

TR 2001/D7 - Income tax: Australian films - Division 10B tax concessions

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Draft Taxation Ruling

Income tax: Australian films – Division 10B tax concessions

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Preamble

Draft Taxation Rulings (DTRs) represent the preliminary, though considered, views of the Australian Taxation Office. DTRs may not be relied on by taxation officers, taxpayers and practitioners. It is only final Taxation Rulings that represent authoritative statements by the Australian Taxation Office of its stance on the particular matters covered in the Ruling.

What this Ruling is about

1. This Ruling examines tax avoidance schemes connected with films. Specifically, it examines tax benefit transfer arrangements under which taxpayers with no or limited commercial exposure to the success or failure of a film enter into contrived financial (and other) arrangements to obtain the benefit of deductions from film makers who cannot benefit directly under Division 10B of Part III of the *Income Tax Assessment Act 1936* ('ITAA 1936'). These practices distort the tax concession intended by Division 10B.

2. This Ruling does not deal with:

- (i) investments under the Film Licensed Investment Company measures;
- (ii) the source of income under film distribution agreements with non-residents or section 79D of the ITAA 1936; or
- (iii) arrangements under which investors are actually exposed to the real risks and benefits of ownership of certified Australian films. See Class of Person/Arrangement.

Class of person/arrangement

3. This Ruling applies to persons who enter into or carry out the following arrangement:

- An investor acquires a special purpose company as a wholly owned subsidiary;

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- The special purpose company is set up to acquire an Australian film from a film studio;
- The investor makes a capital contribution to the special purpose company. The amount of the capital contribution is typically between 20% and 25% of the amount payable by the special purpose company to acquire the film;
- A loan is taken out by the special purpose company. The amount of the loan is typically between 75% and 80% of the amount payable by the special purpose company to acquire the film;
- The loan is guaranteed by the studio or by an entity nominated by the studio;
- The investor's capital contribution and the loan are used by the special purpose company to fund the purchase of a film copyright from the film studio. The copyright is purchased pursuant to an assignment agreement between the special purpose company and the film studio;
- The special purpose company's tax deduction is transferred to the investor under the group loss transfer provisions. This results in a tax saving to the investor;
- The capital contribution/loan ratio is such that the special purpose company's tax saving applicable to the Division 10B deduction exceeds the investor's capital contribution;
- At the time that the special purpose company acquires copyright, it is obliged to enter into a distribution agreement with a distributor which is an associate of the studio. The distribution agreement grants to the distributor the exclusive right and licence to distribute and exploit the film;
- The distributor is entitled to the copyright if there is a default or insolvency event of the special purpose company;
- There is no provision for the special purpose company to terminate the distribution agreement as a result of an insolvency event, or a breach of the agreement, by the distributor;
- In consideration for entering into the distribution agreement the special purpose company is given an income entitlement based on a profit sharing formula;

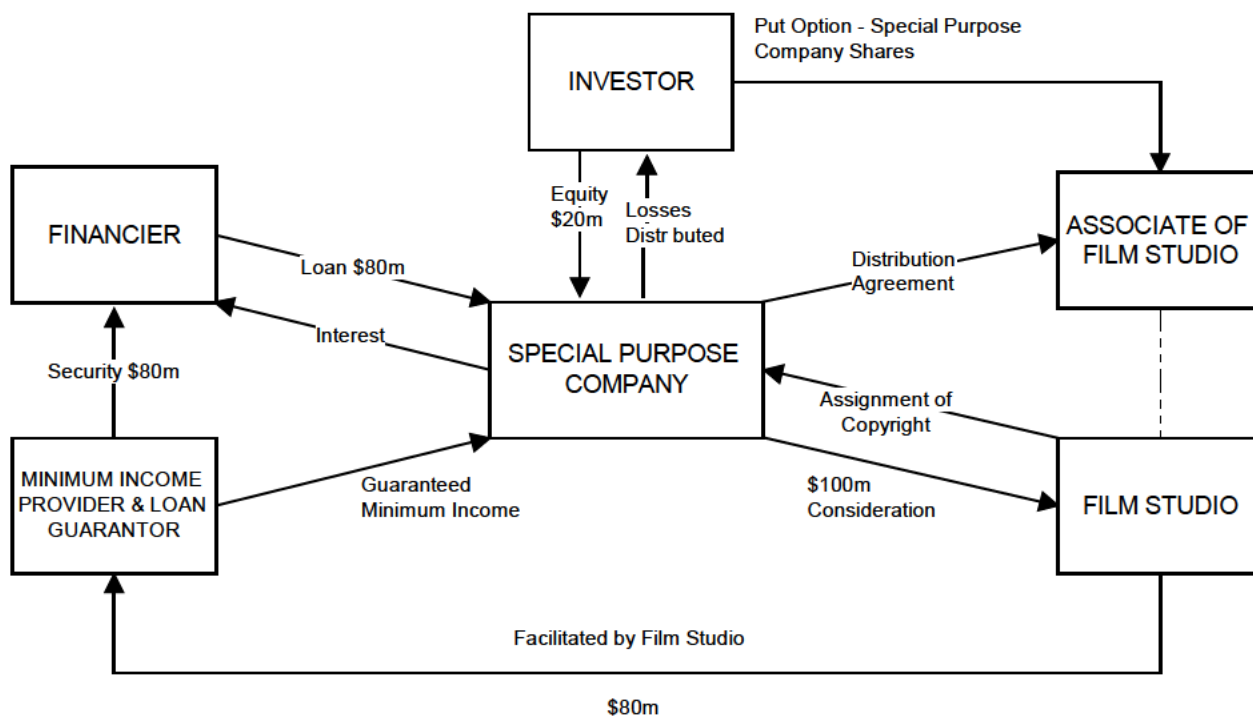
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- Under the profit sharing formula the distributor is entitled to recover a substantial distribution fee, distribution expenses, supervisory fees, an overhead charge, financing costs, and the cost of production of the film. The special purpose company secures an entitlement to a percentage share of any residual amount;
- The studio separately ensures that a minimum income, approximately equal to the special purpose company's interest commitment in respect of its borrowing, will be payable to the special purpose company in consideration for entering into the transaction documents;
- The investor acquires a put option over the shares it holds in the special purpose company. The put option is exercisable at a specified time typically not earlier than six years after the date in which the put option is acquired and provides that the investor may dispose of the shares to the distributor or to another entity nominated by the studio for a nominal sum;
- The guarantor funds the repayment of the loan.

