

PR 2000/33 - Income tax: NoRegrets Virtual Store Franchise Project

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⚠ This document has changed over time. This is a consolidated version of the ruling which was published on *5 April 2000*



Product Ruling

Income tax: NoRegrets Virtual Store Franchise Project

Contents	Para
What this Ruling is about	1
Date of effect	12
Withdrawal	14
Arrangement	15
Ruling	42
Explanations	55
Detailed contents list	91

Potential investors may wish to refer to the ATO's Internet site at <http://www.ato.gov.au> or contact the ATO directly to confirm the currency of this Product Ruling or any other Product Ruling that the ATO has issued.

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 1999/95 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.*

No guarantee of commercial success

The Australian Taxation Office (ATO) **does not** sanction or guarantee this product as an investment. Further, we give no assurance that the product is commercially viable, that charges are reasonable, appropriate or represent industry norms, or that projected returns will be achieved or are reasonably based.

Potential investors must form their own view about the commercial and financial viability of the product. This will involve a consideration of important issues such as whether projected returns are realistic, the 'track record' of the management, the level of fees in comparison to similar products, how the investment fits an existing portfolio, etc. We recommend a financial (or other) adviser be consulted for such information.

This Product Ruling provides certainty for potential investors by confirming that the tax benefits set out below in the **Ruling** part of this document are available, **provided that** the arrangement is carried out in accordance with the information we have been given, and have described below in the **Arrangement** part of this document.

If the arrangement is not carried out as described below, investors lose the protection of this Product Ruling. Potential investors may wish to seek assurances from the promoter that the arrangement will be carried out as described in this Product Ruling.

Potential investors should be aware that the ATO will be undertaking review activities to confirm the arrangement has been implemented as described below and to ensure that the participants in the arrangement include in their income tax returns income derived in those future years.

Terms of Use of this Product Ruling

This Product Ruling has been given on the basis that the person(s) who applied for the Ruling, and their associates, will abide by strict terms of use. Any failure to comply with the terms of use may lead to the withdrawal of this Ruling.

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, the arrangement is sometimes referred to as the NoRegrets Virtual Stores Franchise, or just simply as 'the Project'.

Tax law(s)

2. The tax law(s) dealt with in this Ruling are:

- section 6-5 of the *Income Tax Assessment Act 1997* ('ITAA 1997');
- section 8-1 of the ITAA 1997;
- section 27-5 of the ITAA 97;
- section 27-30 of the ITAA 97;
- Part 3-1 of the ITAA 1997;
- section 82KL *Income Tax Assessment Act 1936* ('ITAA 1936');
- section 82KZM of the ITAA 1936;
- section 82KZMA of the ITAA 1936;
- section 82KZMB of the ITAA 1936;
- section 82KZMC of the ITAA 1936;
- section 82KZMD of the ITAA 1936; and
- Part IVA of the ITAA 1936.

3. On 11 November 1999 the Government announced further changes, those to do with 'tax shelters'. Some of those changes apply from the dates of announcement and others are proposed to apply from nominated dates in the future.

4. Although this Ruling mentions certain of those announced changes, the information given on the treatment of expenditure which may be affected by them is not binding on the Commissioner. Legally binding advice in respect of those changes cannot be given until the relevant law(s) are enacted.

5. However, if the changes become law the operation of that law will take precedence over the application of this Ruling, and to that extent, this Ruling will be superseded. If requested, when the relevant law(s) are enacted, the Commissioner will formalise the non-binding

information shown in this Ruling by issuing a new Product Ruling that describes the operation of those law(s).

Class of persons

6. 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'.

7. 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

8. 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 industry norms. A financial (or other) adviser should be consulted for such information.

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

10. The class of persons defined in the Ruling may rely on its contents, provided the arrangement (described below at paragraphs 15 to 40) 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.

Note: a material difference may arise in relation to a variation in the facts of the arrangement described in the Ruling. It may also arise in circumstances where the person otherwise included in the class of persons enters into the arrangement as described, but also enters into transactions or arrangements (including financial arrangements) that, when viewed as a whole with the arrangement described in the Ruling, will produce a different tax consequence for the arrangement. This

might include, for example, where the Participant borrows to enter into the arrangement by way of limited non-recourse loan and the overall consequence might be that the arrangement is one that would have attracted the application of a tax avoidance provision.

