



PR 2001/65 - Income tax: NoRegrets Managed Retail Franchise Project

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 This document has changed over time. This is a consolidated version of the ruling which was published on *16 May 2001*



Product Ruling

Income tax: NoRegrets Managed Retail Franchise Project

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Preamble

The number, subject heading, and the *What this Product Ruling is about* (including *Tax law(s)*, *Class of persons* and *Qualifications* sections), *Date of effect*, *Withdrawal*, *Arrangement* and *Ruling* parts of this document are a 'public ruling' in terms of Part IVAAA of the *Taxation Administration Act 1953*. Product Ruling PR 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

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.

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 Managed Retail 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 17-5 of the ITAA 1997;
 - division 27 of the ITAA 1997;
 - division 35 of the ITAA 1997;
 - Part 3-1 of the ITAA 1997;
 - section 82KL *Income Tax Assessment Act 1936* ('ITAA 1936');
 - section 82KZL of the ITAA 1936;
 - section 82KZM of the ITAA 1936;
 - section 82KZMA – 82KZMD of the ITAA1936;
 - sections 82KZME – 82 KZMF of the ITAA 1936; and
 - Part IVA of the ITAA 1936.

Goods and Services Tax

3. In this Ruling all fees and expenditure referred to include Goods and Services Tax ('GST') where applicable. In order for an entity (referred to in this Ruling as a Franchisee) to be entitled to claim input tax credits for the GST included in its expenditure, it must be registered, or required to be registered for GST and hold a valid tax invoice.

Business Tax Reform

4. The Government is currently evaluating further changes to the tax system in response to the *Ralph Review of Business Taxation* and continuing business tax reform is expected to be implemented over a

number of years. Although this Ruling deals with the laws enacted at the time it was issued, future tax changes may affect the operation of those laws and, in particular, the tax deductions that are allowable. Where tax laws change, those changes will take precedence over the application of this Ruling, and to that extent, this Ruling will be superseded.

5. Taxpayers who are considering investing in the Project are advised to confirm with their taxation adviser that changes in the law have not affected this Product Ruling since it was issued.

Note to promoters and advisers

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 Tax Office suggests that promoters and advisers ensure that potential investors are fully informed of any changes in tax laws that take place after the Ruling is issued. Such action should minimise 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 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

13. This Ruling applies prospectively from 16 May 2001, 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 2004. 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:

- Product Ruling application dated 16 February 2001;
- NoRegrets Managed Retail Franchise Prospectus dated 4 April 2001;
- **Draft copy of Franchise Agreement between NR Online Ltd as trustee of the NR Online Unit Trust ('the Franchisor') and the Franchisee provided on 16 February 2001;**
- Licence Agreement between NoRegrets Pty Ltd and NR Online Ltd as trustee of the NR Online Unit Trust and NoRegrets Pty Ltd as trustee of the NR Unit Trust dated 19 April 1999;
- Draft Deed of Variation of Licence Agreement between NoRegrets Pty Ltd and NR Online Ltd as trustee of the NR Online Unit Trust and NoRegrets Pty Ltd as trustee of the NR Unit Trust dated 13 February 2001;
- Agency Agreement between NR Online Ltd as trustee of the NR Online Unit Trust and NRVS Manager Pty Ltd as trustee of the NRVS Manager Unit Trust dated 19 April 1999;
- Deed of Variation to Agency Agreement between NR Online Ltd as trustee of the NR Online Unit Trust and NRVS Manager Pty Ltd as trustee of the NRVS Manager Unit Trust, dated 5 April 2000;

- Trust Deed for the NR Online Unit Trust dated 29 March 1999;
- Deed of Variation to Trust Deed for the NR Online Unit 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 Unit Trust made between NR Online Ltd and NRVS Franchise Holdings Pty Ltd as trustee of the NRVS Holdings Unit Trust dated 19 April 1999;
- Copy of Custodian Agreement between NR Online Ltd as trustee for the NR Online Unit Trust and Charter Securities Pty Ltd dated 30 March 1999;
- Deed of Variation to NR Managed Retail Franchise MIS Custodian's Agreement between NR Online Ltd as trustee for the NR Online Unit Trust and Charter Securities Pty Ltd dated 5 April 2000; 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, 24 February 2000, 22 December 2000, 8 February 2001, 13 February 2001, 5 April 2001, 19 April 2001, 24 April 2001, 25 April 2001.

