TR 2014/1EC - Compendium

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Ruling Compendium – TR 2014/1

A compendium of responses to the issues raised by external parties to Draft Taxation Ruling TR 2013/D2 - *Income tax: commercial software developers: derivation of income from agreements for the right to use proprietary software and the provision of related services.*

Summary of issues raised and responses

Issue No.	Issue raised	Response
1	The Draft Ruling does not properly deal with the proper interpretation that should be given to the principle enunciated in *Arthur Murray (NSW) v. FCT* (1965) 114 CLR 314 (*Arthur Murray*) and in particular what practical business people in the industry accept as properly earned. In failing to do so, the proposed taxation regime will create an administratively costly and cumbersome environment where potentially each individual contract will need to be reviewed and classified with timing differences which may be numerous but minor. We believe that the Draft Ruling should embrace a principle that while the accounting principles are not determinative of the tax rules, in the case of software income recognition, they provide a reasonable and practical solution to the question of income recognition based on what practical business people in the industry accept as properly earned.	The Commissioner's consultation has revealed a divergence of accounting and taxation treatments across the industry with some of those directly consulted, recognising income for accounting and tax purposes consistent with the Commissioner's view. As is stated at paragraph 119 of TR 2009/5 and repeated in TR 2013/D2 and the final Ruling: The Commissioner's view is that there is no basis for preferring a taxation outcome based on an accounting treatment in accordance with current accounting standards over a taxation outcome based on the application of well established legal principles to a particular set of facts. The accounting treatment in paragraph 11 of Appendix 1 to Australian Accounting Standard AASB 118 *Revenue* looks to defer income regardless of whether an unqualified right exists to retain the income from the outset. This is a different approach to that accepted for derivation of income in Australian tax cases. The Commissioner also notes as a practical matter that where standard form contracts are employed, each will only require a single

		review and classification.
2	If the principle suggested in (1) above is not recognised, then we believe that the 'contingency of repayment' principle as outlined in the Draft Ruling should be extended to cover circumstances where the commercial environment is such that, notwithstanding the legal position, the customer expects the provision of further rights or services to support what the customer has purchased.	When a taxpayer has an unqualified right to retention of an amount of income, it has come home in the *Carden's case*[1] sense and is therefore derived. As such and in accordance with law it properly bears an incidence of taxation in that income year. A customer's expectation of further rights or services does not affect the incidence of derivation.
3	In the absence of (1) and (2), we believe that the Draft Ruling should provide for 'safe harbour rules of thumb' to ensure that commercial software developers are not required to analyse, classify and recognise the income from each individual contract. Such a position would be administratively cumbersome with little foreseeable benefit.	Business taxpayers in general must undertake suitable analysis of contractual arrangements with customers to determine whether or not income is 'earned' or 'unearned' in the sense contemplated in *Arthur Murray*. We have not been persuaded at this stage that there is an appropriate 'safe harbour' option. The Commissioner must administer the law consistently across the general body of taxpayers.
4	In addition we note that the title of Draft Ruling has changed from 'Income from software licensing agreements to 'commercial software developers'. The latter term is more limited than the former and may exclude from operation of the Draft Ruling a number of taxpayers who distribute software but do not develop it as such. We believe that reversion to the earlier title is appropriate.	Agreed. The title of the final ruling has been reverted for the reasons stated.
5	Include an example similar to **example 3** where the terms of the contract require the software provider to provide updates/upgrades as they become available and the software provider has a history of making available such updates /upgrades.	Agreed.
6	Include an example similar to **example 10** where the terms of the contract do not prevent customers from claiming damages in the event of down time.	Agreed.

[1] *CT* v *Executor & Trustee Agency Co of South Australia* (1938) 63 CLR 108 (*Carden's case).*

7	Paragraph 128 could be clarified to better articulate the established principle of derivation. The current wording suggests that an 'obligation to take further steps' is an additional criterion to a recoverable debt being created. This is done by using 'and' between the two points, which seemingly conflicts with leading cases such as *Gasparin, Farnsworth, Carden's & Henderson*. Perhaps an alternative way of drafting paragraph 128 could be: > For an accruals taxpayer, a gain has 'come home' when a recoverable debt has been created. In establishing if a recoverable debt has been created it is necessary to determine whether there are further steps to be taken before the taxpayer becomes entitled to payment. Finally, we think that *Gasparin* and *Farnsworth* are potentially more suitable case references for the TR as they look at steps that are required before income is derived, whereas *AGL* demonstrates that exceptional circumstances amounted to a condition precedent before a recoverable debt was created.	Noted. Adjustments have been made to paragraph 137 and paragraphs 162 and 163 of the final Ruling.
8	A contrary position is taken in the GST context to the view at paragraph 124 of the Draft Ruling in relation to the nature of a grant of a right to use proprietary software. The technical position taken in the Draft Ruling is neverthless agreed.	Noted.