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Date of effect

12. This Ruling applies prospectively from 5 April 2000, 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).

13. 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

14. This Product Ruling is withdrawn and ceases to have effect after 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

15. 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:

- Product Ruling application dated 8 April 1999;
- Draft NoRegrets Virtual Stores Prospectus dated 24 February 2000;
- **Draft copy of Franchise Agreement between NR Online Pty Ltd as trustee of the NR Online Unit Trust ('the Franchisor') and the Franchisee undated;**
- Licence Agreement between NoRegrets Pty Ltd and NR Online Pty Ltd as trustee of the NR Online Unit Trust and NoRegrets Pty Ltd as trustee of the NR Unit Trust dated 19 April 1999;
- Agency Agreement between NR Online Pty Ltd as trustee of the NR Online Unit Trust and NRVS Manager Pty Ltd as trustee of the NRSV Manager Unit Trust dated 19 April 1999;
- Draft Deed of variation to Agency Agreement between NR Online Pty Ltd as trustee of the NR Online Unit Trust and NRVS Manager Pty Ltd as trustee of the NRSV Manager Unit Trust
- Subscription Deed between NR Virtual Stores Ltd and NRVS Franchise Holdings Pty Ltd as trustee of the NRVS Holdings Unit Trust and NR Online Ltd dated 19 April 1999;
- Trust Deed for the NR Online Unit Trusts dated 29 March 1999;
- Deed of Variation to Trust Deed for the NR Online Trust made between NR Online Ltd and NRVS Franchise Holdings Pty Ltd as trustee of the NRVS Holdings Unit Trust dated 9 April 1999;
- Second Deed of Variation of Trust Deed for the NR Online Trust made between NR Online Ltd and NRVS Franchise Holdings Pty Ltd as trustee of the NRVS Holdings Unit Trust dated 19 April 1999;

- Draft copy of Custodian Agreement to be made between NR Online Ltd and Charter Securities Ltd dated 24 March 1999; and
- additional correspondence received from the applicant dated 21 June 1999, 27 July 1999, 5 August 1999, 8 October 1999, 19 October 1999, 2 November 1999, 9 November 1999, 2 December 1999, 4 February 2000, 14 February 2000 and 24 February 2000.

Note: certain information received from the applicant has been provided on a commercial-in-confidence basis and will not be disclosed under Freedom of Information legislation.

16. The document highlighted is that one to which a Franchisee is a party. 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 with the exception of a Management Agreement with an independent party. That independent party will not be associated directly or indirectly with the Franchisor. The effect of these agreements is summarised as follows.

Overview

17. The arrangement is called the 'NoRegrets Virtual Store Franchise Project'. The Project is to carry out the marketing and sale of intimate apparel and other products using a Virtual Store located on an Internet facility. The Franchisees will receive an individual Franchisee Web Address ('FWA') which links directly to the NoRegrets Virtual Store contained on the NoRegrets website. The Franchisees will conduct their business through a virtual store constituted by their FWA and the NoRegrets website. A manager must be appointed by Franchisees to receive orders and procure and deliver merchandise.

18. The Franchisees will enter into a Franchise Agreement with NR Online Pty Ltd as trustee of the NR Online Unit Trust ('NR Online') for the grant of the franchise which will provide Franchisees with rights including –

- use of the NoRegrets brand name and system to market and sell intimate apparel and other products;
- allocation of an individual FWA which directly links to the NoRegrets website and virtual store;
- the benefit of the sales generated from NoRegrets client database for their franchised business for the franchise term;

- the provision of training and promotional materials;
- administrative services.

19. The Franchise Agreement stipulates that a Franchisee must appoint a Manager. That Manager can be NR Online or another party which is approved by the Franchisor.

20. NR Online, as Manager, has entered into an Agency Agreement with NRVS Manager Pty Ltd as trustee for the NRVS Manager Unit Trust to provide the management services for those NoRegrets Virtual Store franchisees who appoint NR Online as Manager.

21. Where NR Online has been appointed as manager, the sale price for the goods supplied to the customer will be received by NR Online who will first deduct the cost of those goods, then deduct any ongoing fees (as detailed below) from those amounts and pay them to the relevant parties, and then forward the balance to Franchisees on a quarterly in arrears basis.

22. Where another independent party has been appointed as Manager, the sale price for the goods supplied will be received by that party and dealt with in accordance with the terms of any agreement between the Franchisee and that Manager.

23. Returns to the Franchisee from the business will consist of the sale price of goods supplied to customers less the cost of those goods (60% of the sales price), being the gross profit amount.

24. The Prospectus indicates that the profitability of a Franchisee's business is not dependent upon the availability of income tax deductions.

Franchise Agreement

25. The Franchisees will make payments to the Franchisor in respect of the grant of the franchise to market and sell intimate apparel and other products using a Virtual Store located on an Internet facility. The payments will be a Grant of Franchise fee, a Service fee, a Management fee and a Rental fee.

26. The Franchisee obtains the rights to use the NoRegrets system, use the NoRegrets brand name, receipt of initial promotional material (including but not limited to 2,000 business cards) and use of the NoRegrets client database. Some terms and conditions in relation to the grant of the franchise are that the Franchisee:

- will pay the fees related to the franchised business;
- must appoint a Manager which can either be the Franchisor or another party approved by the Franchisor;

- not use any promotional materials or methods other than those approved by the Franchisor; and
- attend such training as is required by the Franchisor.

27. In return for the payment of the Service fee, the Franchisor is required to –

- do all things to enable potential clients to access the Franchisee's Web Address and the NoRegrets website;
- provide data and information to the Franchisees concerning the NoRegrets intellectual property for their benefit in conducting the business; and
- protect the NoRegrets intellectual property.

