



# ***PR 2001/87 - Income tax: The Hatchling Film Project***

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 This document has changed over time. This is a consolidated version of the ruling which was published on *15 June 2001*



# Product Ruling

## Income tax: The Hatchling Film Project

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### Preamble

*The number, subject heading, and the **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 IVAAA 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

The Australian Taxation Office (ATO) **does not** sanction or guarantee this product as an investment. 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 investors 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, how the investment fits an existing portfolio, etc. We recommend a financial (or other) adviser be consulted for such information.

This Product Ruling provides certainty for potential investors by confirming that the tax benefits set out below 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 below, investors lose the protection of this Product Ruling. Potential investors may wish to seek assurances from the promoter that the arrangement will be carried out as described in this Product Ruling.

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

### Terms of use of this Product Ruling

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.

Potential investors may wish to refer to the ATO's Internet site at <http://www.ato.gov.au> or contact the ATO directly to confirm the currency of this Product Ruling or any other Product Ruling that the ATO has issued.

## 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. In this Ruling this arrangement is sometimes referred to as 'Hatchling', 'the Film', 'the Product' or as 'the Project'.

### Tax law(s)

2. The tax laws dealt with in this Ruling are:
- Division 10BA of Part III of the *Income Tax Assessment Act 1936* ('ITAA 1936');
  - Section 26AG (ITAA 1936);
  - Part IVA (ITAA 1936);
  - Section 8-1 of the *Income Tax Assessment Act 1997* ('ITAA 1997');
  - Section 17-5 (ITAA 1997); and
  - Division 27 (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 *New Tax System (Goods and Services Tax) Act 1999* ('the GST Act'). In order for a person or entity to be entitled to claim input tax credits for the GST included in its expenditure, it must be registered, or required to be registered for GST under the GST Act and hold a valid tax invoice. GST is payable on a taxable supply by the person or entity making the taxable supply.

### Business Tax Reform

4. The Government is currently evaluating further changes to the tax system in response to the *Ralph Review of Business Taxation* and continuing business tax reform is expected to be implemented over a number of years. Although this Ruling deals with the laws enacted at the time it was issued, future tax changes may affect the operation of those laws and, in particular, the tax deductions that are allowable. Where tax laws change, those changes will take precedence over the

application of this Ruling and, to that extent, this Ruling will be superseded.

5. Taxpayers who are considering investing 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 investors in projects such as this. In keeping with that intention, the Tax Office suggests that promoters and advisers ensure that potential investors are fully informed of any changes in tax laws that take place after the Ruling is issued. Such action should minimise suggestions that potential investors have been negligently or otherwise misled.

### **Class of persons**

7. The class of persons to which this Ruling applies is those persons who enter into the arrangement described below on or after the date this Ruling is made, and who stay in the arrangement until it is completed, i.e., being a party to the relevant agreements until their terms expire, and deriving assessable income from this involvement as a result (as set out in the description of the arrangement).

8. The class of persons to which this Ruling applies does not include persons who terminate their involvement in the arrangement prior to its completion, or who do not intend to derive assessable income from it.

### **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, as the arrangement entered into is not the arrangement ruled upon; and
- the Ruling will be withdrawn or modified.

10. Without limiting the generality of the term, a 'material difference' may arise in relation to a variation in the facts of the arrangement described in the Ruling. It may also arise in circumstances where additional transactions or arrangements (including financing arrangements) are entered into that, when viewed as a whole with the arrangement described in the Ruling, will produce

a different taxation consequence from the arrangement described in this Ruling. This might include, for example, where the investor borrows to enter into the arrangement by way of a limited or non-recourse loan and the overall consequence might be that the arrangement is one that would have attracted the application of a tax avoidance provision. A material difference may also arise where an investor enters into or benefits from any device which limits or eliminates the risk in respect of the amount contributed by the investor.

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## **Date of effect**

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12. This Ruling applies prospectively from 15 June 2001, 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).

13. 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 begun to be carried out, and the income year to which it relates has not yet commenced, the Product Ruling applies to the taxpayer to the extent of the inconsistency only (see Taxation Determination TD 93/34).

