TR 2021/D4 - Income tax: royalties - character of receipts in respect of software

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Status: **draft only – for comment**

Draft Taxation Ruling

Income tax: royalties – character of receipts in respect of software

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**

Status: **draft only – for comment**

What this draft Ruling is about

1. This draft Ruling[1] deals with the circumstances in which receipts from the licensing and distribution of software will be royalties as defined in subsection 6(1) of the *Income Tax Assessment 1936* (ITAA 1936).

Previous ruling

2. This Ruling replaces Taxation Ruling TR 93/12 *Income tax: computer software*, which has been withdrawn from 1 July 2021.

3. In addition to the matters covered by this Ruling, TR 93/12 dealt with the assessability of receipts in respect of software and the treatment of software as trading stock under subsection 70-10(1) of the *Income Tax Assessment Act 1997* (ITAA 1997). These matters are considered to be generally well understood and it is proposed to deal with them through guidance to be published on ato.gov.au.

Ruling

4. The character of receipts from the licensing and distribution of software depends on the terms of the agreement between the parties taking into account all the facts and circumstances of the particular case.

5. An amount is a royalty as defined in subsection 6(1) of the ITAA 1936 to the extent that it is paid or credited as:

(a) consideration for the grant of a right to do something in relation to software that is the exclusive right of the owner of the copyright in the software (paragraph (a) of the definition). Examples include payments for the grant of a licence which permits

(i) the licensee to reproduce software or to modify or adapt software (see Examples 1 and 2 of this Ruling, and contrast Example 3 of this Ruling), and

(ii) a distributor of software to sub-licence the use of the software, whether the software is distributed by way of physical carrying media, digital download or cloud-based technology (see Examples 4 and 5 of this Ruling, and contrast Example 6 of this Ruling).

(b) consideration for the supply of know-how in relation to software (paragraph (c) of the definition). Examples include payments for the supply

[1] 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.

of source code[2] relating to software (see Example 2 of this Ruling, and contrast Example 3 of this Ruling).

(c) consideration for the supply of assistance furnished as a means of enabling the application or enjoyment of the supply (paragraph (d) of the definition) (see Example 7 of this Ruling, and contrast Example 8 of this Ruling).

6. The following amounts are not royalties as defined in subsection 6(1) of the ITAA 1936:

(a) consideration for the grant of a licence which allows only the simple use of software, that is, it allows the licensee or end-user to use the software for the purpose for which it was designed, but does not otherwise permit the end-user to use the copyright in the software[3] (see Example 3 of this Ruling).

(b) consideration for the grant of distribution rights in relation to software where the distributor is not permitted to do anything in relation to the software that is the exclusive right of the owner of the copyright in the software (see Example 6 of this Ruling).

(c) consideration for the transfer of all rights relating to the copyright in software.

(d) proceeds from the sale of goods where hardware and software are sold to an end-user in an integrated form without being separately priced, or where physical carrying media on which software is stored is sold to an end-user, provided in either case that the end-user is only granted simple use rights.

(e) consideration for the provision of services in the modification or creation of software.

7. In certain cases, apportionment may be required to ascertain the extent to which a receipt from the licensing or distribution of software is a royalty. Apportionment is to be done on a fair and reasonable basis taking into account all the facts and circumstances of the particular case.

Example 1 – licence to reproduce software

8. *DevCo is an Australian subsidiary of a foreign company, DevParent. DevParent develops a suite of database software which it licences to DevCo.*

9. *Under the terms of the licence agreement, DevCo makes payments to DevParent in exchange for the right to reproduce the software for sale to local customers.*

10. *The payments made by DevCo to DevParent are royalties under paragraph (a) of the definition of royalty in subsection 6(1) of the ITAA 1936. This is because the payments are for the right to reproduce the software.*

[2] 'Source code' refers to a set of instructions in a high-level computer language that can be read by humans. Source code is distinct from 'object code' which a computer can read and execute but which cannot be read by humans. Source code can be used to modify or adapt software; see *Task Technology Pty Ltd v Commissioner of Taxation* [2014] FCAFC 113.

[3] As discussed in paragraph 68 of this Ruling, the concept of simple use does not cover situations where the end-user has been granted more extensive rights in respect of software, for example, the right to modify or adapt the software.

