


# ***TR 2008/7EC - Compendium***

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## Ruling Compendium – TR 2008/7

A compendium of responses to the issues raised by external parties to Draft Taxation Ruling TR 2007/D5 – Income tax: royalty withholding tax and the assignment of copyright

This compendium of comments has been edited to maintain the anonymity of entities that commented on the draft ruling.

### Summary of issues raised and responses

Issue No.	Issue raised	Response
1.	<p><b>Context setting</b></p> <p>In respect of the definition of copyright, the following points were made–</p> <p>As copyright is a form of personal property, it can be dealt with in any manner that is analogous to other forms of personal property. This is consistent with the Australian Government's view on the matter:</p> <p style="padding-left: 40px;"><i>Copyright can be dealt with in the same way as other forms of personal property. It can be assigned, licensed, given away, sold, left by will, or passed on according to the laws relating to intestacy or bankruptcy – Attorney-General's website cited.</i></p> <p>The <i>Copyright Act 1968</i> (Copyright Act) clearly envisages that the bundle of rights that comprise copyright can be separated into divisible, distinct parcels of rights (subsection 196(2) of the Copyright Act). As copyright is movable property, it follows that a partial assignment of copyright constitutes the disposal of certain divisible rights from the assignor to the assignee under the conditions specified in the assignment.</p> <p>As the assignee is the deemed owner of the copyright for all purposes of the Copyright Act, the assignee of the copyright can make a civil claim (referred to as an 'action' in Part V, Remedies and Offences, of the Copyright Act) for the infringement of copyright (section 115 of the Copyright Act).</p> <p>The Copyright Act distinguishes an assignment of copyright (including a partial assignment) and a licence of copyright (section 196).</p>	<p>In relation to the Copyright Act there is no disagreement with these points.</p>

<p>2.</p>	<p><b>General proposition</b></p> <p>It is contended that payments which constitute a sale of rights under a copyright should not be treated as royalties as it is not payment ‘for use of’ an item of property.</p> <p>An assignment of copyright, which constitutes a significant sterilisation of the rights of the original copyright owner, should be treated as a sale of an asset and not the receipt of a royalty.</p> <p>Payments for the acquisition of copyright should be properly characterised as a capital acquisition which does not attract a liability to royalty withholding tax.</p>	<p>This proposition is too broadly expressed to be accepted without some qualification because the Commissioner considers that in certain circumstances the payments may be a royalty pursuant to Australia’s tax treaties and domestic law. However in many other situations the proposition may be correct. The purpose of the ruling is to try and draw out the distinctions in a practical way in accordance with the law.</p> <p>The Commissioner accepts that an ‘outright sale’ of copyright is not a payment for the use of, or right to use the copyright and therefore is not a royalty.</p> <p>The issue and divergence of opinion rests in what constitutes an outright sale and/or a ‘significant sterilisation of rights’. This will be further drawn out and discussed below. However it is considered that payments made for partial assignments, specifically those that are not comparable to an outright sale, having regard to the factors set out in paragraph 16 of the ruling, are for the use of, or right to use copyright and therefore royalties.</p>
<p>3.</p>	<p><b>The ordinary or case law meaning of royalty</b></p> <p>The cases disclose two key conditions that a payment must satisfy before it can be regarded as a royalty. First, the payment must be calculated by reference to the actual or intended use of the copyright. Second, the payment must be consideration for the grant or exercise of a right that would otherwise belong exclusively to the owner of the copyright.</p> <p>A payment for the partial or full assignment of copyright could never be a ‘royalty’ under the ordinary meaning because the payer of the amount will become the owner of the underlying property, and the recipient will cease to be the owner. Importantly, there will be no grant of separate rights in relation to the underlying property.</p> <p>Cases cited:</p> <ul style="list-style-type: none"> <li>• <i>McCauley v. FCT</i> (1944) 69 CLR 235 (<i>McCauley</i>);</li> <li>• <i>Stanton v. FCT</i> (1955) 92 CLR 630 (<i>Stanton</i>);</li> <li>• <i>Thomson v. Deputy Federal Commissioner of Taxation</i> (1929) 43 CLR 360 (<i>Thomson</i>); and</li> <li>• <i>Minister of National Revenue v. Spooner</i> (1933) AC 684 (<i>Spooner</i>).</li> </ul>	<p>The two key conditions set out are accepted in general but the application of these conditions needs to be considered across all scenarios. While ownership of property may transfer from the payee to the payer, associated payment(s) may still be a royalty dependent on the circumstances. That is, where the payments are made in relation to use, are calculated and made dependent upon use, the payments will be royalties as commonly understood. This point is explained at paragraphs 26 to 30 of the ruling.</p> <p>Although <i>McCauley</i> is in respect of timber cut from land, the majority judgements from the decision also make this point clear. That is, a change of ownership is not the determinative factor in characterising the payments in relation to royalties. Latham CJ noted, at page 240: <i>It was an agreement for the sale of growing timber to be taken away by the purchaser, and was therefore an agreement for the sale of goods.</i></p> <p>Latham CJ described the contention for the Commissioner as being:</p> <p style="padding-left: 40px;"><i>it being admitted that the moneys received were not the proceeds of any business carried on by the taxpayer and that they represent the price of goods which were capital assets, nevertheless, as that price was paid in the form of royalties, the moneys are part of the taxpayer’s assessable income.</i></p> <p>Hence the question for decision was whether certain payments made to the taxpayer were received as or by way of royalty under its ordinary meaning.</p>