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.

17. 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

18. The arrangement is called the 'NoRegrets Managed Retail Franchise Project'. The Project is to carry out the marketing and sale of intimate apparel and other products using a Online Store located on an Internet facility. The Franchisees will receive an individual

Franchisee Web Address ('FWA') which links directly to the NoRegrets Online Store contained on the NoRegrets website. The Franchisees will conduct their business through a Online Store constituted by their FWA and the NoRegrets website. A manager must be appointed by Franchisees to receive orders and procure and deliver merchandise.

19. The Franchisees will enter into a Franchise Agreement with NR Online 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 Online 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.

20. 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.

21. 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 Managed Retail franchisees who appoint NR Online as Manager.

22. 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.

23. 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.

24. Returns to the Franchisee from the business will consist of the sale price of goods supplied to customers less the cost of those goods, being the gross profit amount. The cost of the goods will be their Merchandise Wholesale Price, being, for the first \$5000 of Franchised Business Sales Revenue 60% of the Retail Price; and thereafter, 50%

or such lower percentage as determined by the Franchisor from time to time.

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

Franchise Agreement

26. 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 Online 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.

27. 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.

28. 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.

29. In return for the payment of the Management fee, where NR Online Ltd is appointed Manager, it is required to:

- market and promote the NoRegrets Online 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 delivery to the customers; and

- provide financial & accounting services and general administration for the franchised business.

30. The Franchisor and the Manager are committed to provide the following services within 30 days of an application for a NoRegrets Managed Retail 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 Online Store Franchisee account; and
- Establishment of a Franchisee Activity Access Account.

Fees

31. The Franchisees will make the following payments in relation to each franchise on application:

- a Grant of Franchise Fee of \$2,194.50 to the NR Online Unit Trust, as Franchisor, for the grant of the franchise;
- a Service fee of \$4,594.70 to the NR Online Unit Trust, as Franchisor, for the provision of services during the initial period of 13 months;
- a Rental fee of \$220 to the NR Online Unit Trust, as Franchisor, for one year's rental of the Online Store website address;
- where applicable, a Management Fee of \$5,915.80 to the NR Online Unit Trust, as Manager, for the management of the franchised business during the initial period of 13 months.

32. In respect of the Service fee and the Management fee (where applicable) the amounts of \$2,880.90 and \$338.80 respectively are for franchise initialisation services to be provided within 30 days of the execution of the Franchise Agreement, and the balance of those fees are for services to be provided over the remainder of the initial 13 month period.

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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:

- an annual Rental fee payable on the first day of each relevant year, starting at \$220 and, from the third year and onwards, adjusted by the greater of 2% or the Consumer Price Index All Groups Sydney during the previous year plus 2%, to the NR Online Unit Trust, as Franchisor, for the rental of the Online Store website address;
- starting after the expiration of the initial 13 month period, a Service fee of 9.35% of sales revenue to the NR Online Unit Trust, as Franchisor, for the provision of services to be deducted from Franchised Business Sales Revenue or paid on a monthly basis, as applicable; and
- starting after the expiration of the initial 13 month period, where applicable, a Management Fee of 23.65% of sales revenue to the NR Online Ltd, as Manager, for the management of the franchised business.

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

Fee Type	Year 1	Year 2	Year 3
Grant of Franchise Fee	\$2,194.50	-	-
Service Fee	\$4,594.70 for initial period of 13 months	9.35% of sales revenue payable after the expiration of the initial period of 13 months	
Rental of Online Store	\$220	\$220	\$220 adjusted by the greater of 2% ; or the Consumer Price Index All Groups Sydney plus 2%
Management Fee (where applicable)	\$5,915.80 for initial period of 13 months	23.65% of sales revenue payable after the expiration of the initial period of 13 months	

Payment option

35. Franchisees may pay the fees for the first year of the project either as a single lump sum payment on application or by taking a payment option requiring 12 equal instalments over an 11 month period.

36. Under this payment option 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 \$761.30 over the period of the finance.

37. A Franchisee who elects to use this Payment option and who has contracted with NR Online Ltd as Manager, is required to pay \$1,140.53 on application which is followed by 11 monthly instalments of \$1,140.53.

38. 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

39. 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 (other than that described at paragraphs 35 - 38) 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

Assessable income

41. A Franchisee's share of proceeds from the Project, less any GST payable on these proceeds, will be assessable income under section 6-5. Section 17-5 excludes from assessable income an amount relating to GST payable on a taxable supply.