## **Withdrawal**

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14. This Product Ruling is withdrawn on 30 June 2004 and ceases to have effect on and from that date. The Ruling continues to apply, in respect of the tax laws ruled upon, to all persons within the specified class who enter into the specified arrangement during the term of the Ruling. Thus, the Ruling continues to apply to those people, 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 the persons' involvement in the arrangement.

## **Arrangement**

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15. The arrangement that is the subject of this Ruling is described below. This description is based on the following documents. These documents, or relevant parts of them, as the case may be, form part of and are to be read with this description. The relevant documents or parts of documents incorporated into this description of the arrangement are:

- Notification of Intention to Submit a Product Ruling by the applicant dated 8 January 2001;
- Application for a Product Ruling prepared by the Applicants Representative and BP Management Ltd and enclosed documentation dated 31 January 2001;
- 5<sup>th</sup> Draft of the Production Agreement between Film Productions Pty Ltd (“The Producer”), BP Management Ltd (“The Responsible Entity”), Film Management Company Pty Ltd (“The Management Company”) and Each Several Investor (“The Investor”) dated 5 April 2001;
- Prospectus to be issued by The Responsible Entity dated 20 April 2001;
- Draft undated Scheme Compliance Plan received by the ATO on 6 April 2001;
- Distribution and Production Consulting Agreement between BP Management Ltd and Cinema Group LLC dated 13 March 2001;
- 3<sup>rd</sup> Draft of the Assignment Deed between David Binks and Film Management Company Pty Ltd dated 5 April 2001;
- 3<sup>rd</sup> Draft of the Assignment Deed between Conundrum New Media Pty Ltd and Film Management Company Pty Ltd dated 5 April 2001;
- 3<sup>rd</sup> Draft of the Assignment Deed between Terra Firma Pty Ltd and Film Management Company Pty Ltd dated 3 April 2001;
- 4<sup>th</sup> Draft of the Deed of Assignment between Film Management Company Pty Ltd and BP Management Ltd dated 5 April 2001;

- Draft Letter of Appointment appointing Terra Firma Pty Ltd as Executive Producer of the film dated 8 March 2001;
- 5<sup>th</sup> Draft of the Production Services Agreement between Film Productions Pty Ltd and Conundrum New Media Pty Ltd dated 4 April 2001;
- Draft undated Writers Agreement between David K. Binks and BP Management Ltd received by the ATO on 19 February 2001;
- Draft Scheme Constitution received by the ATO on 7 June 2001;
- Macquarie Bank Limited Loan Documentation and Application Form for Individuals dated June 2001;
- Correspondence from the Applicant's representative to the ATO dated 2, 5, 15, 17, 21, 22, and 26 February 2001, 8, and 30 March 2001, 5, 6, 19, 25 and 26 April 2001, 3, 9, 15, 16, 21, 24, 28 and 30 May 2001, and 1, 6 and 7 June 2001;
- Correspondence from the ATO to the Applicant's representative dated 12 January 2001, 12 February 2001, 6, 19 and 20 April 2001, 3, 9 and 29 May 2001 and 6 June 2001.

**Note:** certain information received from BP Management Ltd and the Applicant's representative has been provided on a commercial-in-confidence basis and will not be disclosed or released under the Freedom of Information Legislation.

16. There are no other material agreements either formal or informal, and whether or not legally enforceable, to which an investor, or any other participant in this arrangement, or an associate of an investor or other participant shall be party. These agreements have the effect as summarised as follows.

## **The Film Project**

17. The arrangement is an investment scheme to raise a minimum and total subscription of \$9,966,415 consisting of \$9,156,000 Deductible Units at \$1 per unit and \$810,415 Non-Deductible Units at \$1 per unit. The funds raised will be used to produce a Large Format Film provisionally entitled "Hatchling". The film is an adaptation of an idea by David Binks.

18. A Provisional Certificate numbered P4814 was issued by the Department of Communications and the Arts on 11 February 1996, in respect of the film. This 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 of the ITAA 1936.

19. The planned completion date for the film is 31 December 2002 but is subject to availability of The Film Director, Cast and Crew. The completion date is negotiable between the parties to the arrangement but will definitely be no later than 30 June 2003 to comply with the two year requirement of Division 10BA.

