Monthly Tax Update

*May 2018*

# Franchise businesses and tax

The Australian Competition & Consumer Commission (ACCC) is the government body responsible for enforcing the Franchising Code of Conduct, and if you or someone you know are considering entering into a franchise arrangement, this will probably be a good starting point to get an idea of what to expect.

The code imposes strict obligations on franchisors to make sure that franchise agreements are fair (you can use the search tool on the ACCC's website to find it).

It is a requirement that both franchisees and franchisors act in good faith in all their dealings with one another. Another significant point that should be kept in mind is that penalties for failure to comply can be significant. However, if you've got a plan and are determined to forge ahead, it is also good to know that from a tax point of view, starting and running a franchise business is broadly the same as starting and running most other small businesses.

## About this newsletter

Welcome to our monthly tax update.
We hope you find the content informative.
Should you require further information on how any of the content could affect you, please do not hesitate to contact Ray or Neal on (03) 9428 1033 or

Ray Barrett | Ray.Barrett@barrettwalker.com.au
Neal Patel | Neal.Patel@barrettwalker.com.au

© Content in partnership with Taxpayers Australia

There are additional considerations however, in that there are different tax treatments for franchise-specific payments and transactions between franchisee and franchisor. (The person who grants the right to use a business under some brand name or trade mark, and the right to manufacture and distribute their products or services, is known as the franchisor. The person who receives these rights is known as the franchisee.) The franchisor and each franchisee need to have separate Australian business numbers (ABNs).

## Franchise fee deductions

The initial franchise fee or transfer fee that is paid to the franchisor forms part of the cost base for your franchise business as a capital asset. As these fees are capitally invested in the business, you as the franchisee do not deduct the fee as a business expense from your annual income tax.

Depending on the circumstances, franchise renewal fees may form part of a franchisee's cost base. Any franchise renewal fees not included in the cost base may be deductible as a business expense and subject to the prepayment rules (more below). Generally you can deduct the fees paid to the franchisor for ongoing training as a business expense.

The prepayment rules cover expenses incurred in a current income year under an agreement for something to be done, in whole or in part, in a later income year. This alters the timing of a deduction for certain prepaid expenses that would ordinarily be immediately deductible in full in the year they are incurred. The subsequent timing of such a deduction can generally be made over an "eligible service period", which in most cases means when the agreement is in force.

## Goods and services tax

Payments made to the franchisor will generally also include a goods and services tax (GST) component, as in most cases the franchisor will be GST registered. If you as the franchisee are also GST registered, you will be able to claim a GST credit from the ATO for the GST amount included in:

- initial franchise fees
- franchise renewal fees
- franchise service fees or royalties
- advertising fees
- transfer fees, and
- training fees.

## Royalties or interest payments

An agreement to purchase a franchise often includes ongoing payments of royalties, interest payments or levies to the franchisor. These payments typically cover head office expenses, such as administration, advertising and technical support.

Unlike the initial up-front fee, when you work out your annual income tax liability you are generally able to deduct payments of royalties, interest payments and levies in the year these are incurred, as they are and will be a continuing expense in carrying on the business.

## Non-resident franchisors

You may, depending on the original franchisor business that takes you on as a franchisee, find that you are required to make royalty or interest payments to non-resident franchisors that are based in another country. The ATO generally requires that franchisees withhold a flat rate of 30% from the gross amount of a royalty payment and 10% from the gross amount of an interest payment. However, a double tax agreement with the non-resident franchisor's country of residence may reduce this rate. Check with us if this is an issue.

You will need to pay the ATO the amounts withheld from royalty and interest payments, and have us report these amounts in your activity statement for the relevant reporting period. We will later need to report the total annual amount of royalty and interest payments and amounts withheld to the ATO.

A franchisee can only deduct the royalty payment to a non-resident franchisor as a business expense if you have withheld tax from the royalty payment and the amount has been paid to the ATO.

## Ending a franchise agreement

If you either transfer a franchise to another party or terminate your franchise agreement, you may need to alert us in case there are both capital gains tax (CGT) and GST consequences.

When you transfer or terminate a franchise, the initial franchise fee or transfer fee that is included in the business's cost base may be relevant in working out the net capital gain (if any) to include in a subsequent tax return. ■

# Interest deductibility after income-producing activity ceases

An issue that sometimes arises for business owners is whether interest expenses incurred on borrowed funds used in a business remain deductible after the business's income earning activities have ceased.

As a general rule, in order for interest expenses to be deductible in the relevant income year, a taxpayer is generally required to demonstrate that the expense was either incurred in gaining or producing assessable income, or necessarily incurred in carrying on a business for the purpose of gaining or producing that assessable income.

In either case, the taxpayer is required to demonstrate that there is sufficient connection between the interest expense incurred and the derivation of assessable income. In past court cases on this matter, in determining such a connection, consideration was given to the purpose of the borrowing (commonly referred to as the "purpose" test) and the use to which the borrowed funds have been put (the "use" test).

In each judgment, the courts allowed a deduction for interest expenses incurred on borrowed funds notwithstanding the disposal of the relevant income producing assets.

**Case 1: Partners borrowed to acquire a delicatessen business.**

After a number of years of trading, the business was sold at a loss. The proceeds of the disposal were paid to the lender but were insufficient to satisfy the liability fully. The court held that the interest expense incurred on the outstanding loan balance remained deductible.

**Case 2: The taxpayer, with her husband, borrowed money to fund a trucking and equipment hire business.**

After her husband's death, the wife sold the assets of the business but the proceeds (plus other amounts on hand) were insufficient to fully repay the loan. She subsequently refinanced the loan because she was able to obtain a lower interest rate through an alternative lender. In these circumstances, notwithstanding that the business had ceased, it was held that the interest costs incurred relating to the refinanced loan were deductible as the new loan was considered to have taken on the same character as the original borrowing.

## Establishing a connection

Based on the principles in these cases, the ATO maintains that a sufficient connection between the former income earning activities and the interest expenses incurred following cessation of those activities must continue to be maintained.

In practical terms, and to ensure success in making any such claims, it must be determined whether a connection between the interest expense and the former income-earning activities remains or whether this has been broken.

The ATO has acknowledged that ongoing interest expenses, in the above circumstances, may still be deductible irrespective of:

- the loan not being for a fixed term
- the taxpayer having a legal entitlement to repay the principal before maturity, with or without penalty, or
- the original loan being refinanced, whether once or more.

The ATO does state, however, that any connection would be broken if it could be concluded that the taxpayer:

- had kept the loan on foot for reasons unassociated with the former business activity, or
- had made a conscious decision to extend the loan to obtain a commercial advantage that is unrelated to the previous attempts to earn assessable income. ■