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Tax Alert

ATO issues updated draft ruling TR 2024/D1 on software royalties

At a glance

- TR 2024/D1 provides the ATO's updated draft view on when payments under a software arrangement will be royalties
- The use of or the right to use IP rights will give rise to a royalty
- The draft ruling provides two detailed scenarios to illustrate the draft view
- The ATO interpretation of the royalty definition is a legalistic one, focussing on a rights based approach
- Consultation is open with submissions closing on 1 March 2024
- How EY can help

The ATO has issued its updated draft software royalty withholding tax ruling, Draft Taxation Ruling (TR) 2024/D1, *Income Tax: royalties – character of payments in respect of software and IP rights* ('TR 2024/D1') for consultation (link). This draft TR is an update following the ATO's publishing of draft TR 2021/D4 in 2021.

TR 2024/D1 (the draft ruling) is a substantial rewrite of the previous draft but fundamentally maintains the draft ATO view reached in TR 2021/D4 that payments made for the grant of a right to use IP or for the use of IP will be a royalty.

Comments on the draft ruling are due by 1 March 2024.

The ATO's views in the updated draft may apply very broadly and will require detailed analysis and review of covered arrangements to determine potential impacts and required actions in response.

Key highlights

- A payment will be a royalty where it is consideration for the use of or the grant to use relevant IP rights. The ATO has adopted a legalistic interpretation of the royalty definition and a liberal interpretation of the Copyright Act 1968 as part of reaching this conclusion.
- The circumstances under which a software distribution arrangement will give rise to a royalty are broad and wide ranging. This includes distribution arrangements involving physical copies, digital downloads, and cloud/software as a service (SaaS) and is not limited to the software/IT industry.
- Characterisation requires consideration of the substance of arrangements and all the facts and circumstances, with the legal form not being determinative. This will be practically difficult for organisations to do with any certainty.
- The circumstances in which apportionment will be available are limited especially where rights are bundled in a single arrangement and payment and the principal purpose of the payment is for the relevant rights.
- The copyright rights which will give rise to a royalty are broad and the ATO's interpretation of how the rights exist or are used in software arrangements is

untested and liberal. The factual circumstances which may give rise to the use of copyright and other IP rights are very broad.

- The focus on a 'rights based approach' means the ATO's analysis will be an examination of the rights required by the distributor to deliver its contractual obligations. These could be implied rights and inferred from conduct.
- While double tax agreements will take primacy over domestic tax law in the event of an inconsistency, the interpretation of tax treaties is subject to domestic law definitions of undefined terms and copyright. The ATO appears to give little regard to the OECD commentary.

ATO View

The ATO maintains its view that the character of payments in relation to a software arrangement depends on all the facts and circumstances of a particular case including the terms of any agreement and the conduct of the parties.

ATO view - The following amounts are royalties:

- The grant of a right to use IP e.g., the grant of a right to reproduce a computer program.
- The use of an IP right e.g., the use of a copyright right that is the exclusive right of the copyright owner such as communicating the right or authorising the doing of an act in relation to the copyright.
- The supply of know how in relation to an IP right.
- The supply of assistance furnished as a means of enabling the application or enjoyment of the supply.
- The sale by a distributor of hardware with embedded software where the distributor is granted or uses rights in the IP of the software.

ATO view - The following amounts are not royalties:

- Consideration for the right to distribute copies of a computer program, without the use of or the right to use copyright or another IP right.
- Consideration for the transfer of all the rights relating to copyright in software.
- Payments from a distributor wholly for:
    - Hardware with embedded software,
    - Physical carrying media on which software is stored,

  provided the distributor does not use or is granted the right to use copyright or another IP right in the software.
- Consideration for the provision of services that are unrelated to any IP right.

We set out further analysis of what is a royalty below.

The ruling section of TR 2024/D1 also provides the following:

- Where a double tax agreement (DTA) applies, the royalty definition in the DTA will be given primacy.
- The ATO view is that 'consideration' does not have its technical meaning in contract law and 'consideration' is what 'moves the payment'.
- An amount may be a royalty regardless of how it is described or computed.

Software Arrangement

TR 2024/D1 introduces the concept of a "software arrangement" being the arrangements to which the draft ruling applies.

