



# ***PR 2005/77 - Income tax: Film Investment - 'Armoured X'***

 This cover sheet is provided for information only. It does not form part of *PR 2005/77 - Income tax: Film Investment - 'Armoured X'*

 This document has changed over time. This is a consolidated version of the ruling which was published on *18 May 2005*



## Product Ruling

### Income tax: Film Investment – ‘Armoured X’

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Potential participants may wish to refer to the Tax Office website at [www.ato.gov.au](http://www.ato.gov.au) or contact the Tax Office directly to confirm the currency of this Product Ruling or any other Product Ruling that the Tax Office has issued.

#### **Preamble**

*The number, subject heading, **What this Product Ruling is about** (including **Tax law(s)**, **Class of persons** and **Qualifications** sections), **Date of effect**, **Withdrawal**, **Arrangement** and **Ruling** parts of this document are a ‘public ruling’ in terms of Part IVA of the **Taxation Administration Act 1953**. Product Ruling PR 1999/95 explains Product Rulings and Taxation Rulings TR 92/1 and TR 97/16 together explain when a Ruling is a ‘public ruling’ and how it is binding on the Commissioner.*

### **No guarantee of commercial success**

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The Tax Office **does not** sanction or guarantee this product. Further, we give no assurance that the product is commercially viable, that charges are reasonable, appropriate or represent industry norms, or that projected returns will be achieved or are reasonably based.

Potential participants must form their own view about the commercial and financial viability of the product. This will involve a consideration of important issues such as whether projected returns are realistic, the ‘track record’ of the management, the level of fees in comparison to similar products and how the product fits an existing portfolio. We recommend a financial (or other) adviser be consulted for such information.

This Product Ruling provides certainty for potential participants by confirming that the tax benefits set out in the **Ruling** part of this document are available, **provided that** the arrangement is carried out in accordance with the information we have been given, and have described below in the **Arrangement** part of this document.

If the arrangement is not carried out as described, participants lose the protection of this Product Ruling. Potential participants may wish to seek assurances from the promoter that the arrangement will be carried out as described in this Product Ruling.

Potential participants should be aware that the Tax Office will be undertaking review activities to confirm the arrangement has been implemented as described below and to ensure that the participants in the arrangement include in their income tax returns income derived in those future years.

### **Terms of use of this Product Ruling**

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This Product Ruling has been given on the basis that the person(s) who applied for the Ruling, and their associates, will abide by strict terms of use. Any failure to comply with the terms of use may lead to the withdrawal of this Ruling.

## What this Product Ruling is about

1. This Ruling sets out the Commissioner's opinion on the way in which the 'tax law(s)' identified below apply to the defined class of persons, who take part in the arrangement to which this Ruling relates.

### Tax law(s)

2. The tax laws dealt with in this Ruling are:

- section 26AG of the *Income Tax Assessment Act 1936* (ITAA 1936);
- section 79D of the ITAA 1936;
- section 82KL of the ITAA 1936;
- Division 5 of Part III of the ITAA 1936;
- Division 10BA of Part III of the ITAA 1936;
- section 124ZAG of the ITAA 1936;
- section 124ZAO of the ITAA 1936;
- Part IVA of the ITAA 1936;
- Division 35 of the *Income Tax Assessment Act 1997* (ITAA 1997); and
- section 995-1 of the ITAA 1997.

Unless otherwise stated, all legislative references that follow are in relation to the ITAA 1936.

### Goods and Services Tax

3. In this Ruling, where applicable, all fees and expenditure referred to include Goods and Services Tax (GST) set out in the *A New Tax System (Goods and Services Tax) Act 1999* (GST ACT). An entity is entitled to claim input tax credits for the GST included in its expenditure provided that the acquisition is a creditable acquisition under Division 11 of the GST Act.

### Changes in the Law

4. Although this Ruling deals with the laws enacted at the time it was issued, later amendments may impact on this Ruling. Any such changes will take precedence over the application of this Ruling and, to that extent, this Ruling will be superseded.

5. Taxpayers who are considering participating in the Project are advised to confirm with their taxation adviser that changes in the law have not affected this Product Ruling since it was issued.

**Note to promoters and advisers**

6. Product Rulings were introduced for the purpose of providing certainty about tax consequences for participants in Produced Films such as this. In keeping with that intention the Tax Office suggests that promoters and advisers ensure that participants are fully informed of any legislative changes after the Ruling is issued.