		<p>Per Latham CJ at page 241:</p> <p><i>In my opinion the word 'royalty' is properly used for the purpose of describing payments made by a person for the right to enter upon land for the purpose of cutting timber of which he becomes owner, where those payments are made in relation to the quantity of timber cut or removed. Thus I am of opinion that the moneys received by McCauley were royalties and accordingly part of his assessable income (emphasis added).</i></p> <p>McTiernan J at page 246 reinforces that payments made to purchase assets may nonetheless constitute royalties:</p> <p><i>The word 'royalty' is also commonly applied to moneys which the lessee of a mine pays to the lessor for the right to work it: the amount of the royalty may be fixed by reference to quantities of material won from the mine. Hence in a business or commercial sense the word may be used to refer to moneys <u>which are part of the proceeds of the sale of a capital asset</u> (emphasis added).</i></p> <p>The explanation in the ruling in respect of case law royalties is consistent with a range of texts, for example refer to Woellner Barkoczy Murphy Evans, Australian Taxation Law 2007, 17<sup>th</sup> Edition at paragraph 5-500:</p> <p><i>Some examples of 'royalties' in ordinary usage include:</i></p> <ul style="list-style-type: none"><li>• ...</li><li>• <i>payments for an assignment or sale of copyright calculated by reference to subsequent sales of the material for which copyright was transferred. An example is royalties payable to an author as consideration for the absolute assignment of copyright to the publisher, where the amount of royalty depends upon the number of books sold.</i></li></ul> <p>In terms of the decisions cited:</p> <p>The <i>Spooner</i> and <i>Thomson</i> cases do not deal with the meaning of royalty but rather concentrate on the distinction between income and capital. That they are not on point was recognised by Latham CJ in <i>McCauley</i> at page 239.</p> <p>The <i>McCauley</i> and <i>Stanton</i> decisions both involved the sale of timber. In <i>McCauley</i> payments for the right to cut and remove timber was held to be a royalty. In contrast the payments in <i>Stanton</i> were not royalties because the payments had to be made whether or not the purchaser's rights were exercised and the fixed price was calculated by the timber described and not upon the amount actually taken.</p>
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		<p>Accordingly the proposition put that a payment for the partial or full assignment of copyright could <u>never</u> be a royalty under the ordinary meaning because the payer of the amount will become the owner of the underlying property and the recipient will cease to be the owner is not accepted. Examples 2, 2(a) and 2(b) at paragraphs 42 to 47 illustrate the distinction.</p>
<p>4.</p>	<p><b>Consideration not calculated with reference to use</b></p> <p>The consideration for the partial assignment of copyright reflects the agreed value of the acquired property. The payment is not calculated by reference to the revenue that could be generated through the production or reproduction of the assigned property. In other words, there is no nexus between the payment made by the assignee and the manner in which the copyright is used. This is because the assignee has acquired from the assignor a distinct, divisible set of rights as specified under the assignment and payment for it does not represent consideration for the exploitation of the rights granted. Therefore the payment for the partial assignment of the copyright cannot be regarded as being 'for the use of, or right to use' the copyright as there has been an outright acquisition of certain rights comprised under the assignment.</p> <p>Case law referred to:</p> <ul style="list-style-type: none"> <li>• <i>McCauley v. FCT</i> 3 AITR 67;</li> <li>• <i>Stanton v. FCT</i> 6 AITR 216;</li> <li>• <i>FCT v. Sherritt Gordon Mines</i> 77 ATC 4365 (<i>Sherritt</i>);</li> <li>• <i>Withers v. Nethersole</i> (1948) 1 All ER 400 (<i>Withers</i>);</li> <li>• <i>Desoulter Bros v. Hanger &amp; Co Ltd and Artificial Limb Makers</i> (1936) 1 All ER 535 (<i>Desoulter Bros</i>).</li> </ul>	<p>Where parties are dealing at arms length the price paid for an assignment will be determined by its market. Revenue and profits which will be generated would be expected to be a factor in determining the market value of an assignment. As noted in a public comment on this draft ruling:</p> <p style="text-align: center;"><i>As a practical matter it would be rare to find an assignment of copyright that did not consider the anticipated return (and therefore, by implication use) in determining the consideration for that assignment.</i></p> <p>The general proposition that there is no nexus between the payment price of a partial assignment and its intended use is not accepted. Each case would need to be assessed on its own facts to determine any nexus. Notwithstanding, the matter can only be one of the factors taken into account with other relevant factors in deciding whether the payment represented a royalty.</p> <p>Therefore the conclusion that a payment for a partial assignment cannot be for the use of, or right to use does not follow.</p> <p>In terms of the decisions cited: <i>McCauley</i> and <i>Stanton</i> have been discussed above. <i>Sherritt</i> revealed a legislative defect in that royalties were defined by reference to the UK tax treaty which had no application to a Canadian resident. The court also found that there was not a royalty within the ordinary meaning because the payments at issue were for technical assistance and information which the payer was entitled to use, once supplied without the grant of any additional right to do so. In <i>Withers</i> the issue was whether 'royalty' receipts in respect of a partial assignment of film rights for a period of 10 years were income or capital. The court found that as the taxpayer was not carrying on a trade or profession the receipts were capital and not 'annual profits or gains' pursuant to the UK tax legislation in force at the time. Similarly the issue in <i>Desoulter Bros</i> was also whether the sum in question was income or capital.</p>