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4. The following diagram illustrates the key features of a typical arrangement.



5. The nature of these arrangements is such that the investors are likely to be large corporate taxpayers.

6. This Ruling also applies to persons who enter into or carry out the following arrangement:

- A company, trust or partnership acquires rights as owner of, or licensee under, copyright in relation to a film which is an Australian film for the purposes of Division 10B from a film maker;
- All, or all but an insignificant part, of the rights are transferred, sublicensed, or become exploitable by the film maker or an associate of the film maker. This is achieved by way of:
 - an assignment;
 - an exclusive distribution agreement, or otherwise, either immediately or soon after the film rights are acquired; or
 - a put or call option (or an arrangement with an embedded put or call option) in respect of the rights that it is reasonable to assume will be exercised by the film maker, or an associate of

the film maker, either immediately or soon after the film rights are acquired;

- The company, trust or partnership, or an associate, obtains finance either directly or indirectly from the film maker or an associate of the film maker, or a guarantee by the film maker or an associate of the film maker. The finance represents the substantial part of the price of acquiring the film rights;
- The net income which is reasonable to expect will be derived from the film by the company trust or partnership, or by the shareholders, partners, or beneficiaries, or by those ultimately interested therein, will be less than the value to them of the tax benefits obtained by them under the arrangements;
- The combined effect of the loan and guarantee arrangements and the tax saving ensures there is no financial risk associated with the investment.

7. Whilst the Explanation is based on the arrangement identified in paragraph 3, the principles also apply to the arrangement identified in paragraph 6. On the basis of those principles, the ruling in paragraphs 11 to 18 will apply to the arrangement in paragraph 6 if the disposal of the rights is simultaneous with their acquisition. Otherwise paragraphs 13 to 18 will apply. Unless there are additional facts as a result of which a taxpayer is exposed to the real risks and benefits of ownership of a certified Australian film, the remaining paragraphs of the Ruling will apply.

Background

The operation of Division 10B

8. Division 10B enables the ‘owner’ of a ‘unit of industrial property’ to deduct the capital expenditure (not otherwise deductible) in acquiring the unit.

9. The ‘owner’ of a ‘unit of industrial property’ is defined in subsection 124K(1) to mean ‘the person who **possesses** the rights in respect of that unit of industrial property’ (emphasis added).

10. A ‘unit of industrial property’ is also defined in subsection 124K(1) and means the rights, including equitable rights, possessed by a person as the owner of, or licensee under, a patent, copyright or design. The rights are those possessed by a person under an Australian law or equivalent rights possessed by a person under a foreign law.

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Ruling

Ownership

11. The special purpose company is never ‘the owner’ as defined in subsection 124K(1) and Division 10B has no application.

12. The transaction documents purport to simultaneously transfer the rights from the studio to the special purpose company and dispose of them to the distributor. There is never a measurable period of time during which the special purpose company possesses the rights. The integrated nature of the assignment and distribution agreements and the terms of the various other transaction documents have the effect that the studio retains effective possession, and control of the copyright. The special purpose company cannot be said to ever truly possess copyright.

Cost of the film

13. Alternatively, if the special purpose company does become the owner, a deduction based on the cost of the film may be available. Cost is determined having regard to the provisions of subsection 124R(3) which applies where the parties are not dealing at arm’s length in relation to the acquisition. Having regard to the provision of guarantees and the granting of the put option, we are satisfied that the relevant parties to these arrangement are not dealing with each other at arm’s length in respect of transactions concerning copyright.

14. The cost of the film for the purposes of subsection 124R(3) should be based on the value to the special purpose company of its interest in the distribution agreement rather than the cost of production plus mark-up. Furthermore, the value of other benefits obtained by the investor and the special purpose company under other agreements within the arrangement should be deducted from the amount payable by the special purpose company under the assignment agreement in determining the arm’s length cost of the film.

Disposal in whole

15. If the special purpose company becomes ‘the owner’, we consider that the special purpose company immediately disposes of all of its rights relating to the copyright under the distribution agreement. In particular, the general tenor of the distribution agreement constitutes an in substance disposal of the copyright to the distributor. In these cases subsection 124M(4) applies and no section 124M deduction is allowable.

16. Where there has been a disposal of copyright, the availability of any deduction is considered under section 124N. The section 124N deduction is the difference between the residual value at the time of disposal and the amount of consideration for the disposal.

Residual value on disposal

17. Where there has been an immediate disposal, the residual value equals the cost of the unit to the special purpose company, and this would be its arm's length value – refer paragraphs 14 and 15 above. The amount of consideration for the disposal would also be its arm's length value less any assessable amounts payable under the distribution agreement. The arm's length value cannot change between the time of acquisition and the immediate disposal of the rights. Therefore there would be no amount deductible under section 124N.

Disposal in part

18. Alternatively, if there has been a disposal of copyright in part by way of the grant of an exclusive licence such that the distributor is a licensee and therefore an 'owner' for the purposes of subsection 124K(1), there can still be no residual value for the purposes of section 124M. In the event of an immediate disposal in part, the residual value is the cost of the copyright less the consideration for the disposal in part. The whole of the exploitable rights in relation to the film have been transferred to the distributor and the special purpose company retains no residual exploitable rights. Therefore, the arm's length value of the part disposed of is equal to the arm's length value of the copyright acquired. Accordingly there is no residual value pursuant to section 124S and no amount deductible under section 124M.

