STD 96/5 - Title:Calculation of tax payable on goods containing tax-advantaged computer programs

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This Document is a Ruling for the purposes of section 77 of the *Sales Tax Assessment Act 1992* and may be relied upon by any person to whom it applies.

Sales Tax Determination

Title: Calculation of tax payable on goods containing tax-advantaged computer programs

Background

The sales tax law provides a concession for goods containing tax-advantaged computer programs (TACPs). Where those goods are the subject of an assessable dealing, sales tax will not be payable on the value of the TACPs contained in the goods.

As some taxpayers have experienced difficulty determining whether goods contain TACPs, the Australian Taxation Office (ATO) has obtained advice from computer engineers about the properties of storage devices. This determination identifies the storage devices that commonly contain TACPs, explains how to value TACPs and provides Safe Harbour values for the calculation of sales tax payable.

Issues

1. Which storage devices commonly contain TACPs?

2. How can TACPs be valued?

3. How can refund or credit claims for tax overpaid on goods containing TACPs be calculated?

Decisions

1. The following storage devices commonly contain TACPs:

- **CD-ROMS**
- **magnetic based disks** (e.g., floppy disks and hard disks)
- **magnetic tapes for mainframes**.

Where these devices store computer programs, the taxable value of the goods embodying them will be reduced by the value of the program. The reduction in value is known as the exempt part of the taxable value.

The following storage devices do not commonly contain TACPs:

- **laser disks**
- **laser vision disks**
- **magnetic cards**
- **magnetic backup tapes**
- **microchips**, other than microchips covered by *subsection 14(2)* of the *Sales Tax Assessment Act 1992* (the Act), see page 6 of this Determination
- **music CDs**
- **OROMs and DataROMs**
- **solid state disks**
- **Write Once Read Many times (WORM) disks**.

2. The exempt part of the taxable value of goods embodying TACPs is the replacement value of the TACP. The value of the TACPs includes the value of data that is used in connection with and is integral to the execution of the program. In this case tax is only payable on the wholesale value of the storage device, for example, blank disks. For mixed music, video and data CD-ROMs and enhanced CDs referred to in page 5 of this Determination, the value of data cannot be included as part of the program. The formula in this part of the **Decision** section can be used to value the TACPs on these discs if the value cannot be separated from the value of the data.

Where the program is commercially available and is sold with other goods, the wholesale value of the replacement program under the particular licensing agreement supplying it should be used. (For example, the replacement value of original equipment manufacturer (OEM) software is determined by reference to the particular contract under which it is supplied).

Where the replacement value of the TACPs is not ascertainable, taxpayers may value the TACPs embodied in qualifying storage devices in goods as follows:

- for goods with a wholesale value up to and including $5,000, 10% of the wholesale value of the goods;

- for goods with a wholesale value up to and including $20,000, $500 plus 7.5% of (the wholesale value of the goods less $5000);

- for goods with a wholesale value over $20,000, $1,625 plus 5% of (the wholesale value of the goods less $20,000).

If several goods are sold in a package and only some contain TACPs, the formula only applies to the wholesale value of the particular goods embodying TACPs. However, a monitor, CPU, keyboard and mouse sold as a complete unit may be treated as one item of goods.

These percentages reflect the value of all TACPs in the goods, even where they contain more than one TACP.

3.   The principles in this determination (and STD 95/2 on permanent and non-permanent microchips) may be used to settle outstanding refund claims for goods containing TACPs.

Refunds relating to goods containing microchips, under the sales tax law that applied from 1 January 1993 to 9 May 1995, will only apply where the microchips contained in the goods meet the criteria set out in STD 95/2.

In relation to microchips, where there is no replacement value for the program, refund claims may be settled using either:

- the replacement value of the microchip storing the program; or

- 25% of the wholesale dealer list price of the least expensive part containing the microchip storing the TACPs (for example, the lowest price of the circuit boards, control units or other part containing the microchip storing the TACPs). Where more than one part contains a microchip storing TACPs, this can be claimed for each part.