**Class of persons**

7. The class of persons to whom this Ruling applies is those persons more specifically identified in the Ruling part of this Product Ruling and who enter into the arrangement specified below on or after the date this Ruling is made. They will have a purpose of staying in the arrangement until it is completed (that is, being a party to the relevant agreements until their term expires), and deriving assessable income from this involvement as set out in the description of the arrangement. In this Ruling, each of these persons, referred to as 'Investors' will be wholesale clients for the purpose of the *Corporations Act 2001* or will have accepted an offer which qualifies as a small scale offer for the purpose of the *Corporations Act 2001* (refer to paragraphs 52 to 59).

8. The class of persons to whom this Ruling applies does not include persons who intend to terminate their involvement in the arrangement prior to its completion, who otherwise do not intend to derive assessable income from it or are non-residents of Australia for the purposes of the ITAA 1936 or ITAA 1997.

**Qualifications**

9. The Commissioner rules on the precise arrangement identified in the Ruling. If the arrangement described in the Ruling is materially different from the arrangement that is actually carried out, the Ruling has no binding effect on the Commissioner. The Ruling will be withdrawn or modified.

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## Date of effect

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11. This Ruling applies prospectively from 18 May 2005, the date this Ruling is made. However, the Ruling does not apply to taxpayers to the extent that it conflicts with the terms of settlement of a dispute agreed to before the date of issue of the Ruling (see paragraphs 21 and 22 of Taxation Ruling TR 92/20).

12. If a taxpayer has a more favourable private ruling (which is legally binding), the taxpayer can rely on the private ruling if the income year to which the private ruling relates has ended, or has commenced but not yet ended. However, if the arrangement covered by the private ruling has not commenced and the income year to which it relates has not yet commenced, this Ruling applies to the taxpayer to the extent of the inconsistency only (see Taxation Determination TD 93/34).

## Withdrawal

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13. This Product Ruling is withdrawn and ceases to have effect after 30 June 2006. The Ruling continues to apply, in respect of the tax law(s) ruled upon, to all persons within the specified class who enter into the arrangement specified below. Thus, the Ruling continues to apply to those persons, even following its withdrawal, who entered into the specified arrangement prior to withdrawal of the Ruling. This is subject to there being no change in the arrangement or in the persons' involvement in the arrangement.

## Arrangement

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14. The arrangement that is the subject of this Ruling is described below. This description incorporates the following relevant documents or parts of documents lodged with the Tax Office:

- Application for a Product Ruling dated 24 March 2005 as constituted by documents provided on 5 and 14 April 2005, and additional correspondence dated 14 and 21 April 2005;
- Draft **Production and Investment Agreement** ('PIA') between Baldwin Films Pty Ltd ('the Production Company'), Pacific Production Partners Pty Ltd (the 'Investor Representative') and the Investors, undated and received by the Tax Office on 5 May 2005;
- Draft Film Investment Memorandum, undated and received by the Tax Office on 5 May 2005;

- Copy of the application form for a Provisional Certificate provided to the Department of Communications Information Technology and the Arts and received by the Tax Office on 14 April 2005; and
- A Provisional Certificate under section 124ZAB.

**Note:** certain information has been provided on a commercial-in-confidence basis and will not be disclosed or released under Freedom of Information legislation.

15. In accordance with the above documents, an Investor who participates in the arrangement must be a wholesale client or have been accepted as an Investor as part of a small scale offering in accordance with the *Corporations Act 2001*. The meaning of wholesale client and small scale offering is explained in paragraphs 52 to 59 in the Explanation area of this Product Ruling.

16. The documents highlighted are those that the Investors enter into. There are no other agreements, whether formal or informal, and whether or not legally enforceable, which an Investor, or an associate of the Investor will be a party to that are part of the arrangement to which this Ruling applies. The effect of the agreements is summarised as follows.

### **The Participants**

17. The parties involved in the arrangement are:

- **Investor:** A person, who signs a PIA and incurs capital expenditure in acquiring an interest in the Copyright in the Film.
- **Investor Representative:** Pacific Production Partners Pty Ltd will be appointed as the Investor Representative and will act as one of the necessary signatories of the Trust Account in accordance with the PIA (clause 10.1).
- **Production Company:** Baldwin Films Pty Ltd will act as the Production Company and agrees to produce and complete the Film pursuant to clause 4.4 of the PIA.