\* J Cherrington, J Willis: Paper presented at TIA International Masterclass NSW Division Sept 2007 at page7.

		<p>Subsection 128A(1AA) of the <i>Income Tax Assessment Act</i> (ITAA 1936) defines income to include a royalty. Therefore the question of whether royalty receipts are income or capital is not relevant in determining whether withholding tax will apply (refer to the ruling at paragraph 58).</p> <p>Further such a distinction is not relevant in determining whether a receipt will be a royalty, as explained by Latham CJ in <i>McCauley</i> at pages 239-240:</p> <p><i>The Commonwealth Income Tax Assessment Act, however, does tax, and validly taxes, certain receipts which are of a capital nature (Resch v. Federal Commissioner of Taxation (1)). Thus, even if it be conceded that the timber sold in this case was a capital asset, that fact does not necessarily mean that the proceeds of the sale are not taxable. The question for decision is whether the proceeds of the sale of timber, though representing the price of a capital asset, were an 'amount received as or by way of royalty'.</i></p> <p>Additionally refer to <i>Case U33 87 ATC 250</i> where it was found that the lump sum payment was a royalty within the extended section 6(1) definition and was also a capital receipt.</p>
<p>5.</p>	<p><b>The extended definition of royalty under section 6(1)</b></p> <p>The assignment of copyright will also not meet the extended definition in section 6(1) of the ITAA 1936 because once again the payment is for the copyright itself not for the use of or right to use.</p> <p>The relevant amount must therefore be paid or credited 'for ... the use of ... any copyright' or 'for ... the right to use ... any copyright'. That is, the amount must be paid or credited for the use of, or the right to use, copyright that another person will continue to own. It follows that the same restrictions apply to the extended definition, as identified above in relation to the ordinary meaning. A payment for a partial or full assignment of the copyright will therefore be excluded from the extended definition on the basis that it is a payment 'for the copyright' rather than a payment 'for the use of the copyright' or 'for the right to use the copyright'.</p>	<p>The Commissioner accepts that an unlimited assignment is equivalent to an outright sale and therefore the payment made is not a royalty.</p> <p>The critical issue therefore is in what circumstances will a partial assignment be equivalent to an outright sale, being 'for the ownership of the copyright' as opposed to being for the 'use of, or right to use the copyright' The issue and the determining factors are set out in paragraphs 13-20 of the ruling.</p>

