



PR 1999/81 - Income tax: The Finishing Touch Franchise Project

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Product Ruling

Income tax: The Finishing Touch Franchise Project

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Preamble

*The number, subject heading, and the **What this Product Ruling is about** (including **Tax law(s)**, **Class of persons** and **Qualifications** sections), **Date of effect**, **Withdrawal**, **Arrangement** and **Ruling** parts of this document are a 'public ruling' in terms of Part IVAAA of the **Taxation Administration Act 1953**. Product Ruling PR 98/1 explains Product Rulings and Taxation Rulings TR 92/1 and TR 97/16 together explain when a Ruling is a public ruling and how it is binding on the Commissioner.*

What this Product Ruling is about

1. This Ruling sets out the Commissioner's opinion on the way in which the 'tax law(s)' identified below apply to the defined class of persons, who take part in the arrangement to which this Ruling relates. In this Ruling this arrangement is sometimes referred to as the Finishing Touch Franchise Project, or just simply as 'the Project'.

Tax law(s)

2. The tax law(s) dealt with in this Ruling are:
- section 6-5, *Income Tax Assessment Act 1997* ('ITAA 1997');
 - section 8-1, (ITAA 1997);
 - Part 3-1 (ITAA 1997);
 - Part IVA, *Income Tax Assessment Act 1936* ('ITAA 1936');
 - section 82KJ (ITAA 1936);
 - section 82KK (ITAA 1936);
 - section 82KL (ITAA 1936); and
 - section 82KM (ITAA 1936).

Class of persons

3. The class of persons to whom this Ruling applies is those who enter into the arrangement described below on or after the date this Ruling is made. They will have a purpose of staying in the arrangement until it is completed (i.e., being a party to the relevant agreements until their term expires) and deriving assessable income from this involvement, as set out in the description of the arrangement. In this Ruling these persons are referred to as 'Franchisees'.

4. The class of persons to whom this Ruling applies does not include persons who intend to terminate their involvement in the arrangement prior to its completion, or who otherwise do not intend to derive assessable income from it.

Qualifications

5. The Ruling provides this specified class of persons with a binding ruling as to the tax consequences of this product. The Commissioner accepts no responsibility in relation to the commercial viability of this product and gives no assurance the prices charged for the product are reasonable, appropriate, or represent the industry norm. A financial (or other) adviser should be consulted for such information.

6. The Commissioner rules on the precise arrangement identified in the Ruling.

7. The class of persons defined in the Ruling may rely on its contents, provided the arrangement (described below at paragraphs 12 to 18) is carried out in accordance with details described in the Ruling. If the arrangement described in the Ruling is materially different from the arrangement that is actually carried out:

- the Ruling has no binding effect on the Commissioner, as the arrangement entered into is not the arrangement ruled upon; and
- the Ruling will be withdrawn or modified.

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Date of effect

9. This Ruling applies prospectively from 23 June 1999, the date this Ruling is made. However, the Ruling does not apply to taxpayers to the extent that it conflicts with the terms of 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).

10. If a taxpayer has a more favourable private ruling (which is legally binding), the taxpayer can rely on the private ruling if the income year to which the private ruling relates has ended, or has commenced but not yet ended. However, if the arrangement covered by the private ruling has not begun to be carried out, and the income year to which it relates has not yet commenced, the product ruling applies to the taxpayer to the extent of the inconsistency only (see Taxation Determination TD 93/34).

Withdrawal

11. This Product Ruling is withdrawn and ceases to have effect on 30 June 2002. The Ruling continues to apply, in respect of the tax law(s) ruled upon, to all persons within the specified class who enter into the specified arrangement during the term of the Ruling. Thus, the Ruling continues to apply to those persons, even following its withdrawal, for arrangements entered into prior to withdrawal of the Ruling. This is subject to there being no change in the arrangement or in the persons' involvement in the arrangement.

Arrangement

12. The arrangement that is the subject of this Ruling is described below. This description is based on the following documents. These documents, or relevant parts of them, as the case may be, form part of and are to be read with this description. The relevant documents or parts of documents incorporated into this description of the arrangement are:

- Draft Franchise Agreement between Mikado Investments Pty Ltd ('the Franchisor') and the Franchisee;
- Draft Agreement Appointing Exclusive Agent between the Franchisee and the Exclusive Agent;

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- Draft pro-forma Guarantee Agreement between the Franchisor and the Franchisee;
- Draft Information Memorandum;
- Product Ruling application dated 18 February 1999; and
- Additional information provided dated 18 May 1999 and 11 June 1999.

