THE TAX INSTITUTE

6 August 2021

Christopher Ferguson
Assistant Commissioner, Public Groups and International
Australian Taxation Office
By email: christopher.ferguson@ato.gov.au

Dear Christopher,

Draft Taxation Ruling TR 2021/D4 – Income tax: royalties – character of receipts in respect of software

The Tax Institute welcomes the opportunity to make a submission to the Australian Taxation Office (**ATO**) in relation to the draft Taxation Ruling TR 2021/D4 – Income tax: royalties – character of receipts in respect of software (**Draft Ruling**).

We invite the ATO to consider our submission and respectfully request that further action as recommended in this submission is taken to enhance the Draft Ruling to ensure clear guidance and practical insight is provided to the community. We have set out below our main concerns in relation to the Draft Ruling, in particular:

- matters which were within the scope of Taxation Ruling TR 93/12 *Income tax: computer software* (**TR 93/12**) but are not within the scope of the Draft Ruling should be addressed in interpretive guidance and not through guidance published on the ATO's website;
- we consider that further clarity and guidance including practical examples are required to demonstrate the way in which the Commissioner intends to apply copyright law principles and definitions to tax law principles and definitions; and
- we consider that the Draft Ruling should apply on a prospective basis but to the extent that it does not, clarity should be provided as to the extent that it applies retrospectively and appropriate transitional arrangements should be made.

Our detailed submission is contained in **Appendix A**.

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. Please refer to **Appendix B** for more about The Tax Institute.

If you would like to discuss any of the above, please contact Tax Counsel, Julie Abdalla, on (02) 8223 0058.

Yours faithfully,

Peter Godber

President

APPENDIX A

The Tax Institute is of the view that it is beneficial for the ATO to provide binding guidance on the taxation treatment of royalty receipts in respect of software. We have set out below some areas of the Draft Ruling which we consider could be improved to assist taxpayers in understanding their obligations and complying with the law, and the administration of the law by the ATO. Some of our recommendations are higher level and encourage a reconsideration or clarification of the rationale underpinning the guidance, in some cases through the use of practical examples. Others relate to more specific areas where we have suggested drafting amendments to achieve what we understand to be the intended objective consistent with the law.

Matters covered by previous ruling not addressed in the Draft Ruling

The Draft Ruling notes that certain matters considered in TR 93/12 which are not addressed in the Draft Ruling are proposed to be dealt with through guidance published on the ATO's website.

The Tax Institute is of the view that matters relating to the assessability of receipts in respect of software and the treatment of software as trading stock under subsection 70-10(1) of the *Income Tax Assessment Act 1997* (**ITAA 1997**) should be addressed in interpretative guidance (either in a taxation ruling or taxation determination). We do not consider that ATO website content is a suitable channel for providing the level of guidance or assurance that is appropriate in these circumstances.

Application of copyright law by the Commissioner

Further, we recommend that the ATO provide greater clarity, including through additional examples, on the circumstances in which an end-user will be treated as having exercised a copyright right by using or accessing software (for example, if the end-user reproduces or copies software as part of an installation, or if the end-user accesses software-as-a-service (**SAAS**).

In particular, The Tax Institute is of the view that further detail regarding the statements of principle at paragraphs [56] and [61]-[62] of the Draft Ruling are required. Those paragraphs concern the right to "communicate the work to the public" as being an exclusive right of the copyright owner. As currently drafted, the Commissioner's view expressed in the Draft Ruling is that "use by an end-user via cloud-based technology such as software-as-a-service" may constitute a communication (and therefore a use of copyright) (refer paragraph [62]).

Paragraph [62] of the Draft Ruling also states that "[d]epending on the circumstances of the particular case the communication may be taken to have been made by any number of people including the end-user and the software distributor." This gives the impression that an end-user can be the relevant party communicating the software, which would suggest that they could be granted rights exclusive to the copyright owner.

We have two main reservations about the abovementioned views. Firstly, we do not consider that the view that "use by an end-user via cloud-based technology such as software-as-a-service" may constitute a communication is supported by the language of section 10 or subparagraph 31(1)(a)(iv) of the *Copyright Act 1968* (**Copyright Act**) or in paragraph [661] of Justice Nicholas' judgement in *Roadshow Films Pty Limited v iiNet Limited* [2011] FCAFC 23 which is cited in footnote 10.

