TR 2024/D1 - Income tax: royalties - character of payments in respect of software and intellectual property rights

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There is a Compendium for this document: **TR 2021/D4EC** .

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Generated on: 28 November 2026, 05:51:08 AM

Status: **draft only – for comment**

Draft Taxation Ruling

Income tax: royalties – character of payments in respect of software and intellectual property rights

Relying on this draft Ruling

This publication is a draft for public comment. It represents the Commissioner's preliminary view on how a relevant provision could apply.

If this draft Ruling applies to you and you rely on it reasonably and in good faith, you will not have to pay any interest or penalties in respect of the matters covered, if this draft Ruling turns out to be incorrect and you underpay your tax as a result. However, you may still have to pay the correct amount of tax.

Table of Contents **Paragraph**

What this draft Ruling is about 1
Previous rulings 5
Class of entities and scheme 8
Definitions 9
Ruling **11**
Determination of royalty in *IBM Corporation* – no apportionment was necessary 20
Scenario 1 – performance of contract requires use copyright rights 23
Scenario 2 – agreement lacking in specificity regarding the parties' rights and obligations 36
Date of effect 42
Appendix 1 – Explanation **44**
Context 44
Introduction 46
Part 1 – Royalties **47**
Consequences of a payment being a royalty 47
Domestic tax law definition of a royalty 50
Interaction between the domestic tax law definition of royalty and the tax treaty definition of royalty 51
Payment for services 57
Other like property or right 58
Relevance of OECD Commentary 61
Elements of a royalty 71
However described or computed 74
Consideration 75

For 81
To the extent 103
Scenario 3 – *Reasonable method of apportionment* 116
Use 119
Part 2 – Copyright **120**
Payment for any copyright 120
Copyright 121
Any copyright 127
Copyright rights 130
Reproduction right 133
Material form 137
Communicate the work to the public 142
Communication 145
Determining the content of the communication 147
Making available online 149
Content of the communication 151
To the public 153
Make an adaptation 156
Commercial rental arrangement 157
Authorisation right 163
Matters relevant to determining authorisation 166
Software-as-a-service – authorising an Act 172
Part 3 – Non-copyright rights **175**
Part 4 – Embedded software **179**
Storage medium 179
Appendix 2 – Alternative views **183**
Appendix 3 – Your comments **187**

What this draft Ruling is about

1. This draft Ruling[1] considers when an amount paid under a software arrangement is subject to royalty withholding tax.[2] This turns upon whether an amount paid is a royalty as defined in subsection 6(1) of the *Income Tax Assessment Act 1936* (ITAA 1936) and the various tax treaties.[3]

[1] For readability, all further references to 'this Ruling' refer to the Ruling as it will read when finalised. Note that this Ruling will not take effect until finalised.
[2] Under section 128B of the *Income Tax Assessment Act 1936*.
[3] See sections 3AAA and 3AAB of the *International Tax Agreements Act 1953*.

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2. All legislative references in this Ruling are to the ITAA 1936, unless otherwise indicated.

3. The focus of this Ruling is on payments for the use of, or right to use, copyright or other like property or right. However, such payments may also be for the use of, or right to use, other intellectual property (IP) rights, or otherwise fall within the definition of a 'royalty'. This will also affect the characterisation of the payment.

4. The Ruling does not consider:

- whether or not the payment constitutes assessable income under sections 6-5 or 15-20 of the *Income Tax Assessment Act 1997* (ITAA 1997)
- the application of the transfer pricing rules[4] in Division 815 of the ITAA 1997 or former Division 13
- the potential application of Part IVA to software arrangements involving payments for the use of, or right to use, any IP right.

Previous rulings

5. Taxation Ruling IT 2660 *Income tax: definition of royalties* sets out the Commissioner's view on the meaning of royalties in subsection 6(1) and the context of various tax treaties. 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 Income Tax Assessment Act 1936?* deals with one aspect of payments to non-resident authors in respect of copyright. Taxation Ruling TR 2008/7 *Income tax: royalty withholding tax and the assignment of copyright* deals with the application of royalty withholding tax to assignments of copyright.

6. This Ruling replaces draft Taxation Ruling TR 2021/D4 *Income tax: royalties character of receipts in respect of software*, which in turn replaced Taxation Ruling TR 93/12 *Income tax: computer software* which was withdrawn with effect from 1 July 2021.

7. 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 ITAA 1997. These matters are now considered to be generally well understood and not needing to be covered in this Ruling.

Class of entities and scheme

8. This Ruling applies to cross-border payments made:

- by an Australian resident, or a non-resident, which is related to or connected with a permanent establishment in Australia
- under a software arrangement.

[4] In Division 815 of the ITAA 1997 (or former Division 13 of Part III).

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Definitions

9. The following table contains a list of definitions of terms used throughout this Ruling:

Table 1: List of terms and their meanings

Term	Meaning
Access control technological protection measure	Unless otherwise stated, this has the same meaning as in the definition of 'access control technological protection measure' in subsection 10(1) of the *Copyright Act 1968* (Copyright Act).
Agreements Act	*International Tax Agreements Act 1953.*
Commercial rental arrangement	Entry into such an arrangement is an exclusive right that forms part of the copyright under the Copyright Act.[5] Unless otherwise stated, this has the same meaning as in the definition 'commercial rental arrangement' in subsection 30A(2) of the Copyright Act.
Computer program	A set of statements or instructions to be used directly or indirectly in a computer in order to bring about a certain result.[6]
Copyright	The exclusive right to do certain acts under the Copyright Act.[7]
Distributor	An entity: • in a position to earn income (directly or indirectly through a sub-distributor) relating to the use of, or right to use, software, and • who is not the owner of the IP in relation to that software.
Domestic tax law definition of royalty	A reference to 'royalty or royalties' as defined in subsection 6(1).
Intellectual property rights or IP rights[8]	Any copyright, patent, design, model, plan, secret formula or process, trademark, or other like property or right.

[5] See paragraph 31(1)(d) of the Copyright Act.

[6] This is the same definition of 'computer program' in subsection 10(1) of the Copyright Act. See also section 47AB of the Copyright Act, regarding the meaning of computer program.

[7] In relation to works, see subsections 31(1) and 13(2) of the Copyright Act. This approach is consistent with the notion that where a term in a tax treaty is not defined, it will take its meaning from the domestic law of the country applying the tax treaty: see *Commissioner of Taxation v Seven Network Limited* [2016] FCAFC 70 (*Seven Network Limited*) at [63], per Kenny, Perram and Davies JJ. The term 'copyright' is used in the standard tax treaty definition but is not defined in it, nor is it defined in subsection 10(1) of the Copyright Act. However, section 8 of the Copyright Act provides that, subject to section 8A of the same Act (not presently relevant), copyright does not subsist other than by virtue of that Act. The Copyright Act tells us that copyright consists of certain exclusive rights which, however, differ as between the various classes of subject matter. The subject matter of most relevance for present purposes is a 'literary work', copyright in which consists of the exclusive rights specified in subsections 31(1) and 13(2) of the Copyright Act. It follows from the lack of definition of 'copyright' in the standard tax treaty definition that the term 'copyright' in this Ruling has the meaning that it has under the Copyright Act for the purposes of the tax treaty and the domestic tax law definition of royalty.

[8] This is a broader term than 'intellectual property' defined in subsection 995-1(1) of the ITAA 1997.

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Term	Meaning
OECD Commentary or OECD Commentaries	The terms 'OECD Commentary' and 'OECD Commentaries' are used in this Ruling to refer to the commentaries to the OECD Model Convention.[9]
OECD Model or OECD Model Convention	Unless otherwise stated, references in this Ruling to the 'OECD Model' or 'OECD Model Convention' are references to the 2017 version.
Other like property or right	Unless otherwise stated, this has the same meaning as in the definition 'royalty or royalties' in subsection 6(1).
Paid or payment	References in this Ruling to an amount paid should be taken to include a reference to an amount credited. Similarly, references to a payment should be taken to include a reference to a credit.
Software	The ordinary meaning is used in this Ruling, being 'programs which enable a computer to perform a desired operation or series of operations (opposed to hardware)'.[10]
Software arrangement	An agreement, arrangement or scheme under which a distributor makes payment or payments directly or indirectly[11] to the owner or licensee (as the case may be) of the copyright (or other IP) for the right to be in a position to earn income relating to the use of, or right to use, software.
Standard tax treaty definition	Refers to any definition of 'royalty or royalties' found in a tax treaty that includes a provision in the same, or substantially the same, terms as the following[12]: 1. Royalties arising in a Contracting State and beneficially owned by a resident of the other Contracting State may be taxed in that other State. 2. However, those royalties may also be taxed in the Contracting State in which they arise, and according to the law of that state… 3. The term "royalties" in this Article means payments or credits, whether periodical or not, and however described or computed, to the extent to which they are made as consideration for: a) the use of, or the right to use, any copyright, patent, design or model, plan, secret formula or process, trademark or other like property or right; b) the supply of scientific, technical, industrial or commercial knowledge or information; c) the supply of any assistance that is ancillary and subsidiary to, and is furnished as a means of enabling the application or enjoyment of, any such property or right as is mentioned in subparagraph (a) or any such knowledge or information as is mentioned in subparagraph (b); …

[9] OECD (2019) *Model Tax Convention on Income and on Capital 2017 (Full Version*), OECD Publishing, Paris.
[10] Macmillan Publishers Australia, *The Macquarie Dictionary* online, www.macquariedictionary.com.au, accessed 6 December 2023.
[11] Refer to paragraph 86 of this Ruling for an explanation on indirect payments.
[12] This version of the definition is sourced from Article 12 of the *Agreement Between the Government of Australia and the Government of Finland for the Avoidance of Double Taxation with Respect to Taxes on Income and the Prevention of Fiscal Evasion* [2007] ATS 36.

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Term	Meaning
Tax treaty	A comprehensive agreement given the force of law in Australia by the Agreements Act.[13]

10. Currently, the tax treaties where the definition of 'royalty or royalties' materially varies from the standard tax treaty definition are the:

- United States of America (USA)[14] and Mexican[15] tax treaties[16]
- Singapore[17] tax treaty.[18]

Ruling

11. Where a tax treaty applies, the royalty definition in that tax treaty is given primacy over the domestic tax law definition of royalty.[19] The domestic tax law definition of royalty is inclusive and covers amounts that would fall within the ordinary meaning of a royalty consistent with Australian case law. As a consequence, the domestic tax law meaning of royalties is broader than the standard tax treaty definition (which is exhaustive). It follows that where an amount is a royalty under a standard tax treaty definition, it will also be a royalty under the domestic tax law definition and royalty withholding tax will apply at the rate provided for in that tax treaty

12. The character of payments in relation to a software arrangement for, or that results in, the use of, or right to use, software in Australia, depends upon all the facts and circumstances of the particular case, including the terms of any agreement between the parties and the conduct of the parties in relation to the software arrangement.