28. In return for the payment of the Management fee, the Manager is required to –

- market and promote the NoRegrets Virtual Store and merchandise;
- undertake all activities in relation to the fulfilling of customer orders including the procurement of merchandise, arranging the packaging of the merchandise and its deliver to the customers; and
- provide financial & accounting services and general administration for the franchised business.

29. The Franchisor and the Manager are committed to provide the following services within 30 days of an application for a NoRegrets Virtual Store Franchise being accepted and the Franchise Agreement being executed -

- Administration of the selection and registration of an FWA;
- Connect the FWA;
- Produce and deliver the Franchisee's induction kit including the printing of the FWA business cards;
- Allocate user name, passwords and provide materials relating to the Franchise Business Development Module;
- Establishment of the Virtual Store Franchisee account; and
- Establishment of Franchisee Activity Access Account.

Fees

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

- a Grant of Franchise Fee of \$1,995 to the NR Online Trust, as Franchisor, for the grant of the franchise;
- a Service fee of \$4,177 to the NR Online Trust, as Franchisor, for the provision of services;
- a Rental fee of \$200 to the NR Online Trust, as Franchisor, for the rental of the Virtual Store website address;
- where applicable, a Management Fee of \$5,378 to the NR Online Trust, as Manager, for the management of the franchised business.

31. In respect of the Service fee and the Management fee (where applicable) the amounts of \$2,619 and \$308 respectively are for services to be provided within 30 days of the execution of the Franchise Agreement.

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

- a Service fee of 8.5% of sales revenue to the NR Online Trust, as Franchisor, for the provision of services on a monthly basis;
- a Rental fee of \$200 to the NR Online Trust, as Franchisor, for the rental of the Virtual Store website address; and
- where applicable, a Management Fee of 21.5% of sales revenue to the NR Online, as Manager, for the management of the franchised business on a monthly basis.

33. The Franchisees will make the following payments in relation to each franchise in the subsequent years until the completion of the 15 year project period:

- a Service fee of 8.5% of sales revenue to the NR Online Trust, as Franchisor, for the provision of services on a monthly basis;
- a Rental fee, being the \$200 adjusted by the greater of 2% or the Consumer Price Index All Groups Sydney during the previous year increased by 2%, to the NR Online Trust, as Franchisor, for the rental of the Virtual Store website address; and

PR 2000/33

- where applicable, a Management Fee of 21.5% of sales revenue to the NR Online, as Manager, for the management of the franchised business on a monthly basis.

34. The following table summarises the fees payable by Franchisees –

Fee Type	Year 1	Year 2	Year 3
Grant of Franchise Fee	\$1,995		
Service Fee	\$4,177	8.5% of sales revenue	8.5% of sales revenue
Rental of Virtual Store	\$200	\$200	\$200 adjusted by the greater of 2% or the Consumer Price Index All Groups Sydney
Management Fee (where applicable)	\$5,378	21.5% of sales revenue	21.5% of sales revenue

35. The Goods and Services Tax will be applicable to services provided by the Franchisor and any Manager after 1 July 2000. The Franchise Agreement states that the Goods and Services Tax is to be added to the amount of fees detailed above.

Payment Option

36. Franchisees may pay the fees for the first year of the project, being \$11,750 in total, either as a single lump sum payment or in 12 equal instalments over an 11 month period (see paragraphs 37 - 39).

37. A Franchisee who elects to use this Payment option is required to pay \$1,036.84 on application which is followed by 11 monthly instalments of \$1,036.84.

38. The Franchisor will charge interest on the outstanding balance of the application monies at the rate of 10.7% per annum. The total

interest which is expected to be incurred by the Franchisee is \$692 over the period of the finance.

39. If a Franchisee fails to make a payment under this option the Franchisor will issue a written notice to the Franchisee detailing the breach and requiring it to be remedied. If the Franchisee fails to remedy the breach within 30 days of the receipt of that notice, the Franchisor will take the following steps to recover the debt from the defaulting Franchisee –

- Terminate the Franchise agreement and immediately disconnect the Franchisee's FWA from the NR website; and
- Commence proceedings against the Franchisee for the recovery of outstanding monies.

Finance

40. Franchisees can fund their investment in the Project themselves or borrow from an independent lender. Finance arrangements organised directly by a Franchisee with independent lenders are outside the arrangement to which this Ruling applies.

41. This ruling does not apply if a Franchisee enters into a finance agreement that includes any of the following features –

- there are split loan features of a type referred to in Taxation Ruling TR 98/22;
- entities associated with the Project (other than that described at paragraphs 36 - 39) are involved in the provision of finance for the Project;
- there are indemnity arrangements or other collateral agreements in relation to the loan designed to limit the borrowers risk;
- additional benefits will be granted to the borrowers for the purpose of section 82KL or the funding arrangements transform the Project into a 'scheme' to which Part IVA may apply;
- terms or conditions are non-arms length;
- repayments of the principal and interest are linked to the derivation of income from the Project;
- the funds borrowed, or any part of them, will not be available for the conduct of the Project but will be transferred (by any mechanism) back to the lender or any associate; or

- lenders do not have the capacity under the loan agreement, or a genuine intention, to take legal action against defaulting borrowers.