Where there is no replacement value for the program, microchip storing the program or part containing the microchip, the formula in dot point 2 can be used.

Taxpayers who have claimed credits in their returns in excess of the values set out above may adjust those credit claims, without penalty, to reflect these agreed values. The adjustment should be completed no later than the return due on 21 August 1996. Where taxpayers have already deducted credits in returns for a greater amount and do not adjust them, they will need to be able to substantiate their claim. If the ATO subsequently finds that a sales tax credit has been overclaimed, the penalty provisions of the sales tax legislation may apply.

| **Date of effect** | This determination is effective immediately. It applies to all goods that contain TACPs, except goods that are the subject of a formal taxable value agreement or a standard industry taxable value. |

Reasons *We have based our decision on the following legislative provisions:*	*Section 45* of the Act provides that where a computer program is tax-advantaged, the taxable value of the goods in which the program is embodied will be reduced by the value of the program. The reduction in taxable value is described as an exempt part of the taxable value.
Section 45 of the *Sales Tax Assessment Act 1992*	Other provisions dealing with TACPs are *sections 5, 13, 14* of the Act and *section 10* of the *Copyright Act 1968*.
Section 5 of the *Sales Tax Assessment Act 1992* and *section 10* of the *Copyright Act 1968*	Computer program is defined in *section 5* of the Act and *section 10* of the *Copyright Act* as:

> *a set of instructions (whether with or without related information) intended, either directly or after either or both of the following:*
>
> > *(a)conversion to another language, code or notation;*
> > *(b)reproduction in a different material form*
>
> *to cause a device having digital processing capabilities to perform a particular function.*

| *Section 13* of the *Sales Tax Assessment Act 1992* | *Section 13* of the Act defines the meaning of embodying computer programs in goods. Computer programs are taken to be embodied in goods if they are treated in such a way that the computer program can be reproduced from the goods. |
| *Section 14* of the *Sales Tax Assessment Act 1992* | *Section 14* of the Act defines a TACP as a computer program that is embodied on a storage device, other than a microchip. Computer programs for educational or entertainment use that are embodied on microchips will also be tax-advantaged where the microchip on which the program is embodied is contained in a cartridge that is marketed exclusively for use with a personal computer or home electronic device that is for use with a computer monitor or television screen. |

Storage devices that commonly contain TACPs

The following devices commonly contain TACPs:

CD-ROMS (including enhanced CDs), magnetic tapes for mainframe computers and magnetic based disks in personal computers commonly store *computer programs* as defined in the *Copyright Act*.

Sometimes these devices embody both computer programs and data. There is some doubt in these circumstances whether the *Copyright Act* provides protection to this data as a *computer program* or as a *literary work*. However, the ATO has decided that where the data is used in connection with and is integral to the execution of that TACP, the value of that data and other information is a part of the value of the program. Examples of data that can be valued as part of the program are:

- multi-media software such as an encyclopaedia on a CD-ROM disk, which has TACPs, video, pictures, sounds, text, search and copy facilities;

- a spell checker with data comprising a dictionary that is an integral part of the program.

On the other hand, mixed music, video and data CD-ROMs and enhanced CDs have a minor computer program enabling them to search, retrieve and reproduce data using the computer's CD player. Unlike other multi-media software, the primary function of these relates to the reproduction of music, sound, text and or video clips. Consequently, the value of the music and video data on music and video CD-ROMs and enhanced CDs cannot be valued as part of the program. Where the value of programs cannot be separated from the value of this data, the formula in point 2 of the **Decision** section can be used.

Storage devices that do not commonly contain TACPs

The following devices do not commonly contain TACPs:

- **Laser vision and laser disks:** these nearly always store video and audio information using analogue and not digital methods (as required by the *Copyright Act*). In most cases the computer program is stored on a separate device.

- **Magnetic backup tapes, Optical ROMs (OROMs), DataROMs and WORM disks:** these contain data used for storage (e.g., transactions copied for archiving), maintenance of records (e.g., births and deaths) and information on disk. The computer program is generally stored on a separate device. Whilst some may store a computer program, these are generally compressed and cannot cause a device to perform a function and are merely used to facilitate storage and retrieval.

