



PR 2003/18 - Income tax: Film Investment - 'The Backstreet General'

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 This document has changed over time. This is a consolidated version of the ruling which was published on *30 April 2003*

Product Ruling

Income tax: Film Investment – ‘The Backstreet General’

Contents	Para
What this Product Ruling is about	1
Date of effect	11
Withdrawal	13
Arrangement	14
Ruling	45
Assumptions	53
Explanations	54
Detailed contents list	75

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.

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 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

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 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 Backstreet General', 'the Film' or '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 124ZAG (ITAA 1936);
 - Section 124ZAO (ITAA 1936);
 - Division 5 of Part III (ITAA 1936);
 - Section 995-1 of the *Income Tax Assessment Act 1997* (ITAA 1997);
 - Section 26AG (ITAA 1936);
 - Section 17-5 ('ITAA 1997'); and
 - Part IVA (ITAA 1936).

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'). A person or 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.

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. 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 term expires), and deriving assessable income from this involvement as a result (as set out in the description of the arrangement. In this Ruling, each of the persons, referred to as 'Investors', will be wholesale clients for the purposes of the *Corporations Act. 2001*.

8. 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

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.

10. A Product Ruling may only be reproduced in its entirety. Extracts may not be reproduced. As each Product Ruling is copyright, apart from any use as permitted under the *Copyright Act 1968*, no Product Ruling may be reproduced by any process without prior written permission from the Commonwealth. Requests and inquiries concerning reproduction and rights should be addressed to:

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Department of Communications, Information Technology and the Arts
GPO Box 2154
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Date of effect

11. This Ruling applies prospectively from 30 April 2003, 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 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

13. This Product Ruling is withdrawn on 30 June 2005 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 the persons' involvement in the arrangement.

Arrangement

14. 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:

- Application for a Product Ruling as constituted by documents provided on 25 November 2002, 23 December 2002, 19 March 2003 and 4 and 11 April 2003 and additional correspondence dated 21 November 2002, 19 December 2002, 26 February 2003 and 4, 11 and 15 April 2003;
- Correspondence from the ATO to the Applicant dated 5 and 12 December 2002, 31 January 2003 and 14 April 2003;
- Budget Summary for the Film ‘The Backstreet General’, received by the ATO on 23 December 2002;
- Provisional Certificate under section 124ZAB dated 17 February 1989, received by the ATO on 23 December 2002;
- Draft Production and Investment Deed between 3 Spears Pty Limited (the Production Company), Intertropic Pty Limited (the Australasian Head Distributor), G.J. Hartigan & Co (the Representative) and the Investors received by the ATO on 11 April 2003;
- Draft Distribution Agreement between Modern Entertainment, Ltd. (the International Distributor) and 3 Spears Pty Limited, received by the ATO on 4 April 2003;
- Draft Information Memorandum received by the ATO on 23 December 2002; and
- The Constitution of 3 Spears Pty Limited dated 15 December 2000 and received by the ATO on 23 December 2002.

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 as defined in section 761G of the Corporations Act 2001, as explained in paragraphs 40 to 44 below. **This Ruling does not apply unless an Investor is a wholesale client.**

The Participants

16. The following entities are participants in the project:
- G. J. Hartigan & Co will act as the Investors' Representative (the Representative);
 - 3 Spears Pty Limited (3 Spears) will act as 'the Production Company' of the film. The film will be made exclusively in Australia. There will be no manager of the Film other than 3 Spears;
 - The Investors will licence their interest in the copyright to 3 Spears and Intertropic Pty Limited (Intertropic);
 - 3 Spears will license Modern Entertainment, Ltd. (Modern) to act as distributor of the film worldwide except for Australasia; and
 - Intertropic, which has the same shareholders and directors as 3 Spears, will distribute the film in Australasia.

The Project

17. The Project involves the production of an Australian feature film to be titled 'The Backstreet General' ('the Film').

