



PR 1998/2 - Income tax: consequences for investors in the proposed animated feature film 'The Magic Pudding'

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 This document has changed over time. This is a consolidated version of the ruling which was published on *28 October 1998*



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Income tax: tax consequences for investors in the proposed animated feature film 'The Magic Pudding'

other rulings on this topic

IT 2111; IT 2629

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Preamble

*The number, subject heading, and the **What this Product Ruling is about**, **Tax laws**, **Class of persons**, **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** and are legally binding on the Commissioner. Product Ruling PR 98/1 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.*

What this Product Ruling is about

1. This Ruling sets out the Commissioner's opinion on the way in which the 'tax laws' 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 'The Magic Pudding', 'the film', 'the project', or 'the product'.

Tax law

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

- Division 10BA of the *Income Tax Assessment Act 1936* (ITAA 1936);
- section 26AG;
- Part IVA;
- section 8-1 of the *Income Tax Assessment Act 1997*;

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

Class of persons

3. 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. They will have a purpose of staying 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).

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

Qualifications

5. The Ruling provides this specified class of persons with a binding ruling as to the tax consequences of the product. The Commissioner accepts no responsibility in relation to the commercial viability of the product. A financial (or other) adviser should be consulted for such information.

6. The Commissioner rules on the precise arrangement identified in the Ruling.

7. The class of persons defined in the Ruling may rely on its contents, provided the arrangement (described below at paragraph 13) is carried out in accordance with details described 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.

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addressed to the Manager, Legislative Services, AusInfo, GPO Box 1920, Canberra ACT 2601.

Date of effect

9. This Ruling applies prospectively from **28 October 1998**, 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).

10. 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

11. This Product Ruling is withdrawn on 1 July 2001 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 persons, even following its withdrawal, for arrangements entered into 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

12. 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:

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- Application for a product ruling dated 14 September 1998, received from KPMG on behalf of Energee Entertainment Pty Ltd.
- Correspondence from KPMG dated 29 September 1998, 8 October 1998 and 14 October 1998 which clarifies and amends the application for a Product Ruling.

13. The details of the arrangement are summarised as follows.

The Project

- The project involves the production of an Australian animated feature film to be titled 'The Magic Pudding' ('the film'). The film will be based on the characters and concept of the 'The Magic Pudding' written by Norman Lindsay in 1918.
- Provisional Certificate number PO5037 has been issued by the Department of Communication and the Arts on 15 April 1997 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, [as confirmed by a letter received from the Department of Communication and the Arts dated 25 May 1998](#).
- The planned completion date is 28 February 2000. This date is negotiable between the parties to the arrangement but will definitely be no later than 30 June 2001 in order to satisfy the two-year requirement in Division 10BA.
- The film will be produced for a total cost of \$11.735m to be raised from Australian resident investors.
- Minimum individual investment has been set at [\\$500,000](#).
- The investors will make capital contributions towards the production of the film, under a contract to be executed no later than 30 June 1999.
- The investors are expected to claim a deduction in their income tax returns for the year ended 30 June 1999 in respect of capital moneys expended by way of contribution to the film.
- The investors, in their income tax returns for subsequent years, are also expected to include as income distributions

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received from the film, and to claim as deductions interest expenditure incurred in respect of loans taken out for the purpose of investing in the film.

The participants

- Mr David Alan Sharp of Greenwood Challoner and Mr Adrian Howard Abbott of Abbotts Accountants Advisory P/L jointly will act as 'the investors' representative'.
- The Magic Pudding Ltd (ACN: 082 684 071) will act as 'the manager' of the film. This company was incorporated on 19 May 1998 for the specific purpose of raising funds for the production of the film.
- Energee Entertainment Pty Ltd (ACN: 003 916 523) will act as 'the producer' of the film. The film will be made at the company's studio at Artarmon.
- Energee Distribution Pty Ltd (ACN: 082 701 808) will act as 'the head distributor' of the film. It was incorporated on 20 May 1998 and is a 100% subsidiary of Energee Entertainment Pty Ltd. It is also involved in other animated productions including 'Clutch Cargo'.
- The Magic Pudding Ltd, Energee Entertainment Pty Ltd and Energee Distribution Pty Ltd have [some directors in common](#).
- Sub-distribution rights [have been or are expected](#) to be granted to Ravensburger GmbH, LUK International SA, Beyond International, the Australian Broadcasting Commission and Showtime ('the sub-distributors') in consideration for payment of certain distribution advances and pre-sale amounts subsequent and conditional upon delivery of the film.

