



LANTERI  
PARTNERS GROUP

WEALTH MANAGEMENT

Here for the future...

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## 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.

### About this newsletter

We are very proud to announce our monthly Newsletter!! It is intended for you, our clients, as well as future clients of Lanteri Partners Group. You will be informed on the latest news and announcements regarding changes to legislation mainly within financial planning and wealth management industry. Each issue will have significant contributors including our Managing Director, Michael Lanteri and other key individuals who are specialists in their areas of expertise. We hope you find this newsletter of great value. Thank you.

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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.

## **Franchising and tax cont**

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.

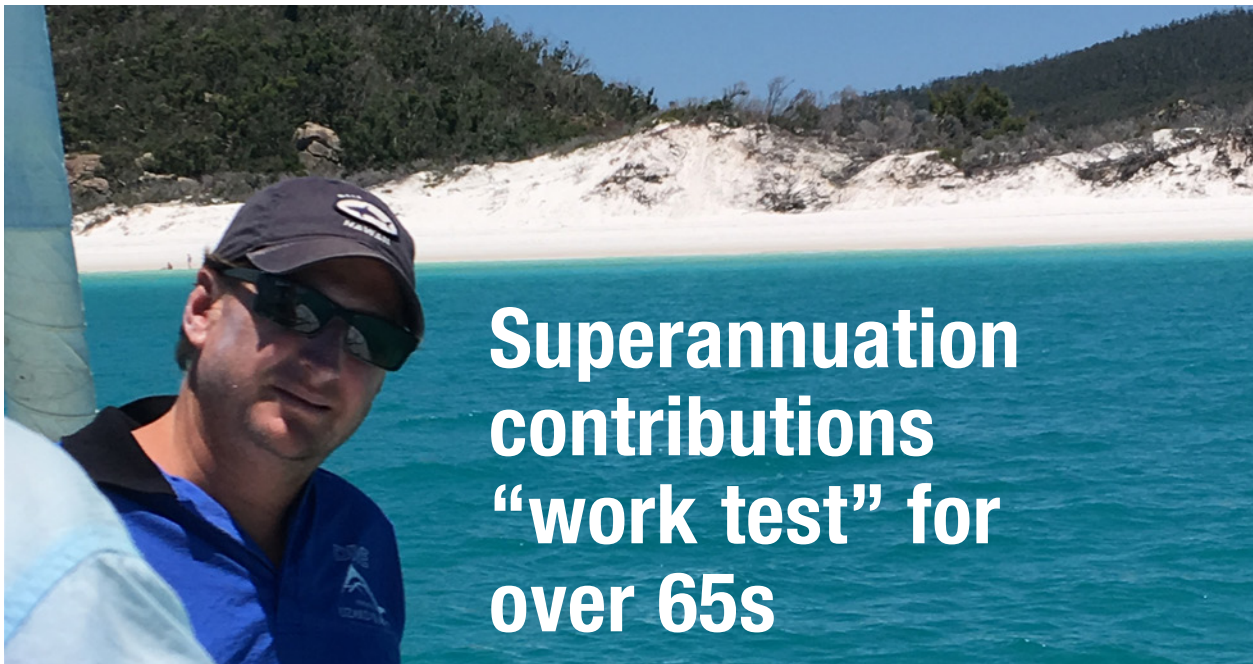
In practical terms, and to ensure success in making any such claims, it must be determined whether a connection between the interest expense and the former income-earning activities remains or whether this has been broken.

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. ■



Whether or not the trustee of a complying superannuation fund can accept member contributions for those aged between 65 and 75 depends on the member satisfying a “work test”.

The work test requires a member to have been gainfully employed for at least 40 hours in a period of not more than 30 consecutive days during the financial year a contribution is made.

To be “gainfully employed” a person must either be employed or self-employed for gain or reward in any business, trade, profession, vocation, calling, or occupation or employment.

The definition of “gain and reward” is particularly broad and does not limit itself to salary or wages. It includes business income, bonuses, commissions, fees or gratuities, in return for personal exertion.

If the contribution is made to an industry or retail fund, the person making the contribution is generally required to tick a box that states that the work test has been satisfied.

In the case where the contribution is made to an SMSF, a *Work Test Declaration* would typically suffice as proof the work test has been passed.

It is however essential to retain evidence of the work performed as there is always the risk of being asked (in the event of an ATO audit) to provide appropriate evidence that the work test has been met. If the ATO is not satisfied with the evidence provided, the contribution is likely to be disallowed.

Many questions have been asked about the work test over the years. The following is a compilation of answers to some of the most relevant questions.

#### **WORK TEST AND VOLUNTARY WORK**

Jane worked unremunerated for a charity throughout the 2016-17 financial year. Would Jane satisfy the work test in that year?