18. Provisional Certificate number P3138, dated 17 February 1989, has been issued by the Department of the Arts, Sport, the Environment, Tourism and Territories in respect of the Film to Phillip Avalon. 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 is negotiable between the parties to the arrangement, however it will be completed within 24 months after the end of the financial year in which capital moneys were first expended in producing, or by way of contribution to the cost of producing, the Film.

20. The Film will be produced for a total cost of \$5.489 million to be raised from Australian resident investors. The Investors will make capital contributions towards the production of the Film under a contract to be executed no later than 30 June 2004. There is no minimum subscription and in the event the Film is not fully subscribed, by 30 June 2004, all funds will be returned to Investors.

21. Only wholesale investors will be eligible to invest in the Film and the Project will not require a prospectus or product disclosure statement for the purposes of the Corporations Act.

Accession Deed

22. The Accession Deed is between the Investor, 3 Spears as the Production Company, Intertropic as the Australasian Head Distributor and G. J. Hartigan & Co as the Representative.

23. Under clauses 2(a) to (c) an Investor will pay their investment into the Production Account and will be entitled to a share of Copyright in the Film. The Investors share of the Copyright is in accordance with Item 2 of the Schedule and clause 3 of the Production and Investment Deed as follows:

3 Spears	50%	
Investors	50% x	$\frac{\text{the Investors investment}}{\text{the total of all Investor investments}}$

24. At clause 2(d) the Investor grants an exclusive licence of the Investor's interest in the Copyright of the Film to 3 Spears and will be entitled to receive a share of the Australasian Gross Receipts and the Ex Australasian Gross Receipts as outlined in paragraphs 29 and 30 below.

25. The Investor irrevocably and exclusively appoints G. J. Hartigan & Co, or its nominee, to solely represent them in all dealings with 3 Spears in relation to the Film and to solely exercise on behalf of the Investor all rights of approval and consent of the Investor under the Production and Investment Deed and otherwise as is provided in the Production and Investment Deed (clause 2(f)).

Production and Investment Deed

26. The Production and Investment Deed is between 3 Spears (the Production Company), Intertropic (the Australasian Head Distributor) and G. J. Hartigan & Co on behalf of the Investors.

27. Each Investor contributes their investment as a portion of the Budget before 30 June 2004 (clause 7). Each Investment is paid into a

Production Account solely under the control of 3 Spears (clauses 7, 8 and Schedule Item 2). Under clause 8.3, 3 Spears must arrange for payment out of its own funds any costs not included in the Budget which are not production costs under Division 10BA, and such costs may not be paid from the Production Account.

28. Within 30 days after the completion date of the Film, 3 Spears is to establish the Ex Australasian Collections Account and Intertropic is to establish the Australasian Collections Account (paragraphs 8.1(b) & (c)).

29. At clause 1.1, the Ex Australasian Gross Receipts means all money resulting from marketing for viewing outside Australasia and actually received by 3 Spears by the Expiry Date (see paragraph 31). Under clause 10.4 the Ex Australasian Gross Receipts received by 3 Spears are to be distributed in accordance with Part A Schedule 4 in the following order:

- 1st 1% of Gross Receipts to be paid to the Representative as its fee;
- 2nd to the Investors pro rata and pari passu until each has received 120% of the net amount they have invested in the Film;
- 3rd to 3 Spears for the amount of Overages paid or borrowed by 3 Spears for Overages including any interest on loans;
- 4th to the Completion Guarantor to repay any moneys provided by the Completion Guarantor in relation to the Film;
- 5th
 - (a) to 3 Spears 50%;
 - (b) to the Investors 50%, and to each Investor pari passu and pro rata that their Investment bears to the total of all Investments; and
- 6th after the Expiry Date, all Ex Australasian Gross Receipts are payable to 3 Spears.