### **Defined terms**

18. Terms which have been defined within the PIA include the following:

- **Budget** means the budget for the Film set out in the Annexure to the PIA.
- **Budgeted Cost** means the cost of production of the Film as provided for in the Budget (including the Budgeted Non-Deductible Expenses).

- **Completion Date** means the date of completing the Film which shall be no later than 30 June 2006.
- **Copyright** means:
  - (a) any copyright under the *Copyright Act 1968* (Cth);
  - (b) any copyright under the laws of a country other than Australia; and
  - (c) rights in the nature of or analogous to the rights in (a) or (b) under the law of Australia or any other country.
- **Expiry Date** means the date 7 years after the Completion Date.
- **Gross Receipts** means the balance of all money (excluding governmental funding, grants or rebates) received by the Distributor or Production Company from marketing the Film and exploitation of the Ancillary rights after deduction of any distributor's, exhibitor's or agent's commission or expenses, royalties, residuals, bank's charges, transaction taxes or other deductions which are bona fide and made at arm's length.
- **Minimum Subscription** means the amount set out in item 1 of the Schedule.
- **Non-Deductible Expenses** means any expenses in connection with the production and the Marketing of the Film which are not capital moneys expended by way of contribution to the cost of production of the Film, as defined under Division 10BA.
- **Overage** means any amount in excess of the Budgeted Cost required to complete the Film which is expended by the Production Company.
- **Proceeds Account** means the bank account opened by the Production in accordance with clause 8.1 of the PIA, into which all Gross Proceeds must be deposited.
- **Production Account** means the bank account opened by the Production Company in accordance with clause 4.1 of the PIA.
- **Trust Account** means the bank account opened by the Production Company in accordance with clause 2.1 and operated by the Production Company and the Investor Representative on behalf of the Investors in accordance with the PIA.
- **Underage** means any part of the Budgeted Cost not spent on the Production of the Film.

**The Project**

19. The Project involves the production of a Film entitled 'Armoured X'. Provisional Certificate number P06942 dated 8 March 2005 has been issued by the Department of Communications, Information Technology and the Arts in respect of the Film to be made by the Production Company. The certificate is currently in force in relation to the Film and states that the proposed film will, when completed, be a 'qualifying Australian film' for the purposes of Division 10BA.

20. The total budgeted cost of the Film is \$2,108,748 (GST inclusive) which comprises direct production costs of \$2,067,248 and Non-Deductible Expenses of \$41,500.

21. Investors will make capital contributions towards the budgeted costs of the Film and the Minimum Subscription is as defined in item 1 of the schedule to the PIA. No product disclosure statement will be lodged. Investors may be either:

- wholesale clients as defined in section 761G of the *Corporations Act 2001* (refer to paragraphs 54 to 57); or
- retail clients as part of a small scale offering as defined in section 1012E of the *Corporations Act 2001* (refer to paragraphs 58 to 59).

**Production Investment Agreement**

22. The PIA is between the Production Company, the Investor Representative, and the Investor.

23. The Investor agrees to invest the sum specified in Item 2 of the Schedule.

24. Pursuant to clause 2.3, the Production Company will deposit and hold the production investments in a Trust Account controlled by the Investor Representative pending the receipt of the Minimum Subscription by 30 June 2005. If the Minimum Subscription is not obtained the production investments plus interest (if any) will be refunded.

25. When the Minimum Subscription is obtained the funds will be transferred to a Production Account established by the Production Company in accordance with clause 4.2.

26. The Investors will be one of the first owners of Copyright in the Film. The Investors will hold the Copyright as tenants in common with the other copyright owners of the Film. The initial Copyright interests in the Film will be as follows:

Investors:	50%
Production Company:	50%



27. The Investor's entitlement to the ownership of a share of the Copyright of the Film will cease on the Expiry Date (clause 6.4). After the expiry date the copyright will revert to the Production Company.

28. The Production Company agrees that it will, with all diligence, produce and complete the Film prior to the Completion Date as required by the PIA and as set out in the Budget.

29. The Production Company may re-allocate items of expenditure within the Budget at its absolute discretion provided that the production investment may not be expended on a greater proportion of Non Deductible Expenses (clause 4.5).