<p>6.</p>	<p><b>The extended definition of royalty under section 6(1)</b></p> <p>It is common practice for an assignee to enter into partial assignments that are limited in a number of ways. The existence of these limitations does not impact on the value of consideration for the assignment by virtue of the fact that the value is determined with regard to these limitations.</p> <p>For example, there would be little or no value to an Australian resident in obtaining worldwide publishing rights in respect of assigned copyright material if it only publishes material in Australia and New Zealand. Further, any value of assigned copyright that is limited to a time period of the number of times that the assigned copyright can be published is usually exploited within those limitations. Therefore there would be little value in having such limitations removed. The value in respect of any literary work or photograph that is subject to copyright with a limitation period (usually 6 month assignments) is usually diminished significantly (and arguably exhausted) during that period by virtue of the fact that there are more recent literary works or photographs that have greater value in the market place.</p>	<p>The Commissioner considers that if the value of the assignment is determined with regard to the limited rights obtained then these limitations influence the amount of consideration paid.</p> <p>From a global perspective, the market value for geographic regions (or countries) will be influenced by many factors such as population and demand for a product within that region. In an arms length situation the price paid by the assignee would be expected to reflect the exploitation value of the rights obtained with reference to the particular markets for the period of time that the rights are required.</p> <p>The ruling in Example 3 at paragraph 48 recognises that the economic value of the copyright may be significantly diminished during the assignment period. There would also be examples where the economic value of copyright is not significantly diminished where subsequent literary works or photographs cannot be produced for whatever reason or are not relevant (for example historical articles or those in respect of deceased people of interest).</p> <p>The fact that an assignee only requires material for a relatively short period of time, compared to the period that copyright subsists, points to the need to only 'use' the copyright rather than a need to 'own' the copyright. That is, where assignments are specifically limited, the assignee will not fully acquire all the substantial ownership rights in respect of the Australian copyright. The Commissioner therefore considers that the payments that the assignee makes in these circumstances are in respect of the use of the copyright and are therefore royalties.</p>
<p>7.</p>	<p><b>Economic substance</b></p> <p>The legislature, the courts and the Commissioner have all consistently accepted that it is inappropriate to tax transactions on the basis of their purported 'economic substance' or some 'economic equivalence' approach. We therefore submit that the interpretative approach taken in the draft ruling should be reconsidered and substantively amended.</p> <p>The principle that one looks to the substance of an agreement does not condone applying the taxation law to its economic substance. The courts have always comprehensively rejected any attempt to assess taxpayers on such a basis. So, in <i>Slutzkin &amp; Ors v. FCT</i> (1977) 140 CLR 314, Barwick C.J. said at page 319:</p>	<p>The ruling does not take an economic substance or economic equivalent approach as commented. The ruling explains when payments for the assignment of copyright will be royalties pursuant to Australia's tax treaties and section 6(1) of the ITAA 1936. Accordingly the case and ATO View references made are not on point.</p> <p>If a payment is for the use of, or right to use copyright it will be a royalty. This is to be contrasted to the situation where the payment (not already being a royalty according to the case law meaning) is only for the ownership of the copyright (that is an outright sale). The ruling explains that, for tax purposes certain partial assignments are in substance, payments for the use of, or right to use, not for the ownership of the copyright. Substance in this context is not its economic equivalent but what the payments are essentially for. This point was made in the draft ruling TD 2007/D5 by reference to the decision of <i>Cliffs International Inc v. FCT</i> 79 ATC 4059 by a footnote 13 page 13. Barwick CJ relevantly explained at page 4064 as follows:</p>

*... the choice of the form of transaction by which a taxpayer obtains the benefit of his assets is a matter for him: he is quite entitled to choose that form of transaction which will not subject him to tax, or subject him only to less tax than some other form of transaction might do. I.R. Commrs v. Duke of Westminster (1936) AC 1, too easily forgotten, is still basic in this area of the law. There is no room in that area for any doctrine of economic equivalence. To the legal form and consequence of the taxpayer's transaction, which in fact has taken place, effect must be given: see Commr of I.R. (N.Z.) v. Europa Oil (N.Z.) Ltd. 70 ATC 6012; (1971) AC 760.*

Subsequent decisions have also continued to reject economic equivalence as a basis for taxation (*Consolidated Press Holdings Ltd & Anor. v. FCT* 98 ATC 5009 Hill J at p.5026).

The legislature must always insert specific provisions whenever it wishes to tax taxpayers on the economic substance of a particular arrangement. One example of such a provision can be found in the Debt/Equity rules in Division 974 of the *Income Tax Assessment Act 1997* (ITAA 1997) specifically, section 974-5(1) of the ITAA 1997:

*The test for distinguishing between debt interests and equity interests focuses on economic substance rather than mere legal form (see subsection 974-10(2)). The test is designed to assess the economic substance of an interest in terms of its impact on the issuer's position.*

In ATO ID 2003/972 Income Tax: Debt/Equity financing: unsecured notes that may be converted into preference shares the Commissioner expressly acknowledged this feature of the Debt/Equity rules:

*Division 974 of the ITAA 1997 classifies an interest in a company as a debt interest or an equity interest for tax purposes according to the economic substance of the rights and obligations of an arrangement rather than merely its legal form.*

Notice the necessary implication that, but for Division 974, such an interest would be classified (consistently with cases such as *Europa Oil*, *Slutzkin* and *CPH*) according to the mere legal form of the rights and obligations that comprise a particular financing arrangement.

*Then, the description given such payments by the parties cannot decide their quality. What was meant, in my opinion, in *Europa Oil (NZ) Ltd (no 2) v. Commr of IR (NZ)* 76 ATC 6001; (1976) 1 WLR 464, was that in deciding taxability, and the same is true of deductibility, the nomenclature applied by the party or parties cannot foreclose the examination of what in truth the receipts or payments relevantly are.*

Note that this reference has not been relied upon in the final ruling.

