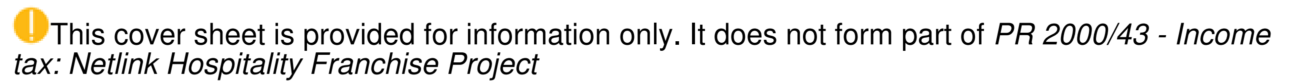
PR 2000/43 - Income tax: Netlink Hospitality Franchise Project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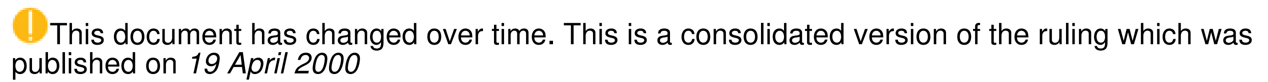
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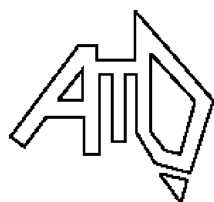

Australian Taxation Office

Product Ruling
Income tax: Netlink Hospitality Franchise Project

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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**, **Previous Rulings**, **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 Netlink Hospitality Franchise, or just simply as 'the Project'.

Tax law(s)

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

- section 6-5 the *Income Tax Assessment Act 1997* ('ITAA 1997');
- section 8-1 (ITAA 1997);
- section 27-5 (ITAA 97)
- section 27-30 (ITAA 97)
- Part 3-1 (ITAA 1997);
- section 82KL *Income Tax Assessment Act 1936* ('ITAA 1936');
- section 82KZM (ITAA 1936);
- section 82KZMA (ITAA 1936);
- section 82KZMB (ITAA1936);
- section 82KZMC (ITAA 1936);
- section 82KZMD (ITAA 1936); and
- Part IVA (ITAA 1936).

3. On 11 November 1999 the Government announced further changes to the tax system as part of The New Business Tax System. A number of those changes, especially those to do with 'tax shelters' could affect the tax laws dealt with in this Ruling. 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).

6. 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 avoid suggestions that potential investors have been negligently or otherwise misled.

Class of persons

7. 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'.

8. 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

9. 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.

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

11. The class of persons defined in the Ruling may rely on its contents, provided the arrangement (described below at paragraphs 16 to 36) 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.

12. A Product Ruling may only be reproduced in its entirety. Extracts may not be reproduced. As each Product Ruling is copyright, apart from any use as permitted under the *Copyright Act 1968* , no part may be reproduced by any process without prior written permission from the Commonwealth. Requests and inquiries concerning reproduction and rights should be addressed to the Manager, Legislative Services, AusInfo, GPO Box 1920, Canberra ACT 2601.

Date of effect

13. This Ruling applies prospectively from 19 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).

14. 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

15. This Product Ruling is withdrawn and ceases to have effect after 30 June 2003. 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

16. 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:

- Application for Product Ruling dated 5 November 1999;
- **Draft (revision 3.0a) Franchise Ageement (incorporating Draft Franchise Regulations) to be made between Franchisees and Netlink Hospitality Australia Pty Ltd. (the Franchisor);**
- **Management Agreements to be made between Franchisees and either IBIS Marketing Pty Ltd, Colisa Pty Ltd or Welfare Strategies Pty Ltd;**
- Franchise Disclosure Document date 14 September 1999;
- Additional correspondence dated 27 January 2000, 7 February 2000, 17 March 2000 and

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

17. The documents highlighted are those 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. The effect of these agreements is summarised as follows.

Overview

18. The arrangement is called the 'Netlink Hospitality Franchise Project'. The Project is to provide intranet computer terminals to hotel rooms which will enable hotel residents to have internet and e-mail access. Franchisees will progressively lease terminals from the Franchisor over a five year period through which income will be generated from terminal use and the provision of interactive electronic advertising space to subscribers.

19. The Franchisee's will be able to identify specific terminals as theirs and will be able to identify a specific geographcial region.

20. The advertising space will be provided to subscribers on either a regional or global basis for specified periods of time.

21. The Franchisees will enter into a Franchise Agreement with Netlink Hospitality Australia Pty Ltd for the grant of the franchise which will provide Franchisees with rights including the following:

- provision and maintenance of terminals;
- allocation of suitable locations and sites for the installation of terminals;
- provision of Initial training to enable the Franchisee to efficiently conduct the Franchise Operations;
- advice and information concerning the marketing and promotion of services;
- provision of an Operations and Procedures Manual;
- provision of Technical advice; and
- provision of advertising campaigns and other promotional activities.