13. An amount may be a royalty even if it is not paid periodically and howsoever the payment is described or computed. For example, payments made under an agreement need not be described as being for, or being calculated with reference to, the use of, or right to use, specified IP rights.[20]

[13] For more detail concerning the Commissioner's general approach to interpretation of tax treaties, see Taxation Ruling TR 2001/13 *Income tax: Interpreting Australia's Double Tax Agreements*.
[14] *Convention between the Government of Australia and the Government of the United States of America for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income* [1983] ATS 16.
[15] *Agreement between the Government of Australia and the Government of the United Mexican States for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income* [2004] ATS 4.
[16] The significance of the variation is discussed in paragraphs 21 to 25 of TR 2008/7.
[17] *Agreement between the Government of the Commonwealth of Australia and the Government of the Republic of Singapore for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income* [1969] ATS 14.
[18] The significance of the variation is discussed in ATO Interpretive Decision ATO ID 2012/67 *Income Tax: Singaporean resident company receiving Australian sourced royalties*.
[19] Subsection 4(2) of the Agreements Act. See also *International Business Machines Corporation v Commissioner of Taxation* [2011] FCA 335 (*IBM Corporation*) at [7] and *Seven Network Limited* at [8–16], per Kenny, Perram and Davies JJ.
[20] See paragraph 111 of TR 2008/7.

14. The following payments are characterised as a royalty where they are paid as consideration for one or more of the following[21]:

(a) the grant of a right to use IP, regardless of whether that right is exercised (paragraph (a) of the standard tax treaty definition) – for example, the grant of the right to reproduce a computer program, regardless of whether or not that right is exercised[22]

(b) the use of an IP right (paragraph (a) of the standard tax treaty definition) – for example, the use of a copyright right consists of doing an act in respect of a copyright work that is the exclusive right of the copyright holder, such as authorising the communication of a computer program[23]

(c) the supply of know-how in relation to an IP right referred to in subparagraphs 14(a) and (b) of this Ruling (paragraph (b) of the standard tax treaty definition)

(d) the supply of assistance furnished as a means of enabling the application or enjoyment of the supply (paragraph (c) of the standard tax treaty definition)

(e) the sale by a distributor of hardware with embedded software, where the distributor is granted or uses rights in the IP of the software.

15. The following payments are not royalties:

(a) consideration that is wholly for the grant of a right to distribute copies of a computer program, without the use of, or right to use, the copyright or another IP right

(b) consideration for the transfer of all rights relating to the copyright in software[24]

(c) payments from a distributor that are consideration wholly for the acquisition of hardware with embedded software, provided that the distributor does not use, and is not granted the right to use, any copyright or another IP right in the embedded software

(d) payments from a distributor that are consideration wholly for the acquisition of physical carrying media on which software is stored, provided that the distributor does not use, and is not granted the right to use, any copyright or another IP right in the embedded software

(e) consideration for the provision of services that are unrelated to any IP right referred to in paragraph (a) of the standard tax treaty definition or any knowledge or information mentioned in paragraph (b) of the standard tax treaty definition.

16. The enquiry under the standard tax treaty definition and the domestic tax law definition of royalty is often expressed as whether or not the payment is paid 'as consideration for' certain things. In this context, 'consideration' is what moves the payment and is something of value given in exchange for it. 'Consideration' does not have its technical meaning in contract law.

17. Where a payment is consideration for several things, only some of which fall within the standard tax treaty definition, the payment is a royalty to the extent that it is 'for' the

[21] In our view, the payments will be characterised as a royalty both under the standard tax treaty definition and domestic tax law definition of royalty.
[22] See paragraphs 133 to 136 of this Ruling.
[23] See paragraphs 163 to 171 of this Ruling.
[24] See TR 2008/7.

things that are within that definition. That is, the payment must be a royalty to at least some extent, even if it is also for other things that are not within the definition of a royalty.

18. If an undissected amount is paid as consideration for matters all of which are sufficiently connected with the things mentioned in the definition of royalty, the whole amount of the payment will be taken to be a royalty in the first instance. However, it does not necessarily follow that because an amount is paid as consideration for several things that it is paid only in part for each of them. For example, this will be the case where any IP rights granted are inseparable, from a practical and business point of view, from any other things for which the consideration is paid (see Scenario 1 of this Ruling).

19. In certain cases, apportionment may be required to ascertain the extent to which any payment is a royalty. Apportionment is to be done on a fair and reasonable basis considering all the relevant facts and circumstances of the particular case.

Determination of royalty in *IBM Corporation* – no apportionment was necessary

20. *IBM Corporation* involved payments from an Australian-resident company to non-residents in the USA in respect of a software licence agreement. In consideration for all the rights granted under the agreement, the Australian resident paid an agreed percentage of all revenue derived from authorising, licensing and distributing IBM programs to the non-resident rights holders.

21. The relevant definition of royalties was found in the USA tax treaty and the Court found it unnecessary to greatly focus on the interactions between the tax treaty and the domestic tax law definition of royalty.

22. Taking the whole of the agreement into account, the Court found that the non-residents granted such IP rights as were necessary for the use, marketing and distribution of the relevant products by the resident company. The agreement was not simply a distribution agreement which conferred distribution rights independently of the grant of IP rights. No apportionment was necessary, meaning that all the amounts paid under the agreement for the bundle of rights were royalties under the USA tax treaty. As a consequence, royalty withholding tax was payable on all the amounts paid under the agreement.

Scenario 1 – performance of contract requires use of copyright rights

23. *International Corporation (International) is a worldwide provider of software (Programs). It is a resident of the USA and parent company of the International Group.*

24. *Ireland Enterprises Limited (IEL) is a company registered in Ireland and member of the International Group. Operational Business Australia Pty Ltd (OBA) is an Australian company and head company of the MEC Group for the purposes of Part 3-90 of the ITAA 1997.*

25. *OBA became the principal distributor of the Programs in Australia through entry into a Licence Agreement (Agreement) between IEL and OBA. The key terms of the Agreement are:*

- *Clause 1 – OBA is appointed and authorised as a non-exclusive distributor of International Programs.*
- *Clause 2 – IEL retains all intellectual property rights to the Programs, including copyright.*

- *Clause 3 – OBA is granted a right to market, promote, distribute, copy (for the limited purpose of permitting end-users to make copies for their internal use) and sell licences for the Programs to end-users.*
- *Clause 4 – the distribution rights permit OBA to enter into end-user licence agreements (EULAs) for the Programs with end-users in Australia.*
- *Clause 5 – OBA must pay a royalty-free fee to IEL that equates to 97% of its net revenue from Product sales, in consideration for the rights granted under Clause 3. This clause states that the fee is not a royalty.*

26. *End-users obtain use of the Programs through one of 3 ways: electronic download, via cloud content hosted on servers controlled by IEL, or through physical copies shipped to them by IEL. In each situation, end-users are required to first enter into an EULA with OBA. After entering into an EULA, OBA will invoice the end-user and receive payment from them.*

Application of our view

27. *The relevant royalty definition is found in Article 13 of the Irish tax treaty.*[25] *For the purposes of this Ruling, this definition is a standard tax treaty definition. In our view, the rights granted to OBA under the Agreement include rights to do things that constitute rights to use copyright in the Programs.*

28. *The right to communicate a copyright work to the public is an exclusive right of the copyright owner. Although communication of the Programs originates from IEL in all 3 situations (electronic download, cloud content, physical copies), this does not preclude OBA from being one of the entities responsible for determining the content of the communication.*

29. *Entry into an EULA between OBA and the end-user is a precondition to the end-users using the Programs. The terms of the EULA specify which Programs an end-user will obtain use of. Therefore, OBA is one of the entities responsible for determining the content of the communication. Because of this, OBA authorises the communication of the Programs to the end-user by IEL.*

Authorise communication

30. *The exclusive right to communicate a work includes the exclusive right to authorise that communication. Considering the 3 propositions for what constitutes 'authorisation' (refer to paragraph 167 of this Ruling), OBA has authorised the communication of the Programs because:*

- *Before an end-user can obtain access to the Programs, they were required to enter into an EULA with OBA. Therefore, OBA had the power to prevent the communication of the work because it had the power to control whether it entered into an EULA.*[26]
- *The terms of the EULA were the basis upon which communication of the Programs arose. It gave a measure of control over the act of communication*

[25] *Agreement between the Government of Australia and the Government of Ireland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income and Capital Gains* [1983] ATS 25.
[26] Technological protection measure.

in circumstances where communication of the work would not occur if the EULA did not exist.

- *OBA facilitated the communication of the Programs by billing end-users and receiving payments from them. The provision of these financial facilities reflected or were an aspect of the commercial nature of the relationship between OBA, IEL and the end-users that facilitated the communication of the software.*
- *OBA was aware the Programs would be communicated to the end-users and it was in their financial interest for there to be an increasing use of the Programs to an increasing number of end-users, as this would result in the derivation of greater income by OBA.*
- *There was a commercial relationship between OBA and IEL. OBA marketed and entered into EULAs and IEL was responsible for ownership and management of the servers. Both OBA and IEL financially benefitted from the Programs being communicated to end-users, as the revenue derived by both was a function of the number of EULAs entered into.*

Authorise reproduction

31. *Clause 3 permits end-users to make copies of the Programs. This reflects the circumstance that OBA has been granted an exclusive right of the copyright holder, being the right to authorise end-users to reproduce the Programs.*

Grant access to the Program

32. *Further, OBA is granted permission by IEL to grant access to the Program, which is controlled by the access control technological protection measure implemented by IEL.*

Copyright or other like property or right

33. *The Commissioner is of the view that the authorisation right and the right to grant access are acts comprised in copyright, and therefore use of a copyright right, as they facilitate the use of copyright in a computer program by the end-user. Alternatively, these rights are 'other like property of rights' within paragraph (a) of the standard tax treaty definition of 'royalty', being valuable rights which entitle OBA to exploit the copyright in Programs by distributing use of the Programs to end-users.*

Characterisation of payment

34. *The terms of the Licence Agreement are relevant to, but not determinative of, the characterisation of the payment.*[27] *The payments under the Agreement are characterised from a practical and business point of view.*[28] *That is, neither the use of the term 'distributor' in Clause 1, nor the grant of a right to 'distribute' in Clause 2, are determinative*

[27] For example, see *Radaich v Smith* [1959] HCA 45, where McTiernan J quotes Denning LJ in *Facchini v. Bryson* (1952) 1 TLR 1386:
> the parties cannot by the mere words of their contract turn it into something else. Their relationship is determined by the law and not by the label they choose to put on it.

[28] See paragraphs 81 to 102 of this Ruling.

of the character of the payment. Similarly, the fact Clause 5 states the fee is 'not a royalty' does not determine the character of the fee.