30. In relation to Overages, if the Budget for the Film has been expended and the Film is not yet completed the Production Company must arrange to pay any Overages from its own funds (clause 4.6). The Investors shall not be obliged to contribute more moneys in order for the Film to be completed without an additional agreement in writing from the Investors (clause 4.8).

31. Under clause 4.7 Underages shall be applied towards the enhancement of music and special effects for the Film.

32. In accordance with Item 7 of the Schedule the Gross Proceeds will be distributed as follows:

- a) to the Investor pro-rata pari passu with the other investors until recoupment of 100% of the production investment; and
- b) thereafter, as to 50% to the Investor pro-rata pari passu with the other investors and 50% to the Production Company.

33. The Investors entitlement to a share of the Gross Proceeds will cease on the Expiry Date (clause 8.4).

## **Distribution**

34. Under clause 6.2 of the PIA the Investor grants the Production Company the irrevocable exclusive licence throughout the universe to use, exploit and authorise the use and exploitation of the Copyright in the Film.

35. Clause 7 of the PIA provides for the Production Company having the exclusive right to carry out the marketing of the Film and exploitation of the Ancillary Rights.

36. No distributor has yet been appointed to handle domestic or overseas sales. The Production Company or an Australian distribution company appointed by it will undertake the distribution of the Film in Australia. An existing major Australian distribution company may be appointed to handle overseas sales. Alternatively, the controller of the Production Company may form an Australian distribution company to conduct overseas sales either directly or through one or more sales agents.

**Finance**

37. Prospective Investors may make their own arrangements to obtain finance to invest in the Project. No assistance with the financing of investments will be offered by the Production Company or the Investor's Representative.

38. This Ruling does not apply if a finance arrangement entered into by an Investor to fund the Investor's Investment in the Film includes or has any of the following features:

- there are split loan features of a type referred to in Taxation Ruling TR 98/22;
- there are indemnity arrangements or other collateral agreements in relation to the loan designed to limit the borrower's risk;
- the funding arrangements transform the Project into a 'scheme' to which Part IVA may apply;
- the loan or rate of interest is non-arm's length;
- repayments of the principal and payments of interest are linked to the derivation of income from the Project;
- the funds borrowed, or any part of them, will not be available for the conduct of the Project but will be transferred (by any mechanism, directly or indirectly) back to the lender or any associate of the lender;
- lenders do not have the capacity under the loan agreement, or a genuine intention, to take legal action against defaulting borrowers; or
- entities associated with the Project are involved or become involved, in the provision of finance to Investors for the Project.

**Ruling**

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**Division 10BA**

39. A deduction is available to an Investor in the Film under Division 10BA for the amount contributed toward the direct production costs of the Film, that is, 98% of the investment amount. For example, for each \$100,000 contribution to the direct cost of producing the Film, a deduction of \$98,000 will be allowed as a deduction.

40. No deduction is available under Division 10BA for the amount contributed toward the Non-Deductible Expenses.

41. A deduction is not available until the Minimum Subscription has been achieved.

42. Upon completion of the Film, after the audit has been carried out by an independent auditor, Division 10BA deductions will be withdrawn from Division 10BA Investors in respect of the moneys spent on non-tax deductible items, as per section 124ZAG.

## **Partnership and section 26AG**

43. For the year ending 30 June 2005 and subsequent years of income, Investors who initially acquire 50% of the Copyright in the Film will comprise a tax law partnership for the purposes of Division 5 of Part III (see definition of 'partnership' in section 995-1 of the ITAA 1997). The partners will receive income jointly from the commercial exploitation of their Copyright interest in the Film.

44. All amounts received by the Partnership in respect of the Film are assessable income of the Partnership under section 26AG in the income year in which they are received. However, pursuant to subsection 26AG(9), any income received by a Partnership from the use of, or the right to use, the Copyright is taken to have been derived by the partners. No such income is taken into account for the purposes of calculating the net income or loss of the Partnership of any year of income and, if this is the only income derived by the Partnership, it will not be necessary to lodge partnership income tax returns. Any income derived will be taken to be the income of each Investor in proportion to their share in the partnership.

## **Section 124ZAO**

45. Interest in respect of investment funds borrowed and any other revenue outgoings relating to the investment incurred by the Investors to make their contributions may be deductible to the Investors in accordance with section 8-1 of the ITAA 1997, but only to the extent of film income which is derived from the Film (subsection 124ZAO(2)). Any excess interest and revenue outgoings may be carried forward indefinitely and offset against future income from the Film (subsection 124ZAO(3)).