22. The Franchise Agreement provides that the Franchisee may conduct the business themselves or appoint a Manager to conduct the franchise business on their behalf. The Manager must be approved by the Franchisor in accordance with the criteria established by the Franchisor.

23. The Franchisor has already identified three alternate entities which it considers are suitably qualified to provide management services. Management contracts have been prepared which state that the alternate managers will undertake the obligations imposed upon a Franchisee by the Franchise Agreement.

24. Returns to the Franchisee from the business will consist of income generated from terminal use and the provision of interactive electronic advertising space to subscribers. The income flow to Franchisees will be as follows:

- the income directly generated by terminal use will be returned to the specific Franchisee who leases that terminal and thereby provides the relevant services;
- a pro-rata share of advertising income generated within a specific geographical region; and
- a pro-rata share of the global advertising income.

25. Franchisees can monitor the use and the performance of their terminal on a daily basis by logging on to the Netlink Hospitality Site.

26. The forecast returns for the Project indicate that the Franchisee should be in a net profit position (before interest expense) in the third year. The profitability of a Franchisee's business is not dependent upon the availability of income tax deductions.

Franchise Agreement

27. When a Franchisee enters into the franchise through the execution of the Franchise Agreement they also become a party to the Franchise Regulations. These two documents jointly detail the obligations of the Franchisee and Franchisor in respect of the project.

28. The Franchisees will make payments to the Franchisor in respect of the grant of the franchise to provide intranet computer terminals to hotel rooms. The payments will be a Marketing Fee, Lease Fee, Franchise Fee and a Management Fee (where applicable).

29. The Franchisee obtains the rights to:

- access the Netlink System;
- use the Netlink Intellectual Property in connection with the supply of intranet computer terminals and networking, Web-browser and E-mail software;
- use and promote certain trade and business names, trade and service marks and commercial symbols in connection with the Netlink System; and
- lease terminals from Netlink Hospitality Australia Pty Ltd.

30. In return for the Franchisee Fee the Franchisor is required to:

- grant the franchise to the Franchisee;
- conduct launch marketing to establish the business; and
- provide initial training to the Franchisee to enable them to conduct the business.

31. In return for the Marketing and Lease Fees the Franchisor is required to provide specific services including:

- provide and maintain intranet terminals for use by Franchisees, including the replacement of any terminal which is not in working order;
- determine and allocate suitable locations and sites for the installation of terminals;
- provide advice and information to the Franchisee for promoting and marketing the Products and Services;
- provide and maintain the Host system, the network, browser and e-mail software;
- provide operations and procedural manuals;
- provide technical advice including the establishment and operation of a dedicated help; and
- conduct research, advertising campaigns and other promotional activites. The Franchisor is required to provide the Franchisee with an annual statement detailing the contributions received and the disbursements made, and include a schedule of the expected advertising and promotion to be carried out for the ensuing year.

32. The Franchise Agreement and Regulations of the Franchise provide that the Franchisee can personally manage the franchise business or appoint a manager to conduct the business on their behalf. The Franchisor will determine the suitability of managers in accordance with the criteria it has developed. The Franchisor has identified three suitable managers and Management Agreements have been drafted for use by Franchisees.

Management Agreement

33. In return for the Management Fee the Manager is required to provide specific services including:

- appoint and oversee a sales manager;
- ensure that the Franchisee's terminals are in working order;
- provide monthly reports to the Franchisee on the state and use of the Franchisee's Terminals and advertising obtained by the Manager on the Franchisee's behalf.

Fees

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

- Franchise Fee of $1,000 on application to NetLink Hospitality Australia Pty Ltd, as Franchisor, for the grant of the franchise;
- a Marketing fee of $3785 on application plus a payment in arrears of an amount equal to 80% of the Gross income of the franchise business for each month less $343.33 to Netlink Hospitality Australia Pty Ltd, as Franchisor, for the provision of marketing services;
- a Lease fee of $205 on application to Netlink Hospitality Australia Pty Ltd, as Franchisor, for the lease of one terminal; and
- where applicable, a Management Fee of $1,870 to the manager for the management of the franchised business.

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

- Franchise Fee of $1,000 in advance of the first anniversary to NetLink Hospitality Australia Pty Ltd, as Franchisor, for the grant of the franchise;
- a Marketing fee of $3785 in advance of the first anniversary plus a payment in arreas of an amount equal to 80% of the Gross income of the franchise business for each month less $343.33 to Netlink Hospitality Australia Pty Ltd, as Franchisor, for the provision of marketing services;
- a Lease fee of $410 in advance of the first anniversary to Netlink Hospitality Australia Pty Ltd, as Franchisor, for the lease of two terminals; and
- where applicable, a Management Fee of $1,870 adjusted by the greater of the CPI increase for the previous 12 month period or 3%, to the manager for the management of the franchised business.

