

IT 2629 - Income tax: taxation incentives for the Australian film industry

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TAXATION RULING NO. IT 2629

INCOME TAX: TAXATION INCENTIVES FOR THE AUSTRALIAN FILM
INDUSTRY

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Reference no.:	Subject refs:	Legislative refs:
I 1012567	AUSTRALIAN FILM CONCESSIONS DIVISION 10B DIVISION 10BA	26AG, 51(1), 124K 124L, 124N, 124P, 124R, 124U, 124UA, 124ZAE, 124ZAF, 124ZAFA

OTHER RULINGS ON THIS TOPIC: IT 2111, IT 2377, IT 2476

PREAMBLE The purpose of this Ruling is to clarify the relationship between Divisions 10B and 10BA of the Income Tax Assessment Act 1936 (the Act) which contain provisions relating to investment in Australian films. As such this Ruling is not a statement of new interpretation and practice. Rather it provides an overview of the two Divisions which give a tax deduction for investment in Australian films. The Ruling is relevant to those taxpayers who are considering investing in Australian films and has been prepared in response to a number of enquiries which have been received from investors and producers. The Ruling should be read in conjunction with Taxation Rulings IT 2111 and IT 2476.

2. The Ruling while in a narrative style, highlights the fundamental differences between the two Divisions on a point by point basis. Attached is a table which summarises the key differences between them.

RULING Broad overview of the two Divisions

Division 10B

3. Under Division 10B both residents and non residents are able to claim deductions for capital expenditure incurred in acquiring rights in or under copyrights (referred to as 'unit of industrial property') relating to an Australian film.

4. A taxpayer has two methods of claiming as a deduction the costs of acquiring the copyright in an Australian film under Division 10B. Where a taxpayer has elected that Division 10BA not apply (see paragraph 16 below) or the taxpayer is ineligible for a deduction under that Division (for example, expenditure has not been incurred in obtaining an initial interest in a film

copyright), he or she is entitled to deduct the costs incurred over two years. Alternatively the taxpayer may elect under subsection 124UA(2) to deduct the costs of the unit over the effective life of the copyright as calculated in accordance with section 124U (see paragraph 7 below).

5. The two year write-off concession is available for the capital cost of Australian film rights in cases where the rights or films to which they relate are first used for the purpose of producing income after 21 November 1977. In these cases half the cost of acquiring the interest in the copyright is deductible in the year of income during which the film was first used to produce assessable income and the other half in the following year (section 124UA). It should be noted that subsection 124UA(4) limits the availability of the two year write-off concession to cases where the copyright, or the film the subject of the copyright, is first used for the purpose of producing any income on or after 22 November 1977. The restriction applies to the production of either assessable or non assessable income; and takes into account the use of the copyright by previous owners.

6. An exception to the two year write off period is where copyright is held for a specified time that expires within the year of income during which the copyright is first used for the purpose of producing assessable income. In this case the full amount can be deducted in that year.

7. Where a taxpayer elects under subsection 124UA(2) to remain outside the provisions of section 124UA and to claim deductions over the life of the copyright, the effective life of the copyright is determined under section 124U. This section operates to deem a maximum life of 25 years. However, where the copyright is due to lapse before the end of 25 years the deduction period will be shortened to reflect the life of the copyright.

Division 10BA

8. Under Division 10BA concessional treatment is provided where a taxpayer incurs capital expenditure under a contract entered into on or after 1 October 1980 in producing, or as a contribution to the production of, an Australian film and as a consequence acquires an interest in the initial copyright of the film. The concession is available only to Australian residents.

9. The amount of deduction available under Division 10BA varies according to when the contract was entered into. For contracts entered into on or before 23 August 1983 the deduction available is 150% of the capital expenditure; after 23 August 1983 and on or before 19 September 1985 it is 133% and after 19 September 1985 and on or before 24 May 1988 - 120%. Where the expenditure is incurred under a contract entered into after 24 May 1988, the deduction is 100% of the capital expenditure incurred.

10. For expenditure incurred after 12 January 1983 the deduction is allowable in the year of income the expenditure is incurred

and not when the film is completed and used to earn assessable income. However, under subsection 124ZAFA(2) it is necessary that the film be completed and the copyright used by the taxpayer for the purpose of producing assessable income within 24 months of the end of the financial year in which contributions towards or expenditure on the production of the film are first made.