Deductions where a Franchisee is not registered nor required to be registered for GST

42. A Franchisee may claim tax deductions using the methods and tables in paragraphs 43 to 45 where the Franchisee:

- participates in the Project by 30 June 2002 to carry on the business of a NoRegrets Managed Retail Franchisee;
- incurs the fees shown in paragraphs 31 to 34; and
- is not registered nor required to be registered for GST.

Section 8-1 – prepaid fees

43. Expenditure incurred by a Franchisee who participates in the Project is subject to the prepayment rules contained in sections 82KZME and 82KZMF. Therefore, a Franchisee who prepays fees that are otherwise allowable under section 8-1 **cannot** claim a tax deduction for the full amount of the fees in the year in which the

expenditure is incurred unless it is 'excluded expenditure' (see note (ii) below).

44. The amount and timing of tax deductions allowable each year for such fees must be determined using the formula in subsection 82KZMF(1). In that formula, which is shown below, the 'eligible service period' means, generally, the period over which the services are to be provided.

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

45. In this Project, the tax deductions allowable for the Service Fees and Management Fees (detailed at paragraphs 31 to 32 in the Arrangement) must be calculated by applying the formula to the amount incurred each year by the Franchisee. The application of this method is shown in the Examples 2 and 3 at paragraphs 101 and 102.

Fee type	ITAA 1997	Refer to notes	Initial Year	Second Year	Third Year
Service Fee	8-1	(i)	Amount must be calculated – see notes	Amount must be calculated – see notes – but includes some balance of the initial fee that falls within this year, plus any applicable monthly service fee of 9.35% of sales revenue	Any remaining balance of the initial fee, plus any monthly service fee of 9.35% of sales revenue
Management Fee (where applicable)	8-1	(i)	Amount must be calculated – see notes	Amount must be calculated – see notes – but includes some balance of the initial fee that falls within this year, plus any applicable monthly management fee of 23.65% of sales revenue	Any remaining balance of the initial fee, plus any monthly management fee of 23.65% of sales revenue
Rental	8-1	(ii) and (iv)	\$220	\$220	\$220 adjusted by the greater of 2%; or the Consumer Price Index All Groups Sydney plus 2%
Interest	8-1	(iii)	As incurred - see notes	As incurred - see notes	As incurred - see notes

Notes:

- (i) The Management and Service fees shown in paragraphs 31 to 34 above are **NOT** deductible in full in the year incurred. The deduction for each year's fees must be determined using the formula in paragraph 44, above. A Franchisee will be able to calculate the number of days in the eligible service period in the first expenditure year by reference to the Commencement date in the Franchise Agreement. This figure is necessary to calculate the deduction allowable for the fees incurred. The expenditure incurred by a Franchisee on application for both the Service Fees and Management Fees 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. Both the Management and the Service Fees include amounts for 'franchise initialisation services' which will have an eligible service period of 30 days from the Commencement date, while the balance of those fees will have an eligible service period commencing on the 31st day and ending thirteen months after the Commencement date. Refer to paragraph 35.
- (ii) Amounts of less than \$1,000 are 'excluded expenditure'. Excluded expenditure is an 'exception' to the prepayment rules and is deductible in full in the year in which it is incurred. Where a Franchisee has a number of interests in the Project, the aggregate amount is the relevant one to be used in applying the exception.
- (iii) Interest incurred by Franchisees who elect to take up the payment option described at paragraphs 38 to 41 will be deductible. The deductibility or otherwise of interest arising from agreements that Franchisees enter into other than with the Franchisor to finance their participation in the Project is outside the scope of this Ruling. However, all Franchisees who enter into agreements to finance their participation in the Project should read carefully the discussion of the prepayment rules in paragraphs 61 to 74 below as those rules may be applicable if interest is prepaid.
- (iv) Where a Franchisee **chooses** to prepay fees beyond 13 months, sections 82KZME and 82KZMF will not apply to set the amount and timing of that Franchisee's tax deductions. Instead, unless the expenditure is

‘excluded expenditure’, the amount and timing of the tax deductions is determined under either subsection 82KZM(1) or subsection 82KZMD(2). To apportion the expenditure over the eligible service period, these provisions, which apply respectively to ‘small business taxpayers’ and taxpayers who are not ‘small business taxpayers’, effectively use the same formula as that shown above.