No, as an unpaid volunteer, her work does not meet the definition of a “gainfully employed” person.

#### **WORK TEST AND SALARY SACRIFICE**

Peter is over 65, working full-time and salary sacrificing his whole salary to superannuation. Peter has no taxable income to declare in his personal income tax return. How would Peter prove that he satisfies the work test?

Where there is full salary sacrifice then the PAYG payment summary from the employer would still be issued with the salary sacrificed amount being reported as reportable superannuation contributions. This would provide enough evidence of the gain or reward for the work test.

## **Superannuation contributions “work test” for over 65s *cont***

### **PROVING WORK TEST WHERE ONE IS AN EMPLOYEE**

How can an employee prove that they satisfy the work test?

In the case where one is an employee and works for at least 40 hours in a period of not more than 30 consecutive days during a financial year, the existence of PAYG summaries, an employment contract and evidence of superannuation guarantee contributions made on their behalf will provide appropriate evidence of the work test.

### **PROVING WORK TEST WHERE ONE IS NOT AN EMPLOYEE**

How can a self-employed individual prove that they satisfy the work test?

In this case, notes of the work done and the activities performed together with invoices/pay slips substantiating the income derived and the hours worked will provide evidence for the work test. Factors suggesting the individual is genuinely carrying on a business and that the work was done and paid for legitimately, at a commercial rate, will be relevant here.

### **TURNING 65 DURING A FINANCIAL YEAR**

John turned 65 on 22 September 2016. John made non-concessional contributions to a superannuation fund during the 2016-17 financial year. Under what circumstances was John able to contribute?

The main issue here revolves around John turning 65 on 22 September 2016. What is required is for John to meet the work test if the contribution is made after his 65th birthday. In short;

- if the non-concessional contribution is made prior to John turning 65 (that is, before 22 September 2016) he is not required to meet the work test as members under 65 do not have to satisfy a work test to make these contributions.
- if the contribution is made after John's 65th birthday, he must be gainfully employed and work for at least 40 hours in a period of not more than 30 consecutive days in the 2016-17 financial year.

### **TRIGGERING THE BRING-FORWARD PROVISIONS**

Andrew has a total super balance of \$500,000 on 30 June 2017. Andrew contributes \$100,001 to his SMSF just before his 65th birthday in the current

year, triggering the “bring forward rule” for the non-concessional contributions in the 2017-18 year. Will Andrew need to satisfy the work test in each of the following two years in order for the SMSF to be permitted to accept any subsequent member contributions?

Yes, this is because a person who has triggered the “bring forward rule” for non-concessional contributions in a financial year and has since reached age 65 is required to satisfy the work test in later financial years that they may want to contribute up to their brought forward non-concessional contributions cap.

### **TURNING 75 DURING A FINANCIAL YEAR**

Is it possible to make non-concessional contributions after reaching age 75 if the work test was satisfied within the financial year prior to the individual's 75th birthday?

Yes, but only if the contribution is received by the fund within 28 days after the end of the month when a person turns 75. For example, if a person turns 75 in April, then the contribution must be received by their super fund by 28 May.

### **WORK TEST REQUIREMENT AND “RESERVED” CONTRIBUTIONS**

Chris is 69 years old. He made a personal contribution of \$20,000, which was received by his SMSF in June 2017. The contribution was applied to an unallocated contribution account (established in accordance with the rules of the SMSF), and subsequently allocated to Chris's accumulation account on 7 July 2017. Would Chris be required to satisfy the work test in the year the contribution was made to the fund (that is, 2016-17) or in the year the contribution was allocated to Chris's account (2017-18)?

Chris is required to meet the work test in the year the contribution was made to the fund (2016-17) rather than when the contribution was allocated to his account (2017-18). ■



## 2-minute quiz: Business deductions

How well do you know your business deductions?  
Try these questions to find out! Answers on page 7.

### Question 1

A company's financial accounts show the following information in relation to its bad debts and doubtful debts for the year:

- Closing balance for doubtful debts from the previous year: \$172,000
- Doubtful debts provided for (but not written off) during the year: \$89,000
- Bad debts formally written off during the year: \$94,000
- Closing balance for doubtful debts at year end: \$167,000

**What is the deductible amount for the year?**

1. \$172,000
2. \$89,000
3. \$94,000
4. \$167,000

### Question 2

A business incurs these legal expenses:

- A. Legal fees relating to the acquisition of a subsidiary company
- B. Legal fees relating to settling a customer dispute over an allegedly faulty product
- C. Legal fees relating to hiring five new staff members
- D. Legal fees relating to establishing a business loan. The fee was \$300.