Ruling

Effect of Goods and Services Tax

42. For Franchisees who invest in the Project sections 27-5 and 27-30 of the ITAA 1997 will apply to reduce the amount of any deduction allowable by any GST input tax credit to which the Grower is entitled or, in the use of section 27-5 a decreasing adjustment that a Grower has.

Allowable deductions

43. For a Franchisee who invests in the Project the deduction available for the prepaid Service Fee and the prepaid Management Fee will depend upon the date that the Franchise Agreement is executed, and in some cases, whether or not they are 'small business taxpayers.'

IMPORTANT : Paragraph 44 (relating to 'small business taxpayers') and paragraphs 46, 47 and 49 (relating to taxpayers who are not 'small business taxpayers') describe the deductions allowable under the current law, but Franchisees are advised to carefully examine the information contained in paragraphs 51 and 52 relating to proposed changes to the prepayment rules. Franchisees who invest in the Project after 1pm, AEST, 11 November 1999 may be affected by these changes.

Franchisees who are Small Business Taxpayers

44. For a Franchisee who invests in the project and is a small business taxpayer as defined in section 960-335 of the ITAA 1997, the following deductions will be available in the year in which they are incurred -

- the Service fee (section 8-1 of the ITAA 1997);
- the Rental Fee (section 8-1 of the ITAA 1997); and
- where applicable, the Management Fee (section 8-1 of the ITAA 1997).

Franchisees who are not Small Business Taxpayers who invest on or before 31 May 2000

45. Where a Franchisee is not a small business taxpayer as defined in section 960-335 and is carrying on a business the following deductions are available for the year ended 30 June 2000 if the expenditure is incurred through the execution of the Franchise Agreement on or before 31 May 2000 –

Fee type	ITAA 1997 Section	Deductions for expenditure for taxpayers who are not small business taxpayers and are carrying on a business		
		Year 1	Year 2	Year 3
		30/6/2000	30/6/2001	30/6/2002
Service Fee	8-1	\$2,619 *	\$1558 plus the monthly service fee of 8.5% of sales revenue for the relevant months up to 30 June 2001	The monthly service fee of 8.5% of sales revenue
Management Fee (where applicable)	8-1	\$308 *	\$5,070 plus the Monthly Management fee of 21.5% of sales revenue for the relevant months up to 30 June 2001	The Monthly Management fee of 21.5% of sales revenue
Rental	8-1	\$200	\$200	\$200 adjusted by the greater of 2% or the Consumer Price Index All Groups Sydney

* For Franchisees who invest prior to 31 May 2000 the amount of deduction will be increased by a proportion of the balance of the fees for the initial period. This will decrease the amount of deduction available in the next year by a corresponding amount.

Initial period fees X $\frac{\text{Number of days of eligible service period in the expenditure year}}{\text{Total number of days of the eligible service period}}$

PR 2000/33**Franchisees who are not Small Business Taxpayers who invest between 1 June 2000 and 30 June 2000**

46. For a Franchisee who invests in the Project between 1 June 2000 and 30 June 2000 who is **not a 'small business taxpayer'** and is carrying on a business, the deduction available in respect of the Management Fee, Service Fee is determined under subsection 82KZMB(2), using the formula in subsection 82KZMB(3) and the percentages shown in Columns 3 and 4 of the Table in subsection 82KZMB(5). (Example 1 at paragraph 89 illustrates the application of this method).

47. In calculating the deduction available, the term 'expenditure' refers to expenditure otherwise allowable under section 8-1 whose 'eligible service period' ends not more than 13 months after it is incurred by the taxpayer. The 'eligible service period' (defined in subsection 82KZL(1)) means, generally, the period over which the services are to be provided. For these investors deductions will be available as follows –

For the year ended 30 June 2000

- the Rental Fee (section 8-1 of the ITAA 1997);
- The Management and Service fees eligible to be claimed as a deduction is determined using the following formula

$$\text{Available deduction} = A + B$$

Where :

$$A = \$2927 \quad X \quad \frac{\text{Number of days of eligible service period in the expenditure year}}{30 \text{ days}}$$

$$B = (\$2927 \text{ less } A) \times 80\%$$

For the year ended 30 June 2001

- the Rental Fee (section 8-1 of the ITAA 1997);
- The Management and Service fees eligible to be claimed as a deduction is determined using the following formula

Available deduction = \$6,628 + the monthly Service Fee* + the monthly Management fee (where applicable)* + A

*These fees will only be those additional amounts paid for the months up to 30 June 2001

Where :

A = balance of the Year 1 expenditure not previously deducted

For the year ended 30 June 2002

- the Rental Fee (section 8-1 of the ITAA 1997);
- the monthly Service Fee (section 8-1 of the ITAA 1997); and
- where applicable, the monthly Management Fee (section 8-1 of the ITAA 1997).