11. In addition to setting down certain requirements for investors to be entitled to a deduction, Division 10BA also contains a number of safeguard provisions. For example, section 124ZAM provides that there is no deduction under Division 10BA where the investors' contributions under the contract are not at risk; and section 124ZAJ limits the amount of deduction where a transaction is not at arm's length.

12. A significant recent amendment to Division 10BA has been the removal of the requirement that contributions towards the production of a film be deposited in a film account established under the Australian Film Industry Trust Fund. This requirement no longer applies where the applicable rate of deduction is 100%. IT 2111 contains some discussion on how the trust fund operated.

Certificates - Divisions 10B and 10BA

13. As outlined in paragraphs 4 to 13 of IT 2476, both Divisions 10B and 10BA require that the Minister for Arts, Sport, the Environment, Tourism and Territories (ASETT) issue a particular certificate in relation to a film falling for consideration under either Division. The certificate is a prerequisite to an investor obtaining a deduction for an investment in an Australian film under either Division.

14. In the case of Division 10B, the Minister need only certify that the film is an "Australian film". The certificate can be for Australian films that have been produced or are to be produced. In relation to Division 10BA, the Minister must certify that the film is a "qualifying Australian film", i.e. a film which qualifies as an 'eligible film' and an 'Australian film'. (Paragraph 5 of IT 2476 outlines what is meant by an 'eligible film' and an 'Australian film'.) At the time of the moneys being expended there must be a provisional or final certificate in force in relation to the film which certifies that the film will be or is a 'qualifying Australian film'. Otherwise an investor would be denied a deduction under Division 10BA.

15. It is considered that if a film satisfies the requirements of a 'qualifying Australian film' under Division 10BA it will usually, if not always, qualify as an 'Australian film' for the purposes of Division 10B. A certificate issued under Division 10BA is considered sufficient to allow deductions for investment under Division 10B. However, the converse does not apply.

Election that Division 10BA not apply

16. As mentioned at paragraph 4 above, a taxpayer may elect under section 124ZAE that the provisions of Division 10BA not apply to his or her investment in a 'qualifying Australian film'. In the case of a partnership, each partner is entitled to make an election in respect of his or her share of the expenditure incurred. Where an election is lodged, and it must be in writing, the taxpayer is then eligible under Division 10B to claim a deduction for the capital expenditure incurred in acquiring the copyright.

Acquisition of initial and existing copyright

17. Both the initial owner of a copyright to which a unit of industrial property relates and also a taxpayer who acquires for valuable consideration copyright from a previous owner are eligible for a deduction under Division 10B. Apart from where a person acquires copyright in a film in a non-arm's length transaction, the cost for Division 10B purposes will be the amount paid by the taxpayer to acquire the unit.

18. However where the initial owner of copyright has not been dealing at arm's length with the supplier of any goods or services used in the copyright's creation, and the capital expenditure incurred by the owner in creating the copyright exceeds the amount which would have been incurred by the owner if he or she had been dealing at arm's length, then the cost of the unit shall be that amount which in the Commissioner's opinion would have been incurred had the parties been dealing at arm's length. (subsection 124R(2))

19. Similarly, subsection 124R(3) provides that where a taxpayer acquires for valuable consideration copyright from a previous owner (i.e. the taxpayer is not the initial owner of the copyright), and they are not dealing with each other at arm's length, and the capital expenditure incurred by the purchasing taxpayer:

- (i) exceeds the amount that was the cost of the unit to the last preceding owner (i.e. vendor) of the unit; or
- (ii) does not exceed the amount that was the cost of the unit to the vendor, but exceeds the value of the unit at the time of the purchase,

then the cost of the copyright for the purpose of Division 10B shall be taken to be the lesser of the cost of the unit to the vendor or the value of the copyright at the time of purchase.

20. In comparison, Division 10BA through the operation of paragraph 124ZAFA(1)(c) applies only to the first owner or one of the first owners of the copyright of the film when that copyright came into existence. Where an investor disposes of an interest in a copyright, or part of a copyright, and he or she has been claiming deductions under Division 10BA, the person who acquires the copyright may be able to claim a deduction under Division 10B for the cost of acquiring the copyright.