20. Investors in Deductible Units will make capital contributions towards the production of the film under a contract to be executed no later than 30<sup>th</sup> June 2001. The minimum individual subscription amount for individual investors has been set at 3,000 Deductible Units at \$1 each with additional investments available in parcels of 1,000 Deductible Units of \$1 each.

21. The whole amount provided by each Investor in Deductible Units is by way of contribution to the cost of producing the Film. No part of the amount is attributable to acquiring an interest in the arrangement (other than the Investor’s interest in the film copyright). Non-deductible expenditure is to be met from funds contributed by Screen West or from the issue on Non-deductible Units and from other funds provided by parties other than the investors.

22. The film copyright is not held by the Responsible Entity and does not form part of the scheme property. While each Investor participates in the arrangement, that investor is an owner of the copyright for the purposes of Division 10BA.

23. Investors will receive income from their share of the Copyright in the Film until the expiry of the scheme on 30 June 2007 when all units will terminate, lapse, and cease to have any rights.

### **Constitution**

24. Applications for Units in the Scheme can only be made on the application form attached to the Prospectus and the full amount for each Deductible Unit is to be paid on application (clause 10.2). The Responsible Entity will issue Units to applicants (clause 10).

25. Under clause 9.2 the Responsible Entity has the power to issue Deductible Units and Non-Deductible Units. Under clause 9.3 the Responsible Entity may consolidate, divide or reconstruct Units as it thinks fit. The arrangement that is the subject of this ruling assumes that this power is not exercised in relation to Deductible Units after 30 June 2001.

26. The Prospectus details the specific functions of the Responsible Entity. These functions and the respective clauses in the Constitution are as follows:

- establish and maintain a register of Investors in the Scheme (clause 12);
- record unitholders in a register to evidence ownership of Units (clause 10.12 and 12.2);
- prepare annual audited reports for distribution to the Investors;
- convene meetings of Investors when required (clause 5.3);
- follow the complaints handling procedure in relation to any complaints received from Investors (clause 27);
- enter into the Distribution Agreement, Production Agreement, Assignment of Copyright Agreements and any agreement with Screen West (clause 22);
- invest all or part of Application Moneys in investments authorised by clause 7;
- appoint any agents as deemed necessary (clause 8);
- attend to the transfer or transmission of any Investor's Units as required (clause 13); and
- receive and distribute the Application Moneys (clause 7).

27. The Responsible Entity will be remunerated at a rate calculated as 0.5% of Net Licence Revenue in addition to being reimbursed for any costs incurred on behalf of the Scheme in accordance with clauses 15 and 16.

## **Production Agreement**

28. The Responsible Entity, in its individual capacity and on behalf of each Investor, will enter the Production Agreement with Film Management Company Pty Ltd and Film Productions Pty Ltd.

29. Each Investor will become an owner as tenants in common in respect of 60% of the Copyright in the Film. The Management Company shall own 36.49% of the Copyright in the Film and Screen West shall own 3.51% of the Copyright in the Film (Recital C and clause 16.1). On 30 June 2007 each Investor will cease to have a right to receive distributions of any kind whatsoever in respect of their Copyright interests. On 30 June 2007 the Responsible Entity will assign the whole of the respective interest of each Investor in the copyright in the Film to the Management Company for the payment of \$1,100 (clause 16.2).

30. Once minimum subscription has been achieved the Responsible Entity will pay the Investors' application money into the Production Account. The Production Company will use the funds in the Production Account to produce the Film. No part of these funds are to be used for non-deductible expenditure (clause 3.6).

31. In the event that actual costs are lower than budgeted costs, the Underage will be first applied by Film Productions Pty Ltd to film enhancements and secondly repaid to the Responsible Entity (clause 3.12). Alternatively, if actual costs exceed budgeted costs, then Film Productions Pty Ltd must pay the additional amount to complete the Film or, alternatively, it may call on the Completion Guarantor to fund any Overage in order to complete the Film (clause 3.13).

32. Under clause 13.1, Film Productions Pty Ltd can subcontract all or any of its obligations under the Production Agreement. Film Productions Pty Ltd will enter into a Production Services Agreement to subcontract its obligations under the Production Agreement to Conundrum New Media Pty Ltd.

