IT 2626 - Income tax : commission income of insurance agents and brokers

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TAXATION RULING NO. IT 2626

INCOME TAX: COMMISSION INCOME OF INSURANCE AGENTS AND BROKERS

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Reference no.:	Subject refs:	Legislative refs:
I 1012525	INSURANCE AGENTS & BROKERS	19
	- COMMISSION INCOME	25(1)
	- COMMISSION REPAYMENTS	51(1)
	- DERIVATION OF INCOME	

OTHER RULINGS ON THIS TOPIC: IT 2408

PREAMBLE The main purpose of this Ruling is to clarify when commission income is derived for income tax purposes by insurance agents and insurance brokers. It also deals with the question of repayments of commissions paid in advance and overpaid commissions by insurance agents and brokers.

Definitions and Background

2. Insurance agents and insurance brokers are people who, for reward, negotiate contracts of insurance, place risks or effect insurances for other persons. They also play a role in making and settling claims under policies.

3. Insurance agents generally are considered for taxation purposes to be employees of their insurer (see Taxation Rulings IT 2121, 2129 and 2511). However, depending on the circumstances of each particular case, an insurance agent may be engaged under a contract of services as distinct from an employee of an insurer engaged under a contract of service or employment. The term "insurance agent" is used in this Ruling with these two possible situations in mind. Insurance agents may be "tied" to a particular insurer or to more than one insurer or be casual agents who arrange insurance but only as an incidental part of their main business or professional activities e.g. investment advisors, real estate agents, car salespersons.

4. While an insurance agent is an intermediary between an insurer and the insured and acts on behalf of the insurer, an insurance broker is an intermediary acting on behalf of the insured except where acting under a "binder" (i.e. an agreement between an insurer and a broker whereby the broker is able to act on the insurer's behalf in accepting risks and handling claims) when the broker is the insurer's agent. Insurance brokers generally act as independent professional consultants.

5. "Commission" is remuneration, usually expressed as a percentage of the premium or sum insured, payable to the broker or agent for his/her services. It is also known as brokerage when paid to a broker. The term "commission" should be taken to include fees or charges made by a broker to an insured for the broker's services such as a flat policy administration charge, a further percentage of premium or a charge on the basis of time expended. The commission due to an agent is usually set out in detail in the relevant written agency agreement. In the absence of such an express provision, a term would be implied that the principal will pay reasonable remuneration.

6. The activities of insurance agents and insurance brokers are regulated by the Insurance (Agents and Brokers) Act 1984 ("the IAB Act"). That Act is designed to strengthen the financial stability of the industry overall, to protect the insuring public against the negligence or misconduct of agents and brokers and to maintain standards of conduct of, and quality of advice offered by, agents and brokers. The IAB Act has modified the common law principles of agency but section 5 of the Act states that the Act does not affect the operation of any principle or rule of the common law or equity, except in so far as it, either expressly or by necessary intendment, otherwise provides.

7. An "insurance broker" is defined in section 9 of the IAB Act to mean a person who carries on the business of arranging contracts of insurance, whether in Australia or elsewhere, as agent for an intending insured.

8. Where an insurance broker arranges or effects a contract of insurance he/she must, as soon as it is reasonably practicable to do so, give to the insured written particulars of any amounts charged by the broker in respect of the broker's services in connection with the contract. If requested to do so by the insured, the broker must also give to the insured particulars of any commission or other remuneration or benefit received by the broker from the insurer in respect of his/her services in arranging or effecting the contract (subsection 32(1) of the IAB Act).

Insurance Brokers

9. Insurance brokers must register with the Insurance and Superannuation Commissioner ("the ISC Commissioner") under the IAB Act in respect of the class of insurance (e.g. general, life or general and life) in relation to which the broker carries on business.

10. The broker is required to maintain a separate account with a bank (or a building society with which trust funds may be invested), called an "Insurance Broking Account", into which all moneys received from insureds or insurers must be paid (subsection 26(1) of the IAB Act). When a broker receives premiums from an insured payable to an insurer he/she must pay them into the Insurance Broking Account.

11. A broker can only withdraw moneys from an Insurance Broking Account with the written consent of the ISC Commissioner but consent is not required for payment to the broker himself/herself in so far as he/she is entitled to receive the payment (paragraph 26(3)(a) of the IAB Act). By paragraph 27(6)(c) of the IAB Act, a broker may exercise any legal right available to him/her to deduct from any moneys payable by the broker to the insurer any remuneration payable by the insurer to the broker in relation to a contract of insurance. A broker can, accordingly, withdraw from the Insurance Broking Account commission due to the broker without the ISC Commissioner's consent. As this Office understands the position, a broker cannot withdraw commission from an Insurance Broking Account until:

(i) the premiums concerned have been paid into the Account; and

(ii) he/she is legally entitled to be paid the commission - this will depend on the terms of the contract or arrangement entered into between the broker and the relevant insurer.

When these requirements have been satisfied, it would seem that the broker is legally permitted by paragraphs 26(3)(a) and 27(6)(c) of the IAB Act to withdraw his/her commission from the Account. The broker is required to forward premiums received from the insured (or the balance of premiums received if the broker has deducted his/her commission) to the insurer within time limits set out in the IAB Act (section 27 of the IAB Act refers).

12. Under subsection 14(1) and 14(2) of the IAB Act payment of moneys (whether in respect of premiums or otherwise) to an insurance broker in respect of a contract of insurance arranged, or to be arranged, by the broker constitutes a discharge of the insured's liability to the insurer in respect of those moneys.