35. *Taking an objective assessment of the whole agreement and commercial context, performance of the contract required OBA to use copyright rights. The use of these rights was neither separate nor severable from the other rights granted, such as the rights to market and promote the Programs. Therefore, the entire payment is properly characterised as a royalty within the meaning of the Irish tax treaty and, as a consequence, the domestic tax law definition of royalty. Royalty withholding tax will apply at the rate of 10%.*

Scenario 2 – agreement lacking in specificity regarding the parties' rights and obligations

36. *An agreement between AusCo and its foreign parent ForeignCo does not set out all the necessary rights and obligations between the parties to give effect to the software arrangement. However, it does include the following key terms:*

- *(a) AusCo is granted the non-exclusive right to resell ForeignCo's products in Australia.*
- *(b) ForeignCo sells products to AusCo for resale by AusCo in Australia.*
- *(c) AusCo is to maintain and enhance the brand and image of ForeignCo and its products in Australia.*
- *(d) ForeignCo's products are*
  - *(i) computer software available for download from servers owned by ForeignCo and installation onto customer's personal devices, and*
  - *(ii) access to 'cloud-based' software via the internet, which is installed and executed on servers owned by ForeignCo.*
- *(e) AusCo does not have any right, title or interest to any intellectual property, or any licence related to any intellectual property to which ForeignCo may have rights or licences.*
- *(f) ForeignCo also provides to AusCo*
  - *(i) order fulfillment services (for example, allowing customers who purchase products from AusCo to download or access software from ForeignCo's computer servers)*
  - *(ii) relevant information for the promotion of products.*
- *(g) For the grant of the non-exclusive right to distribute ForeignCo's products in Australia, and as consideration for ForeignCo's products purchased by AusCo, AusCo is required to pay ForeignCo 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.*

37. *Customers in Australia enter into a standardised contract which states that AusCo is the entity with which they contract for the purchase of the products and customers in Australia pay AusCo for the products.*

38. *Upon a customer in Australia contracting with AusCo and paying the subscription fee for the purchase of the products to AusCo, ForeignCo grants a limited IP licence to the customer directly (for no further payment from the customer) and grants the customer relevant access to the computer software ('computer program' within the meaning of the Copyright Act) from a computer server it controls.*

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39. *ForeignCo owns or has rights to all the IP in the products and also provides AusCo access to confidential information and know-how regarding the products. ForeignCo is not a party to the sales contract with customers in Australia for the products. However, ForeignCo is party to the software licensing agreement with the customer which accompanies AusCo's contract with the Australian customers.*

Application of our view

40. *The payment by AusCo to ForeignCo is a royalty because, although ForeignCo is not directly paid by customers in Australia, the customers pay AusCo to obtain the right and entitlement to use the software per the terms in subparagraphs 36(d)(i) and (ii) of this Ruling. Such rights and entitlements cannot be provided for sale to the customers without authorisation or communication by ForeignCo as the owner of the copyright in the software. In addition, the Commissioner considers the payment AusCo makes to ForeignCo is a royalty because AusCo:*

- *obtains rights to use trademarks, brand and designs of ForeignCo*
- *obtains the supply of technical or commercial information and know-how from ForeignCo either to itself or to the customer by ForeignCo or some other associate*
- *obtains services ancillary and subsidiary in nature to enable the application or enjoyment of the technical and commercial knowledge or information, copyright and other property or right outlined in this Scenario*
- *uses the copyright right to enter a commercial rental arrangement in respect of the software, as the income derived does not involve an outright sale of the software, but rather, a periodic licence to use the software subject to recurring subscription fees, and*
- *provides access to software protected by access control technological protection measures with the permission of ForeignCo.*

41. *If AusCo or ForeignCo had sufficient evidence that established that the distribution right (or other rights falling outside the definition of royalties) had substantial value independent of the right to use the copyright and other intellectual property, a fair and reasonable apportionment could be applied.*

Date of effect

42. When the final Ruling is issued, it is proposed to apply both before and after its date of issue. However, the Ruling 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 of the Ruling (see paragraphs 75 to 76 of Taxation Ruling TR 2006/10 *Public Rulings).*

43. 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 appropriately relied upon.

Commissioner of Taxation
17 January 2024

Status: **draft only – for comment**

Appendix 1 – Explanation

This Explanation is provided as information to help you understand how the Commissioner's preliminary view has been reached. It does not form part of the proposed binding public ruling.

Context

44. Ever-evolving business models and rapid changes in technology have significantly changed the way that software is distributed and sold since 1993, when TR 93/12 was published. The traditional concepts of distribution in respect of physical goods are less relevant or sufficient and adequate to resolve novel and complex questions which arise in this context.

45. Software is now commonly supplied by electronic means using IP rights. Such rights, although restricted, may be granted to intermediaries to distribute the software or to end-users to access or use the software. As such, many contemporary distribution agreements are likely to contain the grant of rights or the imposition of obligations that are within the standard tax treaty definition of 'royalty'. This Explanation is intended to help you understand our view in this context. Among the many novel and complex issues that arise is how the use, and the right to use, provisions in domestic law and treaty provisions are to be applied to parties to transactions dealing with software rights where the software is supplied by electronic means.

Introduction

46. This Explanation is in 4 parts, as follows:

- Part 1 discusses the definition of royalties and examines various aspects of the definition
- Part 2 examines copyright and what constitutes the use of copyright
- Part 3 touches upon non-copyright rights
- Part 4 briefly discusses embedded software.

Part 1 – Royalties

Consequences of a payment being a royalty

47. The approach taken in this Ruling is to set out the relationship between the domestic tax law definition of royalty and the standard tax treaty and thereafter to discuss the standard tax treaty definition.

48. Where applicable, by reason of the relevant tax treaty and section 12-280 of Schedule 1 of the *Taxation Administration Act 1953*, the payer's obligation to withhold tax depends on whether the payment to the recipient is a royalty.[29] Under the standard tax treaty definition, royalties are taxed in the country in which they arise by withholding tax at

[29] *Seven Network Limited v Commissioner of Taxation* [2014] FCA 1411 (*Seven Network Ltd – first instance*) at [6], per Bennett J.

a rate provided by the tax treaty.[30] Royalties are deemed to arise in Australia where the payer is a person who is a resident of Australia.[31] As the royalty arises in Australia, it is governed by Australian law and is a royalty to which the resident of the other country is beneficially entitled.[32]

49. A payment is characterised as a royalty if it satisfies the definition within subsection 6(1).[33] The recipient is liable to pay income tax for the receipt of income that consists of a royalty.[34] The payer of a royalty is liable to withhold tax.[35] Under section 128B, the taxation is on the payment of the royalty, not the receipt of the payment. The liability to deduct withholding tax is imposed upon an Australian-resident payer of a royalty who paid that royalty to a non-resident.[36]

Domestic tax law definition of a royalty

50. Relevantly, for the purposes of section 128B, the term 'royalty' is defined in subsection 6(1) as:

> ***royalty*** or ***royalties*** includes any amount paid or credited, however described or computed, and whether the payment or credit is periodical or not, to the extent to which it is paid or credited, as the case may be, as consideration for:
>
> (a) the use of, or the right to use, any copyright, patent, design or model, plan, secret formula or process, trade mark, or other like property or right;
>
> (b) the use of, or the right to use, any industrial, commercial or scientific equipment;
>
> (c) the supply of scientific, technical, industrial or commercial knowledge or information;
>
> (d) the supply of any assistance that is ancillary and subsidiary to, and is furnished as a means of enabling the application or enjoyment of, any such property or right as is mentioned in paragraph (a), any such equipment as is mentioned in paragraph (b) or any such knowledge or information as is mentioned in paragraph (c);
>
> …

Interaction between the domestic tax law definition of royalty and the tax treaty definition of royalty

51. Our view on interpreting Australia's tax treaties is set out in TR 2001/13. The interpretive approach is to begin with the text and regard is to be had to the context, object

[30] For example, paragraph 2 in Article 12 of the *Agreement Between the Government of Australia and the Government of Finland for the Avoidance of Double Taxation with Respect to Taxes on Income and the Prevention of Fiscal Evasion* [2007] ATS 36 specifies that 'the tax so charged shall not exceed 5 per cent of the gross amount of the royalties'.
[31] For example, see paragraph 5 in Article 12 of the *Agreement between the Government of Australia and the Government of the People's Republic of China for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income* [1990] ATS 45.
[32] *Seven Network Ltd – first instance* at [23], per Bennett J.
[33] See also paragraph 50 of this Ruling.
[34] Subsection 128B(5A).
[35] Section 128C.
[36] *Seven Network Ltd – first instance* at [23]. per Bennett J.

and purpose of the Treaty provisions.[37] In simple terms, tax treaties allocate taxing rights which are given effect by domestic law.

52. Treaties are incorporated into Australian domestic law by virtue of the relevant section within the Agreements Act.[38] To the extent of any inconsistency, the Agreements Act and the tax treaties listed[39] in it both prevail over other provisions of the ITAA 1936 (excluding Part IVA) and the ITAA 1997.[40] If the royalty article of a tax treaty does not capture a payment that is otherwise a royalty under the domestic tax law definition of 'royalty', section 128B does not apply.[41] Thus, the definition of 'royalties' contained in a tax treaty is given primacy over that in the ITAA 1936 by subsections 4(2) and 17A(5) of the Agreements Act.[42]

53. Where expressions used in a provision of a tax treaty are not defined, they have the meaning those expressions have under the law of Australia relating to income tax.[43]

54. It is considered that the explanation in paragraph 55 of this Ruling in respect of the standard tax treaty definition equally applies to the domestic tax law definition of royalty.

55. Ordinarily, in relation to the standard tax treaty definition, royalties are deemed to arise in Australia if the payer is a resident of Australia for tax purposes or a permanent establishment situated in Australia. As the royalty arises in Australia, it is governed by Australian law and is a royalty to which the resident of the other state is beneficially entitled.[44]

56. The standard tax treaty definition of royalties extends to a payment as consideration for the use of, or the right to use, any specified IP right 'or other like property or right'. Therefore, all rights that can be characterised as IP rights are included in this definition.[45] As such, for the purposes of the standard tax treaty definition, a royalty includes a payment that is consideration for:

- the use of an IP right
- the right to use an IP right
- the use or right to use other like property or right
- the supply of certain knowledge or information, and
- assistance furnished to enable the application or enjoyment of an IP right or certain knowledge or information.[46]

[37] *IBM Corporation* at [10], per Bennett J, citing *McDermott Industries (Aust) Pty Ltd v Commissioner of Taxation* [2005] FCAFC 67 at [38]. See also *A v Minister for Immigration & Multicultural Affairs* [1997] HCA 4; (1997) 142 ALR 331 at [350–352], per McHugh J.
[38] Many current agreements are given the force of law by section 5 of the Agreements Act, but not all. For example, the Singapore tax treaty is incorporated into Australian domestic law by virtue of section 7 of the Agreements Act.
[39] See section 5 of the Agreements Act.
[40] See subsection 4(2) of the Agreements Act; *McDermott Industries (Aust) Pty Ltd v Commissioner of Taxation* [2005] FCAFC 67 at [11].
[41] Section 17A of the Agreements Act. See *Seven Network Ltd – first instance* at [7], per Bennett J.
[42] *Seven Network Ltd – first instance* at [8], per Bennett J.
[43] Subsection 3(9) of the Agreements Act. For example, see the explanation of the meaning of 'consideration' at paragraphs 75 to 80 of this Ruling.
[44] *Seven Network Ltd – first instance* at [23], per Bennett J.
[45] *IBM Corporation* at [11]. per Bennett J.
[46] *IBM Corporation* at [13], per Bennett J.

