TD 2002/23 - Income tax: Is a taxpayer entitled to an income tax deduction for any part of the marketing fee paid in respect of the internet marketing expenses scheme described in Taxpayer Alert 2002/1?

Taxation Determination

Income tax: Is a taxpayer entitled to an income tax deduction for any part of the marketing fee paid in respect of the internet marketing expenses scheme described in Taxpayer Alert 2002/1?

Preamble

The number, subject heading, date of effect and paragraphs 1 to 17 of this Taxation Determination are a 'public ruling' for the purposes of Part IVAAA of the ***Taxation Administration Act 1953*** *and are legally binding on the Commissioner. The remainder of the Determination is administratively binding on the Commissioner. Taxation Rulings TR 92/1 and TR 97/16 together explain how a Determination is legally or administratively binding.*

Date of Effect

This Determination applies to years commencing both before and after its date of issue. However, this Determination 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 the Determination (see paragraphs 21 and 22 of Taxation Ruling TR 92/20).

1. No.

2. Taxpayer Alert 2002/1 ('the Alert') was issued on 31 January 2002. It described an arrangement where a taxpayer claims large income tax deductions for a 'marketing fee' purportedly paid to a tax-haven based internet marketer for assistance in developing, managing and promoting a web-site selling advertising and marketing services. The Alert indicated that the Australian Taxation Office (ATO) is examining the scheme.

3. The ATO has now had careful regard to the facts of the arrangement, which are relevantly as follows.

(a) The taxpayer is usually introduced to the arrangement by his or her tax adviser.

(b) Generally, investors have conducted little or no prior investigation of the commercial viability of the alleged business before entering into the arrangement.

(c) The taxpayer enters into a 'marketing agreement' with an internet marketer located offshore, described in its terms as an agreement to 'establish a location on the internet and to carry on the business of selling advertising and marketing services over the internet'.

(d) The agreement is for one year only.

(e) No budget or business plan for the purported business is provided to the investors.

(f) The taxpayer purports to prepay to the internet marketer a substantial marketing fee.

(g) In consideration for the marketing fee, the internet marketer purports to undertake, for a period of 12 months, to:

- assist and advise in relation to the establishment, maintenance and profitable conduct of an internet location from which an investor can sell advertising space on the internet;
- advertise, market and promote the internet location;
- provide reports to the investor on the activities of this internet business; and
- generally administer and maintain all records and accounts of the business.

(h) Of the total marketing fee, 20% is from the taxpayer's own funds and 80% is said to be borrowed, for a nominal term of one year, from an offshore lender.

(i) The offshore lender is associated with the offshore internet marketer.

(j) A guarantee in respect of the offshore loan is said to be entered into between the offshore lender and an associated entity of the taxpayer, such as an Australian company of which the taxpayer is the sole owner and director.

(k) The loan guarantees are uncommercial as they represent manifestly inadequate security for the lender (for example, the guarantor may be a $2 shell company wholly-owned by the investor), and the evidence indicates that the lender is aware of their inadequacy.

(l) The guarantors of the loans taken out to fund 80% of the marketing fee take out an 'insurance policy' for a small premium with an offshore insurance company associated with the internet marketer. The insurance policy is said to cover the guarantor against the risk of having to repay the loan, however the nominal nature of the insurance premium suggests that the insurance is not commercially realistic.

(m) To the extent that there might be any commercial reality to the insurance and the guarantee, it is likely that their practical effect would be to transfer the purported obligation to repay the loan from the onshore investor and his or her associated guarantor to the offshore insurer, who is associated with the internet marketer.

(n) The taxpayer claims an up-front tax deduction for the full amount of the marketing fee said to have been paid.

(o) The internet marketer 'guarantees' in the marketing agreement a return to the taxpayer equal to the taxpayer's own invested funds.

(p) The location established on the internet to conduct the purported business is demonstrably inadequate for this purpose. The relevant internet location

consists of pages on a single web-site and does not have any advertising material or other marketing of commercial businesses.

(q) The 'business' makes no sales and produces no gross revenue at all in the first year, nor is there any payment of the 'guaranteed' return.

(r) However, the internet marketer unilaterally waives its annual management fees, and the lender extends the 'loan' by 12 months, and defers payment of interest for the same period.

(s) Also, an investor may assign his or her right to future income from the 'internet business' to the offshore lender in consideration for his or her release from the said liability to pay interest.

(t) There is no evidence that any interest or principal is, or will be, paid or repaid on the purported loan that funds 80% of the marketing fee.

(u) Investors generally have a lack of knowledge of, and participation in, the operations of the purported business and keep no records or financial statements regarding its economic performance.

4. There are three alternative elements to the ATO's view that no deduction is allowable to taxpayers who enter into this arrangement.

A. No intention to create legal relations

5. Despite the appearance of the legal documentation, the ATO has formed the view that the parties to the transaction did not have an intention to create a relationship of debtor and creditor with regard to the purported loan. As Tamberlin J noted in *Richard Walter Pty Ltd v. FC of T* 95 ATC 4440 at 4450; 31 ATR 95 at 108: 'The central feature of a loan transaction is that the parties must intend that the whole of the moneys lent should be repaid.'

6. Nor is it accepted that the parties intended to create a business relationship, a guarantee in respect of the loan, or insurance in respect of the guarantee.

7. Therefore, the arrangement did not give rise to any existing or enforceable legal rights or obligations. It follows that the arrangement is not effective in giving the amounts paid by the taxpayer or purportedly paid by the taxpayer the character of deductible expenditure.