Franchisees who are not Small Business Taxpayers who invest after 30 June 2000

48. For a Franchisee who invests in the Project after 30 June 2000 who is **not a 'small business taxpayer'** and is carrying on a business, the deduction available in respect of the Management Fee and Service Fee is determined under subsection 82KZMB(2), using the formula in subsection 82KZMB(3) and the percentages shown in Columns 3 and 4 of the Table in subsection 82KZMB(5).

49. In calculating the deduction available, the term 'expenditure' refers to expenditure otherwise allowable under section 8-1 whose 'eligible service period' ends not more than 13 months after it is incurred by the taxpayer. The 'eligible service period' (defined in subsection 82KZL(1)) means, generally, the period over which the services are to be provided. For these investors deductions will be available as follows –

- the Rental Fee in the year incurred (section 8-1 of the ITAA 1997);
- The Management and Service fees eligible to be claimed as a deduction is determined using the following formula

$$\text{Expenditure} \times \frac{\text{Number of days of eligible service period in the expenditure year}}{\text{Total number of days of the eligible service period}}$$

Note : The expenditure incurred by Franchisees on application to this Project contains two separate components with differing service periods. Therefore, it is necessary to complete the above calculation in respect of those two components to determine the deduction available.

Sections 82KL and 82KZM and Part IVA

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

- expenditure by Franchisees who are small business taxpayers is not within the scope of section 82KZM **(but see paragraphs 51 and 52);**
- section 82KZMB applies to expenditure by Franchisees who are not small business taxpayers and are carrying on a business **(but also see paragraphs 51 and 52);**
- section 82KL does not apply to deny the deductions otherwise allowable; and
- 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.

Proposed new laws

Proposed Changes to Prepayment Rules

51. On 11 November 1999, the Government announced a number of changes to the deductibility of certain prepaid expenditure incurred in respect of 'tax shelter arrangements'. Provided the proposed changes are enacted as announced, the Project will be a 'tax shelter arrangement' and all Franchisees, including 'small business taxpayers', who invest in the Project after 1pm, AEST, 11 November 1999, will be subject to these changes.

52. For these Franchisees the amount of deduction available in respect of the Management Fee and the Service Fee is calculated using the formula shown below (see also Example 2 at paragraph 90). In the calculation, the term 'expenditure' refers to expenditure otherwise allowable under section 8-1 ITAA 1997 whose 'eligible service period' ends not more than 13 months after it is incurred by the taxpayer. The 'eligible service period' (defined in subsection 82KZL(1)) means, generally, the period over which the services are to be provided.

$$\text{Deduction} = \text{Expenditure} \times \frac{\text{Number of days of eligible service period in the expenditure year}}{\text{Total number of days of the eligible service period}}$$

53. The excess remaining after the application of this formula is deductible in the year that the services to which the excess relates are performed.

Note: The expenditure incurred by Franchisees on application to this Project contains two separate components with differing service periods. Therefore, it is necessary to complete the above calculation in respect of those two components to determine the deduction available.

Note to promoters and advisers

54. Product rulings were introduced for the purpose of providing certainty about tax consequences for investors in projects such as this. In keeping with that intention, the Australian Taxation Office suggests that promoters and advisers ensure that potential investors are fully informed of the announcement requiring prepayments in respect of ‘tax shelter’ arrangements to be deductible over the period services are provided. Such action should minimise suggestions that potential investors have been negligently or otherwise misled.

Explanations

Goods and Services Tax

55. Section 27-30 of the ITAA 1997 operates to deny a deduction that would be otherwise available under section 8-1 for the year ended 30 June 2000 to the extent that the loss or outgoing (incurred after 30 November 1999 and on or before 1 July 2000) includes an amount relating to an input tax credit to which a Franchisee will be entitled after 1 July 2000.

56. Section 27-5 of the ITAA 1997 operates to deny a deduction, that would be otherwise available under section 8-1, to the extent that the loss or outgoing incurred (on or after 1 July 2000) includes an amount relating to an input tax credit to which a Franchisee is entitled or a decreasing adjustment that a Franchisee has.

Subdivision 960-Q - Small business taxpayers

57. Whether a Franchisee is a 'small business taxpayer' depends upon the individual circumstances of each Franchisee and is beyond the scope of this product ruling. It is the individual responsibility of each Franchisee to determine whether or not they are within the definition of a 'small business taxpayer'.

58. A 'small business taxpayer' is defined in section 960-335 of the ITAA 1997 as a taxpayer who is carrying on a business and either their 'average turnover' for the year is less than \$1,000,000 or their turnover recalculated under section 960-350 is less than \$1,000,000.

59. 'Average turnover' is determined under section 960-340 by reference to the average of the taxpayer's 'group turnover'. The group turnover is the sum of the 'value of business supplies' made by the taxpayer and entities connected with the taxpayer during the year (section 960-345).

