

PR 2002/27 - Income tax: NoRegrets Managed Retail Franchise Project

⚠ This cover sheet is provided for information only. It does not form part of *PR 2002/27 - Income tax: NoRegrets Managed Retail Franchise Project*

⚠ This document has changed over time. This is a consolidated version of the ruling which was published on *20 March 2002*



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**, **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. 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 participants 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 product fits an existing portfolio, etc. We recommend a financial (or other) adviser be consulted for such information.

This Product Ruling provides certainty for participants 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, participants lose the protection of this Product Ruling. Potential participants may wish to seek assurances from the promoter that the arrangement will be carried out as described in this Product Ruling.

Potential participants 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.

Potential participants 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.

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 Project', or just simply as 'the Project'.

Tax law(s)

2. The tax laws dealt with in this Ruling are:
- section 6-5 of the *Income Tax Assessment Act 1997* ('ITAA 1997');
 - section 8-1 (ITAA 1997);
 - section 17-5 (ITAA 1997);
 - Division 27 (ITAA 1997);
 - Division 35 (ITAA 1997);
 - Division 328 (ITAA 1997);
 - section 82KL of the *Income Tax Assessment Act 1936* ('ITAA 1936');
 - section 82KZL (ITAA 1936);
 - sections 82KZME - 82KZMF (ITAA 1936); and
 - Part IVA (ITAA 1936).

Goods and Services Tax

3. All fees and expenditure referred to in this Ruling include the 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.

Changes in the Law

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, later amendments may impact on this Ruling.

Any such changes will take precedence over the application of this Ruling and, to that extent, this Ruling will be superseded.

5. Taxpayers who are considering participating 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 participants in projects such as these. In keeping with that intention the Tax Office suggests that promoters and advisers ensure that potential participants are fully informed of any legislative changes after the Ruling is issued.

Class of persons

7. The class of persons to whom this Ruling applies is the persons more specifically identified in the Ruling part of this Product Ruling and who enter into the arrangement specified 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 Commissioner rules on the precise arrangement identified 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. The Ruling will be withdrawn or modified.

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Date of effect

11. This Ruling applies prospectively from 20 March 2002, 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).

12. 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 commenced and the income year to which it relates has not yet commenced, this Ruling applies to the taxpayer to the extent of the inconsistency only (see Taxation Determination TD 93/34).

Withdrawal

13. 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 arrangement specified below. Thus, the Ruling continues to apply to those persons, even following its withdrawal, who entered into the specified arrangement 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.

Previous Rulings

14. This ruling applies to the same arrangement that was ruled upon in Product Ruling PR 2001/65. PR 2001/65 was partially withdrawn by public Taxation Ruling TR 2001/14 on 19 December 2001, the date of issue of the latter, to the extent of the inconsistency between the two Rulings (section 14ZAAK, *Taxation Administration Act 1953*). PR 2001/65 is now wholly withdrawn on and from the date this Ruling is made. The inconsistency between PR 2001/65 and TR 2001/14 affects paragraphs 48 to 52 of the former. Those paragraphs only apply to participants who entered into the arrangement during the period 16 May 2001 to 19 December 2001 inclusive.

Arrangement

15. The arrangement that is the subject of this Ruling is specified below. This arrangement is based on and incorporates the following documents:

- 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;
- 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; and
- further correspondence dated 29 June 2001, 17 August 2001, 9 January 2002 and 11 February 2002.

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

16. The document highlighted is that one to which a Franchisee is a party. For the purpose of describing the arrangement to which this Ruling applies, there are no other agreements, whether formal or informal, and whether or not legally enforceable, which a Franchisee, or any associate of the Franchisee, will be party to with the exception of a Management Agreement with an independent party. That independent party will not be associated directly or indirectly with the Franchisor.

17. All Australian Securities and Investment Commission (ASIC) requirements are, or will be, complied with for the term of the agreements. 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 \$5,000 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.

Franchise Agreement

25. The Franchisees will make payments to the Franchisor in respect of the grant of the franchise to market and sell intimate apparel and other products using a 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.