B. No deduction available under section 8-1 of the *Income Tax Assessment Act 1997*

8. The marketing fee is not deductible under paragraph (b) of sub-section 8-1(1) of the *Income Tax Assessment Act 1997* because it is not necessarily incurred in carrying on a business for the purpose of gaining or producing assessable income.

9. The taxpayer is not carrying on a business for the purpose of gaining or producing assessable income. There is no evidence of a purpose of profit making. There is little or no evidence of business activity. There is no business-like organisation of the purported business. There is no evidence that any of the 'marketing fee' was employed in the purported business.

10. Nor is the amount deductible under paragraph (a) of sub-section 8-1(1). If no income is in fact produced, the relevant characterisation of the outgoing is to be found in the relationship between the outgoing and the assessable income that the outgoing 'would be expected to produce': *Ronpibon Tin v. FC of T* (1949) 78 CLR 47 at 58.

11. The question of whether the investment would be expected to produce income is crucial and integral in the present case to the application of the 'real and genuine commercial test' adopted in *Lau v. FC of T* 84 ATC 4618; (1984) 15 ATR 932 and *Brand v. FC of T* 95 ATC 4262; (1995) 30 ATR 426, and accepted as the relevant test by Conti J in *Howland-Rose v. Commissioner of Taxation* 2002 ATC 4200 at 4262; 49 ATR 206 at 276, paragraph 124 of the judgment.

12. In this regard, the transaction documents for the internet marketing scheme on their face might be taken to suggest that there was an expectation on the part of the parties that there could be advertising revenue from banner advertisements placed on the internet site which had been established by the investors with the assistance of the internet marketer. However, in reality, there could be no expectation that the investment would produce assessable income, let alone assessable income in excess of the outgoing in the sense described in *Fletcher v. FC of T* 91 ATC 4950; (1991) 22 ATR 613.

13. When the arrangement is entered into there is no internet site in existence that could be expected to give rise to advertising revenue. That is, there is nothing in existence that could be said to be inherently capable of generating assessable income. The period of the Marketing agreement is only 12 months. There is no business plan, no budget, and no projection of income. There are no examples of internet sites successfully developed into profitable advertising mediums. There is no evidence that the marketing fees purportedly invested in the internet marketing business are actually expended in establishing and developing internet sites for advertising purposes.

14. The likelihood of income being derived from the purported business is so remote that it is not capable of giving the outgoing the character of an expense incurred in gaining or producing assessable income. Moreover, the fact that there appears to have been a general failure on the part of investors to conduct any inquiries, or that they wilfully disregarded easily ascertainable risks that the project would yield little or no return, also supports the conclusion that the outgoing was not genuinely incurred in gaining or producing assessable income (see *Vincent v. FC of T* 2002 ATC 4490 at 4513; (2002) 50 ATR 20 at 46 – paragraph 96 of the judgment).

C. Part IVA applies

15. In our view, no deduction is allowable to investors in the internet marketing expenses scheme. Therefore the arrangement will not give rise to a tax benefit within the meaning of section 177C of the *Income Tax Assessment Act 1936*.

16. However, if the marketing fee were an allowable deduction, the ATO's view on the application of Part IVA would be as follows. Part IVA must be applied on a case-by-case basis, and in each case the ATO must give proper consideration to the individual circumstances of taxpayers before making a decision on the application of Part IVA. However, based on the evidence set out above, it is likely that it would be concluded that, having regard to the statutory factors in section 177D, the sole or dominant purpose for the taxpayer (and the internet marketer) entering into or carrying out a scheme consisting of the

whole, or some part of, the internet marketing arrangement would be to allow the investor to obtain a deduction for the 'marketing fee', which would be a tax benefit as defined by section 177C if it were, in fact, an allowable deduction.

17. Investors who have entered into or are contemplating entering into an arrangement similar to that described in this Taxation Determination, and who believe that the arrangement implemented in their case or proposed to be implemented is distinguishable from that described here, may wish to apply to the Commissioner for a Private Ruling.

Commissioner of Taxation
18 September 2002

Previous draft:
Previously released in draft form as TD 2002/D5

Related Rulings/Determinations:
TR 92/1; TR 92/20; TR 97/16

Subject references:
- schemes & shams
- tax havens
- carrying on a business
- internet
- part IVA

Legislative references:
- ITAA 1997 8-1
- ITAA 1997 8-1(1)
- ITAA 1997 8-1(1)(a)
- ITAA 1997 8-1(1)(b)
- ITAA 1936 Part IVA
- ITAA 1936 177C
- ITAA 1936 177D

Case references:
- Brand v. FC of T 95 ATC 4262; (1995) 30 ATR 426
- Fletcher & Ors v. FC of T 91 ATC 4950; (1991) 22 ATR 613
- Howland-Rose v. Commissioner of Taxation [2002] FCA 246; 2002 ATC 4200; (2002) 49 ATR 206
- Lau v. FC of T 84 ATC 4618; (1984) 15 ATR 932
- Richard Walter v. FC of T 95 ATC 4440; (1995) 31 ATR 95
- Ronpibon Tin NL and Paper Ltd v. FC of T (1949) 78 CLR 47; 8 ATD 431
- Vincent v. FC of T 2002 ATC 4990; (2002) 50 ATR 20

ATO references:
NO: T2002/007271
ISSN: 1038-8982