Section 8-1: service, management and rental fees

60. It is appropriate, as a starting point, to consider whether the fees paid by each Franchisee are deductible by examining paragraph 8-1(1)(a) ITAA 1997. This view 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 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 of the taxpayer.

61. A franchise project can constitute the carrying on of a business. Where there is a business, or a future business, the gross receipts from the sale of intimate apparel and other products will constitute assessable income in their own right. The generation of 'business income' from such a business, or 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.

62. Generally, a Franchisee will be carrying on a business of marketing and selling intimate apparel and other products where:

- the Franchisee has a right to engage in the business of marketing and selling apparel under a system controlled by the Franchisor;
- the Franchisee continues to market and sell NoRegrets brand name intimate apparel and other products, and promote their FWA with the administrative activities of the merchandise sales being 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.

63. The Franchise Agreement gives Franchisees an identifiable interest in a right to use the NoRegrets brand name, to market and sell NoRegrets merchandise and access to the NoRegrets client database. Franchisees will be allocated a FWA through which potential clients can have access to the Virtual Store contained in the NoRegrets website. Franchisees have those rights from the time they are acquired until the end of the Project.

64. Under the Franchise Agreement, Franchisees appoint a Manager to provide various services including the procurement of merchandise and its delivery to customers. The Franchisee retains control of the franchised business at all times.

65. 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. Franchisees to whom this Ruling applies intend to derive assessable income from the franchise business. This intention is related to information in the Prospectus that suggest that the franchise business should return a '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.

66. The service, management and rental fees associated with the franchised business will relate to the gaining of income from this business and, hence, have a sufficient connection to the operations by which this income (from the sale of intimate apparel and other products) is to be gained from this business. They will, thus, be deductible under the first limb of section 8-1. Further, no 'non-income producing' purpose in incurring the fee is identifiable from the arrangement. No capital component is identifiable. The tests of deductibility under paragraph 8-1(1)(a) are met. The exclusions of subsection 8-1(2) do not apply.

Expenditure of a capital nature

67. Any part of the expenditure of a Franchisee entering into the franchised 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.

68. In this Project the Grant of Franchise Fee is considered to be a capital expense. This fee is not deductible under section 8-1 of the ITAA 1997.

Section 82KZM: prepaid expenditure for Small Business taxpayers

69. Section 82KZM operates to spread over more than one income year a deduction for prepaid expenditure incurred by a 'small business taxpayer' that would otherwise be immediately deductible, in full, under section 8-1. 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.

70. Under the Franchise Agreement, the initial Service and Management Fees will be incurred upon execution of the Agreement. This fee is charged for providing services to Franchisees for a period of 13 months from the date of execution of the Agreement. For this Ruling's purposes, no explicit conclusion can be drawn from the arrangement's description that the fee has been inflated to result in reduced fees being payable for subsequent years. The fee is expressly stated to be for a number of specified services. There is evidence this fee is for services to be provided within 13 months of the fee being incurred.

71. Thus, for the purposes of this Ruling, it is accepted that no part of the initial Service and Management Fees is for the Franchisor and Manager to do 'things' that are not to be wholly done within 13 months of the fee being incurred. On this basis, the basic precondition for the operation of section 82KZM is not satisfied and it will not apply to the expenditure for the Service and Management Fees by Franchisees who are 'small business taxpayers'.

Sections 82KZMA - 82KZMD - Prepaid expenditure for taxpayers other than small business taxpayers

72. For a Franchisee who is not a 'small business taxpayer' and is carrying on a business, sections 82KZMA to 82KZMD determine the amount of a deduction otherwise allowable under section 8-1 where

expenditure is incurred under an agreement for the doing of a thing that is not to be wholly done within the income year in which the expenditure is incurred (the expenditure year). Generally, these provisions operate to limit the amount of deduction available in the expenditure year to the amount that relates to that income year.

73. Section 82KZMA is a gateway provision that sets out when the new treatment will apply. Sections 82KZMB and 82KZMC set out the rules for prepayments incurred in the transitional period, for things to be done wholly within 13 months. For Franchisees investing in the Project, transitional treatment applies to prepayments initially incurred in the 1999-2000 income year. Section 82KZMD governs the deductibility of prepayment expenditure where the eligible service period ends more than 13 months after the date the expenditure was incurred, and does not apply to the Project.

74. The deduction available to Franchisees for the Management Fee and the Service Fee will be determined in accordance with the rules contained in section 82KZMB. Because the quantum of both the Management Fee and the Service Fee is lower in the second and subsequent years, the capping provisions contained in section 82KZMC will have no practical effect on the deduction available.

75. During the transitional period the amount of the deduction available to Franchisees is determined using the formula in subsection 82KZMB(3) and the percentages shown in the table in subsection 82KZMB(5).