A software arrangement is "*an agreement, arrangement or scheme under which a distributor makes payment or payments directly or directly to the owner or licensee of the copyright (or other IP) for the right to be in a position to earn income relating to the use of or the right to software*." This definition is broader than a software distributor.

Detailed Scenarios

The ATO explains its position through two detailed scenarios, noting TR 2021/D4 contained eight high level examples only.

Scenario 1 – Australian entity issues EULA

In this scenario, the Australian entity is appointed as a non-exclusive distributor of computer programs in Australia and enters into end-user licence agreements (EULAs) with end-users.

End-users obtain use of the computer programs either through electronic download, via cloud content or through physical carrying media. The end-users enter into EULA's with the Australian entity and are invoiced by the Australian entity.

The ATO view is the entire amount is a royalty as:

- The Australian entity has the right to authorise the communication. While the communication of the program originates from the non-resident, the Australian entity is also responsible for determining the content of the communication by entering into the EULA.
- The Australian entity is also granted the right to authorise end-users to reproduce the program and is granted permission to grant access to the program.

The ATO view is that the entire amount is a royalty and subject to royalty withholding tax. The performance of the contract (i.e., the licence agreement) required the Australian entity to use copyright rights and the use of these rights is not separate or severable from other rights, such as the right to market and promote. It would appear that the ATO view is that no apportionment exists in this scenario.

Scenario 2

In this scenario, the agreement between the Australian entity and the foreign entity does not set out the necessary rights and obligations.

The Australian entity is granted the right to resell products. Customers enter into sales contracts with the Australian entity and pay the Australian entity. The

non-resident grants a limited IP licence to the customers and grants them access to the programs via download or cloud/SaaS.

The ATO view is the payment is a royalty because the customers pay the Australian entity to obtain the right and entitlement to use the software and such rights and entitlements cannot be provided for sale without authorisation or communication by the non-resident.

The payment is also a royalty because the Australian entity obtains other rights e.g. rights to use trademark, supply of technical or commercial information and know-how etc.

The ATO provides that a reasonable apportionment could be applied if there was sufficient evidence that the distribution right had substantial value independent of the right to use copyright or other IP rights. The ATO does not extrapolate as to what evidence would be required.

Interaction with DTA's

The ATO confirms that, to the extent there is inconsistency with domestic tax law, the DTA will prevail.

However, the ATO also notes that in the *IBM* decision the court "*found it unnecessary to greatly focus on the interactions between the tax treaty and the domestic definition of royalty*".

The draft ruling also provides that where an expression used in a DTA is not defined, it will have the meaning it has as under the Australian income tax law. The term 'consideration' is defined by reference to Australian income tax law.

The standard treaty definition of royalty includes the words "other like property or right". This is an IP right which has received recognition in the domestic legal system of a country and may extend the definition of royalty to other categories of IP.

OECD Commentary

The ATO states that the text of a treaty takes primacy but the OECD commentary on the application of the model DTA may need to be considered where the words of a tax treaty are ambiguous.

The ATO also specifically addresses the example in paragraph 14.1 of the commentary. In this example, the OECD commentary provides that there will not be a royalty where a distributor acquires the right to distribute copies and limited copyright.

The ATO's strict reading and interpretation of the example is:

- it only applies where the payer acquires a copy but does not make the copy;
- it does not involve a distribution model where grant of access to software is provided e.g. cloud;
- the distributor does not have the right to reproduce the software;
- there is no payment for the exploitation of any copyright rights in the software.

The ATO states that the example "illustrates the limited circumstances in which payments…will not constitute a royalty" (although the OECD commentary refers to it as a 'frequent' arrangement). It is clear the ATO therefore sees the example as being relevant in very limited circumstances, if at all.

The ATO states, in the "Alternative Views" section of the draft ruling, that the example in the OECD commentary does not stand for the proposition that payments for the supply of software will only be royalties where the rights to reproduce or modify the software are granted. The ATO view is that this ignores the rights that are granted or used and the treaty definition is not so narrowly confined. Furthermore, given the meaning of copyright is taken from the domestic meaning, the copyrights rights in Australia are broader than just reproduction or modification.

Royalty Definition

The draft ruling provides an extensive ATO view on the elements of the standard treaty definition of royalty including the terms: 'however described or computed', 'consideration', 'for', 'to the extent' and 'use'.

Key points from this section are below.