The issue may also be illustrated by relevant Canadian decisions considering whether payments are royalties under Canada's domestic tax law and tax treaties in respect of films (refer Appendix 2 of the ruling for detailed comment).

The conclusion from these Canadian cases that payments for assignments limited by time are for use and payments for unlimited assignments are for ownership is consistent with the ruling.

This is also the approach taken by the Internal Revenue Service of the United States based on US case law refer for example Revenue Rulings 54-409, 60-226 and 71-564. Note that these US rulings have not been referred to in the ruling.

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	<p>The Commissioner has already articulated the relevant principles in Taxation Ruling TR 2006/13 Income tax: sale and leasebacks (at paragraphs 76 and 77).</p> <p>It is contended that the substance of any arrangement for the purposes of determining the basis of taxation will take its legal form unless there are specific sections in the tax law that taxes the economic substance of a particular arrangement. In the absence of these specific taxing provisions, the Commissioner is in no position to imply that the economic substance of all assignments of copyright will be for the use, or right to use copyright.</p> <p>As a matter of law, an assignment of copyright should be considered a transfer of legal ownership and not for the use of or right to use copyright.</p>	
8.	<p><b>Sham</b></p> <p>The analysis of relevant judicial authority in the draft ruling reflects a 'sham transaction' approach and therefore inappropriately cites license cases (such as <i>Longmans Green</i>, <i>Case U33</i> and <i>Franklin Mint</i>) in relation to the treatment of payments in respect of assignments of copyrights. The examples given in the draft ruling reflect the same approach and, on that basis, reach precisely the wrong conclusion as to the imposition of royalty withholding tax.</p> <p>Absent such a 'sham transaction', the taxation law invariably applies to the parties' actual legal rights and obligations. The Commissioner expressly acknowledged the primacy of such rights and obligations in TR 2006/13 at paragraph 79.</p>	<p>The ruling proceeds on the basis that an effective assignment has been made. It is not accepted that the judicial analysis in the ruling reflects a 'sham transaction' approach as suggested (refer Comments 15 and 16 below). Note that cases of <i>Longmans Green</i> and <i>Franklin Mint</i> cited in the draft ruling are not relied upon in the ruling.</p>
9.	<p><b>Rights to take legal action</b></p> <p>Payments made for the assignment of copyright are solely for the transfer of legal ownership of the copyright. As a consequence rights to take legal action are transferred to the assignee.</p>	<p>It is accepted that the rights to take legal action in respect of the property assigned is transferred to the assignee. Rights to take legal action are not determinative of whether the payments made are for the use of, or right to use copyright.</p>

	<p>It is contended that a payment in respect of the acquisition of copyright is not in substance 'for the use of, or right to use copyright'. If it were the assignor (not the assignee) would have legal recourse to any breach of copyright.</p>	
<p>10.</p>	<p><b>Australian copyright law &amp; world wide rights</b></p> <p>It is contended that a separate asset arises in each country for which copyright is acknowledged. Under Australian copyright law, a copyright will only subsist by operation of the Copyright Act. Therefore, under Australian law, the rights arising from a copyright is a distinct asset from those rights afforded in other countries. As such, it is contended that the assignment of copyright, even for a limited period, is an extensive foreclosure of the original copyright holder's asset and should be treated as a sale of an asset.</p> <p>Australian copyright law ultimately finds its source in the <i>Berne Convention for the Protection of Literary and Artistic Works</i> and the <i>Universal Copyright Convention</i>. Australia is a signatory to both Conventions. However, neither Convention automatically has the force of law in any jurisdiction. Instead, the signatories to each Convention thereby agree to enact domestic legislation that will give effect to the relevant rights and obligations (including a mechanism for the assignment of copyright).</p> <p>However, this does not mean that copyrights somehow become a form of global property. They arise, are protected, and can only be assigned, under the law of a particular jurisdiction.</p> <p>It follows that an assignment of the 'Australian copyright' is not, in terms, a partial assignment of the relevant intellectual property. Such a transaction actually involves a full assignment of all the rights that arise under Australian law in relation to that copyright. It is only a 'partial' assignment in the very limited sense of the word – in that the holder of the copyright is not also assigning the rights that arise in relation to that copyright under the domestic laws of the other signatories' jurisdictions.</p>	<p>The situation regarding international copyright protection is summarised below:</p> <p><i>In accordance with Australia's international obligations, section 184 provides that Regulations may be made extending provisions of the Copyright Act 1968 to subject-matter made or published in another country, buildings situated in another country, subject matter made by a citizen, national or resident of another country or bodies incorporated in another country and broadcasts made from another country.</i></p> <p><i>The Copyright (International Protection) regulations 1969 extend copyright protection under the Copyright Act to works, published editions of works, films and sound recordings having the necessary connecting factor to countries who are parties to the Berne Convention, the Universal Copyright Convention and countries who are members of the World Trade Organisation. Protection is also extended to broadcasts having the necessary connecting factor to countries who are party to the International Convention for the Protection of Performers, Producers of Phonograms and Broadcasting Organisations (Rome Convention).</i></p> <p><i>Under s185 the Governor General may make Regulations denying copyright protection to copyright subject-matter if the author or maker is a citizen or national (not resident in Australia) of a country or corporation incorporated in a country, which in the opinion of the Governor General, does not provide adequate protection to Australian works. No regulations have been made under this section.<sup>†</sup></i></p> <p>Section 30 of the Copyright Act specifically envisages owners in different countries of the same particular act or class of acts.</p> <p>Refer to Comment 7 above which discusses two Canadian tax decisions dealing with the international assignment of film copyright.</p> <p>It is not accepted that the approach taken in the ruling is not supported by the underlying legal framework.</p>