Proposed changes to prepayment rules

76. The changes announced by the Government to apply from 11 November 1999 but not yet enacted will affect all taxpayers that participate in a 'tax shelter arrangement' and prepay expenditure for up to 13 months. It is proposed that deductions otherwise allowable under section 8-1 of the ITAA 1997 be spread over the period to which the prepayment relates. Under the proposed changes, there will be no exemption for small business taxpayers and no transitional rules will apply.

77. A tax shelter arrangement is described as existing where:

- under the arrangement, the taxpayer's allowable deductions exceed the assessable income for that year; and
- all significant aspects of the arrangement during the income year are conducted by people (e.g., a manager) other than the taxpayer; and
- either:

- more than one taxpayer participates in the arrangement; or
- the manager, or an associate of the manager, also manages similar arrangements on behalf of others.

78. The arrangement relating to the Project and described at paragraph 15 to 41 of this product ruling is within the description of a 'tax shelter arrangement'. Therefore, the Management Fee and the Service Fee incurred by Franchisees who invest in the Project after 11 November 1999 will be deductible over the period the services are provided. The formula for this apportionment is expected to be the same as that currently shown in subsection 82KZMD(2).

Section 82KL

79. Section 82KL 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' plus the 'expected tax saving' in relation to that expenditure equals or exceeds the 'eligible relevant expenditure'.

80. 'Additional benefit' (see the definition of 'additional benefit' at subsection 82KH(1) and paragraph 82KH(1F)(b)) is, broadly speaking, a benefit received that is additional to the benefit for which the expenditure is ostensibly incurred. The 'expected tax saving' is essentially the tax saved if a deduction is allowed for the relevant expenditure.

81. Section 82KL's operation depends, among other things, on the identification of a certain quantum of 'additional benefit(s)'. Insufficient 'additional benefits' will be provided to trigger the application of section 82KL. It will not apply to deny the deduction otherwise allowable under section 8-1.

Part IVA: general tax avoidance provision

82. For Part IVA to apply there must be a 'scheme' (section 177A); a 'tax benefit' (section 177C); and a dominant purpose of entering into or carrying out the scheme to enable the relevant taxpayer to obtain a tax benefit in connection with the scheme (section 177D).

83. The NoRegrets Virtual Store Franchise Project will be a 'scheme'. The Franchisees will obtain a 'tax benefit' from entering into the scheme, in the form of the tax deductions per franchise that would

not have been obtained but for the scheme. However, it is not possible to conclude the scheme will be entered into or carried out with the dominant purpose of enabling the relevant taxpayer to obtain this tax benefit.

84. Franchisees to whom this Ruling applies intend to stay in the scheme for its full term and derive assessable income from the marketing and sale of the intimate apparel and other products. This is subject to the understanding that Franchisees will be undertaking a continued and an active role in the promotion of their individual FWA.

85. Further, there are no features of the Project, such as the payment of excessive management fees and non-recourse loan financing by any entity associated with the Project, that might suggest the Project was so 'tax driven', and so designed to produce a tax deduction of a certain magnitude, that it would attract the operation of Part IVA. No ruling is given on the application of Part IVA to financing arrangements entered into between investors and other financiers in respect of lending arrangements to invest in the Project.

Section 6-5: assessable income

86. Gross sale proceeds derived from the marketing and sale of intimate apparel and other products will be assessable income of the Franchisees, under section 6-5.

Part 3-1: capital gains tax

87. The grant of the franchise by the Franchisor to the Franchisee results in the Franchisee acquiring a CGT asset. The Grant of Franchise fee of \$1,995 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.

88. Any 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.

Examples

89. **Example 1: Obligation to prepay expenditure arising on or after 21 September 1999 and before 1 pm AEST**

11 November 1999– applies to taxpayers who are not small business taxpayers and are carrying on a business:

Joseph Gardener has extensive business interests and his turnover for the 1999/2000 income year exceeds \$1 million. Therefore, he is not a small business taxpayer and is subject to the 21 September 1999 changes to the tax laws relating to prepaid expenditure. Joseph enters into a contract with Pinetree Pty Ltd to manage his one hectare interest in the No 2 Pine Plantation. Joseph's management contract is executed on 20 October 1999 for management services to be provided from 1 June 2000. Under the contract, the first five year's management fees, payable 12 months in advance on 1 June each year, are \$6,000 in the first year and \$1,200 for each of the following four years. Joseph is unable to deduct the whole of his prepaid management fees in the years in which they are incurred. The fees are instead deductible over the eligible service period over which the management services will be provided. However, as the law currently stands, Joseph is able to take advantage of certain transitional rules that 'shade-in' the effect of the changes to the prepayment laws.

For 1999/2000 Joseph can claim a deduction of \$4,899 for expenditure incurred before 30 June 2000 on management fees. This amount is calculated as A + B where:

$$\begin{aligned}
 & \text{Number of days of eligible service period in the expenditure year} \\
 A = & \text{Management fee} \times \frac{\text{Total number of days of the eligible service period}}{\text{Total number of days of the eligible service period}} \\
 & = \$6,000 \times \frac{30}{365} = \$493 \\
 B = & (\text{Management fee less } A) \times 80\% \\
 & = (\$6,000 - \$493) \times 80\% = \$4,406
 \end{aligned}$$

The balance of the \$6,000 management fees that were prepaid on 1 June 2000 (i.e., \$1,101) is carried forward and can be claimed as a deduction in the 2000/2001-income year.