Note : certain information provided by the applicant has been provided on a commercial-in-confidence basis and will not be disclosed or released under Freedom of Information Legislation.

13. For the purpose of describing the arrangement to which this Ruling applies, there are no other agreements, whether formal or informal, and whether or not legally enforceable, which a Franchisee, or any associate of the Franchisee, will be party to. The effect of these agreements is summarised as follows.

14. The arrangement is called 'The Finishing Touch Franchise Project'. The Project is to carry out an expansion of the provision of car detailing and related services to vehicle owners (including owners of caravans, trucks and other heavy equipment) in Western Australia. This will be achieved through the granting of an additional 20 franchises to provide those services (there are already 22 franchises in existence). The franchise is for a period of 10 years with an opportunity available to the Franchisee to renew the franchise for a further 5 years.

15. Franchisees will enter into a contract with Mikado Investments Pty Ltd as trustee for the Mikado Investments Trust for the Grant of Franchise which will include the right to:

- use the Finishing Touch System in the provision of car detailing and related services to private and corporate owners of motor vehicles including automobiles, caravans, trucks and other heavy equipment;
- receive training and support from the Franchisor in the provision and marketing of those services; and
- receive administrative services including a central sales hot-line telephone support service, allocation of jobs and assignments on a daily basis, development and update of a manual and the development of computer systems.

16. The Franchisee has the option to enter into a contract with an Exclusive Agent who will provide the car detailing and related services on behalf of the Franchisee.

17. Returns to the Franchisee from the business will consist of payments made to the Franchisee by customers to whom Finishing Touch services have been provided.

18. The forecast returns for the Project indicate that:

- where an Exclusive Agent is not used, the Franchisee should be in a net profit position (before interest expense) in the first year; and
- where an Exclusive Agent is used, the Franchisee should be in a net profit position (before interest expense) in the second year.

The Franchise Agreement

19. The Franchisees will make payments to the Franchisor in respect of the grant of the franchise. The payments will be an Establishment fee for the Franchise, a Marketing fee, a Business Consulting fee, a Training fee, a Service Fee, an Agency fee (if applicable), a Guarantee fee (if applicable) and a Pager Service fee.

20. The Franchisees obtain the right to use the Finishing Touch System and to provide services to customers in the Territory of Western Australia. Some terms and conditions in relation to the grant of the franchise include:

- the option for the Franchisee to appoint an Exclusive Agent approved by the Franchisor to conduct the marketing and provision of services to customers;
- the Franchisee can use the Finishing Touch name and image;
- the obligation for the Franchisee to actively promote the business in the Territory and in particular regularly canvass customers and potential customers;
- the obligation for the Franchisee to perform services in accordance with the Finishing Touch System and the operating policies and standards at all times;
- the Franchisee acknowledges that the Franchisor has exclusive rights to the Finishing Touch Name, the Finishing Touch System, the Operations Manual and all Customers and that the Finishing Touch System is proprietary confidential and a trade secret of the Franchisor;
- the Franchisee must purchase, use and maintain the equipment specified or approved by the Franchisor in the operation of the franchised business; and

- the Franchisee must engage sufficient staff to enable the proper and efficient conduct of the Franchised Business and ensure that a minimum monthly gross revenue of \$3,000 be earned.
21. In return for the payment of the fees, the Franchisor will:
- provide training to the Franchisee, a representative and other staff nominated by the Franchisor and the Exclusive Agent (if appointed);
 - operate a central contact point for the public and refer those customers to the Franchisee located closest to the location where the services are to be provided;
 - supply the Franchisee with an operations manual;
 - establish and operate a Marketing Fund to be used in advertising and promotional campaigns; and
 - provide a Business consultant to provide advice and assistance to the Franchisee in operating a small business.

Agreement Appointing Exclusive Agent

22. A Franchisee may appoint an Exclusive Agent to provide Finishing Touch services to motor vehicle owners. In consideration of this, the Franchisee will pay the Exclusive Agent 69% of the monthly gross revenue for the preceding month.
23. The Exclusive Agent is responsible for the purchase of, at its own cost, the equipment required under the Franchise Agreement.
24. The Franchisee may express opinions, make recommendations and give directions to the Exclusive Agent in relation to the conduct of the franchise business. The Exclusive Agent may disregard any opinion or recommendation of the Franchisee but must advise the Franchisee of the reasons for doing so.
25. The Franchisee may terminate the Exclusive Agent Agreement by providing the Exclusive Agent 30 days written notice of termination.
26. The Franchisee receives from the Exclusive Agent a \$3,000 bond as security for the performance by the Exclusive Agent of its obligations. The Franchisee is required to place this amount on deposit in a trust account.
27. The Franchisee is required to return the bond to the Exclusive Agent on termination of this Agreement.