Deductions where a Franchisee is registered or required to be registered for GST

46. Where a Franchisee who is registered or required to be registered for GST:

- participates in the Project by 30 June 2002 to carry on the business of a NoRegrets Managed Retail franchisee;
- incurs the fees shown in paragraphs 31 to 34; and
- is entitled to an input tax credit for the fees

then the tax deductions calculated using the methods and Table in paragraphs 43 to 45 (above) will exclude any amounts of input tax credit (Division 27 of the ITAA). See Example 1 at paragraph 100.

Grant of Franchise fee

47. The fee for Grant of Franchise cannot be claimed as a tax deduction as it is of a capital nature. However, a Franchisee who is registered or required to be registered for GST is entitled to an input tax credit for the GST on the fee.

Section 35-55 – losses from non-commercial business activities

48. For a Franchisee who is an individual and who enters the Project by 28 June 2001, the rule in section 35-10 may apply to the business activity comprised by their involvement in this Project. Under paragraph 35-55(1)(b) the Commissioner will decide for the income years ending 30 June 2001 to 30 June 2002 that the rule in section 35-10 does not apply to this activity provided that the Project is carried out in the manner described in this Ruling.

49. For a Franchisee who is an individual and who enters the Project after 28 June 2001 but before 28 June 2002, the rule in section 35-10 may apply to the business activity comprised by their involvement in this Project. Under paragraph 35-55(1)(b) the Commissioner will decide for the income years ending 30 June 2001 to 30 June 2003 that the rule in section 35-10 does not apply to this

activity provided that the Project is carried out in the manner described in this Ruling.

50. This exercise of the discretion in subsection 35-55(1) will not be required where, for any year in question:

- a Franchisee's business activity satisfies one of the objective tests in sections 35-30, 35-35, 35-40 or 35-45; or
- the 'Exception' in subsection 35-10(4) applies (see paragraph 83 in the Explanations part of this ruling, below).

51. Where either the Franchisee's business activity satisfies one of the objective tests, the discretion in subsection 35-55(1) is exercised, or the Exception in subsection 35-10(4) applies, section 35-10 will not apply. This means that a Franchisee will not be required to defer any excess of deductions attributable to their business activity in excess of any assessable income from that activity, i.e., any 'loss' from that activity, to a later year. Instead, this 'loss' can be offset against other assessable income for the year in which it arises.

52. Franchisees are reminded of the important statement made at Page 1 of this Product Ruling. Therefore, Franchisees should not see the Commissioner's decision to exercise the discretion in paragraph 35-55(1)(b) as an indication that the Tax Office sanctions or guarantees the Project or the product to be a commercially viable investment. An assessment of the Project or the product from this perspective has not been made.

Section 82KL and Part IVA

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

- 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.

Explanations

Section 8-1 - service, management and rental fees

54. 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.

55. 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.

56. 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.

57. 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 Online Store contained in the NoRegrets website. Franchisees have those rights from the time they are acquired until the end of the Project.

58. Under the Franchise Agreement, Franchisees must appoint a Manager to provide various services outlined at clauses 7.2 and 7.3 including the procurement of merchandise and its delivery to customers. The Franchisee retains control of the franchised business at all times.

59. 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.

60. 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.

Sections 82KZME and 82KZMF – prepaid fees

61. Expenditure prepaid by Franchisees for Management Fees and Service Fees meets the requirements of subsections 82KZME(1) and (2) and the expenditures are incurred under an 'agreement' as described in subsection 82KZME(3). Therefore, unless one of the exceptions to section 82KZME applies to the expenditures, the amount and timing of tax deductions for those expenditures are determined under section 82KZMF.

62. In relation to the requirements of subsection 82KZME(1) and (2), the prepaid Management and Service Fees incurred by a Franchisee who participates in the Project:

- are otherwise deductible under section 8-1; and
- have 'eligible service periods' (for each of the fees) that end not more than 13 months after the Franchisee incurs the expenditure; and
- are incurred in return for the doing of a thing under the agreement that is not wholly to be done within the expenditure year.

63. The 'eligible service period' (defined in subsections 82KZL(1)) means, generally, the period over which the services are to be provided.