Payment for services

57. Generally, a payment for services will not constitute the payment of a royalty. However, whether or not a payment for services constitutes a royalty depends on the nature and purpose of the software arrangement giving rise to the payment. For instance, a payment for services will constitute a royalty if those services are ancillary and subsidiary to and furnished as a means of enabling the application or enjoyment of, any property or right that is covered by the definition of royalty. Our view on the distinction between royalties and payments for services rendered is contained in IT 2660.[47]

Other like property or right

58. The standard tax treaty definition of royalty states (emphasis added):

> The term "royalties" in this Article means payments or credits, whether periodical or not, and however described or computed, to the extent to which they are made as consideration for:
>
> a) the use of, or the right to use, any copyright, patent, design or model, plan, secret formula or process, trademark or **other like property or right** …

59. The standard tax treaty definition of royalty includes payments as consideration for the use of, or right to use, 'other like property or right'. The use of these words 'creates a genus of rights known as intellectual property rights'.[48] The expression 'other like property or right' means an IP right that has received the recognition of the domestic legal system of that country.[49] That is, it can extend the operation of a royalty to other categories of IP that were not recognised under the domestic law at the time the treaty was entered.[50] It recognises that different legal systems may deal with IP rights differently and accommodates specific rights being property as IP rights under the domestic law of that country.[51] The right must be defined as an IP right by the domestic law of the resident that made the payment.[52]

60. If a payment made by an Australian resident to the resident of another country is for the use of IP rights (or the right to use an IP right), according to Australian law the payment is characterised as a royalty. This is the case even if the right used or granted is not protected by IP law in the foreign country.[53]

Relevance of OECD Commentary

61. The Commissioner's view on interpreting Australia's tax treaties is set out in TR 2001/13, including the use of the OECD Commentaries as an aid to interpretation. The text of a treaty has primacy in the interpretative process and the OECD Commentaries should not be considered to the exclusion of the words in the treaty.[54] Nonetheless, the OECD Commentaries are an important guide on the interpretation and application of the OECD Model and will often need to be considered where the wording of a tax treaty is ambiguous.[55]

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[47] See paragraphs 25 to 34 of IT 2660.
[48] *Seven Network Ltd – first instance* at [129], per Bennett J, citing *IBM Corporation*.
[49] *Seven Network Ltd – first instance* at [142], per Bennett J.
[50] *Seven Network Ltd – first instance* at [133], per Bennett J.
[51] *Seven Network Ltd – first instance* at [140], per Bennett J.
[52] *Seven Network Ltd – first instance* at [132], per Bennett J.
[53] *Seven Network Ltd – first instance* at [130], per Bennett J.
[54] Paragraph 105A of TR 2001/13.
[55] Paragraph 104 of TR 2001/13.

62. Paragraph 10.1 of the OECD Commentary on Article 12 states that payments solely made in consideration for obtaining the exclusive distribution rights of a product or service in a given territory do not constitute royalties as they are not made in consideration for the use of, or the right to use, an element of property included in that definition.[56]

63. In the context of computer software transactions, the OECD Commentary states the character of payments 'depends on the nature of the rights that the transferee acquires under the particular arrangement regarding the use and exploitation of the program'.[57] A transaction for the acquisition of partial rights in copyright[58]:

> … will represent a royalty where the consideration is for the granting of rights to use the program in a manner that would, without such licence, constitute an infringement of copyright.

64. Paragraph 14 of the OECD Commentary on Article 12 contains guidance on transactions where copyright rights acquired are limited to those necessary to enable end-users to operate the program. It states that the rights are commonly for the acquisition of a 'program copy' and the rights transferred are specific to the nature of computer programs.

65. Paragraph 14.4 of the OECD Commentary on Article 12 contains an example that illustrates the limited circumstances in which payments for the right to distribute copies of a program will not constitute a royalty. It states:

> Arrangements between a software copyright holder and a distribution intermediary frequently will grant to the distribution intermediary the right to distribute copies of the program without the right to reproduce that program. In these transactions, the rights acquired in relation to the copyright are limited to those necessary for the commercial intermediary to distribute copies of the software program. In such transactions, distributors are paying only for the acquisition of the software copies and not to exploit any right in the software copyrights. Thus, in a transaction where a distributor makes payments to acquire and distribute software copies (without the right to reproduce the software), the rights in relation to these acts of distribution should be disregarded in analysing the character of the transaction for tax purposes. Payments in these types of transactions would be dealt with as business profits in accordance with Article 7. This would be the case regardless of whether the copies being distributed are delivered on tangible media or are distributed electronically (without the distributor having the right to reproduce the software), or whether the software is subject to minor customisation for the purposes of its installation.

66. In the example in paragraph 14.4 of the OECD Commentary on Article 12, the payer acquires copies of a program but does not make that copy. The copy has therefore been made by someone else with the right to make that copy. The payer distributes the already existent copy. It does not refer to a case where the distributor does not acquire a copy of the program.[59]

67. The facts contained in the example in paragraph 14.4 of the OECD Commentary on Article 12 place a significant qualification and limitation on its application. That is, in our view, the conclusion that the payments are not a royalty is a consequence of the facts that:

- the distribution intermediary is granted the right to distribute 'copies' of the program, that is, copies of the programs are being acquired (but not made) and distributed by the distributor, rather than a distribution model involving the grant of access to software (such as a 'cloud' distribution)

[56] Paragraph 10.1 of the OECD Commentary on Article 12.
[57] Paragraph 12.2 of the OECD Commentary on Article 12.
[58] Paragraph 13.1 of the OECD Commentary on Article 12.
[59] For example, the example in paragraph 14.4 of the OECD Commentary on Article 12 also does not deal with the question of whether the distributor uses, or has the right to use, any other intellectual property rights of the software owner to carry out the software arrangement.

- the distribution intermediary is not granted the right to reproduce the program, that is, it can be inferred that the manner and form in which the software is distributed does not require reproduction of the program by the distributor
- the copyright rights acquired by the distribution intermediary are limited to those necessary to distribute copies of the software program
- the distributor only pays for the acquisition of the software copies and not to exploit any copyright in the software
- the payments by the distributor are not for the right to use or the use of the software.

68. As long as the points listed in paragraph 67 of this Ruling are satisfied, the characterisation of the payment does not differ if the software copies are distributed on tangible media or distributed electronically.

69. In our view, the conclusion that the payment from the distributor to the copyright holder is not a royalty is a consequence of what the payment is in truth 'consideration for'. That is, under the standard tax treaty definition, a royalty includes any payment to the extent it is made as consideration 'for' the use of, or the right to use, any copyright. The example in paragraph 14.4 of the OECD Commentary on Article 12 states that 'distributors are paying only for the acquisition of the software copies and not to exploit any right in the software copyrights.' The absence of the right to reproduce the software, and to exploit any right in the software copyright, has the consequence that no use of, or right to use, the copyright is part of what the consideration is 'for'.

70. The example contained in paragraph 14.4 of the OECD Commentary on Article 12 cannot be relied upon where the substance of an agreement or arrangement differs from the facts in the example. Furthermore, its relevance and application depends upon the relevant domestic law of the country from which the payment was made.

Elements of a royalty

71. The standard tax treaty definition of royalty states (emphasis added):

> The term "royalties" in this Article means payments or credits, whether periodical or not, and **however described or computed**, **to the extent** to which they are made as **consideration for:**
>
> a) the **use** of, or right to **use** …

72. Paragraphs 74 to 119 of this Ruling discuss the components of the definition of 'royalties' as payments.

(i) however described or computed

(ii) consideration

(iii) for

(iv) to the extent

(v) use.

73. Although the explanation (in paragraph 75 of this Ruling) of the meaning of 'consideration' is separated from the explanation of the meaning of 'for', we recognise that a composite phrase should not be pulled apart into its constituent words, with the meaning

given to each word divorced from its context.[60] Thus, the explanation of each term has been separated out for the benefit of the reader but reflects an interpretation that considers the terms in the context of each other. In particular, the goods and services tax (GST) cases referenced consider whether there was a supply 'for consideration', which we consider analogous to interpreting whether there is 'consideration for' something.

However described or computed

74. The way a payment is described or computed does not determine whether it is properly characterised as a royalty.[61] The term 'described or computed' indicates that both the description and allocation of any payment under an agreement can be disregarded. The substance of the agreement must be ascertained, and this will prevail over its legal form. That is, regardless of how a payment is described or computed in any agreement between the parties, it is necessary to perform an objective assessment of what the payment is 'for' to properly determine its character. A payment is properly characterised as a royalty to the extent it is consideration for the right to use copyright, for example, regardless of whether the agreement under which the payment is made states that the right to use the copyright is 'royalty-free'.

Consideration

75. The term 'consideration' in the definition of royalty is not legislatively defined. Where a word used in a statute has acquired a legal meaning prior to enactment, it is presumed that the legislature intends that word to have the legal meaning unless a contrary intention appears from the context.[62]

76. However, the term 'consideration' has various legal meanings, including meanings in contract law, conveyancing and revenue statutes.[63] Where a word that has more than one legal meaning, the appropriate meaning is governed by the context.[64] For example, in *Chevron*, Robertson J held that the meaning of 'consideration' in the context of the transfer pricing provisions in former Division 13 of Part III was not limited to the contract law meaning.[65]

77. The High Court in *Archibald Howie* examined the meaning of the word 'consideration' for the purposes of the *Stamp Duties Act 1920* (NSW). It held that the term 'consideration' had the wider meaning used in conveyancing, being 'the money or value passing which moves the conveyance or transfer'[66], rather than the meaning in contract law.[67]

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[60] *Sea Shepherd Australia Limited v Commissioner of Taxation* [2013] FCAFC 68 at [34], per Gordon J, citing *Lorimer v Smail* [1911] HCA 44; 12 CLR 504 at [508–510], *R v Carter* [19.34] HCA 50; 52 CLR 221 and *Biga Nominees P/L v Taxation, Commissioner of (Commonwealth)* [1991] Vic SC 137; (1991) 104 FLR 74 at [85–86].

[61] See the definition of 'royalty or royalties' in subsection 6(1) and paragraph 15 of IT 2660.

[62] *Aubrey v The Queen* [2017] HCA 18 at [34].

[63] See *Archibald Howie Pty Ltd v Commissioner of Stamp Duties (NSW)* [1948] HCA 28 (*Archibald Howie*); *Berry v Commissioner of Taxation* [1953] HCA 70; *Chevron Australia Holdings Pty Ltd v Commissioner of Taxation (No 4)* [2015] FCA 1092 (*Chevron*); *Chief Commissioner of State Revenue v Dick Smith Electronics Holdings Pty Ltd* [2005] HCA 3 (*Dick Smith Electronics*); *Commissioner of Taxation v Ludekens* [2013] FCAFC 100; *Commissioner of Taxation v Bogiatto* [2020] FCA 1139; *Commissioner of Taxation v Scully* [2000] HCA 6.

[64] *Re Bidie (decd); Bidie v General Accident Fire & Life Assurance Corp Ltd* [1949] Ch 121.

[65] *Chevron* at [87].

[66] *Archibald Howie* at [152], per Dixon J.

[67] See *Chevron* at [86].

78. Similarly, in *Dick Smith Electronics*, the High Court examined the meaning of the word 'consideration' for the purposes of the *Duties Act 1997* (NSW). They held that the meaning of 'consideration' in that context differed from the meaning of consideration sufficient to support a contract, because the provision would apply in situations where a transfer of dutiable property was not made pursuant to a contract.[68]

79. Commencing with the text, read in the context and having regard to the purpose of the royalty definition and its use in treaties and domestic law, the Commissioner's view is that 'consideration' incorporates a wider notion than consideration in a contractual sense. While the domestic meaning of the term 'consideration' is used in the context of 'any amount paid or credited', the definition of royalty is inclusive, not exhaustive.

80. Because the standard tax treaty definition of royalty asks whether the payment is paid as consideration for the prescribed things, the contractual meaning of consideration is unlikely to be determinative. Most agreements regarding royalties will, for contractual purposes, have executory consideration. In this context, and having regard to the whole of the arrangement, 'consideration' is the thing or things that move the payment.

For

81. A payment must be consideration 'for' one or more of the things contained in the royalty definition. However, how the parties to an agreement treat any right granted, or anything supplied, under that agreement is not determinative of whether it is a right of the copyright holder under the Copyright Act[69], nor is the way in which the parties describe a subject matter determinative of its legal character.[70]

82. Therefore, what a payment is 'for' is a question of fact. The terms of any agreement are the starting point, but they are neither determinative nor sufficient in characterising the payment. The substance of the agreement must be considered, rather than only its legal form. If the contractual performance requires or involves 'use' of an IP right, that right may be an implied term of the contract.

