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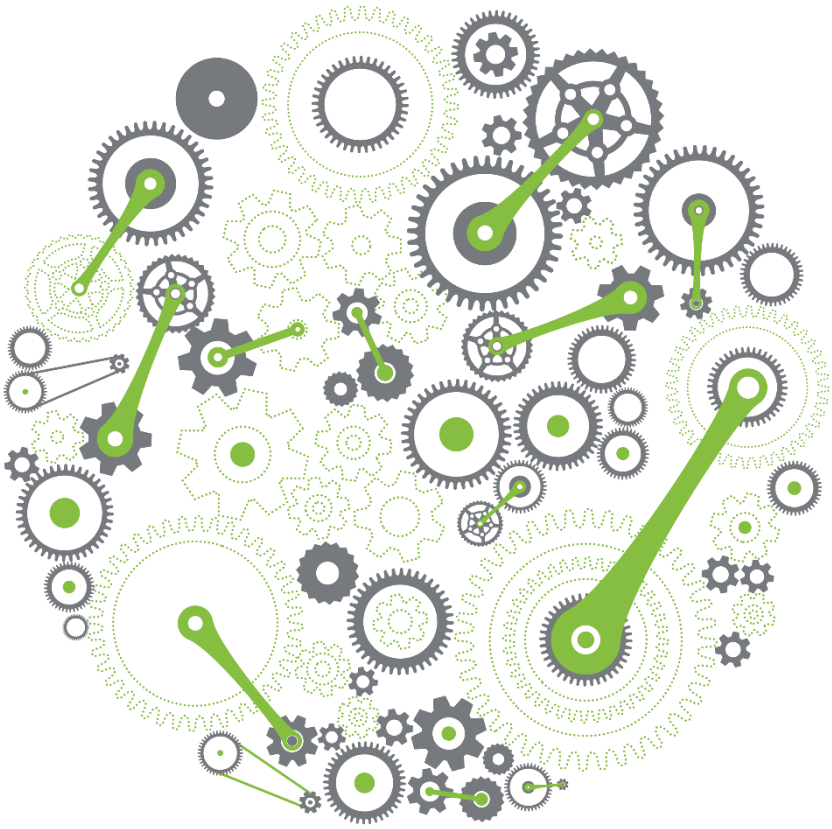

Tax Insights

Commissioner issues new draft ruling in respect of software distribution models

On 17 January 2024, the Commissioner of Taxation (the **Commissioner**) withdrew Draft Taxation Ruling TR 2021/D4 (**TR 2021/D4**) and replaced it with an updated draft for public consultation, TR 2024/D1, "Income tax – royalties – character of payments in respect of software and intellectual property rights" (**TR 2024/D1**).

The now withdrawn TR 2021/D4 was originally issued on 25 June 2021, and was widely seen as attempting to address methods of software distribution and use, whilst simultaneously expanding the scope of when payments for the licensing and distribution of software would constitute royalties. The revised TR 2024/D1 is expressed by the Commissioner as being drafted to alleviate concerns raised by industry stakeholders regarding TR 2021/D4, and to provide clarity in respect of:

- The interaction between the domestic and tax treaty definition of royalty;
- The interpretation and application of the Copyright Act 1968 (Cth) (**the Copyright Act**);
- Apportionment of payments; and
- The impact that TR 2024/D1 has on different software distribution models, including software-as-a-service (**SaaS**).

Taxpayers should also be aware that the structure of TR 2024/D1 has fundamentally changed when compared to TR 2021/D4.

Substantive changes to the new software ruling

Implementation of treaty analysis

Industry feedback on TR 2021/D4 highlighted that it focused solely on the domestic definition of "royalty" set out in section 6 of the *Income Tax Assessment Act 1936* (Cth) (**ITAA 1936**) and did not address the primacy of Australia's tax treaties over domestic law, nor the meaning of "royalty" in Australia's tax treaties or in the *OECD Model Tax Convention on Income and Capital (dated 21 November 2017)*.

The Commissioner has addressed this industry feedback in TR 2024/D1 by acknowledging at [11] and [52] that, where a tax treaty applies, then "the royalty definition in that tax treaty is given primacy over the domestic tax law definition of royalty". This is due to the operation of subsection 17A(5) of the *International Agreements Act 1953* (Cth), which operates to "turn off" an Australian taxpayer's obligation to withhold set out in s 128B(2B) ITAA 1936 in circumstances where a payment is a royalty for domestic tax purposes, but *is not* a royalty for tax treaty purposes.

This acknowledgment has necessarily led the Commissioner to set out his position on the tax treaty meaning of "royalty" and his interpretation of the OECD Commentary, a welcome improvement to TR 2021/D4.