64. In relation to an 'agreement' referred to in subsection 82KZME(3), the Project is an 'agreement' (this being a broad concept under subsection 82KZME(4)), where, during the term of this Product Ruling:

- the Franchisee's allowable deductions attributable to the Project for each expenditure year exceeds the Franchisee's assessable income from the Project (if any) for the expenditure year; and
- the Franchisee does not have day-to-day control over the operation of the Project; and
- there is more than one Franchisee participating in the Project.

65. The prepaid Management and Service Fees incurred by Franchisees do not fall within any of the 5 exceptions to section 82KZME and therefore, the deduction for each year is determined using the formula in subsection 82KZMF(1). Section 82KZMF overrides section 8-1 and apportions the Management and Service Fees over the period that the services for which the prepayment is made are performed.

66. The prepaid Rental fees, being amounts of less than \$1,000 in each expenditure year, constitute 'excluded expenditure' as defined in subsection 82KZL(1). Under Exception 3 (subsection 82KZME(7)) 'excluded expenditure' is not subject to section 82KZMF and is, therefore, deductible in full in the year in which it is incurred. However, where a Franchisee acquires more than one interest in the Project and the quantum of prepaid lease fees is \$1,000 or more, then the deduction allowable for those amounts will also be subject to apportionment under section 82KZMF.

Interest deductibility

(i) Franchisees who use the financing option provided

67. Some Franchisees may finance their participation in the Project by taking up the payment option provided. Under the terms of the Franchise Agreement to be entered into by those Franchisees an interest amount is included in the repayments.

68. Whether the resulting interest costs are deductible under section 8-1 depends on the same reasoning as that applied to the deductibility of Rent, Service and Management Fees. The interest incurred for the year ended 30 June 2001 and in subsequent years of

income will be in respect of an arrangement to finance the Project business operations and is therefore directly connected with the gaining of 'business income' from the Project. Such interest will, therefore, have a sufficient connection with the gaining of assessable income to be deductible under section 8-1, subject to the operation of sections 82KZME and 82KZMF.

(ii) Franchisees who use a different finance provider

69. The deductibility of interest incurred by Franchisees who finance their participation in the Project through a loan facility with a bank or other financier is outside the scope of this Ruling. Product Rulings only deal with arrangements where all details and documentation have been provided to, and examined by the Tax Office.

70. While the terms of any finance agreement entered into between relevant Franchisees and such financiers are subject to commercial negotiation, those agreements may require interest to be prepaid. Under the prepayment rules contained in section 82KZME, 'agreement' (defined in subsection 82KZME(4)) is a broad concept and includes all activities that relate to the agreement including those that give rise to deductions or assessable income. It will encompass activities not described in the Arrangement or otherwise dealt with in the Product Ruling, such as a loan to finance participation in the Project.

71. Therefore, unless the prepaid interest is 'excluded expenditure', where such a loan facility requires interest to be prepaid and the requirements of section 82KZME are met, relevant Franchisees will be required to determine any tax deduction using the formula in subsection 82KZMF(1). The relevant formula is shown above in paragraph 44 and the method is explained in Examples 2 and 3 at paragraphs 101 and 102.

Prepayments where the eligible service period exceeds 13 months

72. Although not required under the Arrangement described in this Product Ruling, some Franchisees may choose to prepay some or all of their fees for periods longer than the agreements require. Specifically, this will occur when the 'eligible service period' relating to the prepaid amount ends more than 13 months after the Franchisee incurs the expenditure. Where the 'eligible service period' exceeds 13 months sections 82KZME and 82KZMF will not apply, as the requirement of paragraph 82KZME(1)(b) is not met.

73. Instead, for a Franchisee who is a 'small business taxpayer' subsection 82KZM(1) applies to apportion the expenditure and

determine the amount and timing of the deductions. Alternatively, for a Franchisee who is not a 'small business taxpayer' subsection 82KZMD(2) applies to apportion the expenditure and determine the amount and timing of the deductions.

74. Both of these provisions, although slightly different in form, apportion deductible expenditure over the 'eligible service period' in the same way as the formula contained in paragraph 44 (above). However, expenditure, which is 'excluded expenditure', is an exception to both provisions (subparagraph 82KZM(1)(b)(ii) and subsection 82KZMA(4) respectively). A tax deduction for 'excluded expenditure' can be claimed in full in the year in which the expenditure is incurred.

Small business taxpayers

75. 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.

76. '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).

77. 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'.

Expenditure of a capital nature

78. 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.

79. 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.

