The Tax Institute

19 March 2024

Elliott Wilson
Senior Law Interpretation Specialist, Tax Counsel Network
Australian Taxation Office

By email: Elliott.Wilson2@ato.gov.au

Dear Elliott,

Draft Taxation Ruling TR 2024/D1 – Income tax: royalties – character of receipts in respect of software and intellectual property

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

In the development of this submission, we have closely consulted with our National Large Business & International Technical Committee and a working group of members with expertise in this area, to prepare a considered response that represents the views of the broader membership of The Tax Institute. We have also reviewed a copy of the comments submitted by the Law Council of Australia dated 18 March 2024 (**LCA submission**).

We have outlined below our primary concerns and emphasise the need to resolve them prior to finalising the Draft Ruling. In this regard, we request the ATO to consider our concerns and take appropriate action to improve the clarity and practicality of the Draft Ruling. In summary:

- the Draft Ruling's 'liberal interpretation' of copyright and other IP law contains statements of legal principle that are, in our view, likely to be incorrect and inconsistent with established jurisprudence;
- relatedly, the proposed abandonment of the 'simple use' concept will likely give rise to a number of unintended consequences for tax compliance and administration purposes;
- as a result of the above-stated concerns, the Draft Ruling has an unduly broad scope of application which appears to give effect to a change of position or an expansion in the ATO's views when compared against the former TR 93/12 *Income tax: computer software* (**1993 Ruling**) and draft Taxation Ruling TR 2021/D4 *Income Tax: royalties – character of receipts in respect of software* (**2021 Draft Ruling**); and

- we consider that the Draft Ruling should apply on a prospective basis only. Prospective application is, in our view, fair and reasonable, having regard to the exceptional circumstances relating to the development of this particular public advice and guidance (**PAG**) product and also consistent with TR 2006/10 (in particular, paragraph 62) and PS LA 2011/27 (in particular Section 5).

Our detailed response and recommendations to improve the Draft Ruling are contained in **Appendix A**. We have attached at **Appendix B** our earlier submission to the ATO on the 2021 Draft Ruling (**2021 Submission**).

Our comments in this submission should be read together with our 2021 Submission, particularly regarding the issues discussed therein which remain unresolved.

The Tax Institute is the leading forum for the tax community in Australia. We are committed to shaping the future of the tax profession and the continuous improvement of the tax system for the benefit of all. In this regard, The Tax Institute seeks to influence tax and revenue policy at the highest level with a view to achieving a better Australian tax system for all.

If you would like to discuss any of the above, please contact our Senior Counsel – Tax & Legal, Julie Abdalla, at (02) 8223 0058.

Yours faithfully,

Scott Treatt
Chief Executive Officer

Todd Want
President

APPENDIX A

We have set out below our detailed comments and observations in relation to the Draft Ruling for your consideration.

Summary

The Tax Institute has identified four key technical issues arising from the Draft Ruling and we encourage the Commissioner to consider our recommendations in relation to each of these issues prior to the finalisation of the Draft Ruling. These are:

1. whether the Commissioner's interpretation and application of copyright law and other intellectual property (**IP**) law is correct;
2. relatedly, the proposed abandonment of the concept of 'simple use';
3. as a consequence of the above two issues, the Draft Ruling has a broad scope of application that appears to indicate a change in position or an extension of the Commissioner's views; and
4. that given the exceptional circumstances, the Draft Ruling should apply only on a prospective basis.

In addition, we set out at Part 5 below, a list of additional matters arising in relation to the Draft Ruling that we encourage the Commissioner to consider.

1. Whether the Commissioner's interpretation and application of copyright law and other IP law is correct

The Tax Institute is of the opinion that the Commissioner's interpretation and application of copyright and other IP laws in the Draft Ruling – including the explanations in Parts 2 and 3 of the Draft Ruling – are likely to be incorrect and inconsistent with established jurisprudence in this area. This view is based, in part, on our understanding of the comments contained in the LCA Submission. As the definition of a royalty will frequently turn on a proper application of copyright and IP law principles, this is an issue of central importance in the Draft Ruling.