<sup>†</sup> R Reynolds and N Stoianoff, Intellectual Property, Text and Essential Cases (Second Edition), The Federation Press 2005, NSW at page 74.

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	The distinction that the draft ruling draws between partial (geographic) assignments of copyright, and full assignments, is therefore not supported by the underlying legal framework.	
11.	<p><b>The operation of Australia’s tax treaties and the treaty definition of royalties</b></p> <p>Section 17A(5) of the <i>International Tax Agreements Act 1953</i> (ITAA 1953) provides that where a payment does not fall within the meaning of a royalty under the agreements, then it will not be subject to PAYG withholding despite it being a royalty under section 6(1) of the ITAA 1936. The section 6(1) definition of royalties differs to the definition in various tax treaties. This is not addressed in the draft ruling and the Commissioner is urged to provide guidance accordingly.</p>	The draft ruling has been comprehensively amended to deal with the operation of Australia’s tax treaties.
12.	<p><b>The operation of Australia’s tax treaties and the treaty definition of royalties</b></p> <p>We also query whether the draft ruling can override the application of the Royalty article of a tax treaty to which Australia is a party. Articles 26 and 31 of the 1969 Vienna Convention on the Law of Treaties provide:</p> <ul style="list-style-type: none"> <li>• every treaty in force ... must be performed ... in good faith; and</li> <li>• a treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose.</li> </ul> <p>To unilaterally extend the meaning of royalty from what it was understood to mean at the time of entering into the treaty could arguably lead to questions concerning this. An example of treaty practice is highlighted by Article 12 of the US/Australia treaty which explicitly extends the definition of a royalty to include ‘income derived from the sale, exchange or other disposition of [copyright] to the extent to which the amounts realized on such sale, exchange or other disposition are contingent on the productivity, use or further disposition of such property or right’. The strong inference here is that income from the sale or other disposition of copyright would not normally be regarded as a royalty.</p>	<p>The ruling does not ‘override’ the application of the royalty article found in Australia’s tax treaties (refer sections 4 and 17A(5) of the ITAA 1953).</p> <p>The operation of the US tax treaty is discussed in the ruling (refer to paragraphs 21 to 24).</p>