**Which of the expenses are fully deductible in the year the expenditure was incurred?**

1. B and C
2. B, C and D
3. C only
4. A, B and C
5. A,B,C and D

This information has been prepared without taking into account your objectives, financial situation or needs. Because of this, you should, before acting on this information, consider its appropriateness, having regard to your objectives, financial situation or needs.

**2-minute quiz: Business deductions *continued***

**Answer 1**

**The correct answer is 3.**

As a general rule, bad debts may be deductible under the general deduction provisions, or alternatively are deductible under a specific section of the tax law.

Broadly, if the company were to claim a bad debt deduction under the specific section, the debt must have been bought to account as assessable income of the taxpayer for the current year or an earlier year. Alternatively, a deduction could be claimed if it is in respect of money lent in the ordinary course of a money lending business – that is, there is no requirement for the debt to have been included in the business’s assessable income.

In order to be deductible, a debt must be actually bad and written off. It is not sufficient that a debt is merely provided for as being doubtful or expected to turn bad in a future income year.

In its relevant guidance, the ATO states:

*A debt may be considered to have become bad in any of the following circumstances:*

- (a) the debtor has died leaving no, or insufficient, assets out of which the debt may be satisfied*
- (b) the debtor cannot be traced and the creditor has been unable to ascertain the existence of, or whereabouts of, any assets against which action could be taken*
- (c) where the debt has become statute barred and the debtor is relying on this defence (or it is reasonable to assume that the debtor will do so) for non-payment*
- (d) if the debtor is a company, it is in liquidation or receivership and there are insufficient funds to pay the whole debt, or the part claimed as a bad debt, and*
- (e) where, on an objective view of all the facts or on the probabilities existing at the time the debt, or a part of the debt, is alleged to have become bad, there is little or no likelihood of the debt, or the part of the debt, being recovered.*

In another section of the same guidance, the ATO states:

*While individual cases may vary, as a practical guide a debt will be accepted as bad under category (e) above where, depending on the particular facts of the case, a taxpayer has taken the appropriate steps in an attempt to recover the debt and not simply written it off as bad. Generally speaking such steps would include some or all of the following, although the steps undertaken will vary depending upon the size of the debt and the resources available to the creditor to pursue the debt:*

- (i) reminder notices issued and telephone/mail contact is attempted*
- (ii) a reasonable period of time has elapsed since the original due date for payment of the debt. This will of necessity vary depending upon the amount of the debt outstanding and the taxpayers’ credit arrangements (eg 90, 120 or 150 days overdue)*
- (iii) formal demand notice is served*
- (iv) issue of, and service of, a summons*
- (v) judgment entered against the delinquent debtor*
- (vi) execution proceedings to enforce judgment*
- (vii) the calculation and charging of interest is ceased and the account is closed, (a tracing file may be kept open; also, in the case of a partial debt write-off, the account may remain open)*
- (viii) valuation of any security held against the debt, and*
- (ix) sale of any seized or repossessed assets.*

**Answer 2**

**The correct answer is 1.**

The reasoning for each expense incurred is as follows:

- A. Legal fees relating to the acquisition of a subsidiary company would generally not be deductible in the income year incurred as the expenditure is of a capital nature, not a direct business expense. It is unclear as to what aspect of the acquisition the legal costs relate to. Depending on their nature, they may form part of the cost base of the shares of the acquired company or, as a last resort, the costs may be deductible over five years as “blackhole expenditure”.
- B. Legal fees incurred in the ordinary course of business which relate to settling a dispute with a customer over an allegedly faulty product would generally be fully deductible in the income year incurred as it is necessarily incurred in carrying on a business.
- C. Legal fees relating to hiring new staff members would also generally be deductible in the year incurred as it is necessarily incurred in carrying on a business.
- D. Legal fees relating to establishing a business loan would generally not be fully deductible in the income year incurred as the expenditure is of a capital nature. Legal fees that are in the nature of borrowing costs may be deductible however over the lesser of the loan term or five years (although an immediate deduction would be available if the amount is \$100 or less). ■

# Look before you leap with testamentary trusts



A testamentary trust works in tandem with a will, and is similar to a discretionary trust, with the major difference being it only takes effect upon the death of the person who made the will. The trust can be funded by some or by all of your assets, and by payments derived as a consequence of death, such as life insurance payouts and superannuation death benefits.

Multiple testamentary trusts can be created specifically in wills or by giving the executor of the will the discretion to set up a separate testamentary trust under certain specified parameters. A well governed trust will ensure desired asset protection is achieved and family and legal disputes minimised or hopefully prevented.

A testamentary trust can exist for up to 80 years, but can also vest (be wound-up) earlier if the trustee so decides. Under a testamentary trust, the ultimate control and legal ownership of the estate is clearly with the trustee. The beneficiaries do not legally own the assets of the trust, but have a right to be considered in the distribution of the income and capital of the trust.