Financing arrangements

- The investors will deposit by 30 June 1999 with the investors' representative a total of [between \\$9.385m and \\$11.735m](#) being their contribution to the cost of producing the film ('the investors contributions'). [An entity within the Energee Group will contribute the balance of the \\$11.735m budget, if necessary.](#)
- The investors' representative, at the direction of the manager, will make progress payments to the producer in

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accordance with an agreed 'draw-down schedule'. The total of the payments will be \$11.735m.

- The \$11.735m in progress payments will be used by the producer to produce the film in accordance with a stipulated 'budget' that has been prepared in accordance with standard industry format.
- Inclusive in the \$11.735m, is the producer's profit margin of \$2.35m (25% of the total budget). The producer warrants that the margin charged for this project is reasonable in comparison to other similar projects.
- The producer will distribute back to investors any 'underages' resulting from the production of the film to the extent that these amounts cannot be productively spent on the film itself. The producer will also maintain separate details of any such amounts and their ultimate application.
- The producer will use the \$2.35m profit to purchase shares in the head distributor. These shares will be issued at market value.
- The head distributor will contract with the investors, [through the investors' representative](#), to secure the distribution rights in the film. As consideration, the investors will be entitled to 'distribution advances' (also referred to as 'pre-sale amounts' totalling \$4.7m. These amounts will be contingent upon delivery of the film by 28 February 2000 by the producer to the head distributor.
- The head distributor will place on deposit with St George Bank, for a fixed period of three years, the \$2.35m received from the producer. [The head distributor will not be able to withdraw unilaterally the deposit until 30 October 2001.](#) The purpose of this deposit is to give assurance to the investors that the head distributor will have funds to meet its obligation to pay the 'pre-sale amounts'.
- The deposit with St George Bank will be on the strict condition that access to the deposit will not be available to either the investors, the investors' representative or St George Bank. [On 30 October 2001, subject to the delivery of the film before that date,](#) the head distributor may direct payment of its 'pre-sale' commitment from this deposit and any accumulated interest.

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- The head distributor may also assign letters of guarantee obtained in respect of the pre-sale commitments made by the sub-distributors to St George Bank to give further assurance to investors that the head distributor will have sufficient funds to meet its obligation to pay pre-sale amounts following delivery of the film.
- Some of the investors' contributions will be funded by way of finance from St George Bank. To the extent to which investors do not borrow from St George Bank, the quantum of the security held by St George Bank in support of the pre-sale obligation of the head distributor will be reduced proportionately.
- All loans from St George Bank will be strictly on a **full recourse basis**, meaning that the borrower is personally liable in respect of the full amount of the loan, irrespective of the performance of the film or investment.
- St George Bank has offered to lend the investors up to \$4.7m on the basis of the deposit to be made by the head distributor and assignment of the letters of guarantee obtained in respect of the pre-sale commitments of the sub-distributors.
- St George Bank may also lend the investors up to \$7.035m (the balance of \$11.735m) on the basis of personal security provided by the investors.
- The investors will be at liberty to choose how best to fund their investment in the film and may do so with their own cash, a combination of cash and finance, or 100% finance.

Ruling

14. Subject to the assumptions listed in the **Explanations** part of this Ruling:

- (a) For the year ended 30 June 1999, a deduction is available to the investors under Division 10BA of the ITAA 1936 for capital moneys expended by way of contribution to the cost of producing 'The Magic Pudding'.
- (b) Distribution advances, pre-sale amounts, or any other amounts payable to the investors for the exploitation of their interest in the copyright and rights attached thereof will be assessable to the investors as film income under section 26AG upon receipt.

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- (c) Interest incurred in respect of funds borrowed by the investors to make their contributions will be deductible to the investors under section 8-1 of the ITAA 1997, but only to the extent of film income which is received (subsection 124ZAO(2) of the ITAA 1936). Any excess interest may be carried forward indefinitely for offset against future film income (subsection 124ZAO(3)).
- (d) The anti-avoidance provisions in Part IVA will not be applied to deny deductibility or to accelerate assessability of the above amounts.

Explanations

Assumptions

15. This Ruling is made on the basis of the following necessary assumptions:

- (a) The investment moneys will be paid to the producer 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 1999. 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)).
- (b) All of the investors are Australian residents (subparagraph 124ZAFA(1)(b)(i)).
- (c) 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)).
- (d) All requirements of the Department of Communication and the Arts will be met and a final certificate will be issued.
- (e) Each investor will become one of the first owners of the copyright in the film (subparagraph 124ZAFA(1)(c)(i)).
- (f) It is the intention of the investors that the copyright in the film will be used for the purpose of producing assessable income from granting rights to exhibit the film to the public in cinemas or by way of television broadcasting

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(subparagraph 124ZAF(1)(c)(ii)). [The investors will also be entitled to a share of the profits derived from licensing the other ancillary rights.](#)

- (g) A declaration will be lodged with the Commissioner of Taxation by an 'appropriate person' within one month after the end of the financial year in which the contributions are first made (subparagraph 124ZAF(1)(d)(iii)).
- (h) 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)).
- (i) 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)). In this respect, the producer will distribute any underages resulting from production of the film back to investors to the extent that the underages cannot be productively spent on the direct costs of production of the film. The underages, if any, will not be spent on marketing the film.
- (j) 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 under the **Arrangement** part of this Ruling.