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

- will pay the fees related to the franchised business;
- must appoint a Manager which can either be the Franchisor or another party approved by the Franchisor;
- not use any promotional materials or methods other than those approved by the Franchisor; and
- attend such training as is required by the Franchisor.

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

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

28. In return for the payment of the Management fee, 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.

29. 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

30. 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.

31. 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.

32. 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;

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- 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.

33. 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

34. 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.

35. 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.

36. 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.

37. 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

38. Franchisees can fund their participation 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.

39. 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 34 - 37) 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

Application of this Ruling

40. This Ruling applies only to Franchisees who are accepted to participate in the Project between the date of issue of this Ruling and 4 May 2002, the expiry date of the Prospectus, and who have executed a Franchise Agreement on or between those dates. The Franchisee's participation in the Project must constitute the carrying on of a business.

The Simplified Tax System ('STS')

41. For a Franchisee participating in the Project, the recognition of income and the timing of tax deductions is different depending on whether the Franchisee is an 'STS taxpayer'. To be an 'STS taxpayer' a Franchisee:

- must be eligible to be an 'STS taxpayer'; and
- must have elected to be an 'STS taxpayer'.

Qualification

42. This Product Ruling assumes that a Franchisee who is an 'STS taxpayer' is so for the income year in which their participation in the Project commences. A Franchisee may become an 'STS taxpayer' at a later point in time. Also, a Franchisee who is an 'STS taxpayer' may choose to stop being an 'STS taxpayer', or may cease to be eligible to be an 'STS taxpayer', during the term of the Project. These are contingencies relating to the circumstances of individual Franchisees that cannot be accommodated in this Ruling. Such Franchisees can ask for a private ruling on how the taxation legislation applies to them.

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 (iii) 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 30 to 31 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 Examples 2 and 3 at paragraphs 112 and 113 respectively.

Tax outcomes for Franchisees who are not ‘STS taxpayers’**Assessable income*****Section 6-5***

46. A Franchisee’s share of sales proceeds from the Project, less any GST payable on these proceeds (section 17-5), will be assessable income of the Franchisee under section 6-5.

Deductions for Service, Management, Lease fees and Interest***Section 8-1***

47. A Franchisee who is not an ‘STS taxpayer’ may claim tax deductions for the following revenue expenses on a per Franchise basis:

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| Fee type | ITAA 1997 | Refer to notes | Initial Year | Second Year | Third Year |
|-----------------------------------|-----------|----------------|---|---|--|
| Service Fee | 8-1 | (i) (ii) | 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) (ii) | Amount must be calculated – see note (ii) | 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 | (iii) (v) | \$220 | \$220 | \$220 adjusted by the greater of 2%; or the Consumer Price Index All Groups Sydney plus 2% |
| Interest | 8-1 | (iv) | As incurred - see notes | As incurred - see notes | As incurred - see notes |

Notes:

- (i) If the Franchisee is registered or required to be registered for GST, amounts of outgoing would need to be adjusted as relevant for GST (e.g., input tax credits): Division 27. See Example 1 at paragraph 111;
- (ii) The Management and Service fees shown in paragraphs 30 to 33 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 31;

- (iii) Amounts of less than \$1,000 are 'excluded expenditure'. Excluded expenditure is an 'exception' to the prepayment rules and, for a Franchisee who is an 'STS taxpayer', is deductible in full in the year in which it is paid (see Example 3 at paragraph 113). However, where a Franchisee has a number of interests in the Project, the aggregate amount of the prepaid fees may be \$1,000 or more. Such Franchisee's **MUST** determine the deduction using the formula shown above at paragraph 44;
- (iv) Interest incurred by Franchisees who elect to take up the payment option described at paragraphs 34 to 37 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 71 to 82 below as those rules may be applicable if interest is prepaid;
- (v) Where a Franchisee **chooses** to prepay fees for the doing of a thing (e.g., the provision of management services or the leasing of land) that will not be wholly done in the income year the fees are incurred, the prepayment rules of the ITAA 1936 may apply to

apportion those fees. In such cases, the tax deduction for the prepaid fee must be determined using the formula shown in paragraph 44 unless the expenditure is 'excluded expenditure'.