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

- Franchise Fee of $1,000 in advance of the second anniversary to NetLink Hospitality Australia Pty Ltd, as Franchisor, for the grant of the franchise;
- a Marketing fee paid monthly in arrears for an amount equal to 80% of the Gross income of the franchise business for each month less one twelth of the lease for for that year and one twelth of the optional management fee for that year;

- a Lease fee of $615 in advance of the second anniversary to Netlink Hospitality Australia Pty Ltd, as Franchisor, for the lease of three terminals; and
- where applicable, a Management Fee of the prior year's amount adjusted by the greater of the CPI increase for the previous 12 month period or 3%, to the manager for the management of the franchised business.

37. The following table summarises the fees payable by Franchisees in relation to the first three years of the project:

Fee Type	Year 1	Year 2	Year 3
Franchise Fee	$1,000	$1,000	$1,000
Marketing Fee	$3,785 plus an amount equal to 80% of the Franchisees Gross Income reduced by $343.33 (payable monthly in arrears)	$3,785 plus an amount equal to 80% of the Franchisees Gross Income reduced by $343.33 (payable monthly in arrears)	An amount equal to 80% of the Franchisees Gross Income reduced by 1/12th of Lease Fee and 1/12th optional Management fee (payable monthly in arrears)
Lease Fee (the number of terminals leased increases yearly)	$205	$410	$615
Management Fee (where applicable)	$1,870	$1,870 Adjusted by the greater of 3% or the CPI	Prior year's amount. Adjusted by the greater of 3% or the CPI
TOTAL **(indicative only)**	$6,860	$7,065	$7,270

38. 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.

Finance

39. There is no finance package directly offered by the Franchisor. The Franchisor has held discussions with Laton Finance in relation to

the provision of finance to Franchisees. 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.

40. 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 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;
- the loan or rate of interest is 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

Goods and Services Tax

41. For Franchisees who invest in the Project sections 27-5 and 27-30 of the ITAA 1997 will limit deductions for expenditure which include amounts of Goods and Services Tax [GST] paid to reduce any deduction allowable by any GST input tax credit to which the Franchisee is entitled.

Allowable deductions

42. For a Franchisee who invests in the Project the deduction available for the prepaid Marketing Fee and the prepaid Management Fee will depend upon the date that the investment is made and the Franchisee's taxation status.

IMPORTANT: Paragraph 43 (relating to 'small business taxpayers') and paragraphs 44 and 45 (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 49 and 50 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

43. 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 Marketing Fee (section 8-1 of ITAA 1997);
- the Lease Fee (section 8-1 of ITAA 1997); and
- the Management Fee, where applicable, (section 8-1 of the ITAA 1997).

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

44. For a Franchisee who invests in the Project who is **not a 'small business taxpayer'** and is carrying on a business, the deduction available in respect of the Management Fee and Lease 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 85 illustrates the application of this method).

45. 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 Lease Fee (section 8-1 of the ITAA 1997);
- the Marketing Fee and, where applicable, the Management Fee eligible to be claimed as a deduction is determined using the following formula:

Available deduction = A + B + monthly Marketing fee payments

Where :

$$A = (\$3,785 + \$1,870) \times \frac{\text{Number of days of eligible service period in the expenditure year}}{\text{Total number of days of the eligible service period}}$$

B = (($3,785 + $1,870) *less* A) x 80%

For the year ended 30 June 2001

- the Lease Fee (section 8-1 of the ITAA 1997);
- the Marketing Fee and, where applicable, the Management Fee eligible to be claimed as a deduction is determined using the following formula:

Available deduction = A + B + C + the monthly Marketing fee

Where :

$$A = (\$3,785 + \$1,870^{*}) \times \frac{\text{Number of days of eligible service period in the expenditure year}}{\text{Total number of days of the eligible service period}}$$

B = (($3,785 + $1,870*) *less* A) x 60%

* This figure will have been increased by the greater of CPI or 3%

C = balance of the Year 1 expenditure not previously deducted

For the year ended 30 June 2002

- the Lease Fee (section 8-1 of the ITAA 1997);
- the monthly Marketing fee (section 8-1 of the ITAA 1997);
- the balance of the Year 2 expenditure not previously deducted; and

- where applicable, the monthly Management Fee eligible to be claimed as a deduction is determined useng the following formula:

Available deduction = A + B + C + the monthly Marketing fee

$$A = (\$1,870^*) \times \frac{\text{Number of days of eligible service period in the expenditure year}}{\text{Total number of days of the eligible service period}}$$

B = ($1,870* *less* A) x 40%

* This figure will have been increased by the greater of CPI or 3%

C = balance of the Year 2 expenditure not previously deducted

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

46. 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 Lease 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).