Recouped expenditure - the application of section 82KL

19. Section 82KL of the ITAA 1936 applies to the arrangement to deny any deduction as the expenditure is 'eligible relevant expenditure' incurred as part of a 'tax avoidance agreement' and the expenditure is effectively recouped under the arrangement.

Eligible relevant expenditure

20. An amount paid by a taxpayer in relation to the acquisition of a film which is an Australian film for the purposes of Division 10B is eligible relevant expenditure (subsection 82KH(1F) and paragraph (h) of the definition of 'relevant expenditure' in subsection 82KH(1)).

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Tax avoidance agreement

21. These arrangements constitute a ‘tax avoidance agreement’ under subsection 82KH(1) for the purposes of section 82KL.

Additional benefit

22. An arrangement which involves deductible expenditure by a taxpayer being financed wholly or partly by a loan which will be effectively repaid by another person is a ‘recoupment arrangement’. An amount recouped under a recoupment arrangement is an ‘additional benefit (subsection 82KH(1) and subsection 82KH(1F).

23. Under these arrangements a loan is obtained by the special purpose company to finance the acquisition of film rights. The loan is effectively guaranteed by the studio. The effect of the transaction documents is such that:

- it is reasonable to expect that the special purpose company will not have to repay the whole or a part of the loan prior to the put option being exercised; or
- steps may be taken to collapse the loan; or
- the put option is exercised while the debt remains outstanding; or
- guarantees are relied upon to enable repayment of the outstanding debt.

Expected tax saving

24. The tax saved by the investor pursuant to the loss transfer provisions is an ‘expected tax saving (subsections 82KH(1) and (1B)).

25. In each of the circumstances shown at paragraph 20 above the special purpose company is acquired by the distributor or another entity nominated by the studio with an unpaid loan effectively guaranteed by the studio. Section 82KL will therefore apply to disallow the deductions claimed where the amount payable by the guarantor (or the amount of the unpaid loan at the time when the put option is exercised) plus the expected tax saving equals or exceeds the amount of the deductions.

General anti-avoidance provisions - the application of Part IVA

26. Part IVA of the ITAA 1936 applies if a reasonable person would conclude that the sole or dominant purpose of a person, not necessarily the investor, entering into or carrying out the scheme, or a

part of the scheme, was to enable the relevant taxpayer to obtain a tax benefit in connection with the scheme.

27. For Part IVA to apply, there must be an evaluation of all the relevant scheme facts in the context of paragraph 177D(b) of the ITAA 1936 to ascertain whether the sole or dominant purpose test is satisfied in relation to a particular taxpayer.

28. The arrangements outlined in paragraphs 3 and 6 above have a number of features which achieve the following results:

- the lack of any financial risk to the investor;
- the obtaining of a profit by the investor regardless of how the film performs; and
- tax savings to the investor in excess of the cost to the investor of participating in the scheme.

29. A reasonable person would therefore conclude that the sole or dominant purpose for a person or persons entering into or carrying out the scheme is to enable the investor and the special purpose company to obtain a tax benefit.

Date of effect

30. This Ruling applies to years of income commencing both before and after its date of issue.

31. This Ruling does not apply to taxpayers, to the extent that it conflicts with the terms of a 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).

Previous Rulings

32. An overview of the operation of Division 10B and Division 10BA is provided in Taxation Ruling IT 2629.

Explanations

The operation of Division 10B

33. Division 10B enables the owner of a unit of industrial property to deduct the capital expenditure (not otherwise deductible) in acquiring the unit. The ‘owner’ of a ‘unit of industrial property’ is

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defined in subsection 124K(1) to mean ‘the person who **possesses** the rights in respect of that unit of industrial property’ (emphasis added).

34. A ‘unit of industrial property’ is also defined in subsection 124K(1) and means the rights, including equitable rights, possessed by a person as the owner of, or licensee under, a patent, copyright or design. The rights are those possessed by a person under an Australian law or equivalent rights possessed by a person under a foreign law.

35. The nature of copyright in relation to a cinematograph film is set out in section 86 of the *Copyright Act 1968* which states:

‘Nature of copyright in cinematograph films

86. For the purposes of this Act, unless the contrary intention appears, copyright, in relation to a cinematograph film, is the exclusive right to do all or any of the following acts:

- (a) to make a copy of the film;
- (b) to cause the film, in so far as it consists of visual images, to be seen in public, or, in so far as it consists of sounds, to be heard in public;
- (c) to communicate the film to the public.’

36. The subsection 124M(1) deduction for a year of income is based on ‘the residual value of the unit in relation to the taxpayer as at the end of the year of income’. Residual value is determined under section 124S.

Ownership

37. Section 124M applies to a person who is an owner of a unit of industrial property. This means there must be some period of time during which the special purpose company possessed the rights in respect of the film. In our view, the transaction documents have the effect of ensuring that the special purpose company is never the ‘owner’ of a unit of industrial property, as defined in subsection 124K(1).

38. From the time of the assignment agreement and throughout the period of the distribution agreement, the distributor has the exclusive right, with respect to the film, to do all of the acts in the nature of copyright as specified in section 86 of the *Copyright Act 1968*.

39. The transaction documents simultaneously transfer the rights from the studio to the special purpose company and dispose of them to the distributor. There is never a period of time during which the special purpose company possesses the rights. It is immaterial whether the legal title rests with the special purpose company. The effect of the transaction documents is that the studio does not surrender

effective possession or control of the ‘rights’ in respect of the film given the relationship between the studio and the distributor. Rather, having regard to the ‘back to back’ nature of the assignment and distribution agreements and the integrated nature of the various other agreements, the overall effect of the arrangement is to ensure that the rights in respect of the film remain at all times with the studio or its associates.