Tax outcomes for Franchisees who are 'STS taxpayers'

Assessable Income

Section 6-5

48. A Franchisee's share of sales proceeds from the Project, less any GST payable on these proceeds (section 17-5), will be assessable income of the Franchisee under section 6-5.

49. The Franchisee recognises ordinary income from carrying on their franchise business at the time the income is received (paragraph 328-105(1)(a)).

Deductions for Service, Management, Lease fees, and Interest

Section 8-1 and section 328-105

50. A Franchisee who is an 'STS taxpayer' may claim tax deductions for the following revenue expenses on a per Franchise basis:

| Fee type | ITAA 1997 | Refer to notes | Initial Year | Second Year | Third Year |
|-----------------------------------|-----------|-------------------------|---------------------------------------|---|--|
| Service Fee | 8-1 | (vi) (vii) (viii) | 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 | (vi) (vii) (viii) | 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 | (ix) (xi) | \$220 | \$220 | \$220 adjusted by the greater of 2%; or the Consumer Price Index All Groups Sydney plus 2% |
| Interest | 8-1 | (vii) (x) | When paid – see notes | When paid – see notes | When paid – see notes |

Notes:

- (vi) If the Franchisee is registered or required to be registered for GST, amounts of outgoing would need to be adjusted as relevant for GST (e.g., input tax credits): Division 27. See Example 1 at paragraph 111;
- (vii) If, for any reason, an amount shown in the Table above is not fully paid in the year in which it is incurred by a

Grower who is an 'STS taxpayer' then the amount is only deductible to the extent to which it has been paid, or has been paid for the Grower. Any amount or part of an amount shown in the Table above which is not paid in the year in which it is incurred will be deductible in the year in which it is actually paid;

- (viii) Notwithstanding note (vii), the Management and Service fees shown in paragraphs 30 to 33 above are **NOT** deductible in full in the year in which they are paid by, or on behalf of a Franchisee who is an 'STS taxpayer' as they are prepaid expenditure. The deduction for each year's fees must be determined using the formula in subsection 82KZMF(1) shown at 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 31;
- (ix) Amounts of less than \$1,000 are 'excluded expenditure'. Excluded expenditure is an 'exception' to the prepayment rules and, for a Franchisee who is not an 'STS taxpayer', is deductible in full in the year in which it is incurred (see Example 3 at paragraph 113). However, where a Franchisee has a number of interests in the Project, the aggregate amount of the prepaid fees may be \$1,000 or more. Such Franchisee's **MUST** determine the deduction using the formula shown above at paragraph 44;
- (x) Interest incurred by Franchisees who elect to take up the payment option described at paragraphs 34 to 37 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 71 to 82 below as those rules may be applicable if interest is prepaid;

- (xi) Where a Franchisee **chooses** to prepay fees for the doing of a thing (e.g., the provision of management services or the leasing of land) that will not be wholly done in the income year the fees are incurred, the prepayment rules of the ITAA 1936 may apply to apportion those fees. In such cases, the tax deduction for the prepaid fee must be determined using the formula shown in paragraph 44 unless the expenditure is 'excluded expenditure'.

Tax outcomes that apply to all Franchisees

Grant of Franchise fee

51. 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.

Division 35 - deferral of losses from non-commercial business activities

Section 35-55 - Commissioner's discretion

52. For a Franchisee who is an individual and who enters the Project between the date of issue of this Ruling and 4 May 2002 inclusive, the rule in section 35-10 may apply to the business activity comprised by their involvement in this Project.

53. Information provided with the application for this Product Ruling indicates that a Franchisee who acquires the minimum interest of one franchise in the Project during the year ended 30 June 2002 is unlikely to pass one of the tests set out in sections 35-30, 35-35, 35-40 or 35-45, or produce a taxation profit until the income year ended 30 June 2003.