'*However described or computed*':

- The way a payment is described or computed does not determine whether it is a royalty. The substance of the arrangement must be ascertained, and this will prevail over its legal form.

'*Consideration*':

- Has a wide meaning beyond just consideration in a contractual sense. It is "the thing or things that move the payment". The contractual meaning of consideration is unlikely to be determinative.

'*For*':

- What a payment is 'for' is a question of fact. The terms of any agreement are the starting point but they are neither determinative nor sufficient.
- If contractual performance requires or involves 'use' of an IP right, that right may be an implied term of contract.
- The objective 'purpose' of the payment must be determined having regard to all the circumstances including the commercial and financial relations and the manner in which any rights will be used.

'*To the extent*':

- An undissected payment for matters all of which are sufficiently connected with the things mentioned in the royalty definition will be a royalty.
- Where a payment is consideration for things listed in the royalty definition and for other things, the payment will be a royalty to some extent. A fair and reasonable apportionment is required.
- A payment principally for the grant of IP rights (where other rights are ancillary or incidental) will be for the grant of the IP rights. In applying this

view, if the software arrangement has no value or substance without the IP rights, then the payment will wholly be a royalty.

- In many software arrangements, the IP rights granted are not separate or severable from any other rights and the distribution agreements cannot be performed without the use of the IP rights granted.

"Use":

- Use of IP covers all forms of exploitation of the right or property.
- There is no discussion on 'incidental' use nor any extrapolation of 'exploitation'.

Apportionment

The draft ruling provides that apportionment may be required in certain cases, depending on the facts and circumstances, to ascertain the extent to which a payment is a royalty.

However, the ATO also refers to the *IBM* decision where the court found no apportionment was required in circumstances where the amounts paid were for a bundle of rights which were royalties.

A Scenario 3 covers a reasonable method of apportionment. In that scenario:

- Under a single contract, a distributor is granted the right to distribute physical copies of computer games and the right to distribute online access to video-editing software.
- Although the rights are granted under one contract, they are independent of each other.

The ATO provides that consideration for the right to distribute physical copies of a game is not a royalty. It may be possible to apportion the lump sum consideration to reflect the 'market value' of the differing rights and a reasonable method of apportionment would consider that valuable IP rights are granted and a majority of the consideration would be allocated to those rights.

It is unclear whether the basis of apportionment is a 'market valuation' exercise (as opposed to some other exercise which involves determining relative value) and it is also unclear the basis of the ATO's conclusion that the IP rights are the more valuable rights (simply because they are IP rights).

Copyright Rights

The draft ruling provides a lengthy technical analysis of copyright and each of the copyright rights which the ATO concludes are relevant in a software arrangement.

Given 'copyright' is not defined in the DTA's, the existence of copyright is determined by the language of the Copyright Act *"given a liberal interpretation but not departing altogether from its language and principles."*

The ATO view is that the term 'copyright' is a reference to any exclusive right of the copyright owner in a work to which Australian copyright law applies. Under section 31(1) of the Copyright Act, these rights are to:

- Reproduce the work in a material form
- Communicate the work to the public
- Make an adaptation of the work
- Enter into a commercial rental agreement
- Authorise a person to do an act.

The ATO also notes that the Copyright Act protects the right of copyright owners to control access to a work by access control technological protection measures. While it appears unclear from the draft ruling whether this is actually a 'copyright right', it appears that the ATO view is that would be a copyright right (or otherwise a like property or right).

The draft ruling notes that software arrangements commonly involve the things mentioned above regardless of whether the contractual arrangements specifically mention these rights. This includes SaaS/cloud arrangements.

Key points in relation to each of the rights are below.

Reproduction Right:

- Software acquired under licence is reproduced when it is copied as part of the technical process of installing it on a computer or device or downloaded onto a computer or device.

Communication to the public:

- This can be electronically transmitting the work or making available online such as through software as a service (SaaS).
- A communication is taken to have been made by the person responsible for determining the content of the communication. There may be more than one person responsible for determining the content of a communication.
- An offshore entity in control of the servers which hosts SaaS software is one entity responsible for determining the content of communication. Any intermediary who enters into a licence with the end-user may be responsible for determining the content of the communication where the licence specifies the terms upon which software is made available to the end-user.