Disposal of copyright

21. Under section 124P of Division 10B where a taxpayer who is the owner of an interest in a film copyright disposes of the whole or part of the copyright and the consideration received exceeds the residual value the excess is to be included in assessable income in the year the disposal took place. Where at the time of disposal the copyright has no residual value, it is the consideration received which is included in the taxpayer's assessable income. The residual value is determined according to section 124S and is broadly the cost of the unit less previously allowed deductions. Section 124P applies whether or not the effective life of the copyright has expired at the time of disposal. It should be noted that subsection 124P(3) limits the amount to be included under subsection 124P(1) to the sum of the deductions in respect of that particular unit of industrial property which have been allowed, or are allowable, under Division 10B in assessments of income of the taxpayer less the sum of any amounts which have been included under section 124P in the taxpayer's assessable income in respect of that unit in a previous year(s).

22. Conversely, where the taxpayer disposes of the film copyright in whole and the residual value exceeds the consideration received on disposal the taxpayer is entitled under subsection 124N(1) to a deduction for the difference. Should the copyright cease to be in force, or a licence in it is surrendered and no consideration is receivable by the licensee in respect of the surrender, and there is a residual value of the copyright or licence to the owner/licensee (who is the taxpayer), then, under subsection 124N(2), the residual value is an allowable deduction.

23. In addition to the specific provisions contained in Division 10B, the Capital Gains Tax provisions may have application to the disposal of copyright, or interests in copyright, acquired after 19 September 1985. It is not proposed to look at the application of these provisions in this Ruling.

24. In comparison, a taxpayer who qualifies for a deduction under Division 10BA for capital investment in Australian films is assessable under section 26AG on the capital and revenue receipts from the film. Where the deduction entitlement is more than 100% (see paragraph 9 above), the taxpayer is entitled to a partial exemption under section 23H on the net receipts.

25. If the taxpayer's interest is disposed of in a non-arm's length transaction for an artificially low price, then the sale price will be the value of the interest, not the contract price (subsection 26AG(6)). Where the interest is disposed of with other property for an overall price then the Commissioner is empowered to determine the part attributable to the taxpayer's interest (subsection 26AG(5)). There are other subsections in section 26AG which apply to particular types of disposal of interest, for example, disposal where entitlement to deduction is affected by the 'at risk test' in section 124ZAM or receipts

for infringement of copyright. However, it is not proposed to look in this Ruling at section 26AG in detail.

Expenditure claimable under the two Divisions

26. As outlined above, Division 10B provides, inter alia, that capital expenditure incurred in acquiring rights in or under copyright relating to an 'Australian film', as defined in section 124K, may be deducted over two income years.

27. Section 124R of Division 10B defines the cost of a unit of industrial property, including an Australian film, for the purposes of that Division. Under paragraph 124L(1)(a) where the taxpayer is the original owner of the film copyright the cost of the film will be the amount of expenditure of a capital nature that has been directly incurred in the film's production by the taxpayer subject to the safeguarding provisions of the Division. Under paragraph 124L(1)(b) where a taxpayer acquires a film copyright by purchase (i.e. it is not an initial interest) and is dealing at arm's length the cost of the film for Division 10B purposes is the amount paid to acquire the film. See paragraph 17 above for the determination of cost where the transaction is not at arm's length. Where the owner has acquired the copyright for no consideration, the cost is the residual value immediately before disposal (paragraph 124R(1)(c)).

28. Costs which would not be considered to form part of the cost of an industrial unit under subsection 124R(1) include the cost of the acquisition of film material copyright not used in the film, brokerage and legal expenses and marketing costs. Costs have to be capital in nature, and, where the taxpayer is the original owner of the copyright, also directly incurred in relation to the film's production, to qualify for deduction under Division 10B. These tests also have to be applied where a taxpayer elects under section 124ZAE that the provisions of Division 10BA not apply and so the costs fall for consideration under Division 10B. Some costs which can be characterised as revenue expenses such as marketing costs can generally be claimed under subsection 51(1). Unlike Division 10BA, the deductibility of revenue costs is not limited by the operation of section 124ZAO (see paragraph 32 below).

