed: *Henderson's* case; *Rowe's* case; and the *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

28. Where an amount has been previously included in the assessable income of the agent and has been repaid or never collected because of industry practice, the amount repaid or never collected would represent a loss or outgoing incurred in gaining or producing assessable income of the agent. It would therefore be allowed as a deduction from the assessable income under subsection 51(1) of the ITAA in the year in which it is repaid or the decision is made that it will never be collected because of industry practice.

Illustrations of standard agency agreements

29. Below are some illustrations of the point of income derivation for agents who return their income on an accruals basis, and who use standard State or Territory agency agreement forms. These illustrations are indicative only and are not intended to be exhaustive.

Victoria

30. In Victoria the standard agency agreement form, 'General Sale Authority 001 2/95', states that the agent's fee is payable 'upon the Sale of the Property'. The agreement defines 'Sale' as 'the result of obtaining a Binding Offer'. ' "Binding offer" is an offer ... which, if accepted by the Vendor would (or does) result in a contract enforceable against the Purchaser'. The Supreme Court of Victoria has held that a sale note is an enforceable contract: *Tait v. Bonnice* [1975] VR 102; *G & S Koikas v. Green Park Construction Pty Ltd* [1970] VR 142. Under Australian law the existence of a condition does not affect the enforceable nature of a contract: *Perri & Anor v. Coolangatta Investments Pty Ltd* (1982) 149 CLR 537. Accordingly, an enforceable contract exists and therefore agents are considered to have derived their commission income when the sale/purchase contract is signed by the vendor and the purchaser.

New South Wales

31. In New South Wales the standard agency agreement form, 'Sales Inspection Report and Selling Agency Agreement (and Continuing Agency) SA00100 9/94', states: 'The fee to which the Agent is entitled shall be due and payable on completion of the sale or upon demand if the sale is not completed owing to the default of the Principal [i.e., the vendor] after the parties have entered into a binding contract'. Given that an agent would not be entitled to any fee in the event of a default by a purchaser we consider that the fee will remain contingent and defeasible, and will not be derived, until settlement or demand following vendor default.

Australian Capital Territory

32. In the Australian Capital Territory there are no commonly used standard agreements. Agents in the ACT should return their commission fee income in accordance with the general principles set out in this Ruling, i.e., when a recoverable debt arises under the agreement they have entered into in relation to the sale of the property.

Western Australia

33. In Western Australia the standard agency agreement form 'Selling Agency Agreement 109A - 5/94' states: 'The selling fee to which the Listing Agent is entitled shall be due and payable on settlement of the sale or upon demand if the sale is not completed owing to the fault of the Vendor'. As in New South Wales, an agent would not be entitled to any fee in the event of a default by a purchaser, and the fee will remain contingent and defeasible, and will not be derived, until settlement or demand following vendor default.

Tasmania

34. In Tasmania the standard selling agency agreement form 'Sole Agency Agreement' states that the agent will be paid if the property is 'sold'. In these cases agents are considered to derive their commission fee when the contract of sale/purchase is completed. In our view the contract will not be completed until settlement occurs.

South Australia, Queensland, Northern Territory

35. Sales agency agreement forms in South Australia ('Sales Agency Agreement 1101'), Queensland ('Appointment to Act as Real Estate Agent FSN005 6/93') and the Northern Territory ('Sole and Exclusive Agency Agreement 3/93') contain provisions whereby in the event of purchaser default agents may not be entitled to their commission.

36. In these cases we consider that agents have not derived their commission income until settlement or vendor default.

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subject references

- allowable deductions
- commission fees
- fees never collected
- income derived
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- refunds
- time of derivation

legislative references

- ITAA 25(1)
- ITAA 51(1)
- Medical Practitioners Act 1938
 (NSW) 35(2)
- Sale of Land Act 1962 (Vic) 24(1)

case references

- Barratt v. FC of T 92 ATC 4275;
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