30. At clause 1.1, the Australasian Gross Receipts means all money resulting from marketing for viewing inside Australasia and actually received by Intertropic (or any distributor appointed in its place) by the Expiry Date. Under clause 10.5 the Australasian Gross Receipts received by Intertropic are to be distributed in accordance with Part A Schedule 4 in the following order:

- 1st 10% to Intertropic;
- 2nd in payment or reimbursement of all Australasian Marketing Expenses, and repayment of loans to meet same and all interest thereon;
- 3rd 1% to the Representative as its fee;
- 4th to the Investors pro rata and pari passu until each has received 120% of the net amount they have invested in the Film;
- 5th to 3 Spears for the amount of Overages paid or borrowed by 3 Spears for Overages;
- 6th to the Completion Guarantor to repay any moneys provided by the Completion Guarantor in relation to the Film;
- 7th
 - (a) to 3 Spears 50%;
 - (b) to the Investors 50% that is to each Investor pari passu and pro rata that their investment bears to the total of all investments; and
- 8th after the Expiry Date, all Australasian Gross Receipts are payable to Intertropic which shall first deduct therefrom all moneys payable under the first two dot points in this paragraph above and next pay the balance to 3 Spears.

Note the amounts distributed 4th, 5th and 6th above are only payable to the extent they have not been distributed at 2nd, 3rd and 4th in paragraph 29, and vice versa.

31. All the Investor's right, title and interest in the Film ceases on 30 June in the year immediately following the date of seven (7) years after the completion of the Film (Expiry Date).

Australasian Distribution

32. The Film will be distributed in Australasia by Intertropic. Under clause 9.2(a) of the Production and Investment Deed each Investor grants Intertropic an exclusive licence to market the Film in Australasia for their interest in the Australasian Underlying Rights and the Australasian Copyright. Intertropic is entitled to a 10% fee and the payment or reimbursement of expenses as outlined in paragraph 30 above.

Distribution Agreement

33. 3 Spears will enter into the Distribution Agreement with Modern for the licensing of all rights in the Film for eleven (11) years from the delivery of the Film. In accordance with clause 7 Modern will be entitled to a distribution fee equal to 10% of Gross Receipts plus distribution expenses. 3 Spears shall be consulted on distribution expenses up to US\$10,000 and shall have approval rights for distribution expenses in excess of US\$10,000. 3 Spears will be entitled to 100% of the remainder of Gross Receipts which Modern will be required to pay into the Ex Australasian Collections Account.

34. At clause 8(vi) 3 Spears warrants that any person entitled to participate in revenues from the Film shall be paid solely by 3 Spears and they shall have no right to payment or accounting from Modern. At clause 8(viii) 3 Spears agrees the Copyright in the Film will be registered in 3 Spear's name in the United States throughout the term of the Distribution Agreement.

Financing Arrangements

35. The Investors will deposit by 30 June 2004 with the Representative a total of \$5.489 million being their contribution to the cost of producing the Film ('the investors' contributions').

36. The Representative will pay all the investors' contributions into the Production Account of the Film once investors' contributions of \$5.489 million have been received by the Representative.

37. The \$5.489 million will be used by 3 Spears to produce the film in accordance with a stipulated budget that has been prepared in accordance with standard industry format.

38. The entire \$5.489 million must be expended so that there are no budget 'underages'.

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

- there are split loan features of the type referred to in Taxation Ruling TR 98/22;
- 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 a borrower's risk;

- the funding arrangements transform the Project into a 'scheme' to which Part IVA may apply;
- 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.

Corporations Act 2001

40. 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. Offers to wholesale clients do not require a prospectus or product disclosure statement.

41. A person will be a wholesale client where the persons satisfies one of the following tests:

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

42. 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.

43. 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.

44. 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.

Ruling

Division 10BA

45. A deduction is available to an Investor in the Film under Division 10BA for 98.6% of the amount contributed to the cost of producing the Film. For example, for each \$100,000 contribution to the cost of producing the Film, a deduction of \$98,600 will be allowed as a deduction.

46. A deduction is not available until the production budget of \$5.489 million has been achieved and the Investor has entered into the Accession Deed and the Production and Investment Deed. The Representative will advise Investors of the date this occurs.

47. 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.