Further and without limitation, The Tax Institute notes the following issues from a copyright and IP perspective:

- the exercise of a right to authorise an act could only be a 'use' of copyright to the extent that the authorised act is the exercise of a primary exclusive right of the copyright owner. It is not clear that the actions identified in the Draft Ruling satisfy this requirement.
- The analysis in respect of the exclusive right to communicate the work to the public is high level, and the ATO's assertion that the software being located on servers overseas does not address whether the software is relevantly communicated to the public in Australia. The location in which an online communication occurs is an open question.

- The right to enter into a commercial rental arrangement in respect of a computer program is directed at the renting of physical items, and is not apt to capture SaaS arrangements (see paragraphs 30A(1)(a), 30A(2)(a) and sections 30A(3)–(4), and the Explanatory Memorandum, Copyright (World Trade Organisation Amendments) Bill 1994 (Cth)). Given this, the analysis provided by the ATO in support of its position is, in our opinion, inadequate to support this view.
- The right to control access to a work by access control technological protection measures is not a positive right to grant access and is not an act comprised in the copyright of a work or other subject matter. Rather, it is a right to take action against someone who circumvents that measure with the requisite mental state as a separate statutory tort.

The issue in the Draft Ruling is that its copyright and IP analysis appears to be relied upon to significantly expand what can constitute a royalty for tax purposes; particularly when considered with the abandonment of 'simple use', discussed below.

The Tax Institute acknowledges that the Commissioner's policy intent in the Draft Ruling is to adopt a 'liberal interpretation' of the copyright law.[1] However, this is a separate and distinct proposition from relying on an application of copyright or other IP principles that are controversial, contestable, or incorrect at law.

Recommendation 1

The Tax Institute recommends that the Commissioner revisit and revise the Draft Ruling to ensure that any statements of legal principle regarding the interpretation and application of copyright and IP law are correct and settled at law.

In this respect, The Tax Institute understands that other submissions have also been made that relate specifically to the Commissioner's statements of legal principle regarding the interpretation and application of copyright and IP law, including the LCA submission which we have reviewed.

We reiterate our reservations expressed in the 2021 Submission concerning the application of copyright law by the Commissioner, and in particular, the analysis of a communication right in the context of a software-as-a-service (**SaaS**) arrangement.

2. Proposed abandonment of the concept of 'simple use'

The Tax Institute acknowledges that as a result of the Draft Ruling's interpretation and application of copyright and other IP principles, the Commissioner proposes to abandon the 'simple use' concept for administrative purposes.[2] The Tax Institute is of the view that this will likely give rise to a number of unintended consequences for tax compliance and administration purposes.

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1 Draft Ruling at [123].

2 Draft Ruling at [183]-[184].

Stated in brief, and without limitation, these consequences include that:

- persons or entities that use software only in their capacity as consumers, or as a necessary incident to their ordinary business activities (e.g. personal use, limited business use, etc), could now fall within the scope of the Draft Ruling and be subject to royalty withholding obligations;[3]
- it is open to infer that the Commissioner has changed his administrative position when characterising payments in circumstances that previously relied on 'simple use' (see below at Part 3); and
- as a result, there may now be a broader set of payments in respect of which amounts are not currently being withheld and – if so – it is unclear how the Commissioner intends to administer such wide-ranging perceived failures to withhold on a retrospective or prospective basis (see below at Part 4).

The Tax Institute acknowledges that given the continually evolving nature of technological change, the 'simple use' concept as defined in the former 1993 Ruling may no longer be appropriate to apply in a number of modern software arrangements.[4] Despite this, there were clear and principled justifications as to why the administrative carve-out for 'simple use' was introduced in the first place, and which still remain relevant today.

As such, we consider that abandoning 'simple use' in its entirety is an unnecessary and disproportionate response that disregards the ATO's role as a regulator and administrator of the taxation law, in favour of the pursuit of a strict (and contestable) interpretation of IP principles.