40. Possession implies custody or control. Title implies the right to use and the right to exclude the use of others. In our view the special purpose company has neither effective possession of, nor title to, the film.

41. Support for the above position is found in *The Law of Intellectual Property* by Staniforth Ricketson, The Law Book Company Limited, London 1984. At paragraph 13.133 (page 360) the following is stated:

‘The proposition that, in this area, the courts will look to the substance of the transaction, rather than its form, is nowhere better evidenced than in *Messenger v. B.B.C.* [1929] A.C. 151 at 155-156 (Lord Hailsham L.C.); cf. *Wyndham v. Hubsch & Co.*, supra.] In this case, by agreement made between the authors of an opera (the “licensors”) and the proprietor of a theatre (the “licensees”), the licensors granted the licensee the sole and exclusive right of representing the play in the United Kingdom, America, and the British Colonies and Dominions. This was held by the House of Lords to operate as an absolute assignment of the performing rights of the opera within the prescribed area and not a mere licence. This construction was also aided by the presence of other clauses in the agreement, for instance, a clause expressly reserving the copyright in the music to the composer and another providing that the performing rights would revert to the licensors and become their absolute property in the event that the opera was not produced in London within three months of the date of the agreement. It will be seen here that the use of the words “licensor” and “licensee” did not prevent the Court from coming to this conclusion.”’

42. The Federal Court decision in *Wilson v. Weiss Art Pty Limited* (1995) 31 IPR 423 supports the view that the substance of an arrangement is relevant to determining its legal consequences. At p. 432 Hill J. stated:

‘Ultimately, the question whether there has been an assignment ... will depend upon whether the writing or the terms of the agreement reflects or reflect an intention on the part of the assignor to effect an assignment of, or to agree to, assign copyright. In reaching a conclusion upon intention the

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commercial significance of the transaction to the parties will, no doubt, form part of the surrounding circumstances to be considered ...’.

43. In our view the ‘surrounding circumstances’ demonstrate that at all times the studio or its associates maintain effective possession and control of the film.

Cost of the film

44. Alternatively, and assuming that the special purpose company did become the owner of a unit of industrial property, subsection 124R(3) applies to determine the cost of the film to the special purpose company. In our view the special purpose company and the studio are not dealing at arm’s length in relation to the acquisition.

45. The integrated nature of the various transactions and agreements entered into in connection with these arrangements and the terms of the agreements indicate that the parties to the arrangements are not dealing at arm’s length in relation to the acquisition of copyright by the special purpose company and the licensing of the copyright under the distribution agreements.

46. For example, we do not accept that a studio and a special purpose company are dealing at arm’s length in relation to an assignment of film copyright where the studio agrees to:

- guarantee by way of a security deposit, or by other arrangements having a similar effect to a security deposit, the payment of the minimum income to, and the loan repayment obligations of, the special purpose company; and
- purchase the special purpose company for a nominal sum at a specified time pursuant to a put option granted to the investor which owns the special purpose company.

47. Because of the availability of the guarantee and the put option, there cannot be true bargaining in relation to the acquisition price under the assignment agreement and the profit sharing formula under the distribution agreement.

48. Accordingly, the cost of the film for the purposes of Division 10B ‘shall be taken to be the cost of the unit [to the studio] or the value of the unit at the time of the purchase [by the special purpose company] whichever is the less.’ We say that the ‘value’ is the value of the rights possessed by the special purpose company as the owner of this copyright in the circumstances where the special purpose company is obliged to deal with those rights at all times thereafter in accordance with the arrangements entered into.

49. In our view the cost of the film for the purposes of subsection 124R(3), and therefore for the purposes of calculating the residual value under section 124S, would be substantially less than the amount allocated under the assignment agreement. This value should be based on the value to the special purpose company of its interest in the distribution agreement rather than the cost of production to the studio plus a percentage mark up.

50. The guarantees and put option have substantial value, but no part of the payment by the special purpose company is allocated to them. However, it is reasonable to attribute a substantial portion of the amount payable under the assignment agreement to other elements of the arrangements including the value of the guarantees and the put option.

Disposal in whole

51. On the assumption that the assignment agreement does constitute an acquisition by the special purpose company, the distribution agreement amounts in substance to a disposal of all of the rights possessed by the special purpose company in relation to the copyright. Therefore, the film could not have a residual value in relation to the special purpose company 'as at the end of the year of income', because the special purpose company is not the relevant person for the purposes of section 124S. No subsection 124M(1) deduction is therefore available to the special purpose company. Additionally, subsection 124M(4) denies any section 124M deduction to the special purpose company.

52. In our view there is a disposal for the purposes of Division 10B having regard to the fact that the holder of copyright in a film simply has the exclusive right to do certain things in respect of that film. Whilst the arrangement may, at law, initially create that right in the special purpose company, the distribution arrangements immediately create effectively the same rights in the distributor. The studio is the assignor of the copyright and at the same time the distributor is the recipient of a virtually identical set of rights. The arrangement practically removes from the special purpose company, in business terms, what it gives to the special purpose company in the same terms.

53. Furthermore, the distribution agreement has certain terms and conditions which are normally associated with an assignment agreement and lacks certain terms and conditions which are normally associated with a distribution agreement. For example, the security arrangements have the effect that the distributor is entitled to the copyright if there is a default or insolvency event of the special purpose company. Similarly, there is no provision for the special purpose company to terminate the distribution agreement as a result

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of any of the usual insolvency events, or any breach of the agreement, by the distributor.

