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20 March 2024

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Dear Mr Wilson,

Draft Taxation Ruling TR 2024/D1 Income tax: royalties - character of payments in respect of software and intellectual property rights

The Corporate Tax Association (**CTA**) welcomes the opportunity to make a submission to the Australian Taxation Office (**ATO**) in relation to draft *Taxation Ruling TR 2024/D1 Income tax: royalties - character of payments in respect of software and intellectual property rights* (**Draft Ruling**).

The CTA is the key representative body representing over 150 major companies in Australia on tax issues impacting the large corporate sector. Further information about the CTA can be found on our website at www.corptax.com.au.

General

A significant amount of work has been done on the Draft Ruling since its first iteration in 2021 as draft Taxation Ruling TR 2021/D4. We acknowledge the significant effort the ATO has made to address numerous issues raised in the 2021 draft.

However, we observe that the Draft Ruling is still very broadly drafted which raises concerns that it is likely to have unintended consequences and cover arrangements that should not otherwise be covered in the scope of royalty taxation. In its current form, the Draft Ruling potentially also captures arrangements where Australian businesses obtain software licences from offshore suppliers for use in Australia only. Offshore suppliers will likely insist on a gross-up for any withholding tax required on any payment deemed a royalty under the Draft Ruling. In turn, Australian businesses may have to permanently pass on the withholding tax cost to Australian consumers which will be unwelcome in the current economic environment.

If the ATO's current unilateral view is not revised, there is an increased likelihood that Australian distributors will relocate offshore, there will be an increase in the cost of software and related services for consumers in Australia, and there will be limitations on access to valuable technical intellectual property (**IP**) to Australian industry.

The focus of the Draft Ruling is "on payments for the use of, or right to use, copyright or other like property or right" (paragraph 3 of the Draft Ruling) in respect of software as well as payments for the use of, or right to use, other IP rights, covering items that otherwise fall within the definition of a 'royalty'. In this regard, our comments are focused on ensuring the Draft Ruling only applies in the correct circumstances.

Comments on specific aspects of the Draft Ruling are set out below.

Specific Comments

1. Cross-border payments subject to the Draft Ruling

It is unclear what is meant by the terminology "by an Australian resident, or a non-resident, which is related to or connected with a permanent establishment in Australia" in paragraph 8. It is unclear if this is intended to refer to a payment that is related to or connected with a permanent establishment in Australia or a non-resident that is related to or connected with a permanent establishment in Australia. Is it intended to capture payments made by a non-resident that are related to or connected with a permanent establishment a non-resident has in Australia? Clarification is needed.

2. 'Software arrangement' and Definition of 'distributor'

We understand the revised Draft Ruling is intended to target 'distributors' of software, including software as a service (**SaaS**) – i.e., those who are acting as distributors/intermediaries between the copyright owner and the end-user. However, the definition of 'distributor' in the Draft Ruling is currently drafted very broadly.

We recommend that the definition of 'distributor' is updated to specifically exclude end-users who are using software for the carrying on of their usual business (i.e. not as part of a software distribution business) especially since historical guidance covering end-user usage under TR 93/12 stands withdrawn as of 1 July 2021[1]. This would be consistent with the ATO response provided as part of the Compendium to TR 2021/D4:

> The revised draft Ruling contains the ATO view on the characterisation of payments made under a 'software arrangement', being an arrangement or scheme under which a distributor makes the payment directly or indirectly to the owner or licensee of the IP. The rights granted or used by a distributor are not necessarily the same as those granted or use by an end-user. **The revised draft Ruling does not cover the character of payments made directly from an end-user to the owner or licensee of the IP, or**

[1] TR 93/12 Income tax: computer software - Notice of Withdrawal

> **payments to a distributor acting as agent for the owner or licensee of the IP[2]. [Emphasis added]**

The current drafting of the definition of 'distributor' could inadvertently capture an entity in a corporate group that obtains a software licence on behalf of that group and the group is merely using the software as end-users as part of their ordinary business activities (i.e. not as part of a software distribution business). It should be made clear in the Draft Ruling that the definition of a 'distributor' does not include an entity in a corporate group in this circumstance. Consequently, the ATO should ensure that the definitions used for a number of copyright concepts, such as 'reproduction right' and 'authorisation right' do not inadvertently give rise to the same issue.

Including a specific exclusion for end-users in the Draft Ruling will provide certainty for most businesses who make payments for the use of software as end-users as part of their ordinary business activities that those payments do not fall within the ambit of the Draft Ruling.

3. Reinstating the concept of 'simple use' of copyright

Payment for the incidental or de minimis use of copyright (whether the end-user is a customer or a distributor), where that payment is necessary to facilitate the use of software as a functional product, should not be considered a royalty. Notwithstanding the primary focus of the Draft Ruling is on distributors, the ATO should reinstate its previous position which was clearly set out in TR 2021/D4 (withdrawn) which states in paragraph 6(a) that:

> Consideration for the grant of a licence which **allows only the simple use of software**, that is, it allows the licensee or end-user to use the software for the purpose for which it was designed, but does not otherwise permit the end-user to use the copyright in the software (see Example 3 of this Ruling). **[Emphasis added]**

As the Draft Ruling currently stands, Australian companies no longer have certainty when they do acquire software for internal use entirely within Australia whether the payment will be deemed a royalty.