Application of the Copyright Act

TR 2024/D1 includes a detailed analysis of the Copyright Act at Appendix 1- Part 2, noting that the tax treaty definition of "royalty" contemplates payments made for the "use of, or the right to use, any copyright" or like rights. The Commissioner utilises this analysis when forming his views in TR 2024/D1, whereas in contrast TR 2021/D4 relied upon a general assertion as to exploitation of exclusive rights of the copyright owner, without recourse to such detailed analysis.

The Commissioner expresses that the term "copyright" is a reference to any exclusive right of the copyright owner in a work to which Australian copyright law applies, and that the Copyright Act further defines the exclusive rights of a copyright owner to include the following acts (see [130]):

1. Reproducing the work in a material form;
2. Communicating the work to the public;
3. Making an adaptation of the work;
4. Entering into a commercial rental agreement; and
5. Authorising a person to do an act.

Notably, the Commissioner observes that the Copyright Act protects the right of copyright owners to "control access to a work by access control technological protection measures and provides legal remedies against the circumvention of such measures", and that many modern software arrangements involve the implementation of such measures (such as technical measures to protect against hacking). These protections under the Copyright Act are not rights to authorise access to computer program and relate only to acts done in Australia.

The Commissioner provides reasoning for distinguishing OECD Commentary on Article 12, which suggests that payments for the supply of software will only be royalties where the rights to reproduce and modify the software are granted as there may be additional rights granted to the distributor to facilitate the supply of the software. This is likely intended to capture the right to enter into a commercial rental agreement, authorising communication of the work or other like rights.

Apportionment of payments

TR 2024/D1 is consistent with TR 2021/D4 in that it acknowledges that apportionment is required and appropriate to ascertain the extent to which a payment is a royalty. Again consistent with TR 2021/D4, the Commissioner states that apportionment should be done on a "fair and reasonable basis". Unfortunately, TR 2024/D1 does not improve on its predecessor by providing examples or methodologies that the Commissioner may consider to be "fair and reasonable" in most circumstances.

Concerningly, the Commissioner has expressed a new view in TR 2024/D1 at [18] and at [107], being that the Commissioner does not accept that a payment for multiple "things" (i.e., IP rights and other, non-IP rights) necessarily results in that payment being paid, in part, for each of those things equally or in some proportion. In other words, the Commissioner is of the view that an amount that is paid for multiple things may not necessarily warrant apportionment if those things (being both royalty and non-royalty items) are, from a practical and business point of view, inseparable, as follows (emphasis added):

> 107…*For instance, where a payment is principally for the grant of IP rights and the other rights granted are ancillary or incidental, the consideration is properly characterised as being entirely for the grant of IP rights. To illustrate this point, if the software arrangement has no value or substance without the use of IP rights,* ***then all the payments under the arrangements will be royalties.***

The Commissioner provides "Scenario 3" at [116]-[118] in illustration of when apportionment may be appropriate.

Categorisation of payments

Broadly, the Commissioner's view in TR 2021/D4 was that if a payment from a payer (**Entity A**) to a copyright owner (**Entity B**) enables Entity A to do something that is the exclusive right of Entity B, then that payment is a royalty for Australian domestic tax purposes (pursuant to section 6 of the ITAA 1936). This position remains unchanged and is reliant upon the Commissioner's analysis of the Copyright Act in Part 2.

In TR 2021/D4, the Commissioner expressed that there were three categories of payments that fell within the domestic meaning of "royalty" pursuant to subsection 6(1) of the ITAA 1936. In TR 2024/D1, the Commissioner expresses the view that five categories of payments are appropriately characterised as royalties for both domestic and tax treaty purposes (see [14] of TR 2024/D1). A table comparing the Commissioner's position under TR 2021/D4 and revised TR 2024/D1 is set out below (summarised):

Revised TR 2024/D1	Equivalent position in now withdrawn TR 2021/D4
(a) Payments for the grant of a right to use IP, regardless of whether that right is exercised	
(b) Payments for the use of an IP right. Consistent with TR 2021/D4, the Commissioner provides an example involving payment for the use of copyright that "consists of doing an act in respect of a copyright work that is the exclusive right of copyright holder"	(a) Consideration for the grant of a right to do something in relation to software that is the exclusive right of the owner of the copyright in the software…
(c) The supply of know-how in relation to certain IP rights	(b) Consideration for the supply of know-how in relation to software…
(d) The supply of assistance furnished as a means of enabling the application or enjoyment of the supply	(c) Consideration for the supply of assistance furnished as a means of enabling the application or enjoyment of the supply
(e) The sale by a distributor of hardware with embedded software, where the distributor is granted or uses rights in the IP of the software	

Similarly, in TR 2021/D4, the Commissioner sets out four categories of payments that are not royalties for domestic law purposes. In TR 2024/D1, the Commissioner sets out five categories of payments that are not royalties (presumably also for domestic and tax treaty purposes) (see [15] of TR 2024/D1). The differences between the two rulings are stark in this respect, with minimal similarity in the text between the two rulings. Notably, the Commissioner has not included "simple use" as a royalty exclusion in TR 2024/D1 (see [183]), whereas it was included at [6(a)] of TR 2021/D4.