54. Support for the propositions in paragraphs 51 and 52 above comes from the decision of the Full Federal Court in *Nomad Films International Pty Ltd v. Export Development Grants Board* (1986) 66 ALR 427. At p. 442 Smithers J. stated:

‘If one looks at the form of the operative words ... of the distribution agreement one finds a “grant” of “an exclusive licence to distribute the film throughout the world”, together with a statement that the licence “shall confer upon the distributor exclusive right throughout the world” to perform the very acts the right to perform which are said by s 86 of the Copyright Act 1986 to constitute the copyright in the film. That section provides, “copyright is the exclusive right to do all or any of the following acts”. A licence is something which authorises the licensee to perform certain acts. But the agreement under consideration confers something different, namely the exclusive right to do the acts in question. This is repetitive of s 86. It certainly describes a situation in which, to the limited extent specified, the owner of the copyright is conferring upon the licensee the very rights which constitute his copyright.’

Residual value on disposal

55. On the basis that the rights in relation to copyright in the film is disposed of in whole, the application of section 124N needs to be considered. Subsection 124N(1) allows a deduction for the difference between the residual value of the film to the special purpose company at the time of disposal and the consideration receivable by the special purpose company in respect of the disposal. Residual value is determined in accordance with section 124S. The consideration receivable is determined in accordance with section 124T. Based on the matters referred to in paragraphs 46 and 47 above, we say that the parties are not dealing at arm’s length in relation to the disposal under the distribution agreement. Under subsection 124T(2) the consideration receivable would equal the value of the unit to the special purpose company at the time of its disposal. In the present circumstances we consider that the value of the unit to the special purpose company at the time of its disposal under the distribution agreement would equal the residual value of the unit determined in accordance with section 124S. As the value of the special purpose company’s rights in relation to copyright does not change between the time of its acquisition by the special purpose company and its immediate disposal, the consideration for the disposal by the special purpose company is equal to the residual value.

56. The consideration receivable under subsection 124T(2) may then need to be adjusted on account of any amounts receivable under the distribution agreement which are to be included in assessable income under provisions other than Division 10B. The only amounts that may be regarded as satisfying the test ‘to be included in the assessable income of the owner’ for the purposes of subsection 124T(3) would be amounts receivable by the special purpose company under the profit sharing formula in the distribution agreement. These would not include the minimum income which is payable in consideration for the special purpose company entering into the transaction documents.

Disposal in part

57. Alternatively, if there has not been a disposal in whole, the distribution agreement has the effect of making the distributor ‘a licensee under ... a ... copyright’ for the purposes of the definition of a ‘unit of industrial property’ in subsection 124K(1), and therefore an ‘owner’ for the purposes of Division 10B. The distribution agreement will constitute a disposal in part as the rights possessed by the distributor as licensee will not, in a literal sense, be identical to the rights possessed by the special purpose company as the assignee under the assignment agreement.

58. If the distribution agreement does constitute a disposal in part of the special purpose company’s rights in relation to copyright, the film will have no residual value to the special purpose company for the purposes of section 124S. Subsection 124T(2) provides that the consideration receivable by the special purpose company for the partial disposal will be the value of the part of the copyright acquired by the distributor at the time of its disposal to the distributor. In these arrangements, the special purpose company effectively disposes of all exploitable rights in relation to the copyright. It retains nothing of any value. Accordingly the consideration receivable will be taken to be equal to the cost of the copyright to the special purpose company. Where linked simultaneous transactions occur involving the acquisition of an asset and its effective immediate disposal, it is not accepted that the value of what is acquired and the value of what is disposed of can be different.

Recouped expenditure – the application of section 82KL

59. Section 82KL of the ITAA 1936 is a specific anti-avoidance provision that operates to deny an otherwise allowable deduction for certain expenditure incurred by the taxpayer, but effectively recouped. Under subsection 82KL(1), a deduction for ‘eligible relevant 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’.

Eligible relevant expenditure

60. Capital expenditure in respect of the acquisition of Australian films which is deductible under Division 10B is ‘relevant expenditure’ and may be ‘eligible relevant expenditure’. ‘Eligible relevant expenditure’ (subsection 82KH(1F)) is ‘relevant expenditure’ incurred under a tax avoidance agreement where, under the tax avoidance agreement, the taxpayer (or an associate) obtains an ‘additional benefit’.

Tax avoidance agreement

61. A ‘tax avoidance agreement’ for the purposes of section 82KL means ‘an agreement that was entered into or carried out for the purpose, or for purposes that included the purpose, of securing that a person who, if the agreement had not been entered into or carried out ... would not be liable to pay income tax ... or would be liable to pay less income tax ...’.

62. An ‘agreement’ for the purposes of section 82KL means ‘any agreement, arrangement, understanding or scheme ...’. The arrangements described in paragraph 6 constitute an agreement.

63. Subsection 82KH(3) provides that ‘an agreement shall be taken to have been entered into or carried out for a particular purpose, or for purposes that included a particular purpose, if any of the parties to the agreement entered into or carried out the agreement for that purpose, or for purposes that included that purpose, as the case may be.’

64. A tax avoidance purpose will be present where features of the kind outlined in paragraph 29 above are found.

Additional benefit

65. ‘Additional benefit’ (see the definition of ‘additional benefit’ at subsection 82KH(1) and paragraph 82KH(1F)(b)) is, broadly speaking, a benefit received which is additional to the benefit for which the expenditure is ostensibly incurred.

66. In these arrangements there are at least three possible additional benefits.

- (a) A non-recourse loan that is not repaid;
- (b) Amounts payable by the guarantor to enable repayment of the loan;

- (c) The benefit arising under the put option agreement between the investor and the studio is an additional benefit. The investor has the right to relinquish its interest in the special purpose company prior to the extinguishment of the special purpose company's loan repayment obligation.