Previous ATO view – TR 2021/D4

The previous position of the ATO recognised certain incidental uses of the copyright did not give rise to a royalty. The ATO's changed view now considers most, if not all, incidental use including use of the software as opposed to the use of the copyright in the software itself to be royalty. The reasons for the ATO's changed view is not clear (if in fact it is a change of view). If there is a change of view, that needs explanation.

The previous position of the ATO with respect to 'simple use' is consistent with global business operating models and provides a commercial and practical approach to modern-day technology. The changed ATO view in the Draft Ruling is not.

[2] This is part of the ATO Response to Item 7 in the Compendium for TR 2021/D4 about 'Copyrighted articles'.

The previous position of the ATO also prevents arbitrary outcomes depending on whether the software is distributed on tangible media or downloaded electronically. Changes in the way the software is now being delivered/distributed does not change the role of the distributor or the reseller. Whether the software is delivered via tangible media or electronically, the distribution activities remain the same and the distributor/reseller continues to carry out such activities without doing anything that impacts the source code/copyrighted software. The downloading of software by way of tangible media (e.g. discs) is less common today but the fact that industry has moved to an online mode of delivering and downloading software should not change the tax outcome.

OECD Commentary

The ATO's reading of paragraph 14 of the OECD commentary[3] is extremely narrow and is without regard to the commercial reality of the transactions. It completely overlooks the fact that the OECD has already specifically dealt with digital downloads of software and other models of software delivery such as SaaS. Please refer to where the OECD commentary mentions copies being 'distributed electronically' as noted in the extract of paragraph 14.4 from the OECD commentary included in paragraph 65 of the Draft Ruling and also the historical context of how the commentary on this issue was developed. The OECD formed a Technical Advisory Group (**TAG**) which noted their recommended principles applied to existing and emerging transactions as required. The OECD included paragraphs 17.1 to 17.4[4] in an update to the commentary in 2003 accepting TAG's recommendations confirming that the OECD has addressed updated modes of software delivery in the commentary. Australia as a member of the OECD should respect the views the OECD has provided.

Reinstating the previous position of the ATO would align the Australian position with that set out in paragraph 14 of the OECD Commentary. The OECD commentary is clear that any minor or ancillary uses of copyright or other rights contained in the royalty definition do not determine the character of the payment. Specifically, copyright used by a distributor that is limited to that which is necessary to distribute copies of the software program should be ignored for the purposes of characterising the transaction. Australia in TR 93/12 (withdrawn) was an early adopter of this approach. Paragraph 14 of the OECD Commentary should not be read down in the manner as has been done in the Draft Ruling.

Alignment with Australia's treaty partners on the interpretation of the OECD commentary is both economically and commercially sound and necessary.

Under the ATO's view, Australian businesses will suffer a competitive disadvantage compared to other OECD countries as distributors will pass on the increased costs. The ATO's revised view is likely to increase tax disputes both domestically and with Australia's Treaty partners under Mutual Agreement Procedure (MAP) applications to resolve treaty interpretation issues arising from the Australian interpretation which is inconsistent with the OECD view for multinational entities that have foreign related parties and are able to access MAP. For Australian businesses that don't have foreign related parties, MAP is not an option and they

[3] Refer to paragraphs 61 – 70 of the Draft Ruling; link to OECD Commentary paragraph 14.
[4] Link to OECD commentary paragraphs 17.1 to 17.4

are unlikely to have enough negotiating power to negate the passing on of the increased costs from distributors.

4. ATO approach focused on 'acquiring' copyright rights not 'exploitation' of copyright

We query whether the ATO's focus on the acquisition of copyright rights rather than the exploitation of the copyright rights is appropriate particularly where the role of the distributor/reseller has not changed and only the way the software is now delivered has changed. The payment made by the distributor is for the cost of the software being sold or service being provisioned by the copyright owner and not to obtain and exercise an IP right.

The activities carried out by the distributor/reseller are distribution activities rather than the usage of the copyright held by the owner to generate business income. While the distribution activities may involve copyrighted software, facilitating and supporting the copyright owner to distribute the software is not 'using' the copyright in the software itself. The distributor/resellers are required to conduct business activities and interact with the end-users to generate income from distribution, but they do not exploit the copyright in the software for their benefit by conducting these business activities.

Here, the ATO's changed unilateral view is inconsistent with the global industry view and OECD guidance.

5. Meaning of 'sufficiently connected with' in relation to undissected amounts paid - when does the whole amount of the payment amount to a royalty where not all the things paid for are royalties

It would be useful if the ATO could clarify what is meant by 'sufficiently connected with' in paragraph 18. Paragraph 17, is about characterising a payment as a royalty where it is 'for' at least some things that fall within the definition of 'royalty'. Paragraph 19, talks about the possibility of apportionment for an amount that is paid for a bundle of items only some of which fall within the definition of 'royalty' considering the 'relevant facts and circumstances.'