Recommendation 2

In acknowledgement of the significant number of *de minimis* or other limited uses of software that continue to occur in practice (many of which will likely fall outside of the intended scope of the Draft Ruling), we consider that the Commissioner should re-introduce a 'simple use' carve-out for administrative purposes.

The Tax Institute supports the concept of 'simple use' being amended or otherwise adapted from the definitions in the former 1993 Ruling or the 2021 Draft Ruling to appropriately respond to the Commissioner's concerns regarding the continually evolving nature of technological change.

As to the form of guidance, The Tax Institute recommends that the 'simple use' concept should be clarified and form part of a finalised taxation ruling (**TR**). Such a carve-out should also be reflected in any other forms of related guidance if published (e.g. a practical compliance guide (**PCG**)).

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[3] It is presumably *not* the Commissioner's intent to impose royalty withholding obligations on these types of end-users. As discussed below, these persons or entities are clearly distinguishable from those to whom the Draft Ruling is presumably intended to apply: i.e. persons or entities that use software as the main/primary purpose of their business activities as a distributor, such as online marketplaces or digital platform providers, etc.

[4] See 2021 Draft Ruling at [42].

3. Broad scope of application and potential change of position or expansion in scope

The Tax Institute is of the view that the cumulative effect of the Draft Ruling's 'liberal interpretation' of copyright and other IP laws (see Part 1), together with its abandonment of 'simple use' (see Part 2), means the Draft Ruling has a disproportionately broad scope of application which may capture many arrangements to which we would not expect the Draft Ruling to apply.

In particular, The Tax Institute's opinion is that the scope of the Draft Ruling appears to give effect to a change in position, or an expansion of the Commissioner's views, when compared against the former 1993 Ruling and 2021 Draft Ruling.

As a consequence, taxpayers may now be at risk if they relied reasonably and in good faith on the Commissioner's views set out in past guidance.

Recommendation 3

The Tax Institute recommends that to the extent the Draft Ruling represents a change in position, or an expansion in scope, this should be clearly communicated to taxpayers.

At least two types of revisions or clarifications should be given effect.

Sub-recommendation 3.1 (clarifying Draft Ruling's scope of application – e.g. meaning of 'end users' and 'distributors')

The Tax Institute recommends clarifying what 'end-users' and/or 'distributors' fall within the scope of the Draft Ruling. This is because a clear distinction exists in practice between persons or entities:

- that use software (or other IP) only in their capacity as consumers, or as a necessary incident to their ordinary business activities – e.g. personal use, limited business use, etc; and
- that use software (or other IP) as the dominant or primary purpose of their business activities as a distributor – e.g. online marketplaces or digital platform providers, etc.

Within this latter use-case, there exists a further spectrum of business activities undertaken by 'distributors' in Australia, ranging from:

- software marketing hubs that merely have an ancillary distribution function; to
- wholesale distributors of software with limited to no other business activities.

Drafting changes that will assist in this respect include, without limitation:

- re-introducing a revised 'simple use' concept (see Part 2);
- excluding certain users from the definitions of 'Distributor' and/or 'Software arrangement' and/or setting out these definitions in further granularity to correspond with their underlying business activities in accordance with their economic substance;
- including new scenarios that make clear what circumstances do not fall within the scope of the Draft Ruling, or where the payment is not a 'royalty';

- including simple adaptations of existing scenarios (e.g. in Scenario 1 but assuming that the 'OBA' entity is removed, and end-users enter into an end-user licence agreement (**EULA**) with IEL directly);[5]
- explaining how mere electronic distribution, which is stated not to involve a royalty at paragraph 68, differs from Scenario 2 and Scenario 3, which involve 'software available for download from servers' and 'online access to … software' respectively; and
- clarifying the relevance, if any, of the relationship between a vendor and a distributor, including whether the fact that they are related parties has any bearing on the underlying technical analysis (see Scenarios 1 and 2).