*continued overleaf* ⇨

Testamentary trusts are formed under the auspices of a valid will or testament rather than other trusts which are ordinarily created during life (inter vivos) under the terms of a trust deed. It is a trust structure that is often used to protect family assets by having greater control over management and distributions of the deceased estate to beneficiaries.

It is crucial that the planning and appointing process of the trustee is well governed. The decision as to who the trustee of the trust is of necessity an important one so as to ensure that the appointee is one that is trustworthy, competent and will serve to protect the beneficiaries' entitlements.

## **i** Key parties in a testamentary trust

- **Settlor:** the person who creates the trust (as part of their will).
- **Trustee:** responsible for carrying out the terms of the will.
- **Beneficiary:** person/s entitled to receive benefits of the trust.
- **Court:** the probate court oversees the handling of the trust by the trustee, ensuring the trust is properly followed.



## **Look before you leap with testamentary trusts cont**

The long term success of a testamentary trust is dependent on planning and a high level of co-operation between family members.

### **Case study 1**

Note both case studies do not consider Medicare levy. John and Jane Johnstone have two children, Jeff aged 6 and Jenny aged 9. Jane died suddenly leaving assets of \$500,000 (excluding the family home). Jane's will included a testamentary discretionary trust under which John along with Jeff and Jenny are potential beneficiaries.

The annual income of the trust is \$30,000 and John as trustee resolves to distribute the income equally between Jeff and Jenny. As the children have no other income, the distributions are tax free as they are under the threshold of \$18,200.

If Jane's will had not included a testamentary trust, the income of \$30,000 would have been added to John's taxable income to bring the total amount to \$120,000 (\$90,000 salary + \$30,000). He would have paid tax of approximately \$32,000 as opposed to tax of approximately \$20,900 (on his salary). Thus, in one year alone the testamentary discretionary trust has saved the family approximately \$11,100 in income tax (\$32,000 – \$20,900).

### **Case study 2**

Adam, age 44, and Agnes, age 46, are married and have three children aged 8, 5 and 3. They own a house together which is valued at \$900,000. They have also taken out a \$550,000 mortgage over the house. Adam's annual salary is \$120,000 (net \$87,963) while Agnes has an annual salary of \$50,000 (net \$42,453). Both have wills and life insurance to the value of \$1.5 million and \$1 million respectively.

**Using a simple will:** Agnes dies and in her will leaves everything to her husband Adam without the use of a testamentary trust. If Adam uses half of Agnes's estate to pay off the outstanding mortgage on the house this will leave Adam with \$450,000. To ensure a maximum future return on the remaining funds, Adam decides to invest the funds at a rate of 4% a year generating an annual income of \$18,000.

Where there is no testamentary trust in place, the \$18,000 will be taxed in Adam's hands at his full tax rate. That would mean that he would have a net income of \$99,308, a total increase of \$11,340 annually.

**Using a testamentary trust:** Let's assume that Agnes in her will leaves her estate to Adam via a testamentary trust. The trust establishes Adam as the trustee and primary beneficiary with Adam and Agnes's children also beneficiaries.

Adam generates an additional annual income of \$18,000 from investing the trust funds at a rate of 4%. By splitting the income, benefits can be distributed between the children and Adam so that there would be no tax payable on the \$18,000. This would be done by ensuring that no distribution to any one beneficiary was greater than the minimum tax free threshold of \$18,200, which they are entitled to even though they are minors because the trust is a testamentary trust, rather than a standard discretionary trust.

By structuring their estates in this way, the family would be \$6,660 better off per year until the children begin earning their own income. This extra money can be taken into consideration when calculating insurance needs.

## **ADVANTAGES AND DISADVANTAGES OF A TESTAMENTARY TRUST**

### **Advantages**

- Asset protection – protects from unwanted claims by creditors, spouses or partners of the testator's children
- Tax benefits – income generated by the trust can be allocated between beneficiaries in a tax effective manner. Beneficiaries under the age of 18 years will be taxed at normal tax (adult) rates, not at penalty rates normally applicable for prescribed minors
- Protection from bankruptcy – a well-structured trust will protect a beneficiary's inheritance in the event of insolvency or bankruptcy.

### **Disadvantages**

- Complexity – a testator, trustee and beneficiaries should be able to clearly understand and approve the scope, structure and operation of the trust
- Lack of flexibility – there needs to be provision made for dispute resolution and asset devolution strategies in the event of the death of one or more primary beneficiaries
- Cost – there will be ongoing administrative costs involved in maintaining the trust, such as accountancy and tax compliance costs. ■