The words "make available online" look to the action or actions of the person making the relevant copyrighted work accessible by others. They do not take into account anything that may or may not be done by any potential end-user of the copyrighted work.[1]

In addition, the view that "[d]epending on the circumstances of the particular case the communication may be taken to have been made by any number of people including the end-user and the software distributor" appears to be based on paragraph [73] of the decision in *Universal Music Australia Pty Ltd v Cooper* [2005] FCA 972. However, paragraph 73 of that case relates to subsection 22(6) and not subsection 31(1) of the Copyright Act, and relates to the situation of the person or persons "responsible for a communication". This

[1] *Roadshow Films Pty Limited v iiNet Limited* [2011] FCAFC 23 [329] (Jagot J, and Nicholas J agreeing at 23 [661]).

is a different matter to whether a work has been made “available online” within the meaning of subsection 10(1) of the Copyright Act.

Secondly, our understanding is that the use of software by end-users would not normally convey such rights. The specific terms of use agreed between a copyright owner or software distributor and end users may dictate that their use of the software involves communicating the software. However, we consider that mere use or access of SAAS by an end-user would not amount to that end user communicating that software and therefore using the exclusive rights of the copyright owner under subsection 31(1) of the Copyright Act.

It would be helpful for an example of this situation to be included in the Draft Ruling to provide a practical illustration of when this situation might arise. It would also be beneficial for additional details on when the end-user is taken to communicate the software, particularly in the context of SAAS, in order to provide greater certainty around the types of arrangements and features that would constitute use of copyright over the software.

In addition, we would suggest that one or more examples are provided around:

- the use of an intermediary between the end-user licensee and the software owner licensor, to demonstrate how “communication” of the software plays out, and where an end-user communicates the software when using SAAS, if this is envisaged as a possibility;
- situations demonstrating the concepts of "[communicating]… to the public" and “making of a copyright work available online irrespective of whether it is electronically transmitted”; and
- situations where there is an intermediary performing a function other than a “distributor” (for example, platform providers or server hosts) where the relevant copyright owner does not pay that intermediary for these functions, and whether this constitutes “communication” or some other use of copyright by the intermediary.

Application date

Once finalised, the Draft Ruling is proposed to apply both before and after its date of issue. The Draft Ruling provides that it will 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…” It also provides that “TR 93/12 applied to some arrangements covered by this draft Ruling. The proposed date of effect for the final Ruling does not prevent TR 93/12 applying prior to its withdrawal to the extent that it has been relied upon.”

As a general principle, where both:

- the ATO issues a new public ruling that covers the same matters as a previous public ruling that has been or will be withdrawn; and
- the new ruling is proposed to operate both prospectively and retrospectively, then as a matter of good tax administration and fairness to taxpayers,

the new ruling should clearly and explicitly describe the areas not covered in the prior ruling that are now addressed in the new ruling and to which the new ruling will operate retrospectively.

Specifically in relation to the Draft Ruling and TR 93/12, we note that the scope of TR 93/12 is broader than that which is indicated in the Notice of Withdrawal in relation to that Ruling. Paragraphs [1] and [2] of TR 93/12 which set out what the Ruling is about provide that: [**emphasis added**]

> *1. This Ruling looks at the income tax implications arising from the development and marketing of computer software.*
>
> *2. The Ruling canvasses:*
>
> *(a) the nature and assessability of receipts from the marketing of computer software, with particular reference to whether or not such payments are royalties; and*
>
> *(b) whether computer software is trading stock for income tax purposes.*
>
> *Paragraph 3 of the Draft Ruling provides: [emphasis added]*

> *"In addition to the matters covered by this Ruling, TR 93/12 dealt with the assessability of receipts in respect of software and the treatment of software as trading stock under subsection 70-10(1) of the Income Tax Assessment Act 1997 (ITAA 1997)."*

This indicates that the Draft Ruling and TR 93/12 rule on the same matter: whether receipts from the licensing and distribution of software will be characterised as royalties. For this reason, we are of the view that the Draft Ruling should only apply prospectively. Alternatively, as outlined above, the Draft Ruling should clearly and explicitly describe the areas not covered in TR 93/12 that are now covered in the Draft Ruling and to which the Draft ruling will operate retrospectively.