29. Section 124ZAF of Division 10BA prescribes the criteria for deductibility of capital expenditure under pre 13 January 1983 contracts, while section 124ZAFA contains the tests for post 12 January 1983 contracts. Essentially a film investor is entitled to a deduction for capital moneys expended in producing, or by way of contribution to the cost of producing an Australian film provided all other criteria, such as existence of a provisional or final certificate, are met. Subsection 124ZAA(6) also requires that the moneys be directly expended in producing the film. As stated in paragraph 9 above, the rate of deduction depends upon the date of the relevant contract.

30. Paragraphs 7 to 10 of IT 2111 outline what is considered to constitute moneys expended "in producing or by way of

contribution to the cost of producing a film" under Division 10BA. Direct film production expenses which qualify for deduction are generally described as those relating to the production process as distinct from those associated with the financing or marketing of the film. As outlined in IT 2111 such expenses would typically include amounts paid for the acquisition of story rights and the surveying of locations, payments to producers, directors and cast, and the costs of insurance of production associated risks, drawing up performers' contracts and the building of sets and scenery.

31. Under Division 10BA, capital outlays not directly incurred in film production such as legal costs for drawing up a prospectus, brokerage fees and commission charges are neither deductible under section 124ZAFA nor deductible under subsection 51(1). However, expenditures related to the marketing of a film, would, subject to section 124ZAO, be deductible under subsection 51(1) where they are incurred in gaining or producing film income that is assessable under section 26AG (see paragraph 24 above). As in the case of Division 10B, the test for deductibility of revenue expenses is under subsection 51(1).

32. Section 124ZAO provides that revenue expenses associated with film investment under Division 10BA are deductible only to the extent of the amount of the proceeds derived from the film that is assessable under section 26AG (or that would be assessable under that section but for the exemption provided by section 23H). Where deductions exceed receipts that are assessable under section 26AG the excess of deductions over income may be carried forward for deduction on the same basis in the following year. It should be noted that film losses incurred in the 1988-89 and earlier years of income qualify for deduction under section 80AAA and any amount not allowed as a deduction at the end of seven years is lost. For film losses incurred following the 1988-89 year of income, section 79F provides for their deduction on an unrestricted time basis. Section 124ZAO has no application to revenue expenses incurred by an investor in relation to those films where the investor has elected under Section 124ZAE that Division 10B will apply.

33. There are a number of provisions which deny or reduce the amount otherwise deductible under Division 10BA. Provisions relating to non-arm's length transactions and expenditure which is not at risk have already been referred to. While it is not proposed to discuss other safeguarding provisions contained in Division 10BA, taxpayers should be aware that they do exist. For example, subsection 124ZAG(1) deals with amounts which are contributed to film production but which are not expended in that production; subsection 124ZAL(1) is concerned with the situation where the film investor partially assigns future copyright; and section 124ZAK deals with the treatment of amounts expended in acquiring assets for use in a film's production where the assets are disposed of or not used in the production of the film.

INTERACTION OF DIVISION 10B AND DIVISION 10BA

34. A question which is commonly asked by taxpayers is whether amounts which qualify for a deduction under Division 10BA can be claimed under Division 10B. Paragraph 124K(2)(b) specifically excludes from Division 10B amounts which qualify for a deduction under Division 10BA and in respect of which the taxpayer has not lodged an election under section 124ZAE. The only exception to this is provided in subsection 124K(2A) which applies where a taxpayer is deemed by section 124ZAM, for the purposes of Division 10BA, not to have expended those moneys or not to have expended part of those moneys. Section 124ZAM requires expenditure claimed under Division 10BA to be at risk. Because of subsection 124K(2A) these amounts may be able to be claimed under Division 10B.

35. In summary, Division 10B and Division 10BA are two separate and distinct Divisions which provide concessional deductions for capital expenditure incurred on Australian films. The two Divisions, apart from some exceptions, such as subsection 124K(2A), are mutually exclusive. In other words, an investor cannot seek to claim a deduction for different expenses in relation to a film under the two different divisions. An investor is not able to apportion and claim parts of the capital contributions to a film's production costs under each Division. While an election may be made so that Division 10BA does not apply, if an amount is considered to be not directly expended in producing a film, then that payment would also probably not qualify for deduction under Division 10B.

COMMISSIONER OF TAXATION
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