<p>13.</p>	<p><b>OECD Model Tax Convention</b></p> <p>It is contended that the OECD's Model Tax Convention treats payments for the partial assignment of copyright as being an asset purchase and not a royalty.</p> <p>The Revised Commentary on Article 12 (Royalties) of the OECD Model Tax Convention expressly states at paragraph 16:</p> <p><i>Each case will depend on its particular facts but in general such payments are likely to be commercial income within Article 7 or a capital gains matter within Article 23 rather than royalties within Article 12. <u>That follows from the fact that where the ownership of rights has been alienated in full or in part, the consideration cannot be for the use of the rights. The essential character of the transaction as an alienation cannot be altered by the form of the consideration, the payment of the consideration in installments or, in the view of most countries, by the fact that the payments are related to a contingency</u> (emphasis added).</i></p>	<p>It is noted that the OECD Model Commentary was updated on 18 July 2008 with a number of amendments made in respect of royalties which assist in clarifying the subject matter of the ruling. Specifically the quoted paragraph 16 now reads as follows:</p> <p><i>Each case will depend on its particular facts but in general if the payment is in consideration for the transfer of rights that constitute a distinct and specific property (which is more likely in the case of geographically-limited than time-limited rights), such payments are likely to be business profits within Article 7 or a capital gain within Article 13 rather than royalties within Article 12. That follows from the fact that where ownership of rights has been alienated in full the consideration cannot be for the use of rights....</i></p> <p>As explained below, this paragraph is specifically in respect of computer software. The more general discussion is in paragraph 8.2 which is as follows.</p> <p><i>Where a payment is in consideration for the transfer of the full ownership of an element of property referred to in the definition, the payment is not in consideration 'for the use of, or the right to use' that property and cannot therefore represent a royalty. As noted in paragraphs 15 and 16 below as regards software, difficulties can arise in the case of a transfer of rights that could be considered to form part of an element of property referred to in the definition where these rights are transferred in a way that is presented as an alienation. For example, this could involve the exclusive granting of all rights to an intellectual property for a limited period or all rights to the property in a limited geographical area in a transaction structured as a sale. Each case will depend on its particular facts and will need to be examined in light of the national intellectual property law applicable to the relevant type of property and the national law rules as regards what constitutes an alienation but in general, if the payment is in consideration for the alienation of rights that constitute distinct and specific property (which is more likely in the case of geographically-limited than time-limited rights), such payments are likely to be commercial income within Article 7 or a capital gains matter within Article 13 rather than royalties within Article 12</i></p> <p>The final ruling comments in detail upon the OECD Model Commentary at paragraphs 95-104.</p>
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<p>14.</p>	<p><b>Proposed retrospective application of the final ruling and TD 2006/10</b></p> <p>The views expressed in the draft ruling are clearly inconsistent with the Commissioner’s longstanding views on the meaning of ‘royalty’. For example, Taxation Determination TD 2006/10 Income tax: can a payment to a non-resident author for the use of his or her article be a royalty for the purposes of subsection 6(1) of the <i>Income Tax Assessment Act 1936</i>?</p> <p>Notice that the Commissioner’s view that the amount will still be a royalty only applies at paragraph 6:</p> <p style="padding-left: 40px;"><i>in the absence of more evidence as to the true nature of the agreement struck between the parties prior to use.</i></p> <p>Such evidence would be completely irrelevant if a payment in respect of a partial assignment is also a royalty.</p> <p>It is considered that the Commissioner’s previous views (as expressed in TD 2006/10) were substantively correct and therefore the draft ruling should not be issued in its current form. However, if this submission is not accepted, such that the final ruling is in substantively its current form, then it is submitted that the final ruling should only operate prospectively.</p>	<p>The Commissioner’s longstanding views in respect of royalties is set out in IT 2660 (dated 28 November 1991). That IT essentially repeats the views expressed in CCM 862 dated 26 July 1968 which was intended to explain, inter alia, the definition of royalties inserted into the ITAA 1936 with effect from 1 July 1968. It is not accepted that the draft ruling is inconsistent with CCM 862, IT 2660, TR 93/12 and TD 2006/10.</p> <p>TD 2006/10 has been misinterpreted. TD 2006/10 takes the view that a payment to an author will be a royalty if the payment is consideration for the use of or the right to use the authors copyright in the article (paragraph 1) notwithstanding that an associated invoice states that the payment is for an assignment. That is, without more evidence as to the true nature of the agreement struck between the parties the payment will be considered to be a royalty. The evidence required to establish that the payment was for an ‘outright sale’ and therefore not a royalty is consistent with IT 2660 and the ruling.</p> <p>The ruling merely clarifies in greater detail the Commissioner’s view on the specific issue in question and is intended to provide more extensive guidance. It is considered to be consistent with these documents. Accordingly no change to the date of effect clause is contemplated.</p>
<p>15.</p>	<p><b>Case U33 87 ATC 250</b></p> <p>It is contended that <i>Case U33 87 ATC 250</i> is not on point.</p>	<p><i>Case U33</i> illustrates that a lump sum payment that is not a royalty as explained by case law, can nonetheless be a royalty under the extended section 6(1) of the ITAA 1936 definition and accordingly has relevance.</p>
<p>16.</p>	<p><b>Franklin Mint Pty Ltd 93 ATC 4637</b></p> <p>It is contended that <i>FCT v. Franklin Mint Pty Ltd 93 ATC 4637 (Franklin Mint)</i> is not on point as it is concerned with the sales tax legislation which is fundamentally different to the income tax definition.</p>	<p>It is agreed that <i>Franklin Mint</i> is a sales tax decision however given the similarity in the drafting of the sections at issue; it is considered that the Court’s reasoning would equally apply in an income tax context. That is, whilst the way that the payment is described or computed may take it out of the definition of a royalty as explained by case law, it can nonetheless be a royalty under the extended section 6(1) of the ITAA 1936 definition.</p> <p>Notwithstanding, the <i>Franklin Mint</i> decision is not relied upon in the final ruling.</p>