67. We do not accept that this is not an additional benefit because it is not a benefit arising in relation to the relevant expenditure (incurred under the assignment agreement). We argue to the contrary. The benefit only has to arise 'in relation to that relevant expenditure being incurred'. This is a wide provision, and we say that the benefit of the put option is provided to the investors because, amongst other things, the investor has agreed to make the payment to acquire the interest in the copyright under the assignment agreement. We say that this is part of the tax avoidance agreement.

68. For the purposes of the expression 'the amount or value of the additional benefit' in section 82KL, 'amount' refers to the face value of an additional benefit expressed in monetary terms, and value refers to the monetary value of property not expressed in monetary terms. The additional benefits referred to in paragraph 66 above are expressed in monetary terms. Accordingly, it is the face value that is the relevant amount of the additional benefit, not the market value or net present value.

Expected tax saving

69. The 'expected tax saving' (see the definition of 'expected tax saving' at subsections 82KH(1) and 82KH(1B)) is essentially the tax saving whether by the taxpayer or another person if a deduction is allowed for the eligible relevant expenditure. The expected tax saving of the investor is:

- (a) the amount of tax the investor would pay if the film deductions were not allowable to the special purpose company (and therefore no entitlement to a deduction for a group loss transfer would arise); less
- (b) the amount of tax the investor would be liable to pay if the film deductions were allowable to the special purpose company.

70. Section 82KL will apply to disallow the deductions claimed where the amount payable by the guarantor (or the amount of the unpaid loan at the time when the put option is exercised) plus the expected tax saving equals or exceeds the amount of the deductions.

71. Subsection 82KL (1) applies where the relevant events have occurred. However, subsection 82KL(2) allows the Commissioner to

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apply section 82KL to disallow a deduction where the relevant events may not have occurred but the Commissioner is satisfied that it might reasonably be expected at a later time, that the sum of the ‘additional benefit’ and the tax saving will exceed the eligible relevant expenditure. Given that the special purpose company will in all likelihood be unable to repay the loan without relying on the guarantee, it might reasonably be expected that an additional benefit will be obtained.

72. Where the Commissioner has applied subsection 82KL(2), but later is satisfied that the particular circumstance relied upon to disallow the relevant deduction will not eventuate, the Commissioner will amend the assessment to allow a deduction for the expenditure (subsection 82KL(3)).

73. Subsection 170(10) enables the Commissioner to give effect to section 82KL by amending assessments of taxpayers at any time.

General anti-avoidance provisions – the application of Part IVA

74. For the general anti-avoidance provisions of Part IVA of the ITAA 1936 to apply, there must be a ‘scheme’ (section 177A) and a ‘tax benefit’ (section 177C). Additionally, it must be concluded that the scheme was entered into or carried out by a person or persons for the sole or dominant purpose of enabling the relevant taxpayer to obtain the tax benefit (section 177D). See, generally, *FC of T v. Peabody* (1994) 181 CLR 359; 94 ATC 4663; (1994) 28 ATR 344, and *FC of T v. Spotless Services Ltd & Anor* (1996) 186 CLR 404; 96 ATC 5201; (1996) 34 ATR 183.

Scheme

75. The film arrangements described at paragraph 6 above constitute a ‘scheme’ for the purposes of Part IVA, given the wide definition of ‘scheme’. Further, a tax benefit is obtained by the investor and the special purpose company from the scheme.

76. The ‘scheme’ includes:

- the arrangement whereby the investor acquires the special purpose company;
- the agreements, undertakings, and courses of action and conduct through which the special purpose company purports to purchase the film from the studio and to enter into the distribution agreement with the distributor;
- the payments made by way of the purchase of copyright, the funding for the purchase of copyright,

the facilitation and servicing of the debt, the minimum income and any other income payments, the put option mechanism, and the mechanism whereby the studio or an associate effectively repays the special purpose company's loan.

77. The parties to the scheme include the investor, the special purpose company, the studio, the distributor, the promoter, the financier, and any guarantor.

Tax benefit

78. The 'tax benefit' to the special purpose company will be the deductions claimed in relation to the arrangement. The 'tax benefit' to the investor will be the deduction for the losses transferred to it by the special purpose company under the loss transfer rules in Subdivision 170-A of the ITAA 1997. The losses are generated in the special purpose company solely by its participation in the arrangement. But for the scheme, the deductions would not be available to the investor and the special purpose company.

Purpose

79. The real issue is whether the investor, or another person or persons, entered into or carried out the scheme, or a part of the scheme, for the sole or dominant purpose of enabling the investor and/or the special purpose company to obtain a tax benefit. This has to be determined having regard to the eight factors referred to in paragraph 177D(b) of the ITAA 1936.

80. A scheme 'may be ... both "tax driven" and bear the character of a rational commercial decision. The presence of the latter characteristic does not determine the answer to the question of whether, within the meaning of Part IVA, a person entered into or carried out a "scheme" for the "dominant purpose" of enabling a taxpayer to obtain a tax benefit' (refer *Spotless* 186 CLR 415; 96 ATC 5201 at 5206; 34 ATR 188). A taxpayer's tax saving exceeding its real economic outlay may indicate a sole or dominant purpose of obtaining a tax benefit, notwithstanding that the investment may bear the character of a rational commercial decision.

81. Part IVA will apply if a reasonable person would conclude that the sole or dominant purpose of the investor, the special purpose company or another person entering into or carrying out the scheme, or a part of the scheme, was to enable the investor and/or the special purpose company to obtain a tax benefit in connection with the scheme.

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82. The relevant person who for the purposes of Part IVA may be judged objectively as having the dominant purpose of enabling the investor and/or the special purpose company to obtain a tax benefit may not be the investor or the special purpose company. It may be the person who designed the scheme or some other person who participated in carrying out the scheme or a part of the scheme.