Taking into account the context of paragraphs 17 and 19, it appears that paragraph 18 is trying to provide for the circumstance where the whole of the payment that is paid for a bundle of items only some of which fall within the definition of 'royalty' is treated as a royalty payment but in the ATO's view the payment cannot be dissected. Paragraph 18 treats the whole amount as a royalty in the first instance, but then goes on to say 'it does not necessarily follow that because an amount is paid as consideration for several things that it is paid only in part for each of them'. It seems to suggest that you can't divide the payment among the things for which it is paid which contradicts paragraph 17 which states that the payment is a royalty **to the extent** it is 'for' the things that fall within the definition of a 'royalty'.

Paragraph 18 then includes the example of IP rights granted that are inseparable from the other 'things' for which the consideration has been paid when viewed from a 'practical and business point of view'. Preventing the dissection of the sum when the things paid for are 'inseparable' logically follows. However, it also seems to suggest the sum should be prevented from being dissected for a bundle of things that are 'sufficiently connected with' each other.

Things being 'inseparable' from each other and things being 'sufficiently connected with' each other are two different concepts. The concept of 'inseparable' suggests the things **cannot** be separated whereas the concept of 'sufficiently connected with' suggests while the things are connected, they **could** be separated from each other. Where an undissected sum is paid for things that are sufficiently connected and could be separated from each other, it follows that the undissected sum could (and perhaps should) potentially be dissected and apportionment of the sum could apply. This is consistent with the concept of 'to the extent' in paragraph 17 and the apportionment provided for in paragraph 19, **both of which require the dissection of the sum.**

It seems the ATO is asserting a new test in paragraph 18 to require a sufficient connection rather than inseparability, of the bundle of things paid for with an undissected sum in an attempt to characterise the whole of the sum as a 'royalty' where only some of the things paid for meet the definition of 'royalty'. If that is the case, it does not appear any legislative or case law basis has been provided to substantiate this new test. Given the purpose of a taxation ruling is to express the ATO's interpretation[5], or opinion[6], of the laws it administers, the Draft Ruling should advise what legislation or case law substantiates this new test.

6. Meaning of 'fair and reasonable'

It would be useful for the body of the Draft Ruling to contain some explanation of what it means when apportionment of an amount paid for a royalty is done on a fair and reasonable basis. An explanation of this is contained in Scenario 3 at paragraphs 116 to 118 in Appendix 1, however it does not provide any rationale for why the ATO views that the majority of the consideration is attributable to the IP rights. Further, the Appendix does not form part of the Commissioner's 'ruling'; it forms part of the 'explanation'. Some additional practical guidance in the body of the final ruling would be useful. Additionally, an example similar to Scenario 3 should be added which explains the circumstances under which apportionment would be required, and a better factual statement as to how the apportionment shares are determined.

7. Scenarios included in the Ruling and Appendix 1

The three scenarios included in the Draft Ruling only set out situations where payments are considered royalties. Examples 3, 6, and 8 in the previous iteration, TR 2021/D4, provided useful scenarios that confirmed when payments would not be considered royalties. We understand that it is not the ATO's intention to depart from this position. As such, it would provide certainty to taxpayers if the Draft Ruling also included similar scenarios that clearly set out situations where a payment by an end-user would not be considered a royalty.

If the ATO has changed its view on any of these examples, it would be helpful to understand. As noted above, Example 3 in TR 2021/D4 (withdrawn) covered 'simple use' of software which is not dealt with in the Draft Ruling.

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[5] See the [ATO Website | Public rulings] which states "They express our interpretation of the laws we administer."

[6] See paragraph 4 of [TR 2006/10]

Application of the Finalised Ruling

The Draft Ruling fundamentally overturns the well-established view in TR 93/12 and recharacterises existing arrangements that have already been reported by taxpayers in their tax returns and other tax filings (such as country-by-country reporting, etc). Taxpayers cannot withhold amounts retrospectively from payments to offshore entities that will trigger royalty treatment under the Draft Ruling nor renegotiate historical transactions under a retrospective application of the ATO's changed view.

Significant uncertainty is also created due to the ATO's unilateral view being in direct conflict with the OECD view and global industry view. Taxpayers who have followed well-established principles and guidance at the time they undertook transactions that will be disturbed by a retrospective application of the Draft Ruling have no feasible way to comply with the Draft Ruling retrospectively.

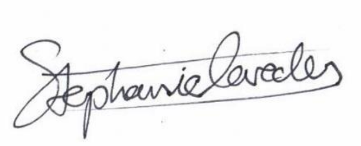
Given our concerns with the changed view that the ATO has taken in the Draft Ruling, we submit if the ruling is finalised, the finalised ruling should only apply prospectively.

Law Council of Australia submission

We also support the submission made by the Law Council of Australia dated 18 March 2024.

Should you have any questions, please do not hesitate to contact me on 0408 028 196 in the first instance.

Yours faithfully,



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