46. The deductibility or otherwise of interest arising from loan agreements entered into with financiers is outside the scope of this Ruling. Refer to paragraphs 75 and 76 for further information.

## **Division 35 of the ITAA 1997**

47. Division 35 of the ITAA 1997 will not apply on the basis that any losses which may arise are attributable to a passive investment which does not constitute a business activity.

## **Section 79D**

48. Section 79D does not apply to deny or defer the deductions otherwise allowable.

**Section 82KL**

49. Section 82KL will not be applied to deny deductions otherwise allowable.

**Part IVA**

50. Part IVA will not apply to deny deductibility or to accelerate assessability of the above amounts.

**Assumptions**

51. This Ruling is made subject to the following assumptions:

- (a) the Investor was a resident of Australia for tax purposes at the time the money was expended (subparagraph 124ZAFA(1)(b)(i));
- (b) the investment moneys will be paid to the Production Company by way of contribution to the cost of producing the Film under a contract entered into on or before the end of the financial year in which the capital moneys are to be expended, being 30 June 2005. The production contract will specify that the investment moneys contributed represent the estimated cost of production of the Film (paragraph 124ZAFA(1)(a) and subparagraph 124ZAFA(1)(d)(iv));
- (c) at the relevant time, a provisional certificate (section 124ZAB) or a final certificate (section 124ZAC) is in force in relation to the Film;
- (d) each Investor, at the relevant time, expects to become one of the first owners of the Copyright in the Film when the Copyright comes into force (subparagraph 124ZAFA(1)(c)(i));
- (e) each Investor, at the relevant time, intends to use the interest in the Copyright for the purpose of producing assessable income from the exhibition of the Film as mentioned in subparagraph 124ZAFA(1)(c)(ii);
- (f) there will be in force a declaration lodged in respect of the Film in accordance with subsection 124ZADA(1) by a person accepted by the Commissioner under subsection 124ZADA(2) as an appropriate person to make such a declaration (subparagraph 124ZAFA(1)(d)(iii));

- (g) before the expiration of six months after the time when the Film is completed, an application will be made for a final certificate in accordance with section 124ZAC, otherwise the provisional certificate shall be deemed never to have been in force (subsection 124ZAB(10));
- (h) all requirements of the Department of Communications, Information Technology and the Arts will be met and a final certificate will be issued;
- (i) the Film will be completed and the Investors' interest in the Copyright in the Film will be used for income producing purposes within two years after the close of the financial year in which the contributions are made (subsection 124ZAFA(2));
- (j) by reason of the said capital moneys being expended, the Investor will become one of the first owners of the Copyright in the Film before 1 July 2007;
- (k) in producing the Film:
  - where an amount is expended by a person ('the Film producer') for the supply of goods or the provision of services; and
  - the Commissioner is satisfied that the Film producer and the person supplying the goods or providing the services are not dealing with each other at arm's length in relation to the transaction,that the amount of moneys expended on the supply of those goods or the provision of those services will not exceed the amount of moneys that would have been expended by the Film producer if the Film producer and the person supplying the goods or providing the services had dealt with each other at arm's length (section 124ZAJ);
- (l) at the time the Investor expends the capital moneys by way of contribution to the cost of producing the Film, the Investor is at risk, according to the definition of 'risk' in subsection 124ZAM(2), with respect to an amount equal to or greater than the amount of those capital moneys expended (subsection 124ZAM(1));
- (m) no pre-sale arrangements, distribution rights agreements, distribution guarantee agreements, or other like agreements, have been, or will be, entered into in circumstances where such agreements would put funds into the hands of the Investors, by loan or otherwise, to enable them to expend capital moneys by way of contribution to the cost of producing the Film;

- (n) in the event of any Underage, the Production Company will expend the Underage in a manner that will preserve the status of the Film as a 'qualifying Australian Film'; and
- (o) the dominant purpose of the Investors is to make a commercial return from their investment in the Film and the arrangements will be executed in the manner described in this Ruling.

## Explanation

### Corporations Act 2001

52. For this Ruling to apply, an offer for an interest in the Film must:

- have been made to, and accepted by an Investor, who qualifies as a wholesale client as defined in section 761G of the *Corporations Act 2001*; or
- be an offer which qualifies as a small scale offering as defined in section 1012E of the *Corporations Act 2001*.