83. Alternatively, the purpose, or purposes of the investor's professional advisers in recommending the scheme may be attributed to the investor entering into and carrying out the scheme on the basis of their advice (refer *FC of T v. Consolidated Press Holdings Limited (No. 1)* 99 ATC 4945, at 4973; (1999) 42 ATR 575, at 603 per French, Sackville and Sundberg JJ). On appeal this was confirmed by the High Court, particularly where the transactions in question are complex (refer *FC of T v. Consolidated Press Holdings Limited & Anor* 2001 ATC 4343, at 4360; (2001) 47 ATR 229, at 247 per Gleeson CJ, Gaudron, Gummow, Hayne and Callinan JJ). The investor may be judged objectively as having the dominant purpose of obtaining a tax benefit, albeit by reference to the purpose of the investor's professional adviser.

84. The promotion of the scheme by others or the existence of a commercial purpose does not preclude the application of Part IVA. Part IVA will apply when the sole or dominant purpose under section 177D is to enable the investor and/or the special purpose company to obtain a tax benefit in connection with the scheme.

85. In paragraph 29 above, arrangements with certain features are identified as arrangements where a reasonable person would conclude that the sole or dominant purpose is to obtain a tax benefit. Each of those features, on its own, may be insufficient to allow a reasonable person to draw the conclusion that the sole or dominant purpose was to obtain a tax benefit. However, a weighing of all these factors against any commercial elements of the arrangements produces that conclusion, particularly as funds from parties other than the investor or the special purpose company are guaranteed to be available to repay the loans and the tax saving by the investor and/or the special purpose company exceeds the real economic outlay of the investor.

86. In considering the application of section 177D the following propositions as stated in *Spotless* are relevant.

‘A person may enter into or carry out a scheme, within the meaning of Pt IVA, for the dominant purpose of enabling the relevant taxpayer to obtain a tax benefit where that dominant purpose is consistent with the pursuit of commercial gain in the course of carrying on a business’ (186 CLR 415; 96 ATC 5201 at 5206; 34 ATR 187).

‘A particular course of action may be ... both “tax driven” and bear the character of a rational commercial decision. The

presence of the latter characteristic does not determine the answer to the question whether, within the meaning of Pt IVA, a person entered into or carried out a “scheme” for the “dominant purpose” of enabling the taxpayer to obtain a “tax benefit”.

‘Much turns upon the identification, among various purposes, of that which is the “dominant”. In its ordinary meaning, dominant indicates that purpose which was the ruling, prevailing, or most influential purpose. In the present case, if the taxpayers took steps which maximised their after-tax return and they did so in a manner indicating the presence of the “dominant purpose” to obtain a “tax benefit”, then the criteria which were to be met before the Commissioner might make determinations under s 177F were satisfied’ (186 CLR 416; 96 ATC 5201 at 5206; 34 ATR 188).

87. In our view the only relevant commercial purpose under these arrangements is the studio’s. When circular flows of funds are eliminated, the studio is left with a cash benefit equal to the investor’s equity contribution to the special purpose company. The investor’s only real economic benefit arises through the income tax deductions available to it.

88. In our view, the factors discussed in the following paragraphs indicate that the sole or dominant purpose of an investor participating in these arrangements would be to obtain a tax benefit. On that basis, Part IVA would apply.

The contrived transfer of a tax benefit

89. The primary result under these arrangements is the transfer of a potential Division 10B deduction from the studio to the special purpose company which is then available to be transferred under the group loss provisions to the investor.

90. These arrangements involve a blatant transfer of the Division 10B tax benefits available to the studio in relation to copyright. The form of the arrangement is such that ownership is purportedly held by a special purpose company which does not bear the normal risks and benefits of ownership. The substance of such a transaction is that the special purpose company is not the owner.

The immediate disposal of all effective rights in relation to copyright, on non-arm’s length terms, following its acquisition

91. The assignment agreement and the distribution agreement are interrelated such that what the studio assigns under the assignment agreement is immediately transferred to an associate of the studio

under the distribution agreement. As indicated at paragraphs 43 and 44 above, we do not accept that the special purpose company is dealing at arm's length with the studio and the distributor in relation to these agreements.

The lack of any financial risk to an investor, and the manner in which the risk is removed

92. In these arrangements the investor is not subject to any financial risk when the tax saving and the put option are taken into account. The special purpose company is not subject to any risk because of the guaranteed income, and mechanisms to fund the loan repayment where the special purpose company receives insufficient income under the distribution agreement formula to repay the loan.

93. The special purpose company, being a wholly owned subsidiary of the investor, partly finances the deductible film expenditure through borrowings, and guarantees are provided for amounts which will equal the interest payments and the debt outstanding if there are insufficient profits. That is, to the extent that the deduction sought is in respect of expenditure funded by a loan with the repayment being covered by guarantees, it is in respect of expenditure which is not at risk.

The provision of guarantees to an investor or an associate

94. Payment of the minimum income amounts and repayment of the loan principal are guaranteed by security effectively provided by the studio. The value of the security is sufficient to cover the loan component of the purchase consideration payable under the assignment agreement and the minimum income payable to the special purpose company.

The use of the consideration for purchase of the copyright to effectively underpin the various guarantees

95. Where the assignment consideration is used to effectively underpin the various guarantees, there is a round robin arrangement within the definition in Taxation Ruling TR 2000/8. In particular, paragraph 27 of TR 2000/8 includes any mechanism employed to effect discharge of liabilities but which do not, in reality, result in an equal enrichment of the creditor either by cash accretion or the gaining of valuable realisable assets.

96. In these schemes, a round robin arrangement exists where:

- the studio transfers to the guarantor an amount equal to the amount to be borrowed by the special purpose company; and
- that amount is placed on deposit with the lender; and
- the special purpose company borrows that amount from the lender; and
- the amount borrowed by the special purpose company is then used, together with the funds the special purpose company has received from the investor, to pay the studio for the copyright.