### **Distribution Agreement**

33. The Responsible Entity and Cinema Group LLC will enter into the Distribution Agreement for a term of 15 years after the initial theatrical premiere exhibition of the Film. Under the Distribution Agreement:

- Cinema Group LLC agrees to provide the production consulting services of Mr Richard James (clause 1);
- Cinema Group LLC agrees to distribute the Film throughout the world, excluding Australia and New Zealand (clause 3); and
- Cinema Group LLC will use its reasonable commercial efforts to secure the following:
  - an investment of US\$1,300,000 in the Film;
  - pre-licences or participation in the Film in the amount of US \$1,300,000; and
  - a distribution guarantee in the amount of US \$1,000,000.

up to a total of US\$2,300,000 (Recital C and clause 2).

34. In return for the production consulting services of Mr Richard James, Cinema Group LLC is to be paid US\$100,000 over the duration of the Film's production (clause 1.07). In addition, Mr Richard James will be entitled to the reimbursement of travel and miscellaneous expenses (clause 1.09).

35. Gross Receipts from the Film and ancillary benefits shall be allocated in the following order (clause 3.03):

- the first US \$1.3 million to the Responsible Entity;
- secondly, a reimbursement of all distribution expenses incurred by Cinema Group LLC;
- thirdly, payment of a distribution fee to Cinema Group LLC equal to 20% (of which 2½% is deferred until after Investor Recoupment) of Gross Receipts (including pre-licence and other pre-production funds sourced by Cinema Group LLC) from the Film;
- fourthly, to the Responsible Entity until Investor Recoupment; and
- thereafter a distribution fee of 25% of Gross Receipts together with the 2½% deferred fee and 10% of Adjusted Gross Receipts to Cinema Group LLC and the balance to the Responsible Entity.

36. Subject to certain conditions, Cinema Group LLC has agreed to give a guarantee, supported by a letter of credit from a financial institution reasonably acceptable to the Responsible Entity, that Gross Receipts remitted to the Responsible Entity in the first year after the premiere will be at least US\$1,000,000 (clause 3.06). The Distribution Agreement may be terminated if Gross Receipts remitted to the Responsible Entity within 5 years of the first premiere of the Film are not equal to or greater than US\$4.5 million (clause 3.08).

## **Deeds of Assignment**

37. Mr David K Binks is the sole author and creator of the original script and artistic works together with all ancillary items that collectively represent the intellectual property rights in the Film. Under the Assignment of Copyright Agreement, Mr Binks assigns to Film Management Company Pty Ltd all intellectual property rights in the Film for the sum of \$1.10.

38. Conundrum New Media Pty Limited (Conundrum) and Terra Firma Investments Pty Ltd have an interest in certain intellectual property rights related to the Film. Under these Deeds, Conundrum and Terra Firma Investments agree to assign to Film Management Company Pty Ltd all of their interest in such intellectual property rights.

39. Film Management Company Pty Ltd also has an interest in certain intellectual property rights related to the Film. Film Management Company Pty Ltd will agree to assign all such intellectual property rights to the Responsible Entity.

**The Participants**

40. The following entities are participants in the Project:

- Film Management Company Pty Ltd acquired the rights to make the film and assigned the rights to The Responsible Entity and the copyright in the film will revert back to it at the completion of the scheme;
- BP Management Ltd will act as “The Responsible Entity” and offeror of the film;
- Film Productions Pty Ltd will be “The Producer” of the film;
- Conundrum New Media Pty Ltd assigns its rights in the film to Film Management Company Pty Ltd and it will enter into the Production Services Agreement to produce the film for Film Productions Pty Ltd;
- Terra Firma Investments Pty Ltd assigns its rights in the film to Film Management Company Pty Ltd;
- David Kingsley Binks assigns his rights in the film to Film Management Company Pty Ltd and he enters into the Writers Agreement with the Responsible Entity;
- Cinema Group LLC will be granted the worldwide distribution rights, excluding Australia and New Zealand, and they will provide the production consulting services of Richard James;
- It is currently intended that Film Finances Inc. will guarantee completion of the film subject to the terms of an agreement to be entered into.

**Financing Arrangements**

41. Investors can fund their investment in the Project themselves, borrow from Macquarie Bank Limited, or borrow from an independent lender.