- **Magnetic cards:** these contain information on a magnetic stripe and are encoded to prevent fraud. While a simple instruction may be present they do not contain a *set of instructions*. Smart cards contain information on a microchip and are subject to the same restrictions imposed on microchips.

Subsections 14(1) and 14(2) of the Sales Tax Assessment Act 1992

- **Microchips:** however, *subsection 14(2)* allows computer programs for educational or entertainment use that are embodied on microchips where the microchip is contained in a cartridge that is marketed exclusively for use with a personal computer or home electronic device that is for use with a computer monitor or television screen.

- **Music CDs:** these store music, error correction and track time data to be manipulated by a processor within the CD player. The instructions are embedded in the processor and there is no TACP on the music CD.

- **Solid state disks:** these are being increasingly used as removable disks in pocket sized computers, for example Flash RAMs. These are not disks, but are microchips containing memory in a plastic package and are subject to the same restrictions imposed on microchips.

Section 77 of the Sales Tax Assessment Act 1992

Taxpayers who sell these types of storage devices but who believe their goods embody TACPs may seek certification from a computer engineer and supply this to the ATO together with a completed *Application for Private Ruling on Sales Tax*. Any ruling by the ATO will have protection for the purposes of *section 77* of the Act and may be relied upon by the person to whom it applies.

Valuation method   Once it has been established that a storage device embodies a TACP, the next step is to value the TACP.

Replacement value   The value attributed to the TACP must be a tangible value based on the amount costed into the price of the goods and not a value based on the notion that the goods cannot operate without the program. The method of valuation which best reflects this is the cost of replacing the TACP embodied in the storage device. The replacement cost should be determined taking into account the terms of the agreement under which the particular TACP is supplied, for example, a wholesaler of goods who supplies a customer with a replacement TACP may use the arm's length wholesale replacement value for those particular goods.

Taxpayers should not adopt an arbitrary value where there is insufficient information to calculate the value of the TACP, nor should they act on rulings given to competitors or letters from suppliers merely stating an exempt percentage that is not supported by documentation. Invoicing of separate amounts is not sufficient to establish a value and full costing information should be obtained from suppliers.

Original equipment   In some cases, new computer hardware equipment or other
manufacturers   equipment is preloaded with TACPs on the computer hard disk memory or bundled with CD-ROM disks that contain TACPs. This is variously called *original equipment manufacturer* software, *white box* software or *lite* software (collectively referred to in this determination as *OEM* software).

OEM software:

- is, under the terms of the distribution agreement, *For Distribution Only with a New PC*,
- is usually packaged in a plain box with minimal documentation,
- often has different levels of user support and/or entitlement to purchase of upgrades compared to full rights software.

By contrast, software giving full rights comes shrink wrapped in an illustrative box with full documentation, an entitlement to user support and a registration card as proof of ownership.

OEM software is supplied under international agreements between software suppliers and hardware manufacturers at a heavily discounted price. Alternatively, many software titles are superseded and have little commercial value. The amount paid by the manufacturers for the rights to the software is usually the greater of the minimum commitment payment paid to the software suppliers or the unit sales multiplied by the agreed royalty rate. The software suppliers are guaranteed a minimum payment from the manufacturers and are further compensated by the practice of purchasers buying upgrades for their software preloaded or bundled in computers purchased by them.

The OEM software should therefore be valued at the cost of replacing the particular TACP embodied in the storage device under the particular licensing agreements between the software suppliers and the manufacturers, rather than the wholesale list price for full rights software. This is usually the agreed royalty rate set out in the licensing agreement.

Safe Harbour values

The Safe Harbours set out in the **Decision** section are based on information provided by industry members and other experts in valuing TACPs in a wide range of goods. They have been developed taking into account the valuation difficulties mentioned previously and with a view to reducing the cost for taxpayers and the ATO in establishing precise valuation figures on a case by case basis.

Communication of the Decision

This Determination has been made available for publication by the sales tax publishing houses.

Commissioner of Taxation
24 April 1996