Fees

28. The Franchisees will make the following payments in relation to each franchise for the first year of the Project:

- an Establishment fee of \$4,000 to the Franchisor for the grant of the franchise;
- a Marketing fee of \$10,500 to the Franchisor for the provision of advertising material, regional promotion and general advertising;
- a Business Consulting fee of \$7,000 to the Franchisor for the provision of advice by a consultant in relation to the running of the franchise;
- a Training fee of \$2,500 to the Franchisor for the provision of on-going field training;
- a Service fee at the rate of 20% of the gross revenue for the year to the Franchisor for the provision of general support including the allocation of jobs/assignments on a daily basis;
- a Guarantee fee (if applicable) of 2% of the outstanding balance of the loan; and
- a Pager Service fee of \$15 per month plus \$0.20 per call to the Franchisor.

29. The Franchisees will make the following payments in relation to each franchise in the second year of the Project:

- a Marketing fee of \$6,500 to the Franchisor for the provision of advertising material, regional promotion and general advertising;
- a Business Consulting fee of \$3,000 to the Franchisor for the provision of advice by a consultant in relation to the running of the franchise;
- a Training fee of \$500 to the Franchisor for continued training;
- a Service fee at the rate of 20% of the gross revenue for the year to the Franchisor for the provision of general support including the allocation of jobs/assignments on a daily basis;
- a Guarantee fee (if applicable) of 2% of the outstanding balance of the loan; and
- a Pager Service fee of \$15 per month plus \$0.20 per call to the Franchisor.

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30. The Franchisees will make the following payments in relation to each franchise in the subsequent years until the completion of the 10 year project period:

- a Marketing fee at the rate of 2% of the gross revenue for the year to the Franchisor for the provision of advertising material, regional promotion and general advertising;
- a Business Consulting fee at the rate of 1% of the gross revenue to the Franchisor for the provision of advice by a consultant in relation to the running of the franchise;
- a Service fee at the rate of 20% of the gross revenue for the year to the Franchisor for the provision of general support including the allocation of jobs/assignments on a daily basis;
- a Guarantee fee (if applicable) of 2% of the outstanding balance of the loan; and
- a Pager Service fee of \$15 per month plus \$0.20 per call to the Franchisor.

31. Franchisees who appoint an Exclusive Agent will pay an Agency fee at the rate of 69% of the gross revenue for that year to the Exclusive Agent for the period in which the Exclusive Agent is contracted.

Financing

32. There is no finance facility available from the Franchisor or any related party. The Franchisee can fund the investments themselves or borrow from an unassociated lending body. The Franchisor has had discussions with a nominated Bank on an informal basis to enable Franchisees to get priority in dealing with that institution.

33. There is no agreement, arrangement or understanding between any entity or party associated with the Project and any financial or other institution for the provision of any finance to the Franchisees for any purpose associated with the Project.

34. A Franchisee may choose to have the Franchisor act as the Guarantor for any finance obtained from a recognised financial institution up to a total of 60% of the total fixed Franchise fees. The Franchisee is required to pay a Guarantee fee of 2% of the outstanding balance of the loan to the Franchisor for the grant of this guarantee.

35. The Guarantee offered by the Franchisor does not limit the liability of the Franchisee. If the Franchisee is in default of their loan and the guarantee is called upon by a financial institution (the lender)

then the Franchisor will seek redress from the Franchisee in relation to that guarantee.

Ruling

36. For a Franchisee who invests in the project, the following deductions will be available:

- the Marketing fees paid for the services outlined in the Franchise Agreement will be an allowable deduction in the year incurred (section 8-1, ITAA 1997);
- the Business Consulting fees paid for the services outlined in the Franchise Agreement will be an allowable deduction in the year incurred (section 8-1, ITAA 1997);
- the Service fee paid for the services outlined in the Franchise Agreement will be an allowable deduction in the year incurred (section 8-1, ITAA 1997);
- the Training fee paid for the provision of training as outlined in the Franchise Agreement will be an allowable deduction in the year incurred (section 8-1, ITAA 1997);
- the Guarantee fee (if any) paid for the provision of a guarantee by the Franchisor in relation to finance obtained to enter the project will be an allowable deduction in the year incurred (section 8-1, ITAA 1997); and
- the Pager Service fees will be an allowable deduction in the year incurred (section 8-1, ITAA 1997).