42. Investors who acquire finance from Macquarie Bank Limited will enter into a full recourse Loan Agreement which has the following features:

- The facility is available up until 30 June 2001 with a maturity date 5 years after the loan drawdown date;
- The Loan Facility’s first interest period will be 18 months after the loan drawdown, followed by

12 months, and thereafter quarterly (clause 3.2 and 3.3);

- The interest rate is 10.25%, it accrues daily, is calculated in arrears and is payable at each interest period (clause 3.1);
- If BP Management Ltd ceases to be the Responsible Entity of the scheme the Investors will be required to repay the loan within 10 business days of receiving written notice to that effect from Macquarie Bank Limited;
- Loan repayments are to be made on the payment dates irrespective of the amount of distributions received from the Scheme (clause 4.1). However, under clause 5.2 an Investor agrees to prepay when he/she receives a distribution from the Scheme.

43. The Macquarie Bank finance does not affect the Investor's ownership of the film copyright. Also, Investors continue to be entitled to and derive income from exploitation of their copyright interest.

44. This Ruling does not apply if an Investor enters into a finance arrangement with any of the following features:

- there are split loan features of the type referred to in Taxation Ruling TR 98/22;
- other entities associated with the Project are involved, or become involved, in the provision of finance to Investors for the Project;
- there are indemnity arrangements, or other collateral agreements, in relation to the loan, designed to limit the borrower's risk;
- 'additional benefits' are or will be granted to a borrower, for the purposes of section 82KL, or 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 principal and payments of interest are linked to 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 means, and whether 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
- the terms or conditions are not arm's length.

## **Ruling**

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45. Subject to the assumptions listed below at paragraph 46 of this Ruling:

- A deduction is available to an Investor in the Project under Division 10BA of Part III of the ITAA 1936 for the amount invested in Deductible Units. Where an Investor who is registered or required to be registered for GST is entitled to an input tax credit on their investment, then the tax deduction otherwise allowable will exclude any amounts of input tax credit (Division 27 of the ITAA 1997);
- A deduction is not available until the minimum subscription has been achieved, the Investor has entered into the Production Agreement, and the Investor's contribution is available to the Producer;
- Any amounts payable to the investors for the exploitation of their interest in the copyright and rights attached thereof, less any GST payable on these amounts, will be assessable to the investors as film income under section 26AG of the ITAA 1936. Section 17-5 of the ITAA 1997 excludes from assessable income an amount relating to GST payable on a taxable supply;
- Interest in respect of funds borrowed by the investors to make their contributions will 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 (124ZAO(2) of the ITAA 1936). Other deductions available to investors are also limited to the extent of film income derived. Any excess interest and any other deductions may be carried forward indefinitely and offset against future film income (124ZAO(3) of the ITAA 1936);
- Upon completion of the film, after the audit has been carried out by an independent auditor, deductions will be withdrawn in respect of the moneys not spent on

Division 10BA eligible items of the budget (124ZAG of the ITAA 1936);

- The anti-avoidance provisions in Part IVA will not be applied to deny deductibility or to accelerate assessability of the above amounts.

46. 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 124ZAF(1)(b)(i));
- (b) The investment moneys contributed by the Investors will be used by way of contribution to the cost of producing the film. Moneys contributed by the Investors towards the cost of production of the film will be directly expended in the production of the film (paragraph 124ZAF(1)(a) read in conjunction with subsection 124ZA(6));
- (c) 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 124ZAF(1)(c)(ii);
- (d) 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 2003;
- (e) Each investor's interest in the copyright in the film amounts to ownership of the copyright for the purposes of Division 10BA and no part of the arrangement involves the ownership of the copyright residing in any party other than the investor;
- (f) 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 124ZAF(1)(c)(i));
- (g) The Investors stay in the arrangement until the Scheme is terminated and they do not redeem or transfer their Units in the Scheme;
- (h) There will be in force a declaration lodged in respect of the film in accordance with subsection 124ZAD(1) by a person accepted by the Commissioner under subsection 124ZAD(2) as an appropriate person to make such a declaration (subparagraph 124ZAF(1)(d)(iii));