Division 35 – losses from non-commercial business activities

80. Under the rule in subsection 35-10(2) a deduction for a loss incurred by an individual (including an individual in a general law

partnership) from certain business activities will not be allowable in an income year unless:

- the 'Exception' in subsection 35-10(4) applies;
- one of four objective tests in sections 35-30, 35-35, 35-40 or 35-45 is met; or
- if one of the objective tests is not satisfied, the Commissioner exercises the discretion in section 35-55.

81. Generally, a loss in this context is, for the income year in question, the excess of an individual taxpayer's allowable deductions attributable to the business activity over that taxpayer's assessable income from the business activity.

82. Losses that cannot be claimed as a tax deduction because of the rule in subsection 35-10(2) are able to be offset to the extent of future profits from the business activity, or are quarantined until one of the objective tests is passed.

83. For the purposes of applying the objective tests, subsection 35-10(3) allows taxpayers to group business activities 'of a similar kind'. Under subsection 35-10(4), there is an 'Exception' to the general rule in subsection 35-10(2) where the loss is from a primary production business activity and the individual taxpayer has other assessable income for the income year from sources not related to that activity, of less than \$40,000 (excluding any net capital gain). As both subsections relate to the individual circumstances of Franchisees who participate in the Project they are beyond the scope of this Product Ruling and are not considered further.

84. In broad terms, the objective tests require:

- (a) at least \$20,000 of assessable income in that year from the business activity (section 35-30);
- (b) the business activity results in a taxation profit in 3 of the past 5 income years (including the current year)(section 35-35);
- (c) at least \$500,000 of real property is used on a continuing basis in carrying on the business activity in that year (section 35-40); or
- (d) at least \$100,000 of certain other assets are used on a continuing basis in carrying on the business activity in that year (section 35-45).

85. A Franchisee who participates in the Project will be carrying on a business activity that is subject to these provisions. Information provided with the application for this Product Ruling indicates that a Franchisee who acquires the minimum investment of one interest in the Project is unlikely to pass one of the objective tests until the

income year ended 30 June 2002 if entering the Project on or before 28 June 2001, or the year ended 30 June 2003, if entering the project after 28 June 2001. Franchisees who acquire more than one interest in the Project may however, pass one of the tests in an earlier income year.

86. Therefore, prior to this time, unless the Commissioner exercises an arm of the discretion under paragraphs 35-55(1)(a) or (b), the rule in subsection 35-10(2) will apply to defer to a future income year any loss that arises from the Franchisee's participation in the Project.

87. The first arm of the discretion in paragraph 35-55(1)(a) relates to 'special circumstances' applicable to the business activity, and has no relevance for the purposes of this Product Ruling. However, for an individual Franchisee who acquires an interest in the Project, the Commissioner will decide that it would be unreasonable not to exercise the second arm of the discretion in paragraph 35-55(1)(b) up to 30 June 2002 for Franchisees who enter the project on or before 28 June 2001, or up to 30 June 2003 for Franchisees who enter the project after 28 June 2001.

88. The second arm of the discretion in paragraph 35-55(1)(b) may be exercised by the Commissioner where:

- (i) the business activity has started to be carried on; and
- (ii) there is an objective expectation that the business activity of an individual taxpayer will either pass one of the objective tests or produce a taxation profit within a period that is commercially viable for the industry concerned.

89. This Product Ruling is issued on a prospective basis (i.e., before an individual Franchisee's business activity starts to be carried on). Therefore, if the Project fails to be carried on during the income years specified above, in the manner described in the Arrangement (see paragraphs 16 to 40), the Commissioner's discretion will not have been exercised, because one of the key conditions in paragraph 35-55(1)(b) will not have been satisfied.

90. In deciding to exercise his discretion the Commissioner has relied upon:

- the financial projections provided by the applicant;
- information provided by the applicant in relation to financial results for the existing Franchisees in the project;
- Australian Bureau of Statistics report 8147.0 entitled 'Use of the Internet by Householders, Australia':

- Internal review undertaken by a Certified Practising Valuer;
- independent, objective, and generally available information relating to the industry.

Section 82KL

91. 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’.

92. ‘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.

93. 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

94. 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).

95. The NoRegets Managed Retail 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.

96. 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.

97. 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.

Part 3-1 - capital gains tax

98. The grant of the franchise by the Franchisor to the Franchisee results in the Franchisee acquiring a CGT asset. The Grant of Franchise Fee 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.