37. For a Franchisee who invests in the Project and appoints an Exclusive Agent to provide the Finishing Touch services to clients on their behalf, a deduction will be available for the Exclusive Agent fee in the year it is incurred (section 8-1, ITAA 1997).

Sections 82KZM, 82KL and Part IVA

38. For a Franchisee who invests in the Project the following provisions have application as indicated:

- the expenditure of the Franchisee does not fall within the scope of section 82KZM;
- section 82KL does not apply to deny the deductions otherwise available to the Franchisee; and

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- the relevant provisions in Part IVA will not be applied to cancel a tax benefit obtained under a tax law dealt with in this Ruling.

Assessability of income from the Project

39. Franchisees who invest in the Project will be assessable on the gross proceeds arising from the Project in accordance with section 6-5 (ITAA 1997).

Capital gains tax

40. Acquisition of the rights under the Franchise Agreement will constitute the acquisition of an asset to which Part 3-1 of the ITAA 97 may apply. The Establishment fee will form part of the cost base of that asset.

Explanations

41. Consideration of whether the fees paid by the Franchisees are deductible begins by examining paragraph 8-1(1)(a), ITAA 1997. This consideration proceeds on the following basis:

- the outgoing in question must have a sufficient connection with the operations or activities that directly gain or produce the taxpayer's assessable income;
- the outgoing is not deductible under paragraph 8-1(1)(b) if it is incurred when the business has not commenced; and
- where a taxpayer merely contractually commits themselves to a venture that may not turn out to be a business, there can be doubt about whether the relevant business has commenced, and hence, whether paragraph 8-1(1)(b) applies. However, that does not preclude the application of paragraph 8-1(1)(a) in determining whether the outgoing in question would have a sufficient connection with activities to produce assessable income.

42. A franchise operation can constitute the carrying on of a business. Where there is a business, or a future business, the gross receipts from the Project will constitute gross assessable income in its own right. The generation of business income from such a business, or a future business, provides the backdrop against which to judge

whether the outgoings in question have the requisite connection with the operations that more directly gain or produce this income.

43. Generally a Franchisee will be carrying on a business of a car detailing operation where:

- the Franchisee has an identifiable interest;
- the Franchisee performs the business activities or they are carried out on the Franchisee's behalf, and
- the weight and influence of the general indicators of a business as used by the Courts point to the carrying on of a business.

An identifiable interest

44. The Franchise Agreement gives Franchisees an identifiable interest in a right to use a system of service delivery (a trade secret) and the right to use the associated trademark. Franchisees have a continuing interest in those rights from the time they are acquired until the end of the Project.

Car detailing services carried out by the Franchisee or on the Franchisee's behalf

45. Under the Exclusive Agent , Franchisees may appoint an Exclusive Agent to provide car detailing services on their behalf. The Exclusive Agent is to provide services in accordance with the Finishing Touch System.

46. The Franchisee retains control of the franchised business under terms in both the Franchise Agreement and the Exclusive Agent Agreement. Franchisees are able to terminate their agreement with the Exclusive Agent at any time by 30 days written notice or in specified circumstances, such as a breach by the Exclusive Agent of a term or condition of the Exclusive Agent Agreement. Where an Exclusive Agent is appointed the Franchisee continues to be carrying on a business.

General indicators of business

47. The general indicators of a business, as used by the Courts, are described in Taxation Ruling TR 97/11. Positive findings can be made from the arrangement's description for all the indicators.

48. Franchisees to whom this Ruling applies intend to derive assessable income from the Project. This intention is related to projections in the prospectus that suggest the Project should return a

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'before-tax' profit to the Franchisees, that is, a 'profit' in cash terms that does not depend on its calculation, on the fees in question being allowed as a deduction.

49. The fees associated with the Project have the requisite connection with the operations that more directly gain or produce this income. That is, the fees directly relate to the gaining of customers and service delivery to those customers and thereby the income stream.

Expenditure of a capital nature

50. Any part of the expenditure of a Franchisee entering into the franchise business that is attributable to acquiring an asset or advantage of an enduring kind is generally capital or capital in nature and will not be an allowable deduction under section 8-1 of the ITAA 1997.

Establishment fee

51. In this project the Establishment fee of \$4,000 is considered to be a capital expense. This fee is not deductible under section 8-1 of the ITAA 1997.

Marketing fee, Business Consulting fee and Training Expenses

52. It is considered that the Marketing fees, the Business Consulting fees and the Training fees incurred by the Franchisees is for the provision of services that will result in the generation of income for the Franchisees. No capital component can be identified and these fees will, thus, be deductible under section 8-1.