- (i) At the relevant time, a provisional certificate (section 124ZAB) or a final certificate (section 124ZAC) is in force in relation to the film;
- (j) 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));
- (k) All requirements of the Department of Communications, Information Technology and the Arts will be met and final certificates will be issued;
- (l) 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 124ZAF(2));
- (m) 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;

- (n) 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));
- (o) 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;
- (p) In the event of any underage, the Producer will expend the underage amount on the production and marketing of the film in a manner that will preserve the status of the film as ‘qualifying Australian Films’;
  - (q) 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;
  - (r) Non-deductible expenditure associated with the Project in respect of Division 10BA will be paid out of funds other than Investors’ contributions in Deductible Units;
  - (s) The amount claimed as a deduction under Division 10BA is in the nature of a contribution and is not attributable to the acquisition of any property, rights or interests, other than the film copyright.

## **Explanations**

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### **The ‘directly expended’ requirement**

47. 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.

48. 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).

49. Our view is that the ‘directly expended’ requirement is not met at the point in time when the Investors make payments in respect of the budget for the Film. Rather, the extent of the application of the money 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.

50. The Investors will pay the application money and obtain Deductible Units in the Scheme. The Responsible Entity will use the application money for the production costs. In doing this, the Responsible Entity is to ensure that funds contributed by Investors are only expended on items within the film production budget. Non-deductible expenditure is to be met from funds contributed by Screen West or from the issue of Non-deductible Units and from other funds provided by parties other than the investors.

51. 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 Production Company has agreed any underage will be first expended on the production of the Film and secondly paid to the Responsible Entity to be distributed among the Investors in proportion to their respective Unit holdings.

52. 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 the Production Company (known as an audit of the 'film fund') is considered inadequate in this regard.

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

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

54. 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).

55. 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 (e.g., 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.'

56. 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 does not mean that post-completion arrangements are also acceptable provided 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.

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

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

58. 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.

59. 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 funds would normally be required.

60. 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 2001, 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.

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

61. 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 (subsection 124ZAO(2) of the ITAA 1936). Any excess interest may be carried forward to succeeding years of income for offset against future film income (subsection 124ZAO(3)).

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

62. Subsection 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.

63. 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* (TAA 1953) under which the Commissioner can remit, in appropriate circumstances, the whole or part of the charge.

#### **Part IVA**

64. 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.

65. 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.

## **Detailed contents list**

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**Commissioner of Taxation**

 15 June 2001
 

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*Previous draft:*

Not previously issued in draft form

*Related Rulings/Determinations:*
 PR 1999/95; TR 92/1; TR 92/20;  
 TR 97/16; TR 98/22; TD 93/34;  
 IT 2111
*Subject references:*

- Australian films
- film income
- film industry
- interest expenses
- product Rulings
- public Rulings
- tax avoidance
- tax administration

*Legislative references:*

- ITAA 1936 Div 10BA
- ITAA 1936 26AG
- ITAA 1936 82KL
- ITAA 1936 124ZAA(6)
- ITAA 1936 124ZAB
- ITAA 1936 124ZAB(10)
- ITAA 1936 124ZAC
- ITAA 1936 124ZADA(1)

- ITAA 1936 124ZADA(2)
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  - ITAA 1936 124ZAF A(1)(b)(i)
  - ITAA 1936 124ZAF A(1)(c)(i)
  - ITAA 1936 124ZAF A(1)(c)(ii)
  - ITAA 1936 124ZAF A(1)(d)(iii)
  - ITAA 1936 124ZAF A(2)
  - ITAA 1936 124ZAG
  - ITAA 1936 124ZAJ
  - ITAA 1936 124ZAJ(1)
  - ITAA 1936 124ZAM
  - ITAA 1936 124ZAM(1)
  - ITAA 1936 124ZAM(2)
  - ITAA 1936 124ZAM(3)
  - ITAA 1936 124ZAO(2)
  - ITAA 1936 124ZAO(3)
  - ITAA 1936 Part IVA
  - ITAA 1936 177A
  - ITAA 1936 177C
  - ITAA 1936 177D
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  - TAA 1953 8AAG
  - ITAA 1997 8-1
  - ITAA 1997 17-5
  - ITAA 1997 Div 27
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