Adaptation:

- An adaptation includes an adaptation of a substantial part of the work. Determining this is a question of fact and degree.

Commercial rental arrangement:

- Whether any particular arrangement constitutes a commercial rental agreement depends on the particular facts and circumstances with a focus on the substance. This will be relevant for SaaS.

Authorisation:

- The term authorise is not defined and can mean sanction, approve, countenance and permit.
- The authorisation right is an independent right form the other primary copyright rights. This means that the authorisation of any exclusive right of a copyright owner is sufficient to evidence the exercise of the authorisation right e.g., where a distributor authorises an end user to temporarily reproduce the work a part of the technical process to use software, the distributor has still authorised reproduction.
- It is unnecessary for the authorising person to also have the right to do the act authorised. e.g., a person may have the right to authorise reproduction without having a right to reproduce.
- It also means a person can authorise the copyright owner itself to do an act comprised in copyright e.g., a distributor can authorise the copyright owner to communicate the work.
- In relation to SaaS, where a distributor intermediary sublicences the software to end-users, the act of sublicensing is authorisation of the communication of the software by the copyright owner and the reproduction of the software by the end user. SaaS may also involve other rights such as access control technological protection measures.

Non-Copyright Rights

The draft ruling also provides that payments may be for the use of or the right to use other IP rights, which fall within the definition of royalty e.g. trademarks. Proper characterisation depends on the specific facts and circumstances.

The ATO states that while its view is that the 'authorisation right' is a copyright right, it may also be "other like property or rights' in the royalty definition.

Embedded Software

The storage medium of software is not determinative of the characterisation – it is the rights used or granted which determines the character.

Payments for the acquisition of hardware/tangible goods with embedded software will not be a royalty if the distributor did not acquire or use any copyright rights and the software facilitated the operation of the good e.g., a mobile handset with pre-installed operating system.

TR 93/12

The draft ruling notes that TR 93/12 (withdrawn effective from 1 July 2021) applied to some arrangements covered by the ruling.

However, no further detail is provided as to the ATO view of when TR 93/12 can be appropriately relied upon.

Key Takeaways

- There are unlikely to be material changes to the draft technical views before the ruling becomes final. TR 2024/D1 is a result of a nearly three year long process and a rewrite of TR 2021/D4, representing the ATO's (untested) views on the interaction of copyright/IP law and tax rules.
- Most, if not all, inbound software distribution arrangements will be potentially in scope. This goes beyond just the software and IT sector and extends into business models which involve any 'software arrangements' as defined by the ATO. The draft view is also not restricted to related party arrangements.
- The copyright analysis is extensive and determinative, albeit there are questions as to how organisations will be able to practically apply the ATO view or assess the risk given its legalistic position. It remains the case that many arrangements will be at risk given the ATO view.
- TR 2024/D1 represents another arsenal in the ATO's toolkit as it continues its focus on intangible arrangements. It is expected that the draft ruling will be followed by heightened ATO compliance and taxpayer reporting obligations including expected disclosures in the international dealings schedule and reportable tax positions schedule.
- There remain open questions as to how Australia's treaty partners will view the draft ruling and the implications for heightened bilateral certainty including BAPA's and MAP's.

Implications

When finalised the ruling will apply both before and after the date it is issued (other than in respect of disputes settled before that date).

The draft ruling is a significant rewrite of the ATO's previous draft ruling and represents a legalistic interpretation of both the definition of royalty and the Copyright Act. It is also clear that the ATO view is that payments made under the vast majority of software arrangements will be wholly, or partly, a royalty. The ATO has squarely put to bed the notion that payments will not be a royalty where a distributor distributes software to simple use end users.

Impacted organisations will need to review their arrangements, including their legal agreements and the substance of their arrangements, to determine the potential impact of the draft ATO view. This will include considering fair and reasonable apportionment methods where appropriate.

The significant focus on IP law and interpretation of copyright law also means that impacted organisations may need to consult with experts in copyright law as part of any analysis.

How EY can help

EY can help:

- Provide your comments or views as part of the consultation process
- Review and advise on the impact of TR 2024/D1 on your software arrangements including providing and seeking IP law advice
- Provide advice on fair and reasonable apportionment methods
- Assist you to proactively engage with the ATO
- Assist in defending positions with a comprehensive suite of evidence and strategic review/audit assistance.

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