99. 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

Example 1 – entitlement to 'input tax credit'

100. Margaret, who is registered for GST, invests in the Green Circle Bluegums Project. The management fees are payable on 1 July each year for management services to be provided over the following 12 months. On 1 July 2000 Margaret pays her first year's management fees of \$5,500 and is eligible to claim a tax deduction for the fees in the income year ended 30 June 2001. The extent of her deduction for the management fees however, is reduced by the amount of any 'input tax credit' to which she is entitled. The Project Manager provides Margaret with a 'tax invoice' showing its ABN and the 'price of the taxable supply' for management services as \$5,500. Using the details shown on the valid tax invoice, Margaret calculates her input tax credit as:

$$1/11 \times \$5,500 = \$500$$

Therefore, the tax deduction for management fees that she can claim in her income tax return for the year ended 30 June 2001 is \$5,000 (\$5,500 less \$500).

Example 2 – apportionment of fees

101. Murray decides to invest in the ABC Pineforest Prospectus which is offering 500 interests of 0.5ha in an afforestation project of 25 years. The management fees are \$5,000 in the first year and \$1,200 for years 2 and 3. From year 4 onwards the management fee will be the previous year's fee increased by the CPI. The first year's fees are payable on execution of the agreements for services to be provided in the following 12 months and thereafter, the fees are payable in advance each year on the anniversary of that date. The project is subject to a minimum subscription of 300 interests. Murray provides the Project Manager with a 'Power of Attorney' allowing the Manager to execute his Management Agreement and the other relevant agreements on his behalf. On 5 June 2001 the Project Manager informs Murray that the minimum subscription has been reached and the Project will go ahead. Murray's agreements are duly executed and management services start to be provided on that date.

Murray, who is not registered nor required to be registered for GST calculates his tax deduction for management fees for the **2001 income year** as follows:

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

$$\$5,000 \times \frac{26}{365}$$

= **\$356** (this is Murray's total tax deduction in 2001 for the Year 1 prepaid management fees of \$5,000. It represents the 26 days for which management services were provided in the 2001 income year).

In the **2002 income year** Murray will be able to claim a tax deduction for management fees calculated as the sum of two separate amounts:

$$\$5,000 \times \frac{339}{365}$$

= **\$4,643** (this represents the balance of the Year 1 prepaid fees for services provided to Murray in the 2002 income year).

$$\$1,200 \times \frac{26}{365}$$

= **\$85** (this represents the portion of the Year 2 prepaid management fees for the 26 days during which services were provided to Murray in the 2002 income year).

\$4,643 + \$85 = \$4,728 (The sum of these two amounts is Murray's total tax deduction for management fees in 2002).

Murray continues to calculate his tax deduction for prepaid management fees using this method for the term of the Project.

Example 3 – apportionment of fees where there is a contractual 'eligible service period' and the fees include expenditure that is 'excluded expenditure'

102. On 1 June 2001 Kevin applies for an interest into the Western Bluegum Project, a prospectus based afforestation project of 12 years. Kevin is accepted into the project and executes a lease and management agreement with the Responsible Entity for the provision of management services and the lease of his Woodlot. The terms of the lease and management agreement require Kevin to prepay the management fees and the lease fee on or before the 30 June each year for the lease of his Woodlot and the provision of management services between the 1 July and 30 June in the following income year. Kevin pays the first year management fee of \$3,600 and first year lease fee of \$500 on 15 June 2001.

Kevin, who is not registered nor required to be registered for GST calculates his tax deduction for management fees and the lease fee for the **2001 income year** as follows:

Management fee

Even though he paid the \$3,600 in the 2001 income year, because there are no 'days of eligible service period' in that year, Kevin is unable to claim any part of his management fees as a tax deduction in his tax return for the year ended 30 June 2001.

Lease fee

Because the \$500 lease fee is less than \$1,000 it is 'excluded expenditure' and can be claimed in full as a tax deduction in Kevin's tax return for the year ended 30 June 2001.

In the **2002 income year** Kevin can claim a tax deduction for his first year's management fees calculated as follows:

$$\$3,600 \times \frac{365}{365}$$

= **\$3,600** (this represents the whole of the first year's management fee prepaid in the 2001 income year but not deductible until the 2002 income year).

For the term of the Project Kevin continues to calculate his tax deduction for prepaid fees using this method.

Detailed contents list

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

Legislative references:

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