For 2000/2001, Joseph can claim a deduction of \$1,861 for expenditure incurred on or after 1 July 2000 and before 30 June 2001 on management fees. This amount is calculated as A + B + C where:

$$\begin{aligned}
 A & = \$1,200 \times \frac{30}{365} = \$99 \\
 B & = (\$1,200 - \$99) \times 60\% = \$661 \\
 C & = \$1,101
 \end{aligned}$$

Note that the third component (Part C) is the amount carried forward from 1999/2000. As in the first year, the balance of the \$1,200 management fees prepaid on 1 June 2001 (i.e. \$440) is carried forward and can be claimed as a deduction in the 2001/2002 income year. It should also be noted that in certain circumstances, not present in most projects with product rulings, 'capping provisions' will apply in the second and subsequent transitional years. These are complex and are not explained in this example.

Similarly, for 2001/2002, Joseph can claim a deduction of \$980 for expenditure incurred on or after 1 July 2001 and before 30 June 2002 on management fees. This amount is calculated as A + B + C where:

$$A = \$1,200 \times \frac{30}{365} = \$99$$

$$B = (\$1,200 - \$99) \times 40\% = \$441$$

$$C = \$440$$

Note that the third component (Part C) is again the amount carried forward from 2000/2001. As in the first two years, the balance of the \$1,200 management fees prepaid on 1 June 2002 (i.e. \$660) is carried forward and can be claimed as a deduction in the 2002/2003-income year.

90. Example 2: Obligation arising after 1 pm AEST 11 November 1999 to prepay expenditure – applies to all taxpayers investing in 'tax shelter arrangements':

Assume the same facts as above except that the management agreement is executed after 11 November 1999. Assume also that the No 2 Pine Plantation is a 'tax shelter arrangement'. For the Management fee of \$6,000 incurred on 1 June 2000 for management services to be provided between that date and 31 May 2001, Joseph can claim a deduction for the 1999/2000 income year determined in the following way:

Management fee	X	Number of days of eligible service period in the expenditure year
		Total number of days of the eligible service period
\$6,000	X	<u>30</u>
		= \$493
		365

In the following year Joseph can claim the balance of the \$6,000 prepayment (ie \$5,507) because that is the year in which the services

are to be provided. The second and third year's management fees are calculated using the same method.

Detailed contents list

91. Below is a detailed contents list for this Product Ruling:

	Paragraph
What this Ruling is about	1
Tax law(s)	2
Class of persons	6
Qualifications	8
Date of effect	12
Withdrawal	14
Arrangement	15
Overview	17
Franchise Agreement	25
Payment Option	36
Finance	40
Ruling	42
Effect of Goods and Services Tax	42
Allowable deductions	43
Franchisees who are Small Business Taxpayers	44
Franchisees who are not Small Business Taxpayers who invest on or before 31 May 2000	45
Franchisees who are not Small Business Taxpayers who invest between 1 June 2000 and 30 June 2000	46
Franchisees who are not Small Business Taxpayers who invest after 30 June 2000	48
Sections 82KL and 82KZM and Part IVA	50
Proposed new laws	51
Proposed Changes to Prepayment Rules	51
Note to promoters and advisers	54
Explanations	55
Goods and Services Tax	55
Subdivision 960-Q – Small business taxpayers	57

Section 8-1: service, management and rental fees	60
Expenditure of a capital nature	67
Section 82KZM: prepaid expenditure for Small Business taxpayers	69
Sections 82KZMA – 82KZMD – prepaid expenditure for taxpayers other than small business taxpayers	72
Proposed changes to prepayment rules	76
Section 82KL	79
Part IVA: general tax avoidance provision	82
Section 6-5: assessable income	86
Part 3-1: capital gains tax	87
Examples	89
Example 1: Obligation to prepay expenditure arising on or after 21 September 1999 and before 1 pm AEST 11 November– applies to taxpayers who are not small business taxpayers and are carrying on a business:	89
Example 2: Obligation arising on after 1 pm AEST 11 November 1999 to prepay expenditure – applies to all taxpayers investing in ‘tax shelter arrangements’:	90
Detailed contents list	91

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Previous draft:

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- taxation administration
- tax avoidance
- tax benefits under tax avoidance schemes
- tax shelters
- tax shelters project

Related Rulings/Determinations:

PR 1999/95; TR 92/1; TR 97/11; TR 97/16; TD 93/34; IT 175; IT 2001

Subject references:

- carrying on a business
- commencement of business
- fee expenses
- franchising
- management fees expenses
- producing assessable income
- product rulings
- public rulings
- schemes and shams

Legislative references:

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