53. Small scale offers and offers to wholesale clients do not require a prospectus or product disclosure statement.

### Wholesale client

54. An Investor in the Film may be a person who is a wholesale client within the definition in section 761G. A person will be a wholesale client where the person satisfies one of the following tests:

- the 'product value test' (paragraph 761G(7)(a));
- the 'individual wealth test' (paragraph 761G(7)(c)); or
- the 'professional investor test' (paragraph 761G(7)(d)).

55. A participant in a managed investment scheme, referred to below as 'the person' or 'the person to whom the offer is made', will satisfy the 'product value test' where:

- the minimum amount payable for the interests in the project on acceptance of the offer by the person to whom the offer is made is at least \$500,000; or
- the amount payable for the interests in the project on acceptance by the person to whom the offer is made and the amounts previously paid by the person for interests in the project of the same class that are held by the person add up to at least \$500,000.

56. A participant in a managed investment scheme, referred to below as 'the person' or 'the person to whom the offer is made', will satisfy the 'individual wealth test' where, it appears from a certificate given by a qualified accountant no more than 6 months before the offer is made, that the person to whom the offer is made:

- has net assets of at least \$2.5 million; or
- has a gross income for each of the last 2 financial years of at least \$250,000 a year.

57. A participant in a managed investment scheme, referred to below as 'the person' or 'the person to whom the offer is made', will satisfy the 'professional investor test' where:

- the person is a financial services licensee; or
- the person controls at least \$10 million for the purposes of investment in securities.

### ***Small scale offering***

58. Alternatively, under section 1012E, an Investor may participate in the project by accepting a 'personal offer' for an interest in the project. Offers made under section 1012E cannot be accepted by more than 20 investors in any 12 month period and these investors, in aggregate, must not invest more than \$2 million dollars (subsection 1012E(2)).

59. An offer will be a 'personal offer' where it can only be accepted by the person to whom it is made, and it is made to a person who is likely to be interested in the offer because of previous contact, or professional or other connection with the person making the offer, or because they have indicated that they are interested in offers of that kind (subsection 1012E(5)).

## **Division 10BA**

### ***The 'directly expended' requirement***

60. Subsection 124ZAA(6) requires that capital money contributed to the production of a film must be expended directly in producing the film in order for a deduction under Division 10BA to be available.

61. Paragraph 8 of Taxation Ruling IT 2111 discusses this requirement. It states: 'Direct expenses on a film production which qualify for a deduction under section 124ZAA can generally be described as **those relating to the production process** as distinct from those associated with financing or marketing of the Film. Such expenses would **typically include amounts paid for the acquisition of story rights and the surveying of locations, payments to the producers, directors and cast, and the costs of insurance of production associated risks, drawing up performers' contracts and the building of sets and scenery**' (emphasis added).

62. The Tax Office view is that the 'directly expended' requirement is not met at the point in time when the Investors make payments to the Production Company in respect of the Budget for the Film. Rather, the extent of the application of the money by the Production Company to elements of production will ultimately determine the portion of the Investors' contribution that meets this requirement. Generally, this will not be known until after the Completion of the Film.

63. The Investors will pay the Investment Amount to the Production Company who will deposit the money into a trust account controlled by the Investor Representative. The money will be held in the trust account until the Minimum Subscription is reached. When Minimum Subscription is reached the money will be transferred to the Production Account.

64. In determining the amount that is 'directly expended' on the production of the Film, we will also consider the ultimate application of any funds obtained by the Production Company as Underage. In this regard, the parties have agreed that any Underage will be retained by the Production Company and applied to enhance the music and special effects for the film.

65. Quantification of the amount of money directly expended on the production of a film, and consequently the deduction available under Division 10BA, can only be determined after a film has been produced. To do this, a full audit of the application of the film production funds would normally be required. The practice of conducting an audit of the contribution account that is held by a production company (known as an audit of the Film) is considered inadequate in this regard.

66. Accordingly, while a deduction should be available in respect of the contributions made by Australian Investors, the deduction will be withdrawn with retrospective effect if the amounts contributed are not directly expended on the Film.