54. Under paragraph 35-55(1)(b) the Commissioner may decide that the rule in section 35-10 does not apply to this activity provided that it is because of the nature of the business activity that it has not yet satisfied one of the tests. However, for this Project, the Commissioner is not satisfied that it is because of the nature of the business activity that it will not satisfy one of the tests. Hence, the

requirements of subparagraph 35-55(1)(b)(i) are not satisfied. **Therefore, the Commissioner will not exercise the discretion under paragraph 35-55(1)(b) of the Act in relation to this Project for the year ended 30 June 2002. Accordingly a deduction for a loss made by an individual from this Project will not be taken into account in the income year ended 30 June 2002 and is required to be deferred until the activity passes one of the tests referred to in paragraph 53 (See Explanations at paragraphs 92 to 102).**

Section 82KL and Part IVA

55. For a Franchisee who participates 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

Is the Franchisee carrying on a business?

56. For the amounts set out in the Tables above to constitute allowable deductions the Franchisee's activities as a participant in the NoRegrets Managed Retail Franchise Project must amount to the carrying on of a business.

57. Where there is a business, or a future business, the gross sales proceeds will constitute gross 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. For schemes such as that of the NoRegrets Managed Retail Franchise Project, Taxation Ruling TR 2000/8 sets out in paragraph 89 the circumstances in which the Franchisee's activities can constitute the carrying on of a business. As Taxation Ruling TR 2000/8 sets out, these circumstances have been established in court decisions such as *FCT v. Lau* 84 ATC 4929.

59. 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.

60. In this Project, each Franchisee enters into a Franchise Agreement. 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.

61. 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.

62. 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.

63. The activities that will be regularly carried out during the term of the Project demonstrate a significant commercial purpose. Based on reasonable projections, a Franchisee in the Project will derive assessable income from the sale of the intimate apparel and other products that will return a before-tax profit, i.e., a profit in cash terms that does not depend in its calculation on the fees in question being allowed as a deduction.

64. The Manager's services are also consistent with general franchise practices. They are of the type ordinarily found in franchise ventures that would commonly be said to be businesses. The interest is of a size and scale to allow it to be commercially viable. (see Taxation Ruling IT 360).

65. The Franchisee's degree of control over the Manager as evidenced by the Franchise Agreement, and supplemented by the Corporations Act, is sufficient. During the term of the Project, the Manager will provide the Franchisee with regular progress reports on

the Franchisee's franchise and the activities carried out on the Franchisee's behalf. Franchisees are able to terminate arrangements with the Manager in certain instances, such as cases of default or neglect.

66. The franchise activities, and hence the fees associated with their procurement, are consistent with an intention to commence regular activities that have an 'air of permanence' about them. For the purposes of this Ruling, the Franchisee's activities in the NoRegrets Managed Retail Franchise Project will constitute the carrying on of a business.

The Simplified Tax System

Division 328

67. Subdivision 328-F sets out the eligibility requirements that a Franchisee must satisfy in order to enter the STS and Subdivision 328-G sets out the rules for entering and leaving the STS.

68. The question of whether a Franchisee is eligible to be an 'STS taxpayer' is outside the scope of this Product Ruling. Therefore, any Franchisee who relies on those parts of this Ruling that refer to the STS will be assumed to have correctly determined whether or not they are eligible to be an 'STS taxpayer'.

Deductibility of service, management and rental fees

Section 8-1

69. Consideration of whether the service, management and rental fees paid by each Franchisee are deductible under section 8-1 begins with the first limb of the section. This view proceeds on the following basis:

- the outgoings in question must have a sufficient connection with the operations or activities that directly gain or produce the taxpayer's assessable income;
- the outgoings are not deductible under the second limb if they are incurred when the business has not commenced; and
- where all that happens in a year of income is that 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 the second limb applies. However, that does not preclude the application of the first limb in determining whether the

outgoing in question has a sufficient connection with activities to produce assessable income.

70. 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 the first limb of section 8-1 are met. The exclusions do not apply.