13. In some cases an intending insured will forward a completed proposal and will pay all relevant moneys directly to the insurer (without any reduction for the broker's commission) and the insurer will pay the broker's commission when it accepts the proposal and agrees to issue a policy.

Insurance Agents

14. Moneys, such as premiums, paid to a person (other than a registered insurance broker) as agent of an insurer in respect of a contract or proposed contract of insurance are subject to a trust in favour of the insurer (subsection 37(1) of the IAB Act). In all cases the agent must pay the moneys to the insurer as soon as is reasonably practicable. The agent may retain certain amounts due to the agent from the insurer, for example, in respect of commission (subsections 37(3A) and 37(3B) of the IAB Act).

15. In almost all cases (in respect of life insurance agents) and often (in the case of general insurance agents) an intending insured pays gross premiums directly to the insurer and the insurer subsequently pays the agent's commission to the agent.

Repayments of Overpaid Commissions or Commissions Paid in Advance

16. Situations arise, although not commonly, in which insurance agents or brokers are called on to repay commissions paid in advance or to repay commissions overpaid. Even if a written agency agreement does not expressly provide for the repayment of any such commissions - and some contracts will so provide - it is considered likely that a term would be implied into the agreement to that effect.

RULING

17. The question when income - in this instance commission income - is derived for the purposes of section 25 of the Income Tax Assessment Act 1936 ("the Act") is one of some difficulty and importance. A useful judicial pronouncement on the meaning of the word "derived" is that of Gibbs J in Brent v. FCT 71 ATC 4195 at 4200; (1971) 2 ATR 563 at 569-570:

> " The Act does not define the word 'derived' and does not establish a method to be adopted as a general rule to determine the amount of income derived by a taxpayer .... The word 'derived' is not necessarily equivalent in meaning to 'earned'. 'Derive' in its ordinary sense, according to the Oxford English Dictionary, means 'to draw, fetch, get, gain, obtain (a thing from a source)'."

18. In FCT v. Thorogood (1927) 40 CLR 454 at 458 Isaacs ACJ observed that "'derived' is not necessarily actually received, but ordinarily that is the mode of derivation". Income is often derived before it is received. As Arthur Murray (N.S.W.) Pty. Ltd. v. FCT (1965) 114 CLR 314; 14 ATD 98 illustrates, however, amounts received in advance for services to be rendered may not be derived until after receipt i.e. until the services are provided.

19. The tests developed by the Courts in attempting to state when income is derived have been conceived and applied in different circumstances to determine different facts and issues. As guides, however, they indicate that in a case such as this something more than the provision of services by the agent or broker is required. The terms of the contract or arrangement entered into between the insurer and the insurance agent or broker will be a major consideration in determining when the commission income of an agent or broker is derived. If the payment of the commission has matured into a recoverable debt, and the agent or broker is not obliged to take any further step before becoming entitled to payment of the commission, this would strongly indicate that the commission income has been derived: Henderson v. FCT (1970) 119 CLR 621, 70 ATC 4016, (1970) 1 ATR 596; Rowe J & Son Pty Ltd v. FCT (1971) 124 CLR 421, 71 ATC 4157, (1971) 2 ATR 497 and FCT v. Australian Gas Light Co. 83 ATC 4800, (1983) 15 ATR 105.

20. Insurance brokers who withdraw moneys from an Insurance Broking Account are considered to derive commission income for income tax purposes at the time it first becomes available for withdrawal from the Account. In situations where a gross premium is forwarded by an intending insured directly to the insurer, the commission is considered to be derived at the time of its receipt from the insurer in accordance with the terms of the arrangement normally entered into between the broker and the relevant insurer. If receipt of the commission was to be deferred for some reason, however, for periods beyond the period for receipt allowed in normal industry practice (e.g because of some modified arrangement made by the broker with the insurer), or if the commission was to be otherwise dealt with, the provisions of section 19 of the Act might apply to deem the income to be derived.

21. An insurance broker may have been paying tax on commission income at the time it was invoiced to the insurer (i.e. before it was received) but needs to changeover, in accordance with this Ruling, to paying tax on commission income when it first becomes available for withdrawal from the Account. The appropriate remedy in such a case is by amendment - within the limits authorised under the Act - to exclude from assessments in preceding years the commission income that would otherwise be taxed twice in the year of the changeover: Country Magazine Pty Ltd v. FCT (1968) 117 CLR 162, 15 ATD 86, 10 AITR 573; Henderson v. FCT (sup).

22. As to insurance agents, where, in accordance with subsections 37(3A) or 37(3B) of the IAB Act, commissions are retained by agents from premium moneys payable to an insurer, the commission income is considered to be derived for income tax purposes at the time the gross premium is received by the agent from the insured. In situations where a gross premium is paid by an intending insured directly to the insurer, the commission is again considered to be derived by the agent at the time of its receipt from the insurer in accordance with the terms of the normal arrangements between the agent and the insurer.

23. In the circumstances in paragraph 16 above, where an agent or broker repays commissions paid in advance or commissions overpaid, it is possible any reduction in commission payable is effected by being offset against commission payments from the relevant insurer(s) from other policies or from the balance of the agent's or broker's account maintained by the principal. The agent or broker may, in effect, be only paid his/her overall net commission entitlements in any income year.

24. In some unusual cases an agent or broker may be required to make a repayment of commission. Where the amount repaid had been previously included in assessable income of the agent or broker, the amount of the repayment would represent a loss or outgoing incurred in gaining or producing the assessable income of the agent or broker. It would therefore be allowable as an income tax deduction under subsection 51(1) of the Act in the year in which the repayment occurs.

COMMISSIONER OF TAXATION
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