### ***The 'at risk' rule***

67. Section 124ZAM reduces claims for Division 10BA deductions where the Commissioner is satisfied that a taxpayer was not at risk in respect of any part of the expenditure of capital moneys the taxpayer made by way of contribution to the cost of producing a film. Subsection 124ZAM(2) specifies the amount of risk is the amount of loss that, in the Commissioner's opinion, would be suffered by reason of the taxpayer's said capital expenditure where no income is derived from the taxpayer's interest in the copyright of the film, other than excepted income as defined in subsection 124ZAM(3).



68. Paragraph 13 of Taxation Ruling IT 2111 discusses the 'at risk' rule and states the rule:

... does not operate to affect the deductions available to Investors where pre-sale arrangements or the sale of distribution rights are effected prior to completion of the Film unless the arrangements put funds into the hands of Investors – by loan or otherwise – to enable them to make their contributions to the costs of film production. Similar considerations apply in respect of a distribution guarantee arrangement under which an amount may be paid to Investors by a producer or another person in exchange for distribution rights, if a specified return is not achieved within a particular period (for example, a specified percentage of the film budget within 2 years). Payments under an arrangement of that kind would also not offend the 'at risk' rule.

69. The 'at risk' rule applies to an Investor's risk of loss before and after completion and distribution of the Film. Any arrangement which limits an Investor's risk of loss can breach the 'at risk' rule. Certain types of common industry arrangements affecting risk during production of the Film are accepted as not offending the 'at risk' rule. This acceptance does not extend to arrangements which put funds into the hands of Investors to enable them to make their contributions to the costs of film production. This cannot be taken to mean that post-completion arrangements are also acceptable if they do not put funds into the hands of Investors to enable them to make their contributions. The position in paragraph 13 of IT 2111 is limited to the situations expressly mentioned.

70. The arrangement ruled on does not contain any features which attract the operation of section 124ZAM.

### ***Non-arm's length transactions***

71. Where, in producing a film, an amount is expended by a person ('the film producer') for the supply of goods or the provision of services, subsection 124ZAJ(1) allows the Commissioner to reduce deductions under Division 10BA for such amounts where he is satisfied that:

- the film producer and the person supplying the goods or providing the services were not dealing with each other at arm's length in relation to the transaction; and
- the amount of moneys expended on the supply of those goods or the provision of those services exceeds the amount of moneys that would have been expended by the film producer if the film producer and the person supplying those goods or providing those services had dealt with each other at arm's length.

72. The Commissioner will not be in a position to determine whether his discretion in subsection 124ZAJ(1) ought to be exercised until such time as the Film has been produced. Furthermore, to make such a determination, a full audit of the Film's application and production fund would normally be required.

73. Accordingly, while a deduction should be available in respect of capital moneys expended by Investors by way of contribution to the cost of producing the Film before the end of the financial year ending 30 June 2005 the deduction will be reduced with retrospective effect if the Commissioner determines that a producer of the Film dealt with a supplier of goods or a provider of services, in the course of producing the Film, in circumstances where the parties were not dealing at arm's length and the producer paid more for the goods or the services than the producer would have paid had the transaction been at arm's length.

#### **Partnership and assessable income**

74. The Investors in the Film will be considered to be a partnership for income tax purposes as they are in receipt of ordinary income or statutory income jointly (see the definition of 'partnership' in section 995-1 of the ITAA 1997). All amounts received by a Partnership of Investors in a Film will be assessable income of the Investors under section 26AG in the income year in which they are received. Although there exists a tax law partnership, subsection 26AG(9) provides that income of a partnership assessable under section 26AG is taken to be income derived by the partners/Investors. The amounts received as income are payments for the right to use the rights attaching to a 'qualifying Australian film' possessed by the Investors in respect of a particular period.

#### **Interest on borrowed funds**

75. Investors should note that the deductibility of interest is outside the scope of this Ruling (refer to paragraph 46). However, interest incurred on borrowed funds should be deductible provided the finance arrangement does not contain any of the features identified in paragraphs 37 and 38.

76. Interest incurred in respect of funds borrowed by the Investors, if any, to make their contributions will only be deductible in any year to the extent of film income derived in that year from the Film (subsection 124ZAO(2)). Any excess interest may be carried forward to succeeding years of income for offset against future film income from the Film (subsection 124ZAO(3)).

## **Division 35 of the ITAA 1997**

77. Subsection 35-5(2) of the ITAA 1997 specifically provides that Division 35 of the ITAA 1997, which regulates the deduction of losses from non-commercial business activities, is not intended to apply to 'activities that do not constitute carrying on a business, for example, the receipt of income from passive investments'.