Revised Examples

The Commissioner provides a total of three "Scenarios" that set out the application of his view to hypothetical facts, two in the ruling, and a third in Appendix 1, Part 1 (down from 8 Examples in TR 2021/D4). Note that Scenario 3 has already been addressed above.

Scenario 1

In Scenario 1, an Australian Taxpayer (**Taxpayer**) is a non-exclusive distributor of software due to its entry into a License Agreement with an offshore IP rights holder (**ForeignCo**). The License Agreement grants the Taxpayer the right to "market, promote, distribute, copy (for the limited purpose of permitting end users to make copies for their internal use) and sell licenses…" for software to end users. Australian customers can access the software via electronic download (**Method 1**), via cloud hosted content on servers controlled by the ForeignCo (**Method 2**), or through physical copies shipped directly by ForeignCo (**Method 3**). Before receiving the software (in whichever form), Australian customers must enter into a EULA (end-user license agreement) with the Taxpayer.

The Commissioner is of the view that the entirety of the payments from the Taxpayer to ForeignCo are royalties, on the basis that:

- The right to communicate the software, including transmission via download (Method 1 – see [143]), access via SaaS (Method 2 – see [144]), or communication of a physical copy (Method 3) is the exclusive right of ForeignCo. Here, the Taxpayer is taken to have made the communication as they determine the content of that communication via the EULA, in exploitation of the exclusive right of ForeignCo, and related payments will be royalties (see [28]-[29] and [147], [152]).

- The Taxpayer has authorised the communication of the software to the end users by virtue of the EULA, noting that the terms of the EULA dictate the basis upon which the communication of the software arose (see [30]).

- The License Agreement permits end-users to make copies for their own internal use. The right to authorise end-users to reproduce the software is the exclusive right of ForeignCo, and related payments made by the Taxpayer to ForeignCo for that right are in the nature of royalties (see [31], [133]-[134]).

- The Taxpayer is granted permission to access the software, which is managed by "access control technological protection measures" implemented by ForeignCo, the copyright holder (as contemplated above) (see [32]).

It is difficult to envisage a circumstance where an Australian entity enters a EULA with Australian customers that would not be subject to royalty withholding tax on the Commissioner's analysis, even if that license was for the simple use of software. Further, any entry into a EULA and/or contract of sale by a foreign IP holder should have appropriate consideration of the Multinational Anti-Avoidance Law.

Scenario 2

In Scenario 2, an agreement between an Australian taxpayer (**the Taxpayer**) and its foreign parent (**ForeignCo**) does not set out all of the rights and obligations between the parties to give effect to a software arrangement. Australian customers contract directly with the Taxpayer, and upon a customer in Australia contracting with the Taxpayer, ForeignCo provides that customer a limited IP license and grants access to the computer software from a server that it controls. ForeignCo retains or has rights to all IP in the software products and provides the Taxpayer with confidential information and know how regarding the products. ForeignCo is not a party to the sales contract between the Taxpayer and the ForeignCo, but it is party to a software licensing agreement with the customer that accompanies the sales contract.

The Commissioner considers that a payment by the Taxpayer to ForeignCo is a royalty, because the customers pay the Taxpayer to obtain the right to use the software, and such a right cannot be provided for sale by the Taxpayer without authorisation or communication by ForeignCo as the copyright right owner. The Commissioner notes that apportionment may be appropriate if it can be shown that the distribution right has "substantial value" independent of the right to use the copyright and other intellectual property of ForeignCo.

Deloitte view

The following points summarise our preliminary view on TR 2024/D1:

- It is clear that the Commissioner intends to continue with an approach which characterises the nature of payments with primary reference to legal form and exchanged rights.

- Taxpayers would benefit from additional commentary or examples / scenarios that set out methodologies that are acceptable to the Commissioner that would give rise to a "fair and reasonable apportionment" in the majority of circumstances (whilst acknowledging that a "one size fits all approach" is not appropriate).

- Taxpayers would benefit from additional examples / scenarios that apply the Commissioner's view to common software distribution models, with more factual variances.

There is a broader concern regarding the Commissioner's view on apportionment, particularly in respect of paragraphs [18] and [107]. It now appears that the Commissioner's expectations about what constitutes "fair and reasonable" apportionment require taxpayers to disprove the assumption that the totality of a payment that is connected with software distribution is a royalty. Whilst TR 2024/D1 is subject to consultation, the Commissioner's approach to characterisation and views regarding apportionment, will likely require taxpayers to carefully consider their software distribution arrangements and supporting documentation moving forward.

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