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:

- the Lease Fee in the year incurred (section 8-1 of the ITAA 1997);
- The Marketing and, where applicable, the Management fees eligible to be claimed as a deduction is determined using the following formula:

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

Sections 82KL and 82KZM and Part IVA

48. 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 49 and 50);**
- section 82KZMB applies to expenditure by Franchisees who are not small business taxpayers and are carrying on a business **(but also see paragraphs 49 and 50)**;
- 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

49. 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.

50. For these Franchisees the amount of deduction available in respect of the Management Fee and the Lease Fee is calculated using the formula shown below (see also Example 2 at paragraph 86). 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.

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

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

Explanations

Goods and Services Tax

51. 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 before 1 July 2000) includes an amount relating to an input tax credit to which a Franchisee will be entitled on or after 1 July 2000.

52. 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

53. 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'.

54. 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.

55. '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: franchise, marketing, lease fees and management fees (where applicable)

56. It is appropriate, as a starting point, to consider whether the fees paid by each Franchisees 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.

57. A franchise project can constitute the carrying on of a business. Where there is a business, or a future business, the gross receipts from providing hotel residents with internet and e-mail access and the provision of advertising services to subscribers 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.

58. Generally, a Franchisee will be carrying on a business of providing hotel residents with internet and e-mail access and the provision of advertising services to subscribers where:

- the Franchisee has a right to engage in the business of providing hotel residents with internet and e-mail access and the provision of advertising services to subscribers under a system controlled by the Franchisor;
- the business activites 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.

59. The Franchise Agreement gives Franchisees an identifiable interest in a right to use the Netlink System and the right to specific terminals. Franchisees will be allocated suitable locations by the Franchisor in which to operate their terminals. Franchisees have those rights from the time they are acquired until the end of the Project.

60. A Franchisee can elect to appoint a Manager to conduct the franchise business on their behalf. The Franchisee retains control of the franchised business at all times.

61. 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 projections in the Information Memorandum 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.

62. The franchise and management 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 providing hotel residents with internet and e-mail access and the provision of advertising services to subscribers) 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

63. 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.

64. In this Project the 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

65. 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.

66. Under the Management Agreement, the initial Marketing Fee and Management Fee (where applicable) will be incurred upon

execution of the Agreement. These fees are charged for providing services to Franchisees for a period of 12 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.

67. Thus, for the purposes of this Ruling, it is accepted that no part of the initial Marketing Fee and Management Fee (where applicable) is for the 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 Marketing Fee and Management Fee (where applicable) by Franchisees who are 'small business taxpayers'.

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

68. 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.

69. 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 occurred, and does not apply to the Project.

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

71. 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

72. 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.

73. 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.

74. The arrangement relating to the Project and described at paragraph 16 to 40 of this product ruling is within the description of a 'tax shelter arrangement'. Therefore, the Management Fee and the Lease 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

75. 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'.

76. '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.

77. 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

78. 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).

79. The Netlink Hospitality 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 leased area 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.

80. 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 providing hotel residents with internet and e-mail access and the provision of advertising services to subscribers.

81. 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

82. Gross sale proceeds derived from providing hotel residents with internet and e-mail access and the provision of advertising services to subscribers will be assessable income of the Franchisees, under section 6-5.

Part 3-1: capital gains tax

83. The grant of the franchise by the Franchisor to the Franchisee results in the Franchisee acquiring a CGT asset. The Franchise fee of $5000 (being $1,000 paid each year for five years) 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.

84. 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 or carried forward.

Examples

85. Example 1: Obligation to prepay expenditure arising on or after 21 September 1999 and before 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 on or before 30 June 2000 on management fees. This amount is calculated as A + B where:

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

$$= \$6,000 \times \frac{30}{365} = \$493$$

B = (Management fee *less* A) X 80%

= (\$6,000 - \$493) X 80% = \$4,406

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 on or before 30 June 2001 on management fees. This amount is calculated as A + B + C where:

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

B = (\$1,200 - \$99) X 60% = \$661

C = \$1,101

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 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) X 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.

86. Example 2: Obligation arising on or after 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:

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

$$\$6{,}000 \times \frac{30}{365} = \$493$$

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.

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Subject references:
- carrying on a business
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- fee expenses
- franchising
- management fees 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:
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- ITAA 1936 82KL(1)
- ITAA 1936 82KZM
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- ITAA 1936 82KZMB
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- ITAA 1936 177A
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- ITAA 1997 27-5
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- ITAA 1997 960-335
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