Sub-recommendation 3.2 (clarifying any changes of position or expansions of view)

The Tax Institute recommends revising the Draft Ruling to clarify whether the Commissioner's views have resulted in a change of position or an expansion from previous administrative practice.

As currently drafted, it is open to infer that the Draft Ruling may have resulted in a change or expansion in relation to:

- determining whether the characterisation of a payment differs depending on software being distributed on tangible media or electronically;[6] and
- payment characterisation in circumstances that previously relied on 'simple use'.[7]

Drafting changes that will assist in this respect include, without limitation:

- inserting a master schedule that includes a comparison table of 'key issues' to show what has or has not changed between the 1993 Ruling and the 2021 Draft Ruling or since then. The content of this schedule can be informed by those issues most commonly raised by parties during this Draft Ruling's consultation period;
- re-inserting and re-analysing Examples 3, 6 and 8 of the 2021 Draft Ruling (which previously relied on the 'simple use' concept) to show how these fact patterns should now be considered; and
- setting out further reasons as to why Scenario 3 of the Draft Ruling characterises payments for the distribution of physical and digital copies of software differently, and how this reconciles with ATO's interpretation of the corresponding OECD Commentary.[8]

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5 See Draft Ruling at [23]-[35].

6 See Draft Ruling at [61]-[68] (concerning the relevance of OECD Commentary), [116]-[118] (Scenario 3), [181] (concerning embedded software); *contra* TR 93/12 at [26]; 2021 Draft Ruling at [31]-[33] (Example 6), [85].

7 See Draft Ruling at [184]-[184]; *contra* Examples 3, 6 and 8 of the 2021 Draft Ruling.

8 See Draft Ruling at [61]-[68] (concerning the relevance of OECD Commentary), [116]-[118] (Scenario 3).

4. Prospective application of the Draft Ruling is fair and reasonable in the circumstances

The Tax Institute considers that in the current circumstances it would be unreasonable for the Draft Ruling, once finalised, to apply retroactively.

Paragraph 62 of TR 2006/10 relevantly provides: '…there are situations where it is appropriate for a public ruling to have a prospective date of application. For example where the ATO has facilitated or contributed to taxpayers adopting a different view of the law.' TR 2006/10 refers to PS LA 2011/27 for further details.

PS LA 2011/27 outlines procedures ATO officers should follow in determining whether there are circumstances that would make it inappropriate to apply the ATO view in relation to past years or periods. In particular, Section 5 of PS LA 2011/27 states that in considering the circumstances when the ATO will not take action to apply its view of the law in past years or periods, ATO officers must have regard to the following factors:

> "The extent to which the ATO has facilitated or contributed to taxpayers adopting a different view of the law (which may result from an industry practice or position), including:
>
> (i) whether the ATO became aware of the position adopted by taxpayers or an industry practice in applying the law (for example, through compliance activity) but did not challenge it within a reasonable timeframe having regard to the size of the risk
>
> (ii) whether the taxpayers' position or industry practice can be reasonably understood from ATO statements on how to apply the law
>
> (iii) whether a general administrative practice supporting the taxpayers' position or industry practice can be deduced from other ATO conduct
>
> (iv) the time that has elapsed since the ATO's first awareness of the issue, publicly announcing it would challenge the position or practice and the time taken to finalise its view."

Having regard to the exceptional circumstances relating to the development of this particular PAG product, and the subject matter contained therein, it is, in our view, appropriate for the finalised ruling to only apply prospectively from its date of issue. Further, having regard to TR 2006/10 (in particular, paragraph 62, referred to above) and to PS LA 2011/27 (in particular Section 5, also referred to above), in our opinion, the only appropriate outcome in these exceptional circumstances is that the Draft Ruling, once finalised, should be applied only on a prospective basis.