The 'directly expended' requirement

16. Subsection 124ZA(6) requires that capital moneys 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 in respect of them.

17. Paragraph 8 of Taxation Ruling IT 2111 discusses this requirement. It states:

'Direct expenses of a film production which qualify for deduction under section 124ZAF can generally be described as **those relating to the production process** as distinct from those associated with the 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 producers, directors and cast, and the costs of insurance of production associated risks, drawing up**

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performers' contracts and the building of sets and scenery'
[emphasis added].

18. Our view is that the 'directly expended' requirement is **not** met at the point in time when the investors, through the investors' representative, make payments to the producer in respect of the budget for the film. Rather, the extent of the application of these moneys by the producer to elements of production will ultimately determine the portion of the investors' contributions which meets this requirement. Generally, this will not be known until after the completion of the film.

19. In determining the amount that is 'directly expended' on production of the film, we will also consider the ultimate application of any funds obtained by the producer as 'underage'. In this regard, the producer of 'The Magic Pudding' has agreed to distribute any underages resulting from production of the film back to investors to the extent that the underages cannot be productively spent on the direct costs of production of the film, and will not expend any such moneys on marketing of the film.

20. Quantification of the amount of moneys directly expended on the production of a film, and consequently the deduction available under Division 10BA, can only be determined after the 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 contributions account that is held by the investors' representative (known as an audit of the 'film fund') is considered as inadequate in this regard.

21. Accordingly, while a deduction should be available in respect of contributions made by investors under the contract to be entered into on or before the end of the financial year in which the capital moneys are to be expended, being 30 June 1999, the deduction will be withdrawn with retrospective effect if the amounts contributed are not directly expended on the film.

The 'at risk' rule

22. 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 his capital outlay on the production of the film. Subsection 124ZAM(2) specifies that the amount of risk is the amount of loss that, in the Commissioner's opinion, would be suffered by reason of the taxpayer's capital outlay were no income to be derived from the film.

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

24. The financial arrangements to be used for the 'Magic Pudding' include two features that may suggest the possible application of subsection 124ZAM(3) to deny a portion of the deductions sought. The first is that the pre-sale arrangement could be seen as effectively reducing the risk to the investors in respect of \$4.7m of their contributions, as the investors are assured of receiving an equivalent sum on delivery of the film irrespective of the performance of the film.

25. The second is that St George Bank has agreed to lend the investors up to \$4.7m on the basis of the deposit [and letters of guarantee to be lodged by the head distributor with St George Bank](#). [This part of the arrangement could be regarded](#) as a mechanism by the head distributor to place the investors in funds to enable them to make their contributions to the film. For the purposes of subsection 124ZAM(3) it is sufficient that placing the investors in funds is only one of the purposes of a pre-sale arrangement.

26. However, in our view, neither of these elements should be seen as attracting the operation of subsection 124ZAM(3) in this case. The terms of the deposit to be placed with St George Bank prevent the investor and/or the Bank from accessing the deposit, should payments under the pre-sale agreements not be made. [The same terms are understood to apply in respect of the letters of guarantee](#). As such, the risk for an investor should non-payment under the pre-sale agreements occur would still be present.

27. Also, the loans to the investors will be made on a full recourse basis and, accordingly, the investors will be personally liable for the full amount of the loan irrespective of whether they receive any income from the film by way of pre-sale or otherwise.

28. Accordingly, we consider that subsection 124ZAM(3) does not apply to the \$4.7m portion of the investors' contributions. Nor would any aspects of the arrangement trigger the operation of the 'at-risk' rule in relation to the balance of the investors' contributions.

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Part IVA

29. Provided that the arrangement of 'The Magic Pudding' is carried out as disclosed (see the **Arrangement** part of this Ruling), it would be accepted as a normal commercial transaction and Part IVA would not apply.

Commissioner of Taxation

28 October 1998

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		- ITAA36 124ZAF(1)(d)(iv)
ATO references		- ITAA36 124ZAF(2)
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subject references

- Australian films
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- interest expenses
- Product Rulings
- Public Rulings
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legislative references

- ITAA36 10BA
- ITAA36 26AG
- ITAA36 124ZAA
- ITAA36 124ZAA(6)
- ITAA36 124ZAB
- ITAA36 124ZAB(10)
- ITAA36 124ZAC
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