Prepayments provisions

Sections 82KZL to 82KZMF

71. The prepayment provisions contained in Subdivision H of Division 3 of Part III of the ITAA 1936 affect the timing of deductions for certain prepaid expenditure. These provisions apply to certain expenditure incurred under an agreement in return for the doing of a thing under the agreement (e.g., the performance of management services or the leasing of land) that will not be wholly done within the same year of income as the year in which the expenditure is incurred. If expenditure is incurred to cover the provision of services to be provided within the same year, then it is not expenditure to which the prepayment rules apply.

72. For this Project only section 82KZL (an interpretive provision) and sections 82KZME and 82KZMF are relevant. Where the requirements of sections 82KZME and 82KZMF are met, taxpayers determine deductions for prepaid expenditure under section 82KZMF using the formula in subsection 82KZMF(1). These provisions also apply to 'STS taxpayers' because there is no specific exclusion contained in section 82KZME that excludes 'STS taxpayers' from the operation of section 82KZMF.

Sections 82KZME and 82KZMF

73. Where the requirements of subsections 82KZME(2) and (3) are met, the formula in subsection 82KZMF(1) (see paragraph 77 below) will apply to apportion expenditure that is otherwise deductible under section 8-1 of the ITAA 1997. The requirements of subsection 82KZME(2) will be met if expenditure is incurred by a taxpayer in return for the doing of a thing that is not to be wholly done within the year the expenditure is made. The year in which such

expenditure is incurred is called the ‘expenditure year’ (subsection 82KZME(1)).

74. The requirements of subsection 82KZME(3) will be met where the agreement (or arrangement) has the following characteristics:

- the taxpayer’s allowable deductions under the agreement for the ‘expenditure year’ exceed any assessable income attributable to the agreement for that year;
- the taxpayer does not have effective day to day control over the operation of the agreement. That is, the significant aspects of the arrangement are managed by someone other than the taxpayer; and
- either:
 - a) there is more than one participant in the agreement in the same capacity as the taxpayer; or
 - b) the person who promotes, arranges or manages the agreement (or an associate of that person) promotes similar agreements for other taxpayers.

75. For the purpose of these provisions, the agreement includes all activities that relate to the agreement (subsection 82KZME(4)). This has particular relevance for a Franchisee in this Project who, in order to participate in the Project may borrow funds from a financier. Although undertaken with an unrelated party, that financing would be an element of the arrangement. The funds borrowed and the interest deduction are directly related to the activities under the arrangement. If a Franchisee prepays interest under such financing arrangements, the deductions allowable will be subject to apportionment under section 82KZMF.

76. There are a number of exceptions to these rules, but for Franchisees participating in this Project, only the ‘excluded expenditure’ exception in subsection 82KZME(7) is relevant. ‘Excluded expenditure’ is defined in subsection 82KZL(1). However, for the purposes of Franchisees in this Project, ‘excluded expenditure’ is prepaid expenditure incurred under the arrangement that is less than \$1,000. Such expenditure is immediately deductible.

77. Where the requirements of section 82KZME are met, section 82KZMF applies to apportion relevant prepaid expenditure. Section 82KZMF uses the formula below, to apportion prepaid expenditure and allow a deduction over the period that the benefits are provided.

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

78. In the formula 'eligible service period' (defined in subsection 82KZL(1)) means, the period during which the thing under the agreement is to be done. The eligible service period begins on the day on which the thing under the agreement commences to be done or on the day on which the expenditure is incurred, whichever is the later, and ends on the last day on which the thing under the agreement ceases to be done, up to a maximum of 10 years.

Application of the prepayment provisions to this Project

79. 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 fees are determined under section 82KZMF.

80. The prepaid Management and Service Fees incurred by Franchisees do not fall within any of the 5 exceptions to section 82KZME. Therefore the deduction for each year is determined using the formula in subsection 82KZMF(1). Section 82KZMF will apportion the deduction for prepaid Management and Service Fees over the period that the services for which the prepayment is made are provided.

81. 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 specifically excluded from the operation of section 82KZMF. A Franchisee who is an 'STS taxpayer' can, therefore, claim an immediate deduction for Rental fees in the income year in which it is paid. A Franchisee who is not an 'STS taxpayer' can claim an immediate deduction for Rental fees in the income year in which it is incurred.