78. The transactions covered by the arrangement amount to an acquisition of passive investments and the deriving of income from those investments. Hence, Division 35 of the ITAA 1997 does not apply to the Project.

## **Section 79D**

79. Section 79D does not apply where there are no 'foreign income deductions' (as defined in subsection 160AFD(9)).

80. The transactions covered by the arrangement do not give rise to 'foreign income deductions' because the deductions under Division 10BA do not relate to any 'assessable foreign income' (as defined in subsection 160AFD(9)). The income derived by the Investors under arrangement will have an Australian source and will not be 'assessable foreign income'.

## **Section 82KL – recouped expenditure**

81. Section 82KL has no application to Division 10BA arrangements and is therefore not relevant to any deductions properly allowable to the Investors under Division 10BA.

## **Part IVA**

82. For Part IVA to apply, there must be a 'scheme' (section 177A), a 'tax benefit' (section 177C), and a dominant purpose of entering into the scheme to obtain a tax benefit (section 177D). The arrangement subject to this Ruling will be a 'scheme'. The Investor will obtain, for example, a 'tax benefit' from entering into the scheme, in the form of a deduction allowable under the provisions in Division 10BA that would not have been obtained but for the scheme. However, it is not possible to conclude, from the arrangement outlined in this Ruling, that the scheme will be entered into or carried out with the dominant purpose of obtaining this tax benefit.

83. An Investor to whom this Ruling applies intends to stay in the scheme for its full term and derive assessable income from the exploitation of the Copyrights of the Film. Further, there are no features of the Project, as described in the said arrangement, that suggest that the Project is so 'tax driven' and 'so designed to produce a tax deduction of a certain magnitude', that the operation of Part IVA is attracted.

**Payment of interest by an Investor where an assessment is amended**

84. Section 204 provides that where an amendment of an assessment increasing the liability of a taxpayer to tax is made, the taxpayer is liable to pay a general interest charge to the Commissioner on the amount by which the tax payable by the taxpayer under the amended assessment exceeds the tax payable by the taxpayer under the assessment that was amended.

85. Investors who expend capital moneys by way of contribution to the cost of producing a film should be aware of this provision because, should the circumstances surrounding the production of a 'qualifying Australian film' require the Commissioner to go back and reduce the deductions claimed by Investors in that film, section 204 will have application. There is a discretion in section 8AAG of the *Taxation Administration Act 1953* under which the Commissioner can remit, in appropriate circumstances, the whole or part of the charge.

**Detailed contents list**

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**Commissioner of Taxation**

18 May 2005

*Previous draft:*

Not previously issued as a draft

*Related Rulings/Determinations:*

PR 1999/95; IT 2111; TR 92/1;  
 TR 92/20; TR 97/16; TR 98/22;  
 TD 93/34

*Subject references:*

- Australian films
- film income
- film industry
- interest expenses
- product rulings
- public rulings
- schemes and shams
- tax administration
- tax avoidance

*Legislative references:*

- ITAA 1936 26AG
- ITAA 1936 26AG(9)
- ITAA 1936 79D
- ITAA 1936 82KL
- ITAA 1936 Pt III Div 5
- ITAA 1936 Pt III Div 10BA
- ITAA 1936 124ZAA(6)
- ITAA 1936 124ZAB
- ITAA 1936 124ZAB(10)
- ITAA 1936 124ZAC
- ITAA 1936 124ZADA(1)
- ITAA 1936 124ZADA(2)
- ITAA 1936 124ZAFA
- ITAA 1936 124ZAFA(1)(a)
- ITAA 1936 124ZAFA(1)(b)(i)
- ITAA 1936 124ZAFA(1)(c)(i)
- ITAA 1936 124ZAFA(1)(c)(ii)
- ITAA 1936 124ZAFA(1)(d)(iii)
- ITAA 1936 124ZAFA(1)(d)(iv)
- ITAA 1936 124ZAFA(2)
- ITAA 1936 124ZAG
- ITAA 1936 124ZAJ
- ITAA 1936 124ZAJ(1)
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- ITAA 1936 177A
- ITAA 1936 177C
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NO: 2005/4966  
 ISSN: 1441-1172  
 ATOLaw topic: Income Tax ~~ Tax offsets, credits and benefits ~~ film  
 production tax offset