The exceptional circumstances here include that:

- on 25 June 2021, the 2021 Draft Ruling was published on the ATO's website; on 1 July 2021, the 1993 Ruling was formally withdrawn; on 30 July 2021, the 2021 Draft Ruling was formally issued; and on 17 January 2024, the 2021 Draft Ruling was formally withdrawn and the Draft Ruling published on the ATO's website;

- during this period (i.e. from June 2021 to January 2024), there were numerous public representations made by the ATO that a revised version of the 2021 Draft Ruling would be issued based on submissions received during the 2021 Draft Ruling's consultation phase. In particular, a number of the submissions made by the tax community including The Tax Institute, had identified common themes – for example – that '[t]he ATO's rights-based approach [was] contrary to the essential nature/economic substance approach in the OECD Commentary on Article 12';[9]
- as a result, there is a nearly three-year period (and counting) where issues regarding the characterisation of software payments have either *not* been subject to any binding rulings, or subject only to *draft* rulings. As is common practice, such draft rulings represent the Commissioner's preliminary view only, with such publications being made available for public comment; and against this context, a number of taxpayers acting reasonably and in good faith may have proceeded on the basis that the 2021 Draft Ruling did not apply to their circumstances, and instead applied the principles contained in the former 1993 Ruling on the basis that the views expressed in the 2021 Draft Ruling were a departure from those expressed in the 1993 Ruling and remained in draft, subject to change.

Additional factors that justify a prospective application of the Draft Ruling here include that:

- the ATO's Draft Ruling, if finalised in its current state, could reasonably be seen as conveying a different view of the law in comparison to the 2021 Draft Ruling and the former 1993 Ruling;
- the ATO will have likely become aware of the position adopted by taxpayers or an industry practice in applying the law (for example, and not limited to, during its public consultation sessions held in respect of the 2021 Draft Ruling);
- the time that has elapsed since the publication of the 2021 Draft Ruling is substantial (i.e. nearly three-years and counting) and the Draft Ruling still remains under development; and
- the ATO's previous publications, including both the 1993 Ruling and the 2021 Draft Ruling, may have facilitated or contributed to the development of taxpayers' views or an industry practice.

The above matters are of particular concern for affected taxpayers since there is no statutory limitation on the assessment and collection of withholding taxes, in contrast to the limits placed on the Commissioner to amend an assessment under subsection 170(1) of the *Income Tax Assessment Act 1936*. This could effectively result in the relevant payments of an affected taxpayer from all prior periods giving rise to outstanding withholding tax obligations.

The Tax Institute otherwise restates and refers to its concerns regarding retrospective application as set out in the 2021 Submission.

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[9] See ATO, Ruling Compendium TR 2021/D4EC, Summary of issues raised and responses (Issue 6) <https://www.ato.gov.au/law/view/document?LocID=%22CTR%2FTR2021ECD4%2FNAT%2FATO%2F00001%22&PiT=99991231235958> (accessed on 1 March 2024).

Recommendation 4

The Tax Institute recommends that the Draft Ruling, once finalised, should only apply prospectively from its date of issue. Prospective application is, in our view, fair and reasonable having regard to the exceptional circumstances relating to the development of this particular PAG product and also consistent with TR 2006/10 (in particular, paragraph 62) and PS LA 2011/27 (in particular Section 5).

5. Additional matters

We set out below a list of additional matters arising in relation to the Draft Ruling that we encourage the Commissioner to consider before finalising.

5.1 Apportionment

The Tax Institute restates and refers to its concerns regarding apportionment as set out in the 2021 Submission.

Further and in addition, in Scenarios 1 and 2 of the Draft Ruling it is contended that the payments by the software distributors, OBA and Aus Co respectively, would be wholly or substantially for the use of copyright or other IP of the foreign software copyright owners. The Draft Ruling does not sufficiently justify this contention. In particular, the approach in the Draft Ruling does not sufficiently factor into the analysis considerations relating to the various things the software distributor might do under the terms of the relevant agreement in addition to providing certain rights in relation to copyright in the software to end users.