82. However, where a Franchisee acquires more than one interest in the Project and the quantum of prepaid lease fees is \$1,000 or more, the deduction allowable for those amounts will also be subject to apportionment according to the formula in subsection 82KZMF(1).

Interest deductibility

(i) Franchisees who use the financing option provided

83. 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. 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.

84. The interest incurred for the year ended 30 June 2002 and in subsequent years of income will be in respect of an arrangement to finance the Franchisee's 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.

85. In the absence of any application of the prepayment provisions (see paragraphs 71 to 82), the timing of deductions for interest will again depend upon whether a Franchisee is an 'STS taxpayer' or is not an 'STS taxpayer'.

86. If the Franchisee is not an 'STS taxpayer', interest is deductible in the year in which it is incurred.

87. If the Franchisee is an 'STS taxpayer' interest is not deductible until it has been both incurred and paid, or is paid for the Franchisee. If interest that is properly incurred in an income year remains unpaid at the end of that income year, the unpaid amount is deductible in the income year in which it is actually paid, or is paid for the Grower.

(ii) Franchisees who use a different finance provider

88. 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.

89. 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. Alternatively, a Franchisee may choose to prepay such interest. Unless such prepaid interest is 'excluded expenditure' any tax deduction that is allowable will be subject to the prepayment provisions of the ITAA 1936 (see paragraphs 71 to 82).

Expenditure of a capital nature

90. 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.

91. 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 – deferral of losses from non-commercial business activities

92. Division 35 applies to losses from certain business activities for the income year ended 30 June 2001 and subsequent years. Under the rule in subsection 35-10(2), a deduction for a loss made by an individual (including an individual in a general law partnership) from certain business activities will not be taken into account in an income year unless:

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

93. 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.

94. Losses that cannot be taken into account in a particular year of income, because of subsection 35-10(2), can be applied to the extent of future profits from the business activity, or are deferred until one of the tests is passed, the discretion is exercised, or the exception applies.

95. The ‘exception’ under subsection 35-10(4) to the general rule in subsection 35-10(2), applies where the loss is from a primary production business activity and is not relevant for the purposes of this Ruling.

96. In broad terms, the 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 (excluding cars, motor cycles and similar vehicles) are used on a

continuing basis in carrying on the business activity in that year (section 35-45).

97. 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 interest of one franchise in the Project during the year ending 30 June 2002, is unlikely to pass one of the tests until the income year ended 30 June 2003. Franchisees who acquire more than one interest in the Project may however, pass one of the tests in an earlier income year.

98. 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 these Projects.

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

- (i) the business activity has started to be carried on; and
- (ii) because of its nature, it has not yet met one of the tests set out in Division 35; and
- (iii) there is an expectation that the business activity of an individual taxpayer will either pass one of the tests or produce a taxation profit within a period that is commercially viable for the industry concerned.

100. If a business activity does not meet all three requirements above then the Commissioner is not able to exercise the second arm of the discretion in paragraph 35-55(1)(b). The meaning of the phrase 'because of its nature' is discussed in Taxation Ruling TR 2001/14. Paragraph 35-55(1)(b) is intended to cover a business activity that because of its nature has a lead time, usually a number of years, between the commencement of the activity and the production of any assessable income.

101. Where a business activity is by its nature capable of producing income relatively soon after commencing it is generally not possible to conclude that the second requirement is satisfied, and hence, that the business activity is eligible for an exercise of the second arm of the discretion.

102. An initial inability to satisfy one of the tests must be due to an innate or inherent feature of the industry overall, or well recognised segments in it, rather than just isolated business activities within that industry. The online retailing business activity covered by this Ruling

is capable of producing assessable income relatively soon after commencing, and therefore does not satisfy subparagraph 35-55(1)(b)(i). **The Commissioner will not exercise the second arm of the discretion in subsection 35-55(1) in relation to the business activity. Accordingly a deduction for a loss made by an individual from this Project will not be taken into account in the income year ended 30 June 2002 and is required to be deferred until the activity passes one of the tests set out above.**

Section 82KL

103. 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’.