Section 82KZM

53. Section 82KZM of the ITAA 1936 operates to spread over more than one income year a deduction for prepaid expenditure that would otherwise be immediately deductible, in full, under section 8-1 of the ITAA 1997. The section applies if certain expenditure incurred under an agreement is in return for the doing of a thing under the agreement that is not wholly done within 13 months after the day on which the expenditure is incurred.

54. Under the Franchise Agreement a Marketing fee of \$10,500, a Business Consulting fee of \$7,000 and a Training fee of \$2,500 are incurred for the first year on execution of the Agreement. These fees are charged for providing services to a Franchisee only for the period of 13 months from the execution of the Agreement. For this Ruling's

purposes no explicit conclusion can be drawn from the arrangement's description, that the fees have been inflated to result in reduced fees being payable for subsequent years. The fees are expressly stated to be for a number of specified services. There is no evidence to suggest that the services covered by the fees could not be provided within 13 months of the fee being incurred. Therefore it cannot be suggested that the 'thing' to be done cannot be wholly done within 13 months of the fee being incurred.

55. The basic precondition of the operation of section 82KZM is not satisfied and the section will not apply to disallow a deduction for the Marketing fee, the Business Consulting fee and the Training fee.

Section 82KL

56. Section 82KL of the ITAA 1936 is a specific anti-avoidance provision that operates to deny an otherwise allowable deduction for certain expenditure incurred, but effectively recouped, by the taxpayer. Under subsection 82KL(1) a deduction for certain expenditure is disallowed where the sum of the 'additional benefit' and the 'expected tax saving' in relation to that expenditure equals or exceeds the 'eligible relevant expenditure'.

57. Section 82KL's operation depends, among other things, on the identification of a certain quantum of 'additional benefits'. Insufficient 'additional benefits' will arise to trigger the application of section 82KL. It will not apply to deny the deduction otherwise allowable under section 8-1 of the ITAA 1997.

Part IVA

58. For Part IVA to apply there must be a 'scheme' (section 177A of the ITAA 1936); a 'tax benefit' (section 177C of the ITAA 1936); and a dominant purpose of entering into the scheme to obtain a tax benefit (section 177D of the ITAA 1936).

59. The Project will be a 'scheme'. The Franchisees will obtain a 'tax benefit' from entering into the scheme, in the form of the tax deductions in relation to the franchised business that would not have been obtained but for the scheme. However, it is not possible to conclude that the scheme will be entered into or carried out with the dominant purpose of obtaining this tax benefit.

60. Franchisees to whom this Ruling applies intend to stay in the scheme for its full term and derive assessable income from the franchise business. Further, there are no features of the Project, such as non-recourse financing of the Franchisee's proposed expenditure, that might suggest that the project was so 'tax driven', and so

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designed to produce a tax deduction of a certain magnitude that it would attract the operation of Part IVA.

Assessability of income from the Project

61. For a Franchisee who invests in the Project any income received by them from the provision of services to vehicle owners will be assessable income to them under section 6-5 of the ITAA 1997.

Capital gains tax

62. The grant of the franchise by the Franchisor to the Franchisee results in the Franchisee acquiring a CGT asset. The Establishment fee of \$4,000 forms part of the cost base of the CGT asset. A capital gain or loss may arise on the happening of a CGT event under part 3-1 of the ITAA 1997. The happening of a CGT event includes the transfer, disposal or loss of that asset. Any net capital gain will be included in the assessable income of the Franchisee in the year in which the CGT event occurs. Conversely, any capital loss will be taken into account in the calculation of the net capital gain to be included in the Franchisee's assessable income or the net capital loss to be carried forward.

Detailed contents list

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23 June 1999

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No draft issued

Related Rulings/Determinations:

PR 98/1; TR 92/1; TR 97/11;
TR 97/16; TD 93/34

Subject references:

- carrying on a business
- commencement of business
- fee expenses
- interest expenses
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- primary production
- primary production expenses
- producing assessable income
- product rulings
- public rulings
- schemes and shams
- taxation administration

- tax avoidance

- tax benefits under tax avoidance schemes

- tax shelters

- tax shelters project

Legislative references:

- ITAA1936 82KL
- ITAA1936 82KL(1)
- ITAA1936 82KZM
- ITAA1936 Pt IVA
- ITAA1936 177A
- ITAA1936 177C
- ITAA1936 177D
- ITAA1997 3-1
- ITAA1997 6-5
- ITAA1997 8-1
- ITAA1997 8-1(1)(a)
- ITAA1997 8-1(1)(b)

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