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Fees make a meal of your clients' interests

PETER BOBBIN explains why financial advisers have a fiduciary duty to charge on a commission basis.

I'm tired of the do-good bleaters who say: 'Fees are good; commissions are bad.'

They are wrong. If faced with a choice, the simple fact is that a financial planner must charge their client on a commission basis. This is because commissions are good; fees are bad.

I'm not here to argue value of advice, there are many who are far more skilled than I as to what value means. Many who bleat that fees are better than commissions commonly do not understand this. So I will not add to the litany of myth-conceptions about the value of advice. I just want to make one point clear – fees are bad; commissions are good.

When a financial planner has the option of charging fees or commissions, it is clear that there is a fiduciary duty to advise on the merits of each, especially the taxation merits.

Disclosure is an important part of modern financial planning regulation. Proper and adequate disclosure is an important tool in managing conflicts of interest. Positive disclosure commands that financial planners must properly inform clients as to a range of issues, all from the personal perspective of the client, so they can make an informed decision concerning their finances.

Many within the Australian Securities and Investments Commission (ASIC) push the point that financial planners must act in the best interest of the client. It is more usual than not that acting in a client's best interest requires a financial planner to charge for their services on a commission basis and not fee-for-service. As with many aspects of a personal financial life, taxation is the key. Commissions are, from the client's perspective, more tax effective than fees-for-service.

Currently, Australia's tax system discourages fee-for-service and encourages commissions, at least if you accept the views of the Australian Taxation Office (ATO). The December 1995 ATO view from Tax Determination 95/60 is that "expenditure on drawing up the plan is incidental and relevant to outlaying the price of acquiring the investment, and is so associated with the making of the investments as to warrant the conclusion that it is capital or capital in nature". The cost of an initial financial plan is not tax deductible.

The ruling goes on to say, "to be wholly deductible, all of a management fee must relate to gaining or producing assessable income. If the advice covers other matters or relates in part to investments that do not produce assessable income, only a proportion of the fee is deductible." This approach has sound reasoning under taxation law. Mind you, what it also says is that the parts of the ongoing service fees that relate to social security, superannuation, estate planning and asset protection are not tax deductible.

The ATO said much the same thing in Tax Determination 2004/139: "If a taxpayer pays ongoing financial advice fees for management of their self-managed superannuation fund's investments as well as advice about their separate investment portfolio, can they deduct all of those fees … in their personal tax return?" The ATO's response was no.

Let's take a very simple example of a family with investment funds of $150,000. If faced with an annual cost for advice of $1,000, it is in the best interest of the client to charge a 0.66 per cent trailing commission and not a fee-for-service of the same amount.

This is because the trailing commission is taken out of the client's income prior to it being credited to them.

If in a good year a client were to get a gross 10 per cent return, adopting the commission basis would mean that they would be credited with $14,000. Any tax that must be paid will be applied to the after-commission investment return.

Compare this to a fee-for-service client who receives the same gross return of $15,000. The big question is, will they be able to claim the $1,000 fee as a tax deduction and be no worse off than being under the commission structure? Will the taxable amount be $15,000 or $14,000 or some amount in-between?

The correct answer is: the assessable amount might be less than $15,000 but it is likely to be more than $14,000.

Faced with this conclusion, the only moral thing that a financial planner can do is charge on a commission basis. They have a fiduciary duty to do so. ASIC should applaud them, as it is in the client's best interest.

Now before the bleating hearts cry that the tax mathematics do not justify commissions, let me make the admission that I have simplified the argument, I have ignored the value of advice proposition. Can I do that? Yes, because to a very large degree this has been dealt with under the disclosure regime of the Corporations Act.

If the client sees value in the $1,000 annual cost for the continuous personal advice or services that they obtain, then the value of advice proposition is met and there can be no challenge to the advisory remuneration, whether it is fee or commission. I do not want to trivialise this point, it is vital to a strong profession that the client understands what they are paying and what they are getting for it. Whether they stay or go to another financial planner will be the ultimate test of the value of advice proposition.

Disclosure ensures that the client is capable of making a personal assessment as to whether advice is valuable to them. Financial services reform and the efforts of ASIC have achieved this.

Some may say that more can be done. Perhaps, but what has been done and what can continue to be done has the interesting effect of pressing the point harder; commissions are good, fees are bad.

The simple fact is that for some it makes no difference. The nature of these services and the advice that they are being provided with means that the fees would be wholly income tax deductible, whether commission or fee-for-service does not matter. However, for very many there will be a component of their financial planning fees that will not be income tax deductible and for some, none of it will be.

Financial planning concerning social security recommendations and superannuation are two areas of advice that the Government has a great deal of interest in. From the client's best interest perspective, both are better served by a commission based cost rather than fees. In this way, the client gains certainty as to the tax effect of the cost of their financial planning. No such guarantee can exist with fees.

What is interesting is that the superiority of commissions over fees is stronger for lower and middle income Australians, whose main financial planning interest will be about their superannuation and social security entitlements. No part of a fee for this service would be income tax deductible (refer to TD 2004/139 mentioned above), but any commission would remain tax effective.

Interestingly, a financial planning income tax rebate would shift the tax advantage in favour of lower to middle income earning Australians. Making financial planning income tax deductible or rebateable would remove the best interest of the client argument that supports commission ahead of fees. But a financial planning income tax deduction or rebate would require the bleaters to admit that, from a taxation perspective, fees are bad, commission is good. I wonder what advice they need or don't need because of their personal financial acumen or comfortable, promised benefit pension?

Where the costs of financial planning are agreeable, because the emphasis is now on good fee disclosure, there is a fiduciary duty, if acting in the best interest of the client, to charge a commission and to abandon fees. So I guess that this means: commissions are good; fees are bad.

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