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17.	<p><b>Definition of 'outright sale'</b></p> <p>Noted that IT 2660 does not define 'outright sale' and neither does the draft ruling.</p> <p>The Macquarie Definition (2<sup>nd</sup> revised edition) defines 'outright' to mean 'complete or total; downright or unqualified; completely or entirely; without restraint, reserve or concealment; openly; at once'. On this basis, the phrase 'outright sale' means a complete, entire sale that is without restraint or reserve. As discussed, the assignment of copyright constitutes the disposal of a distinct asset from the assignor to the assignee under the terms of the assignment. This should be considered to be an 'outright sale' as it represents a 'complete' sale of an item of personal property as such at law.</p>	<p>Factors to be considered in determining whether a partial assignment is comparable to an outright sale have been included in the ruling (refer paragraph 16). However, importantly it is clear that particularly limited assignments are not complete, unqualified or without restraint. It follows that such partial assignments cannot be 'outright sales'. It is accepted that unlimited assignments equate with outright sales.</p>
18.	<p><b>Adverse economic implications</b></p> <p>Assignment of copyrights is the most commercially practical way in which Australian businesses transact with foreign companies. By imposing taxation on the foreign resident who will then invariably on-charge the cost to the Australian purchaser, the Commissioner is effectively levying a second taxation on Australian businesses.</p>	<p>It is recognised that assignments of copyright are the means to transfer copyright under the Copyright Act. However this does not determine the application of Australia's taxation law.</p> <p>Foreign payees (resident in countries with which Australia has a tax treaty) would generally be entitled to tax relief in their country of residence under the relevant tax treaty in respect of the withholding tax imposed thereby eliminating double taxation. The more general matter of the potential economic effect of gross up clauses imposed by non-residents in relation to interest, dividend, and royalty withholding taxes is a policy matter which can be referred to Treasury.</p>
19.	<p><b>Adverse economic implications</b></p> <p>As the assignee of the copyright, being an Australian owner has a clearer and better right to challenge copyright infringements that occur in Australia than does a mere licensee. The copyright assignment represents a transfer of ownership of an asset from the assignor to the assignee for commercial reasons.</p>	<p>The assignee may be better placed than a licensee to challenge copyright infringements. Further it is recognised that assignments of copyright are the means to transfer copyright under the Copyright Act. However neither of these points has an impact on the application of Australian taxation law.</p>
20.	<p><b>The administrative function of the draft ruling</b></p> <p>The draft ruling indicates that it may have been issued to address administrative concerns in relation to excessively 'structured' transactions with respect to copyrights (that is tax-avoidance arrangements)</p>	<p>TD 2006/10 issued in response to Taxpayer Alert TA 2003/4 with both products only dealing with authors. The ruling deals with assignments of copyright more generally. The ruling sets out the Commissioner's views in respect of when assignments of copyright will give rise to royalties. This will assist taxpayers to comply with the law where they may have previously held the view that assignments of copyright will never give rise to royalties.</p>

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	<p>The draft ruling expresses the view that the consideration in respect of a partial assignment of copyright is a 'royalty' for these purposes. If this view is correct then all such consideration would be subject to royalty withholding tax, including consideration in respect of an assignment that was not 'structured' in any blatant, artificial or contrived way, but which merely took such a form as the most natural way to implement an ordinary commercial transaction.</p> <p>Furthermore, the consideration in respect of a full assignment of copyright would still remain outside the scope of royalty withholding tax, even if the transaction was blatantly, artificially or contrivedly 'structured' in this way.</p> <p>The approach taken in the draft ruling will therefore lead to the imposition of royalty withholding tax on taxpayers who have not 'structured' partial assignments of copyrights, and will fail to impose tax on taxpayers who have deliberately 'structured' full assignments. The draft ruling is therefore a poorly targeted response to the concerns that seem to have motivated its issue.</p> <p>We therefore submit that it would be far more appropriate for the Commissioner to apply the general anti-avoidance rules in Part IVA of the ITAA 1936 to overly 'structured' transactions that involve either partial or full assignments of copyrights.</p>	<p>The ruling does not deal with the application of Part IVA (refer paragraph 2) however Part IVA remains available to the Commissioner to deal with schemes falling within the statutory framework.</p>
21.	<p><b>The consequential question – deductibility</b></p> <p>Although the focus of the draft ruling is on withholding tax, for the sake of completeness, we raise the consequential question of whether the interpretation adopted means that such payments entitle the payer to a deduction for the 'royalty'. As the draft ruling seeks to classify assignment payments as payments for rights to use and therefore, prima facie, of a revenue character, this would appear to follow (subject to the application of the prepayment rules).</p>	<p>The scope of the ruling is restricted to the withholding tax implications. The question of deductibility for the payer of royalty payments is a separate matter, to be determined in accordance with the relevant provisions dealing with allowable deductions.</p>