Reasons should be set out as to why the 'majority' of payments in Scenario 3 of the Draft Ruling is being allocated to the online distribution of software, as opposed to the distribution of physical copies.[10] Apportionment will depend on the facts and circumstances of each case and there appear to be material considerations that are clearly relevant to determining this 'majority' split that are insufficiently explained – e.g. the revenue generated by the online vs the physical copies, the contribution made by the distributor to the overall related-party group value chain, and the intentions of the parties entering into the contractual arrangements.

The Draft Ruling would appear more balanced by including examples where apportionment did not result in all or nearly all of the relevant payments being subject to royalty withholding.

5.2 Potential impact of *PepsiCo* decision

The Tax Institute notes that the Federal Court's decision in *PepsiCo, Inc v Commissioner of Taxation* [2023] FCA 1490 (***PepsiCo***) is subject to appeal as at the date of the submission.

A number of interpretive matters and judicial approaches towards payment characterisation adopted by Moshinsky J in *PepsiCo* may accordingly be revisited in a manner that could affect key aspects of the Draft Ruling. The Tax Institute encourages the Commissioner to appropriately take into consideration these ongoing appeal proceedings when finalising the Draft Ruling, and to the extent available, alternative precedents dealing with payment characterisation should be cited.

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[10] See Draft Ruling at [116]-[118] (Scenario 3).

5.3 Appropriate form of PAG

The Tax Institute notes that the extent of guidance and assurance provided to taxpayers in relation to certain tax issues can vary substantially depending on what type of regulatory guidance is available. There are, for example, clear differences between the degrees of guidance and assurance provided by a taxation ruling (**TR**), a taxation determination (**TD**), and a practical compliance guide (**PCG**).

In this respect:

- The Tax Institute encourages the Commissioner to appropriately take into consideration the fact that certain PAG products (e.g. PCGs) are unlikely to provide a sufficient level of guidance and assurance for those technical issues currently set out in the Draft Ruling.
- The ATO has acknowledged the industry is an evolving one, involving rapid changes. Therefore, it is crucial that the ATO outlines clear principles that taxpayers and advisers are able to apply to new and unfamiliar situations, with the binding certainty provided by a ruling, which in turns further facilitates innovation in the relevant industries.
- While PCGs have a place in the administration of the tax system, they are primarily a risk assessment tool for the ATO. From a policy perspective, PCGs should not be used in substitution for what should properly be included in a well-considered binding ruling; and
- The Tax Institute restates and refers to its concerns outlined in the 2021 Submission regarding those matters contained in the 1993 Ruling (relating to trading stock no longer being addressed in a taxation ruling). The Tax Institute maintains that the ATO website is not a suitable channel for providing the level of guidance or assurance that is appropriate in these circumstances.

5.4 Other specific comments

The Tax Institute notes the following specific comments in relation to the Draft Ruling:

- Scenarios 1 and 2: detailed explanations should be set out regarding the manner in which payments are calculated and how this bears upon the payment characterisation analysis. For example, Scenario 1 of the Draft Ruling assumes 'a royalty-free fee to IEL that equates to 97% of its net revenue from Product sales'; and Scenario 2 assumes 'an amount calculated as AusCo's net profit from the sale of the products, less a small margin representing an arm's length fee for distribution services'. As currently drafted, it is not clear what impact (if any) these different calculation methods have to the characterisation or apportionment analysis.
- Paragraph 10: the list of those tax treaties where the definition of 'royalty or royalties' materially varies should be clarified to indicate what relevance (if any) these definitional differences have in respect of the Draft Ruling and its analysis. For example, that despite these material differences, the principles contained in the Draft Ruling still apply generally.

- Paragraph 57: further analysis and/or examples should be included in relation to payments for services. Together with the removal of ‘simple use’, there is a significant degree of uncertainty regarding when certain payments for services will be considered royalties. The IT 2660 guidance (released in November 1991) does not address a number of common, modern-day scenarios – e.g. Example 8 of the 2021 Draft Ruling concerning ‘24-hour help desk support’ but which relied on the simple use concept.

APPENDIX B

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