48. Interest in respect of 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, as per subsection 124ZAO(2). Any excess interest and revenue outgoings may be carried forward indefinitely and offset against future film income, as per subsection 124ZAO(3). Deductions may also be withdrawn by the ATO where moneys, which are specified to be spent on Film production items in the budget, are in fact spent on non-production activities.

49. The deductibility or otherwise of interest arising on funds borrowed from financiers is outside the scope of this Ruling.

Assessable Income

50. The Investors who acquire Copyright 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) as they will be in receipt of income jointly from the commercial exploitation of their Copyright interest. The licence fees received by a Partnership in respect of the Australian Film, less any GST on those licence fees, are assessable income of the Partnership under section 26AG of the ITAA 1936 in the income year in which they are received from 3 Spears and Intertropic. 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.

51. Section 17-5 of the ITAA 1997 excludes from assessable income an amount relating to GST payable on a taxable supply.

Part IVA

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

Assumptions

53. 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 2003 or 30 June 2004. 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 final certificates 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 2005 where investments are accepted on or before 30 June 2003 or 1 July 2006 where investments are accepted after 30 June 2003 and on or before 30 June 2004;
- (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) 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; and
- (o) non-deductible expenditure in relation to administrative items associated with the Film in respect of Division 10BA, not allowed for in the Film budget, will be paid by the Production Company from its own funds.

Explanations

Division 10BA

The 'directly expended' requirement

54. 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.

55. 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 124ZAFA 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).

56. Our view is that the 'directly expended' requirement is not met at the point in time when the Investors make payments to 3 Spears in respect of the budget for the Film. Rather, the extent of the application of the money by 3 Spears 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.

57. The Investors will pay the application money to 3 Spears for application towards the production costs. In doing this, 3 Spears is to ensure that funds contributed by Investors are only expended on items within the film production budget, with non-deductible expenditure to be met by 3 Spears from its own funds.

58. 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 3 Spears as 'underage'. In this regard, 3 Spears has agreed any underage will be expended on the production of the Film in a manner that will preserve the status of the Film as a Qualifying Australian Film.

59. 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

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

60. 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

61. 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).

62. 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.’

63. 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.

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

Non-arm's length transactions

65. 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.

66. 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.

67. 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 2004, 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

68. 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)).

Assessable Income

69. The Investors in The Backstreet General 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). The licence fees received by a Partnership of Investors in a Film, less any GST payable on those licence fees, will be assessable income of the Investors under section 26AG in the income year in which they are received from the Representative. 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.

70. Section 17-5 of the ITAA 1997 excludes from assessable income an amount relating to GST payable on a taxable supply.

Part IVA

71. 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.

72. 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

73. 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.

74. 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.

Detailed contents list

75. Below is a detailed contents list for this Product Ruling:

	Paragraph
What this Product Ruling is about	1
Tax law(s)	2
Goods and Services Tax	3
Business Tax Reform	4
Note to promoters and advisers	6
Class of persons	7
Qualifications	9
Date of effect	11
Withdrawal	13
Arrangement	14
The Participants	16
The Project	17
Accession Deed	22
Production and Investment Deed	26
Australasian Distribution	32

Distribution Agreement	33
Financing Arrangements	35
Corporations Act 2001	40
Ruling	45
Division 10BA	45
Assessable Income	50
Part IVA	52
Assumptions	53
Explanations	54
Division 10BA	54
<i>The 'directly expended' requirement</i>	54
<i>The 'at risk' rule</i>	61
<i>Non-arm's length transactions</i>	65
<i>Interest on borrowed funds</i>	68
Assessable Income	69
Part IVA	71
Payment of interest by an Investor where an assessment is amended	73
Detailed contents list	75

Commissioner of Taxation

30 April 2003

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*Legislative references:**Related Rulings/Determinations:*

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

Subject references:

- Australian films
- film income
- film industry
- interest expenses
- Product Rulings
- Public Rulings
- tax avoidance

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- ITAA 1936 26AG(9)
- ITAA 1936 Div 5 of Pt III
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