While it is appropriate that taxpayers can continue to rely on TR 93/12 where they have done so previously, with a retrospective application, some taxpayers may be in a position where they do not consider they fall within the new views expressed in the Draft Ruling. Our concern in this regard relates to cross-border transactions among large multinational entities and groups which historically had relied on TR 93/12 to support a position that certain payments or transactions were not royalties and consider that the Draft Ruling does not apply to their situation, but did not enter into a settlement with the ATO or otherwise obtain a private ruling applying to their circumstances.

This is 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* (**ITAA 1936**). This would effectively result in the relevant payments of an affected taxpayer from all prior periods giving rise to outstanding withholding tax obligations.

Apportionment of payments on a "fair and reasonable" basis

The Draft Ruling provides at paragraph [79] that a payment will need to be apportioned on a "fair and reasonable basis" in cases where a software distributor makes a single undissected payment, partly for the right to use the copyright in software and partly to secure other rights. We recommend that the ATO includes additional guidance about the factors that will be taken into account in determining whether an apportionment has been made on a fair and reasonable basis.

We consider that it would provide greater clarity to taxpayers if the ATO provides examples of both appropriate and inappropriate methods.

Interaction with tax treaties

The Draft Ruling does not adequately contemplate the interaction with double tax treaties. Our understanding from our members in practice is that it is likely that the majority of cross-border payments in relation to software will be made to residents of countries which have entered into a double tax treaty with Australia. For this reason, the Draft Ruling should provide clarity as to the impact on such arrangements.

We acknowledge that it would be difficult for the Draft Ruling to address the nuances of the interaction with every double tax treaty to which Australia is a party (as well as the impact of the Multilateral Instrument (**MLI**) in modifying any such treaties). However, we consider it would be beneficial for this to be addressed through one or more of the existing examples or by way of an additional example referencing a specific and common double tax treaty with Australia.

Use of undefined terms

There are a number of undefined terms and expressions which are used repeatedly throughout the Draft Ruling. Some examples include:

- modify the software/modify or adapt [the] software
- reproduce the software/reproduce the work in a material form
- software-as-a-service
- cloud-based technology
- distribution of software
- distribution agreement

These terms and expressions are important in the context of matters considered in the Draft Ruling and should be distinctly defined or clearly described.

We provide further context as to why clarification of these terms is important, using the term ‘modify the software’ as an example. This expression is used throughout the Draft Ruling without definition as to what kind of modification is contemplated. In particular, it is not indicated whether a modification to software necessarily requires a change being made to the underlying source code associated with that software. The term ‘modify the software’ could also conceivably encompass choosing between different options that are already imbedded within the software but without the need to access the underlying source code. In The Tax Institute's view, the Draft Ruling should make it clear that the term ‘modify the software’ only relates to the situation where access to the underlying source code has been provided and the source code is modified.

We consider it is preferable to refer directly to definitions in Ruling section, if not to include the definitions upfront. For example, a definition of the term ‘simple use’, which is crucial in the context of matters addressed in the Draft Ruling, is provided in paragraph 68 in Appendix 1 and supported by further explanatory material in footnote 13.

Other specific comments

There are a number of issues we have identified in respect of language used in the Draft Ruling. We are also of the view some of the cases cited in footnotes as support for the views in the Draft Ruling require further consideration. We would be pleased to discuss these with you at your convenience.

APPENDIX B

About The Tax Institute

The Tax Institute is the leading forum for the tax community in Australia. We are committed to representing our members, shaping the future of the tax profession and continuous improvement of the tax system for the benefit of all, through the advancement of knowledge, member support and advocacy.

Our membership of more than 11,000 includes tax professionals from commerce and industry, academia, government and public practice throughout Australia. Our tax community reach extends to over 40,000 Australian business leaders, tax professionals, government employees and students through the provision of specialist, practical and accurate knowledge and learning.

We are committed to propelling members onto the global stage, with over 7,000 of our members holding the Chartered Tax Adviser designation which represents the internationally recognised mark of expertise.

The Tax Institute was established in 1943 with the aim of improving the position of tax agents, tax law and administration. More than seven decades later, our values, friendships and members' unselfish desire to learn from each other are central to our success.

Australia's tax system has evolved, and The Tax Institute has become increasingly respected, dynamic and responsive, having contributed to shaping the changes that benefit our members and taxpayers today. We are known for our committed volunteers and the altruistic sharing of knowledge. Members are actively involved, ensuring that the technical products and services on offer meet the varied needs of Australia's tax professionals.