83. Determining the purpose of a payment requires regard to matters beyond the boundaries of any contracts giving rise to the payment. The objective purpose of the payment must be determined by having regard to the circumstances surrounding the payment, including the commercial and financial relations between the parties and the manner in which any rights granted will be used.

84. The ordinary meaning of the word 'for', in the context of the section, is 'with the object or purpose of: '*to go for a walk*''.[71] The word 'for' is not defined in the ITAA 1936 and there is no indication it is used in any sense other than its ordinary meaning. Therefore, the existence of the word 'for' indicates that the purpose of the payment must be determined.

85. The characterisation of a payment as a 'royalty or royalties' relies on an objective test of whether the payment meets the description contained in subsection 6(1). That such assessment is objective, and that evidence of subjective purpose is not determinative, can be inferred from the words 'however described'. Thus, the character of a payment does not depend upon how the payment is described by the entities involved. Evidence of the subjective purpose of either entity, including the way the payment is described, may be relevant but not determinative.

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[68] *Dick Smith Electronics* at [71], cited in *Chevron* at [86], per Robertson J.
[69] *Seven Network Ltd – first instance* at [100], per Bennett J.
[70] *Seven Network Ltd – first instance* at [121], per Bennett J.
[71] Macmillan Publishers Australia, *The Macquarie Dictionary* online, www.macquariedictionary.com.au, accessed 6 December 2023.

86. Furthermore, the standard tax treaty definition of royalty does not specify to whom the payment must be made. The payment need only be consideration 'for' one of the things specified in the royalty definition. For instance, the payment need not be to the IP owner, but could be to an intermediary or related party of the IP owner.

87. The approach to ascertaining what a payment is 'for' is analogous to that adopted in *Magna Alloys & Research Pty Ltd v Commissioner of Taxation of the Commonwealth of Australia* [1980] FCA 180 (*Magna Alloys*). In that case, the High Court considered whether expenditure was incurred for the purpose of gaining or producing assessable income for the purposes of former subsection 51(1). Brennan J adopted an objective test to determine whether expenditure was incurred for the purpose of gaining or producing assessable income.[72] That test did not depend upon the taxpayer's state of mind, but rather the relationship between the expenditure and the taxpayer's undertaking or business.[73]

88. Characterisation is a question of fact. Because of this, what has been said on questions of characterisation in other revenue law contexts may be informative.[74] We consider that the approach to characterisation adopted for GST is not inapposite in the present context.

89. Specifically, central to the operation of GST law, the definition of a 'taxable supply' includes that 'you make a supply for consideration'.[75] Further, 'supply' and 'consideration' are broadly defined.[76] It is uncontroversial that in respect of this Ruling, a 'distributor' is making a supply of software for consideration under a 'software arrangement'. It follows that the Commissioner considers GST cases on what comprises a 'supply' are informative of what consideration is 'for'.

90. For example, in *Westley Nominees Pty Ltd v Coles Supermarkets Australia Pty Ltd* [2006] FCAFC 115 (*Westley Nominees*), the Full Federal Court considered whether a 'supply' was made to a lessee by the acquirer of a property already subject to the lease.

91. The Court held that upon purchasing the property the acquirer assumed the obligation to honour the lease according to its terms and entered into an obligation to tolerate an act or situation, which constituted a 'supply'.[77] In ascertaining the 'consideration' for that supply, it was held at [58] that:

> The identification of the (whole of the) consideration is inevitably bound up with the identification of the supply, in particular, whether there has been more than one supply and, if so, the allocation of the (whole of the) consideration amongst those various supplies.

92. The Court disagreed that there were 2 supplies, one being the lease and the other being incidental benefits and services from being part of the shopping centre.[78] In determining whether there was an ancillary and incidental supply that was separate and discrete from the main supply, or whether there was a single supply, the Court adopted the same principles that applied in ascertaining whether an outgoing was on capital or revenue account.

[72] *Macquarie Finance Limited v Commissioner of Taxation* [2005] FCAFC 205 at [94].
[73] *Macquarie Finance Limited v Commissioner of Taxation* [2005] FCAFC 205 at [94], citing Brennan J in *Magna Alloys* at [225].
[74] *ATS Pacific Pty Ltd v Commissioner of Taxation* [2014] FCAFC 33 (*ATS Pacific*) at [38–41], per Edmonds J.
[75] Section 9-5 of the *A New Tax System (Goods and Services Tax) Act 1999* (GST Act).
[76] See sections 9-10 and 9-15 of the GST Act.
[77] *Westley Nominees* at [22], per Ryan, Heerey and Edmonds JJ.
[78] *Westley Nominees* at [58], per Ryan, Heerey and Edmonds JJ.

93. The Court's reasoning depended upon[79]:

> …what the expenditure is calculated to effect from a practical and business point of view, rather than upon the juristic classification of the legal rights, if any, secured, employed or exhausted in the process.

94. The Court noted that where a supply was incidental to a principal supply, courts have generally treated the transaction as giving rise to one supply.[80]

95. This approach was endorsed by the Full Federal Court in *ATS Pacific*, which concerned the character of supplies made by ATS Pacific Pty Ltd (ATS), who operated a website which enabled non-resident travel agents to secure products for non-resident tourists who visited Australia. ATS charged the travel agents a fee that included the cost of the products and a margin.

96. At issue was whether there were 2 separate supplies (the products and the arranging services) and whether the arranging services were a separate GST-free supply for separate consideration.[81] The supply was described by the primary judge as being the promise that ATS would ensure the tourists were provided with the products when they came to Australia.

97. The Full Federal Court noted the terms and conditions of the contract were not conclusive of the character of the supply. The character depended as much on the manner and performance of those terms and conditions as the text itself. It also depended on an objective assessment of the commercial or business purposes of the parties to the contract.[82]

98. The Full Federal Court upheld the primary judge's characterisation of the supply as a promise by ATS to ensure the tourists would be provided with the products[83] and agreed that none of the promises supplied by ATS were GST-free.[84] The Full Federal Court disagreed there were 2 separate supplies, as ATS did not supply the products.[85] The critical supply was the promise to the travel agents that ATS would ensure the products were supplied to the tourists.[86]

99. The question whether there were one or 2 supplies, their characterisation and whether one was ancillary or incidental to the other was approached from a practical and business point of view rather than the text of the contract.[87] There was one supply (the supply of the promise) for a single indivisible consideration and the supply of the arranging services where either part of that promise or ancillary and incidental to that supply.[88]

100. The Commissioner's view is also informed by the High Court's remarks on the meaning of 'for' in the case *Commissioner of Taxation v Qantas Airways Limited* [2012] HCA 41, which concerned the GST consequences of fares received from prospective passengers who failed to take the flight. Qantas contended that GST was not payable on the unused fares and should be refunded by the Commissioner.

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[79] *Hallstroms Pty Ltd v Federal Commissioner of Taxation* [1946] HCA 34; 72 CLR 634 at [648], cited in *Westley Nominees* at [59], per Ryan, Heerey and Edmonds JJ.
[80] *Westley Nominees* at [35], per Ryan, Heerey and Edmonds JJ. For example, this approach was endorsed by the Full Federal Court in *ATS Pacific*.
[81] *ATS Pacific* at [9–10], per Edmonds J.
[82] *ATS Pacific* at [29], per Edmonds J.
[83] *ATS Pacific* at [45], per Edmonds J.
[84] *ATS Pacific* at [49], per Edmonds J.
[85] *ATS Pacific* at [62], per Edmonds J.
[86] *ATS Pacific* at [61], per Edmonds J.
[87] *ATS Pacific* at [64], per Edmonds J.
[88] *ATS Pacific* at [64], per Edmonds J.

101. The High Court held that GST was payable on the unused fares. Their decision turned upon the meaning of the word 'for' in the phrase 'the supply *for* consideration'. The Court held at [14] that '… the word "for" is not used to adopt contractual principles. Rather, it requires a connection or relationship between the supply and the consideration'. In other words, there must be consideration 'in relation to' the supply.[89]

102. Similarly, the Commissioner considers that the word 'for' in the definition of royalty requires a connection or relationship between the consideration and one or more things in the definition. For example, in the context of copyright, it is necessary to identify a connection or relationship between the consideration and the use of, or right to use, the copyright in order for the consideration to be 'for' that use or right.

To the extent

103. The definition of 'royalty' anticipates apportionment, which turns upon the characterisation of the payment made.[90] A royalty includes any amount to the extent to which it is paid as consideration for one or more of the things contained in the royalty definition, such as the use of, or the right to use, any IP rights.

104. It must first be ascertained whether, to any extent at all, the consideration is for one or more of the things contained in the royalty definition. The second question is 'the extent' to which the consideration is for one or more of those things.

105. Payments will be characterised as royalties both where they are for the use of IP rights (that is, the exercise of a right) and also for the grant of the right to use the IP (that is, regardless of whether that right is exercised).[91]

106. Where a payment is partially for one or more of the things contained in the definition of 'royalty', that portion of the payment will be characterised as a royalty. This is because a payment is only a royalty 'to the extent' to which it is paid as consideration for one or more of those things.[92] However, where a payment is made as consideration for any of the things listed in the definition then the payment will be a royalty to some extent, even if it is also for other things outside the royalty definition. A fair and reasonable basis for determining that portion of the payment is required.

107. It does not follow that because a payment is partly for something not contained in the royalty definition that the payment is only partly characterised as a royalty. It must be ascertained whether, and to what extent, the payment is for any of the things listed in the royalty definition. For instance, where a payment is principally for the grant of IP rights and the other rights granted are ancillary or incidental, the consideration is properly characterised as being entirely for the grant of the IP rights.[93] To illustrate this point, if the software arrangement has no value or substance without the use of IP rights, then all the payments under the arrangement will be royalties.

108. The interpretation of any agreement between the parties to a payment is fundamental to the characterisation of that payment[94], but not determinative. However, the

[89] *ATS Pacific* at [71], per Pagone J.
[90] *IBM Corporation* at [14], per Bennett J.
[91] *IBM Corporation* at [14], per Bennett J.
[92] *IBM Corporation* at [18], per Bennett J.
[93] In the context of supplies under the GST Act, see Goods and Services Tax Ruling GSTR 2001/8 *Goods and services tax: Apportioning the consideration for a supply that includes taxable and non-taxable parts*. See also *Westley Nominees* at [35], per Ryan, Heerey and Edmonds JJ.
[94] *IBM Corporation* at [16], per Bennett J.

extent to which a payment has the character of royalty income in the hands of its recipient must be determined by considering the substance, not just the form, of the transaction.[95]

109. Ultimately, if the substance of the agreement is that the end-user of the software is paying the distributor for the use of IP rights (which are granted by the distributor to the end-user), then the distributor must have an entitlement to, and make use of, those IP rights to earn income. It follows that the payments the distributor makes under the agreement will be royalties.