97. The special purpose company pays the acquisition cost of the film rights but the only real cash realised by the studio is represented by the investor's funds. There is no change in the overall level of cash in respect of the substantial sum financed through the borrowing.

98. Other financial mechanisms delivering a similar outcome such as the studio or an associate providing security to the bank by way of funds or other property for the loan to the special purpose company are also considered to involve round robin arrangements.

The matching of guarantees with the liabilities of an investor or an associate

99. The minimum income guarantee is designed to cover the special purpose company's interest obligations. The loan guarantee will satisfy the special purpose company's loan repayment obligations.

The effective presence of non-recourse loans

100. The loan to the special purpose company is a non-recourse loan within the definition provided by Taxation Ruling TR 2000/8 at paragraphs 20 – 22.

101. In these arrangements, a special purpose company is used and its only assets are the film rights and any guarantees it is able to call upon. These arrangements are effectively non-recourse because the lender has no recourse beyond the film asset and the specified security given by the guarantor.

The potential to claim two tax benefits in relation to one amount outlaid

102. The investor effectively obtains the benefit of the Division 10B deductions through the group loss transfer provisions and may

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also obtain a tax deduction or loss on the sale of the shares it holds in the special purpose company.

103. To the extent that the tax loss transferred to the investor under Subdivision 170-A of the ITAA 1997 is attributable to the equity contributed by the investor, a further deduction or capital loss on the disposal of the investor's shares in the special purpose company under the put option would, in substance, be a second deduction in respect of the one amount outlaid.

The realisation of a commercial return by means of a tax concession

104. Under the scheme, the tax savings attributable to the Division 10B tax deductions exceed the investor's economic outlay, i.e., the cost of the shares it acquires in the special purpose company.

105. The attraction of the scheme to a potential investor is founded upon the assumption that the Division 10B deductions equal to the cost of the film to the special purpose company are available to the special purpose company and the resulting tax loss can be transferred to the investor under Subdivision 170-A.

106. Under the scheme, the tax saving applicable to the transfer of the tax loss exceeds the investor's effective net outlay and the investor will profit regardless of how the film performs. The practical reality is that the special purpose company is not purchasing a film in order to commercially exploit the film. Rather, the investor participates in the scheme in order to obtain a substantial tax saving.

The presence of dealings, which are not at arm's length, between the parties

107. The integrated nature of the transaction documents means that the parties to the scheme are not dealing at arm's length in relation to the scheme contracts, agreements and transactions.

108. The features of this arrangement which do not appear to involve arm's length dealings include the features identified in paragraphs 46 and 47 above.

The put option to the distributor or to another entity nominated by the studio

109. The effect of the put option is that the investor disposes of its shares in the special purpose company for a nominal sum. The film is thereby effectively returned to the control of the studio (or an associate). This is consistent with our view that neither the special

purpose company nor the investor ever possessed any real rights in relation to the film.

Factors in paragraph 177D(b)

(i) The manner in which the scheme was entered into or carried out

110. The features outlined in paragraph 6 above are relevant to the manner in which a scheme was entered into or carried out and indicate a lack of commerciality. Additional factors in relation to a specific arrangement would also be relevant.

(ii) The form and substance of the scheme

111. The scheme involves a number of integrated transactions which include the assignment agreement between the studio and the special purpose company and a distribution agreement between the special purpose company and the distributor. The assignment agreement and the distribution agreement are for the same period. The distribution agreements grants an exclusive licence to an associate of the assignor under the assignment agreement.

112. In substance the studio, through an associate, retains effective possession of the film at all times. The only real transfers involve a cash payment by the investor which passes through the special purpose company to the studio and the transfer of Division 10B tax deductions from the studio through the special purpose company to the investor.

(iii) The time at which the scheme was entered into and the length of the period during which the scheme was carried out

113. The scheme is entered into and all transaction documents become effective after the film is completed. The Division 10B deductions are available at that time. The scheme is carried out over the period during which the investor continues to own the shares in the special purpose company.

(iv) The result in relation to the operation of the ITAA 1936 or the ITAA 1997 that, but for Part IVA, would be achieved by the scheme

114. Deductions would be available to the special purpose company and the investor.

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(v) Any change in the financial position of the relevant taxpayer that has resulted, or will result, or may reasonably be expected to result, from the scheme

115. The investor will always profit as a result of the scheme as the tax savings applicable to the investor's Subdivision 170-A deductions exceed the investor's investment in the scheme.

116. Because of the presence of the income and loan guarantees the financial position of the special purpose company will not change.

(vi) Any change in the financial position of any person who has, or has had any connection with the relevant taxpayer, being a change that has resulted, or will result, or may reasonably be expected to result, from the scheme

117. The studio receives a profit equal to the amount which the investor pays into the scheme by way of the investor's equity contribution to the special purpose company.

(vii) Any other consequence for the relevant taxpayer, or for any person referred to in (vi), of the scheme being entered into or carried out

118. The scheme may give rise to further business opportunities for the investor such as the making of the loan to the special purpose company.

(viii) The nature of any connection between the relevant taxpayer and any person referred to in (vi)

119. The special purpose company is a wholly owned subsidiary of the investor. The investor holds a put option over the shares in the special purpose company enabling it to sell the special purpose company to the studio.

120. The investor and the studio are connected through the contractual arrangements in the scheme.

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Your Comments

122. You have until 9 November 2001 to make comments on this draft. Please provide comments to:

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Related Rulings/Determinations:

TR 92/20; TR 2000/8; IT 2629

Subject references:

- investing in Australian Films
- copyright
- purpose of obtaining a tax benefit

Legislative references:

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- ITAA 1936 82KH(1)
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