104. ‘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.

105. 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 provisions

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

107. The NoRegrets Managed Retail Franchise Project will be a ‘scheme’ commencing with the issue of the Prospectus. A Grower will obtain a ‘tax benefit’ from entering into the scheme, in the form of tax deductions for the amounts detailed at paragraphs 47 to 50 that would not have been obtained but for the scheme. However, it is not possible to conclude that the scheme will be entered into or carried out with the dominant purpose of obtaining this tax benefit.

108. Growers to whom this Ruling applies intend to stay in the scheme for its full term and derive assessable income from the eventual harvesting of the trees. There are no facts that would suggest

that Growers have the opportunity of obtaining a tax advantage other than the tax advantages identified in this Ruling. There are no non-recourse financing or round robin characteristics, and no indication that the parties are not dealing with each other at arm's length, or, if any parties are not at arm's length, that any adverse tax consequences result. Further, having regard to the factors to be considered under paragraph 177D(b) it cannot be concluded, on the information available, that participants will enter into the scheme for the dominant purpose of obtaining a tax benefit.

Part 3-1 - capital gains tax

109. 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.

110. 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 GST input tax credits

111. Susan, who is a sole trader and registered for GST, contracts with a manager to manage her viticulture business. Her manager is registered for GST and charges her a management fee payable every six months in advance. On 1 December 2001 Susan receives a valid tax invoice from her manager requesting payment of a management fee in advance, and also requesting payment for an improvement in the connection of electricity for her vineyard that she contracted him to carry out. The tax invoice includes the following details:

| | |
|---|-----------------|
| Management fee for period 1/1/2002 to 30/6/2002 | \$4,400* |
| Carrying out of upgrade of power for your vineyard as quoted | <u>\$2,200*</u> |
| Total due and payable by 1 January 2002 (includes GST of \$600) | <u>\$6,600</u> |

*Taxable supply

Susan pays the invoice by the due date and calculates her input tax credit on the management fee (to be claimed through her Business Activity Statement) as:

$$\frac{1}{11} \times \$4,400 = \$400.$$

Hence her outgoing for the management fee is effectively \$4,400 *less* \$400, or \$4,000.

Similarly, Susan calculates her input tax credit on the connection of electricity as:

$$\frac{1}{11} \times \$2,200 = \$200.$$

Hence her outgoing for the power upgrade is effectively \$2,200 *less* \$200, or \$2,000.

In preparing her income tax return for the year ended 30 June 2002, Susan is aware that the management fee is deductible in the year incurred. She calculates her management fee deduction as \$4,000 (not \$4,400).

Susan is aware that the electricity upgrade is deductible 10% per year over a 10 year period. She calculates her deduction for the power upgrade as \$200 (one tenth of \$2,000 only, not one tenth of \$2,200).

Example 2 – Apportionment of fees

112. Ray decides to participate 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. Ray 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 2002 the Project Manager informs Ray that the minimum subscription has been reached and the Project will go ahead. Ray's agreements are duly executed and management services start to be provided on that date.

Ray, is an 'STS taxpayer' who is not registered nor required to be registered for GST. He calculates his tax deduction for management fees for the **2002 income year** as follows:

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

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

= **\$356** (this is Ray's total tax deduction in 2002 for the Year 1 prepaid management fees of \$5,000. It represents the 26 days for which management services were provided in the 2002 income year).

In the **2003 income year** Ray 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 Ray in the 2003 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 Ray in the 2003 income year).

\$4,643 + \$85 = \$4,728 (The sum of these two amounts is Ray's total tax deduction for management fees in 2003).

Ray 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'

113. On 1 June 2002 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 2002.

Kevin, who is not an 'STS taxpayer' is not registered nor required to be registered for GST. He calculates his tax deduction for management fees and the lease fee for the **2002 income year** as follows:

Management fee

Even though he paid the \$3,600 in the 2002 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 2002.

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 2002.

In the **2003 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 2002 income year but not deductible until the 2003 income year).

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

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