110. Where the consideration is calculated and paid separately for different rights, this suggests the rights are separate.[96] If a single amount is calculated and paid as consideration for a number of rights, this suggests the payment is for all the rights. This is because the consideration for the number of rights may only make sense in the context of the entire arrangement.[97]

111. In *IBM Corporation*, the taxpayer argued that the contract should be construed in a manner that the proper characterisation of the payments (that is, whether or not they are royalties) may differ each time a payment is made. They contended that the payments would cease to be properly characterised as a royalty where:

- the law changes so that IP rights no longer apply to the programs
- copyright ceases to exist in the programs, and
- the distribution method changes and does not involve the use of copyright rights.[98]

112. Bennett J did not accept the taxpayer's construction of the contract[99] and held that the characterisation of each payment was the same because the contract remained the same.[100]

113. In reaching this conclusion, Bennett J took the whole of the contract into account and concluded that it granted the taxpayer all IP rights necessary for distribution of the products to occur.[101] The fact that rights were granted that did not fall within the definition of royalty did not change this conclusion. The contract did not grant separate and severable rights, only some of which involved the use of IP rights.[102]

114. In our view, it is commonly the case in a software arrangement that any IP rights granted are neither separate nor severable from any other rights granted. That is, in taking the whole of the agreement into account, the distribution agreements cannot be performed without use of the IP rights granted. In this situation, the entirety of the consideration will be characterised as a royalty.

115. The following scenario illustrates where a reasonable method of apportionment in respect of a software arrangement may be appropriate.

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[95] *Seven Network Ltd – first instance* at [9], per Bennett J. See also *Commissioner of Taxation v Star City Pty Limited* [2009] FCAFC 19 at [29], per Goldberg J, citing Hill J in *Commissioner of Taxation v Broken Hill Pty Company Ltd* [2000] FCA 1431; (2000) 179 ALR 593 at [606].

[96] See paragraph 16 of Taxation Ruling TR 2012/4 *Income tax: the operation of subsection 230-55(4) of the Income Tax Assessment Act 1997 (ITAA 1997) in determining what is an 'arrangement' for the purposes of the taxation of financial arrangements under Division 230 of the ITAA 1997*.

[97] It is also noted that Part IVA, or Division 815 of the ITAA 1997, may also apply where the legal form of a transaction differs from its economic substance. A detailed explanation of those provisions is beyond the scope of this Ruling.

[98] *IBM Corporation* at [33–34], per Bennett J.

[99] *IBM Corporation* at [42], per Bennett J.

[100] *IBM Corporation* at [41], per Bennett J.

[101] *IBM Corporation* at [52], per Bennett J.

[102] *IBM Corporation* at [43], per Bennett J.

Scenario 3 – Reasonable method of apportionment

116. *Under a single contract, a distributor is granted both the right to distribute physical copies of computer games and the right to distribute online access to video-editing software. Although the rights are granted under one contract, they are independent because the acquisition and distribution of the physical computer game copies is not dependent on being able to distribute online access to the video-editing software.*

117. *Consideration solely for the right to distribute physical copies of computer games is not a royalty, as the acquisition and resale of the copies does not require the use of an IP right (or anything else within the royalty definition). In contrast, the rights granted for the distribution of online access to the video-editing software does necessitate the use of IP rights. Depending on the method of granting online access, these rights may include:*

- *communicating (or authorising communication of) a computer program*
- *reproducing (or authorising the reproduction of) a computer program, and*
- *entry into a commercial rental arrangement in respect of a computer program.*

118. *In this scenario, it may be possible to apportion any lump sum consideration paid under the arrangement to reflect the market value of the differing rights. A reasonable method of apportionment would take into account the fact that valuable IP rights were granted in respect of the online access to the video-editing software and that no such rights were granted for distribution of computer game copies. As such, it would be expected that any apportionment method adopted would result in the majority of the consideration being allocated to the IP rights used in respect of the online distribution.*

Use

119. The Commissioner's view is that the 'use' of an IP right covers all forms of exploitation of the right or property short of an outright sale of the right.[103]

Part 2 – Copyright

Payment for any copyright

120. The standard tax treaty definition of royalty states (emphasis added):

> The term "royalties" in this Article means payments or credits, whether periodical or not, and however described or computed, to the extent to which they are made as consideration for:
>
> a) the use of, or the right to use, **any copyright**…

Copyright

121. The standard tax treaty definition of royalty uses the term 'copyright' in an undefined sense. The Commissioner's view on the interpretation of undefined terms in a tax treaty is contained in TR 2001/13, particularly paragraphs 63 to 71.

[103] See paragraph 16 of IT 2660.

122. The 'general definitions' article within most tax treaties contains words similar to[104]:

> … any term not defined in this Agreement shall, unless the context otherwise requires, have the meaning which it has under the laws of that State from time to time in force relating to the taxes to which this Agreement applies.

123. The Commissioner's view is that the existence of copyright is determined by the language of the Copyright Act, given a liberal interpretation but not departing altogether from its language and principles.[105]

124. Copyright is a statutory right that subsists, and is determined and characterised, in accordance with the Copyright Act.[106] Copyright constitutes personal property[107] and the rights comprised in copyright are distinct from the thing in which copyright subsists.[108]

125. The Copyright Act recognises categories of subject matter that may be subject to copyright.[109] The Commissioner's view is that the term 'copyright' is a reference to any exclusive right of the copyright owner in a work[110] to which Australian copyright law applies. Any act done in relation to a substantial part of a work is deemed to be done in relation to the whole of the work.[111]

126. The exclusive rights of a copyright owner of a computer program include the right to do various acts. Refer to paragraphs 130 to 174 of this Ruling.

Any copyright

127. Section 184 of the Copyright Act allows the provisions of the *Copyright (International Protection) Regulations 1969* (Copyright Regulations) to extend to works first published in countries other than Australia. Therefore, the Commissioner's view is that the phrase 'any copyright' is a reference to any work that is protected by copyright law in Australia (Australian work) or a foreign country that is a:

- party to the *International Convention for the Protection of Literary and Artistic Works*, concluded at Berne on 9 September 1886 (Berne Convention) and any territory of that foreign country (Berne Convention country)[112], or
- party to the *International Convention for the Protection of Performers, Producers of Phonograms and Broadcasting Organisations*[113], done at Rome on 26 October 1961 (Rome Convention) and any territory of that foreign country (Rome Convention country)[114], or

[104] For example, see paragraph 3 in Article 3 of *Agreement between the Government of Australia and the Government of the People's Republic of China for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income* [1990] ATS 45.
[105] *Computer Edge Pty Ltd v Apple Computer Inc* [1986] HCA 19; 161 CLR 171 at [188], per Gibbs CJ.
[106] *Seven Network Ltd – first instance* at [46], per Bennett J.
[107] Subsection 196(1) of the Copyright Act.
[108] See *Pacific Film Laboratories Pty Ltd v Commissioner of Taxation (Cth)* [1970] HCA 36; 121 CLR 154 at [165–170], per Windeyer J.
[109] *Seven Network Ltd* at [46], per Bennett J.
[110] In section 189 of the Copyright Act, the definition of 'work' means a 'literary work, a dramatic work, a musical work, an artistic work or a cinematographic film'.
[111] Section 14 of the Copyright Act.
[112] See the definition of 'Berne Convention country' in regulation 3 of the Copyright Regulations.
[113] 496 UNTS 43.
[114] See the definition of 'Rome Convention country' in regulation 3 of the Copyright Regulations.

- party to the *Universal Copyright Convention*, concluded at Geneva on 6 September 1952 (UCC) and any territory of that foreign country (UCC country)[115], or
- party to the *WIPO Copyright Treaty*[116], concluded at Geneva on 20 December 1996 (WCT country)[117], or
- party to the *WIPO Performances and Phonograms Treaty,* concluded at Geneva on 20 December 1996 (WPPT country)[118], or
- member of the World Trade Organization and any territory of that foreign country (WTO country).[119]

128. Section 30 of the Copyright Act envisages different persons doing the same acts or classes of acts in different countries and deems who the owner of the copyright is in those circumstances. Section 184 of the Copyright Act provides that Regulations may be made so that the provisions of that Act apply to countries other than Australia in the same manner those provisions apply in Australia.

129. Regulation 4 of the Copyright Regulations provides that a provision of the Copyright Act that applies in relation to a work (Australian work) applies in relation to a work in any Berne Convention country, Rome Convention country, UCC country, WCT country, WPPT country or WTO country (foreign work) in the same way as the provision applies, under the Copyright Act, in relation to an Australian work or subject matter and as if the foreign work were made or first published in Australia.[120]

Copyright rights

130. The Copyright Act defines exclusive rights of a copyright owner. Under subsubsection 31(1) of the Copyright Act, the exclusive rights of the owner of copyright include the right to do all or any of the following acts:

- reproduce the work in a material form[121]
- communicate the work to the public[122]
- make an adaptation of the work[123]
- enter into a commercial rental agreement[124], and
- authorise a person to do an act.[125]

131. In addition, the Copyright Act protects the right of copyright owners to control access to a work by access control technological protection measures and provides legal remedies against the circumvention of such measures.[126]

[115] See the definitions of 'UCC country' and 'Universal Copyright Convention' in regulation 3 of the Copyright Regulations.
[116] The acronym WIPO is a reference to the World Intellectual Property Organisation.
[117] See the definition of 'WCT country' in regulation 3 of the Copyright Regulations.
[118] See the definition of 'WPPT country' in regulation 3 of the Copyright Regulations.
[119] See the definition of 'WTO country' in regulation 3 of the Copyright Regulations.
[120] Subregulation 4(1) of the Copyright Regulations.
[121] Subparagraph 31(1)(a)(i) of the Copyright Act.
[122] Subparagraph 31(1)(a)(iv) of the Copyright Act.
[123] Subparagraph 31(1)(a)(vi) of the Copyright Act.
[124] Paragraph 31(1)(d) of the Copyright Act.
[125] Subsection 13(2) of the Copyright Act.
[126] Section 116AN of the Copyright Act.

132. Current software arrangements now commonly involve the things mentioned in paragraph 130 and 131 of this Ruling. This is the case whether or not the contractual agreements between the parties (who are often related) explicitly refer to these rights. Payments by software distributors to the extent that they are for the use of, or right to use, any copyright rights will be royalties. These rights are explained further in paragraphs 133 to 174 of this Ruling.

Reproduction right

133. One exclusive right in relation to a copyright work is the right to reproduce the work in a material form.[127] The concept of reproduction in subsection 31(1) of the Copyright Act connotes the copying of a work in which copyright subsists. The reproduction of a work includes reproducing a substantial part of the work.[128]

134. A work is taken to have been reproduced if it is converted into or from a digital or other electronic machine-readable form. Any article embodying the work in a digital or other electronic machine-readable form is also taken to be a reproduction of the work.[129] For example, copying software onto an external storage device would constitute reproducing that work.

135. In considering the meaning of 'embodied', Emmett J stated in *Australian Video Retailers Association Ltd v Warner Home Video Pty Ltd* [2001] FCA 1719 (*Warner Home Video*) that there must be a point at which an article or thing can be identified in which the copyright work is embodied. The ephemeral embodiment of tiny fractions of a copyright work does not constitute making a copy of the copyright work.[130] For example[131]:

> … the fact that over a period of time tiny parts are sequentially stored in the RAM of the DVD player or personal computer does not mean that the film is embodied in such a device.

136. Software acquired under licence is reproduced for the purposes of subsection 31(1) of the Copyright Act when it is copied as part of the technical process of installing it on a computer or device. There is also a reproduction in this sense when software is downloaded onto a computer or device.[132] A reproduction of a work may also occur under cloud computing when a software component is downloaded onto a computer or device, such as for the purpose of enabling an end-user to use the cloud-computing service 'offline' or to enhance the 'online' user experience.

Material form

137. The term 'material form' includes any form of storage of the work, or an adaptation of the work, of a substantial part of it. The term 'material form' is defined in subsection 10(1) of the Copyright Act as:

> … in relation to a work or an adaptation of a work, includes any form (whether visible or not) of storage of the work or adaptation, or a substantial part of the work or adaptation, (whether or not the work or adaptation, or a substantial part of the work or adaptation, can be reproduced).

[127] Subparagraph 31(1)(a)(i) of the Copyright Act. For the purposes of this Ruling, this right is also referred to as the 'reproduction right'.
[128] Paragraph 14(1)(b) of the Copyright Act.
[129] Subsection 21(1A) of the Copyright Act.
[130] *Warner Home Video* at [63–65].
[131] *Seven Network Ltd – first instance* at [66], per Bennett J.
[132] *Dyason, M.P. & Ors v Autodesk Inc & Autodesk Australia Pty Ltd* [1990] FCA 499, per Sheppard J.

138. The High Court case *Stevens v Kabushiki Kaisha Sony Computer Entertainment* [2005] HCA 58 (*Stevens*) considered a substantial part of a computer program being temporarily stored in the Random Access Memory (RAM) of a PlayStation was in a 'material form' within the meaning of subparagraph 31(1)(a)(i) of the Copyright Act. The term 'material form' includes any form of storage of a work or adaptation of that work, or a substantial part of the work or adaptation.[133]

139. The definition of 'material form' at the time involved storage from which the work, or a substantial part of it, could be reproduced. The High Court held at [67] that while the RAM may constitute a 'material form' in the form of invisible storage, it was not a form of storage from which reproduction could occur.

140. Based on the definition of 'material form' at the time, the High Court held that where the 'material form' is a form of invisible storage it must be one from which the work, or a substantial part of it, 'can be reproduced'. The High Court endorsed the view of Emmett J in *Warner Home Video*, who interpreted the phrase 'can be reproduced' as 'ordinarily is able to be produced'. His Honour concluded that in the ordinary course, temporary storage of a substantial part of a computer program in the RAM of a DVD player will not involve a reproduction in a material form.

141. In *Stevens* at [69], their Honours said the data was not in a material or corporeal form, but in a non-material, incorporeal form, comprising essentially electronic impulses. In some circumstances the electronic impulses stored in RAM are in a material form, but they are not in a material form in all circumstances.

Communicate the work to the public

142. Another exclusive right in relation to a copyright work is the right to communicate the work to the public.[134] The exclusive right to communicate a copyright work to the public covers 2 classes of acts.[135]

143. The first class of act involves electronically transmitting the work, whether that transmission occurs over a path, or a combination of paths, provided by a material substance. For example, a communication over the internet may involve transmission over copper wire and optic fibre cables.

144. The second class of act involves making a copyright work available online, irrespective of whether it is electronically transmitted. This does not require that there be an actual communication of the work in the ordinary meaning of that word.[136] A communication may occur in the relevant sense when software is made available through cloud-based technology such as software-as-a-service (SaaS), which is available without being downloaded on the end-user's computer or device.

Communication

145. The transmission of data via the internet often occurs through the representation of binary numbers in an electrical form, such as the transmission of an electromotive force.[137]

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[133] Subsection 10(1) of the Copyright Act.
[134] Subparagraph 31(1)(a)(iv) of the Copyright Act.
[135] See the definitions of 'communicate' and 'to the public' in subsection 10(1) of the Copyright Act. The High Court has held that the expression 'to the public' can encompass a communication to a single person: *Telstra Corporation Ltd v A/asian Performing Right Association Ltd* [1997] HCA 41 (*Telstra*), per Dawson and Gaudron JJ.
[136] *Roadshow Films Pty Limited v iiNet Limited* [2011] FCAFC 23 (*Roadshow*) at [661].
[137] See *Seven Network Ltd – first instance* at [66], per Bennett J.

Where the medium of transmission of a communication is ephemeral, such as the transmission of 'streaming' via the internet, it is often necessary to capture what is transmitted if any practical use is to be made of it.[138]

146. In order for the desired 'certain result' to be produced by the transmission of an electromotive force, it is necessary not only to capture that electromotive force, but for the receiver to convert the electromotive force into the series of statements or instructions that are used directly or indirectly in a computer to bring about that 'certain result'. In this situation, a reproduction of the work may also occur. For example, game code that is embodied in RAM may be reproduced when the code is called off by the central processor and sent to the graphics processing unit.[139]

Determining the content of the communication

147. A communication is taken to have been made by the person responsible for determining the content of the communication.[140] The importance of identifying the person responsible for determining the content of a communication is illustrated in *Roadshow*[141], which involved determining who was responsible for making available online infringing films using BitTorrent software.

148. The software permitted individual internet users to save a film in fragments on their computer and permitted others to request copies of films, which was provided in fragments and subsequently reassembled on the computer from which the request was made. The Court held that the films were made available online each and every time the users connected their computer to the internet. Each person who had installed the software on their computer, so as to respond to a request for the film, was one of the persons responsible for the communication.[142] Thus, it was accepted that there may be more than one person responsible for determining the content of a communication.[143]

Making available online

149. In the same way that the iiNet users of BitTorrent in *Roadshow* made films available online, the Commissioner is of the view that software may be made available online under a SaaS model.

150. The software may be located on one or more overseas servers, with end-users in Australia being able to access the software online via the internet. The end-users may obtain by electronic transmission only those fragments of the software that are necessary for basic functions at any moment in time, rather than the entire software. However, this does not prevent the conclusion that access to the functions of the software by the end-user is a consequence of the software being made available online.

Content of the communication

151. In the context of SaaS, it is not correct to conclude that the sole causative factor for a transmission taking place, or for determining the content of that transmission, is the request from an end-user to access the software. The process of the software being made

[138] See *Network Ten Pty Limited v TCN Channel Nine Pty Limited* [2004] HCA 14 at [40].
[139] *Stevens* at [155–158], per McHugh J.
[140] Subsection 22(6) of the Copyright Act.
[141] Affirmed in *Roadshow Films Pty Ltd v iiNet Ltd* [2012] HCA 16.
[142] *Pokémon Company International, Inc. v Redbubble Ltd* [2017] FCA 1541 at [48], per Pagone J.
[143] *Roadshow* at [337], per Jagot J.

available online is generally not as simple as a request by an end-user that results in the content of what is made available online being determined by the requesting party. In many cases, the content held on the server has already been determined prior to the end-user obtaining a licence to access it.

152. An entity in control of an overseas server that hosts software, under a SaaS model, is one person responsible for determining the content of the communication. The entity in control of the server must have continued to store the software on the server, continued the active operation of the server, and either continued to connect the server to the internet or took no steps to disconnect it from the internet.[144] The entity in control of the server on which the software is hosted determines the content of the communication, by having the software installed on the server so as to respond to a request to access that software by an end-user. So too any intermediary who enters into a licence with the end-user may be responsible for determining the content of the communication, where that licence specifies the terms upon which the software will be made available to the end-user.

To the public

153. In *Telstra*, the High Court considered whether the copyright in various musical and literary works (the music and lyrics of various songs) was infringed by the works being broadcast to persons who were placed 'on hold' after making a telephone call. The term 'broadcast' meant 'transmit by wireless telegraphy to the public'.[145] The only issue in dispute was whether the transmission was 'to the public'.[146]

154. The phrase 'to the public' is broader than the phrase 'in public'[147], as it makes clear that the place where the communication occurs is irrelevant.[148] That is, the communication to individual members of the public in a private or domestic setting is nevertheless a communication to the public.

155. In a commercial setting, an unauthorised communication of copyright work will ordinarily be to the financial disadvantage of the owner's copyright in a work, as the owner would be entitled to expect payment for the work's communication. Consequently, the Commissioner's view is that where the communication of a copyright work occurs in a commercial setting or is for a commercial purpose, it is appropriately seen as being as a communication to a section of the public.

Make an adaptation

156. An adaptation of a work includes an adaptation of a substantial part of the work.[149] Determining whether the adaptation of a work has occurred is a question of fact and degree depending on the circumstances of each case. Whether a part of a work is substantial is determined by the quality of that part, rather than its quantity.[150] Therefore, attention is directed to the significance or importance of the part compared to the whole of

[144] See *Roadshow* at [338], per Jagot J.
[145] *Telstra* 146 ALR 649 at [656], per Dawson and Gaudron JJ.
[146] *Telstra* 146 ALR 649 at [656], per Dawson and Gaudron JJ.
[147] For example, the phrase 'in public' is used in subparagraph 31(1)(a)(iii) of the Copyright Act.
[148] *Telstra* 146 ALR 649 at [657], per Dawson and Gaudron JJ.
[149] Paragraph 14(1)(a) of the Copyright Act.
[150] *Sheldon v Metrokane* [2004] FCA 19 (*Sheldon*) at [32], per Conti J, citing Lord Pearce in *Ladbroke (Football) Ltd v William Hill (Football) Ltd* [1964] 1 WLR 273 at [293].

the work. There should be an objective similarity between the original work and the purported adaptation of it.[151]

Commercial rental arrangement

157. Copyright includes the exclusive right to enter into a commercial rental arrangement in respect of a computer program[152], except a commercial rental arrangement where 'the computer program is not the essential object of the rental'.[153]

158. In the case of a computer program, the term 'commercial rental arrangement' is defined in subsection 30A(2) of the Copyright Act to be an arrangement that has following features:

(a) … a copy of the … computer program is made available … on terms that it will or may be returned …;[154]

(b) … it is made in the course of the conduct of a business;

(c) … the copy [of the computer program is] … made available:

i. for payment in money or money's worth; or

ii. as part of the provision of a service for which payment … is to be made.

159. A 'lending arrangement' is excluded from constituting a commercial rental arrangement.[155] The term 'lending arrangement' is any arrangement where its true nature is the lending of a copy of a computer program under which no amount, other than a deposit to secure the return of the copy, is payable.[156]

160. Emmett J held in *Warner Home Video* that paragraph 31(1)(d) of the Copyright Act only extends to commercial rental arrangements where the object of the rental is to obtain the right or licence to make use of the computer program.

161. *Warner Home Video* involved the rental of DVDs that embodied both a cinematographic film and a computer program which caused the DVD player to play and allowed the user to navigate through the content of the DVD. Australian Video Retailers Association Ltd entered into rental arrangements with customers that involved making copies of the DVDs available for use. It was common ground that the arrangement constituted a commercial rental arrangement.[157] The issue in dispute was whether the computer program embodied on the DVD constituted 'the essential object' of that rental. It was held that the essential object of the rental was not the computer program but the video and audio content of the motion picture, albeit that use of the computer program was necessary to obtain 'the full benefit of the DVD technology'.[158]

162. In the Commissioner's view, arrangements between a software distributor and the software copyright holder often contain the features of a 'commercial rental arrangement' outlined in paragraph 158 of this Ruling. However, whether any particular arrangement constitutes a commercial rental agreement depends upon the particular facts and

[151] *Sheldon* at [32], per Conti J, citing Lockhart and Fitzgerald JJ in *Zeccola v Universal City Studios Inc* (1982) 46 ALR 189 at [193].
[152] Paragraph 31(1)(d) of the Copyright Act.
[153] Subsection 31(5) of the Copyright Act.
[154] In accordance with paragraph 30A(1)(a) of the Copyright Act, the arrangement is to be determined based on its substance and regardless of how it is expressed.
[155] Subsection 30A(3) of the Copyright Act.
[156] Subsection 30A(4) of the Copyright Act.
[157] *Warner Home Video* at [87], per Emmett J.
[158] *Warner Home Video* at [90], per Emmett J.

circumstances, with a focus on the substance of the arrangement and not merely its legal form.

Authorisation right

163. The exclusive right to do an act in relation to a work, includes the exclusive right to authorise a person to do that act in relation to that work.[159]

164. The history of 'authorisation' in Australian copyright law was discussed by Gummow J in *WEA International Inc. & Anor v Hanimex Corporation Ltd* [1987] FCA 571 (*Hanimex*), who stated that the concept was designed to overcome perceived deficiencies in the legislation and common law.[160]

165. The term 'authorise' is not defined in the Copyright Act, but the principle is contained in subsections 13(2), 36(1A) and 101(1A) of that Act. The High Court in *University of New South Wales v Moorhouse* [1975] HCA 26 (*Moorhouse*) stated that the word authorise 'has been held … to have its dictionary meaning of "sanction, approve, countenance".'[161] This meaning was adopted by Bennett J in *Australasian Performing Right Association Limited v Metro on George Pty Limited* [2004] FCA 1123, who stated at [16]:

> Authorise can also mean "permit" (*Moorhouse* at 12 per Gibbs J). It applies both to an express and an implied permission or invitation and it is unnecessary that the authorizing party have knowledge that a particular act comprised in the copyright will be done (*Moorhouse* at 13, 21 c.f. *Adelaide Corporation* at 490-1 per Isaacs J).

Matters relevant to determining authorisation

166. Subsections 36(1A) and 101(1A) of the Copyright Act contain various matters that must be considered in determining whether a person has authorised the doing in Australia of any act comprised in the copyright in a work. The Revised Explanatory Memorandum for the Copyright Amendment (Digital Agenda) Bill 2000, which introduced subsection 101(1A), states at paragraph 157 of the Notes on Clauses that '[t]he inclusion of these factors in the Act essentially codifies the principles in relation to authorisation that currently exist at common law …'.

167. In *Moorhouse,* Gibbs J considered that the High Court decision of *Corporation of the City of Adelaide v Australasian Performing Right Association Limited* [1928] HCA 10 provided authority for 3 propositions regarding what constitutes 'authorisation', being:

- authorisation cannot occur unless the person has some power to prevent it
- the absence of express or formal permission or sanction is not determinative, as inactivity or indifference exhibited by acts of commission or omission, may reach a degree from which an authorisation or permission may be inferred
- the existence of a mental element, such that mere inactivity will not constitute authorisation if the person 'neither knew nor had reason to suspect that the act might be done'.[162]

[159] Section 13 of the Copyright Act.
[160] *Hanimex* (1987) 17 FCR 274 at [283].
[161] *Moorhouse* 133 CLR 1 at [12], per Gibbs J.
[162] *Moorhouse* 133 CLR 1 at [12], per Gibbs J.

168. Unlike subsections 36(1A) and 101(1A) of the Copyright Act, subsection 13(2) of that Act is not concerned with determining whether a person has authorised the doing in Australia of an act without the licence of the copyright owner. Subsection 13(2) of the Copyright Act specifies that the right to 'authorise' an act in relation to a work is itself an exclusive right. This distinction between the concepts of authorisation was articulated in *Hanimex*, where Gummow J stated[163]:

> It should however be noted that the concept of authorization appears both directly and indirectly in the statutory description of infringement. That is to say, it appears in terms in the infringement section, s. 101(1) and it also appears indirectly therein because the expression in s.101(1) "any act comprised in the copyright" itself imports the concept of authorization through the operation of ss.13 and 85.

169. As Gummow J states in *Hanimex*, the '… concept of "authorisation" in the legislation had its own independent operation from what one might call primary infringement …'[164]. Thus, an exercise of the right to 'authorise' will arise where any act that the owner of the copyright has the exclusive right to do is so authorised.

170. In the Commissioner's view, the consequences of the authorisation right being an independent right from any 'primary' right contained in section 31 of the Copyright Act include:

- The authorisation of any exclusive right of a copyright owner is sufficient to evidence the exercise of the authorisation right. That is, it does not matter whether the act authorised would be an infringement of the copyright, nor if it was specifically excluded from constituting an infringement.

  For example, exercise of the authorisation right still occurs where a distributor authorises an end-user to make a temporary reproduction of a copyright work as an incidental and necessary part of the technical process of using a copy of the work. The right to 'reproduce' the work is being authorised even though the act of temporary reproduction is excluded from constituting an infringement of copyright under Australian domestic law.[165]

- It is unnecessary for the person who uses, or has the right to use, the authorisation right to also have the right to do the act authorised.

  For example, a person may have the right to authorise the reproduction of a copyright work without having the right to actually reproduce the work themselves (see Scenario 1 of this Ruling).

- A person can authorise the copyright owner to do an act comprised in that copyright. This is both a consequence of the authorisation right having its own independent operation from the rights contained in section 31 of the Copyright Act and a consequence of the meaning of 'authorise' including sanction, approve, countenance and permit.

  For example, use of the authorisation right occurs where a distributor authorises the copyright owner to communicate the work to the public (see Scenario 1 of this Ruling).

171. Further, it is the Commissioner's view that in addition to an exercise of the authorisation right, the grant of access to a program that is protected by an 'access technological control protection measure' can itself be a use of copyright.

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[163] (1987) 17 FCR 274 at [281].
[164] (1987) 17 FCR 274 at [284].
[165] See section 43B of the Copyright Act.

Software-as-a-service – authorising an act

172. In our view, a payment will be characterised as a royalty both when it is for the use of the authorisation right (regardless of whether the right is granted) or the grant of the authorisation right (regardless of whether the right is used).

173. The 3 propositions regarding what constitutes authorisation referred to in *Moorhouse* are relevant to determining whether 'use' of the authorisation right has occurred. The extent to which a payment is for the 'use' of the authorisation right will depend upon evidence that the taxpayer authorised another person to do an act that is the exclusive right of the copyright owner. Where a taxpayer has been granted the right to authorise an act that is the exclusive right of the copyright owner, any payment will be characterised as a royalty to the extent it is for the grant of that right.

174. In the context of SaaS models, generally the software is located on an overseas server and accessed by an Australian end-user via the internet. Where the SaaS model involves an intermediary, such as a distributor, and the intermediary sublicenses the software to the end-user, this act of sublicensing will generally constitute the authorisation of an act that is the exclusive right of the copyright owner. The act authorised will, depending upon the facts, be the communication of the software, through making it available online, by the copyright owner and the reproduction of the software by the end-user. SaaS may also involve the grant or use of other relevant rights. For example, access control technological protection measures (see paragraph 131 of this Ruling).

Part 3 – Non-copyright rights

175. As acknowledged in paragraph 3 of this Ruling, the focus of this Ruling is on payments for the use of, or right to use, copyright or other like property or right. However, such payments may also be for the use of, or right to use, other IP rights, or otherwise fall within the definition of a 'royalty'.

176. As discussed at paragraphs 30 to 31, 130 and 163 to 174 of this Ruling, while the Commissioner is of the view that the authorisation right is a copyright right, the Commissioner is also of the view that such a right may constitute an 'other like property or right' which entitles a distributor to exploit the copyright and other IP rights in the computer program when distributing the licences to use computer programs to end-users.

177. Further, in the software arrangements covered by this Ruling, there are generally other rights and obligations which indicate the payments are properly characterised as a royalty (to at least some extent). These rights and obligations enable the distributor to fulfil its role in the software arrangements and often include:

- other intellectual property rights granted (for example, trademarks, patents or confidential information)
- know-how, technical or commercial information supplied to the Distributor, and
- services ancillary to the use and enjoyment of any such rights or property supplied.

178. The proper characterisation of the payments described depends on the specific facts and circumstances of each software arrangement and is subject to the Commissioner's views, generally contained in IT 2660. As a result, such payments are not discussed further in this Ruling.

Part 4 – Embedded software

Storage medium

179. The storage medium of software is not determinative of the characterisation of any payment. The character depends upon any IP rights used or granted. Software may be sold under a contract for the sale of a complete product, comprising both a tangible good and software, without being unbundled or separately priced. In this situation, the Ruling refers to the software being 'embedded' in the tangible good.

180. The characterisation of the sale of software embedded in a tangible good is generally the same as the sale of software on any physical carrying media. This would be the case if an Australian distributor did not acquire or use any copyright rights and the software embedded in the tangible good only facilitated the operation of that tangible good. For example, any proceeds from the sale to a distributor of mobile handsets which are acquired pre-installed with operating system software is generally not a royalty.

181. Software may also be sold on physical carrying media separately from any computer or device with which it might be used. In such cases, the carrying medium is generally accompanied by a 'shrink-wrap' end-user licence agreement. While property in the carrying medium may pass to the end-user, the licence nevertheless limits the end-user's powers to deal with the software, for example it cannot be sold or hired without the permission of the licensor.

182. Payments by an Australian distributor of a tangible good embedded with software may constitute a royalty if the Australian distributor uses, or is granted the right to use, copyright or another IP right in the software. For example, if the Australian distributor is granted the right to modify or adapt the embedded software, this may involve the grant or use of a copyright right (refer to paragraph 156 of this Ruling). In this situation, apportionment of any payment may be necessary to reflect the amount paid for the use or grant of the copyright right rather than the acquisition of the tangible good.

Appendix 2 – Alternative views

This Appendix sets out alternative views and explains why they are not supported by the Commissioner. It does not form part of the proposed binding public ruling.

183. An alternative view is that any payments made by a distributor for the right to distribute software to purchasers who make simple use of the software cannot be a royalty.

184. This statement of principle cannot be accepted for the reasons set out in this Ruling. It is wholly inconsistent with the facts and circumstances of the software arrangements set out in this Ruling and a proper analysis of intellectual property law.

185. Another alternative view, based on a narrow reading of paragraph 14.4 of the OECD Commentary on Article 12, is that the payments for the supply of software will only be royalties where the rights to reproduce or modify the software are granted. We do not accept this view because it ignores what additional rights may have been granted to the distributor as part of the arrangements that facilitates the supply of the software. Paragraph (a) of the standard tax treaty definition of royalty is not narrowly confined. Consideration for the use of, or right to use any of the listed intellectual property (for example copyright) or other like property or rights, will be a royalty.

186. In applying Australia's tax treaties, the meaning of copyright will take its meaning from the Copyright Act. Rights in respect of copyright (pursuant to the Copyright Act) in terms of permission, protection and infringement are not limited to the reproduction or modification of a work.

Appendix 3 – Your comments

187. You are invited to comment on this draft Ruling. Please forward your comments to the contact officer by the due date.

188. In particular, consideration is being given to what further guidance we may publish in respect of any compliance approach that will be taken regarding the views set out in this Ruling, including issues concerning apportionment (see paragraphs 115 to 118 of this Ruling). Your comments are also invited in this regard.

189. A compendium of comments is prepared when finalising this Ruling and an edited version (names and identifying information removed) is published to the Legal database on ato.gov.au

190. Please advise if you do not want your comments included in the edited version of the compendium.

Due date: 1 March 2024

Contact officer details have been removed as the comments period has ended.

Status: **draft only – for comment**

Amendment history

31 January 2024

Part	Comment
Paragraph 6	Corrected title of TR 2021/D4.
Paragraph 67 and 98	Corrected minor typographical errors.

References

Previous draft:

TR 2021/D4

Related Rulings/Determinations:

GSTR 2001/8; IT 2660; TD 2006/10; TR 2001/13; TR 2006/10; TR 2008/7; TR 2012/4

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TR 93/12

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NO:	1-BJYYOLO
ISSN:	2205-6122
BSL:	PG
ATOlaw topic:	Withholding taxes and amounts ~~ Dividends, interest and royalties ~~ Royalties

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