Example 2 – licence to modify software including access to source code

11. *SysCo develops system software for manufacturers of electricity smart meters. The software is specialised and performs various functions including interface with other devices, monitoring of power usage, and communication with a central monitoring platform in the event of a fault or outage.*

12. *SysCo develops the software under contract with the manufacturers of the smart meters. The software is installed onto the smart meters and, under the terms of a license, the manufacturers are given access to the source code and are permitted to modify and make future updates to the software.*

13. *The payments received by SysCo are royalties under paragraphs (a) and (c) of the definition of royalty in subsection 6(1) of the ITAA 1936. This is because the manufacturers of the smart meters are given the right to modify the software, and the provision of the source code imparts unpublished technical information or know-how about the software.*

Example 3 – licence for the simple use of software

14. *UserCo subscribes for access to a suite of cloud-based productivity applications offered by SolutionCo.*

15. *As part of the sign-up process, UserCo enters into a standard cloud services agreement under which it agrees to make monthly payments to SolutionCo for the right to access and use the software. The software operates via a browser and UserCo installs elements of the software on its infrastructure to facilitate its efficient operation. A limited version of the software is also able to be downloaded to facilitate offline use.*

16. *Under the cloud services agreement, SolutionCo grants UserCo a non-exclusive, non-transferrable licence to access and use the software subject to the terms of the agreement. A key term of the agreement is that UserCo's use of the software is limited to normal or simple use. For this purpose, UserCo is given access to an online user manual containing a detailed outline of the various functions performed by the software.*

17. *The cloud services agreement places a number of restrictions on UserCo's use of the software. UserCo is not permitted to disclose its account credentials to third parties or allow its account to be used simultaneously on more than 10 devices. UserCo is not allowed to sub-licence the software, unlock or access the source code in the software, or do any other act which would infringe the copyright in the software.*

18. *The monthly payments that UserCo makes to SolutionCo are not royalties under paragraphs (a) or (c) of the definition of royalty in subsection 6(1) of the ITAA 1936. This is because they are payments for the simple use of the software and for technical information relating to the simple use of the software.*

Example 4 – software distribution agreement conferring the right to enter into end-user licence agreements

19. *SoftParent is the parent of a multinational group of companies which develops and markets software. SoftParent owns the copyright in a suite of accounting software for large and small businesses. SoftCo, an Australian subsidiary of SoftParent, distributes copies of the accounting software to customers in Australia.*

20. *SoftCo and SoftParent have entered into a distribution agreement under which SoftCo makes payments to SoftParent in exchange for the right to distribute the software*

in Australia. SoftCo distributes the software by entering into end-user licence agreements with Australian customers. SoftCo does not have the right to reproduce or modify the software.

21. *When a customer places an order, SoftCo notifies SoftParent and SoftParent generates an individual licence key for the customer. The customer uses the individual licence key to download the software from a website located on a server overseas. SoftCo does not own or otherwise control the server or the website.*

22. *Under the end-user licence agreement, SoftCo grants the customer a non-exclusive, non-transferrable licence to download, install and use the software subject to specified terms. The licence agreement allows the customer to download and install the software on a computer, perform normal or simple use, and make a back-up copy, but otherwise limits the customer's use of the software, for example, the customer is not permitted to modify or make multiple copies of the software.*

23. *The payments made by SoftCo to SoftParent are royalties under paragraph (a) of the definition of royalty in subsection 6(1) of the ITAA 1936. This is because the payments are for the right to sub-licence the use of the software to end-users and to specify the terms on which end-users may use the software. This is the exclusive right of SoftParent as the copyright owner and SoftCo would not be permitted to do this without the licence of SoftParent.*

24. *The grant of the right to use the copyright in the software is central to SoftCo performing its distribution function. Based on these facts there is no need to apportion the payment and the whole of the payment from SoftCo to SoftParent will be considered a royalty.*

Example 5 – software distribution agreement conferring the right to enter into cloud services agreements

25. *CloudCo has recently made its photo and video editing software available to customers on a subscription basis under a software-as-a-service offering. The cloud infrastructure on which the software is hosted is located overseas and is owned and controlled by CloudCo.*

26. *AusCo, an Australian subsidiary of CloudCo, sells subscriptions to customers in Australia. AusCo and CloudCo have entered into a cloud distribution agreement which sets out the terms on which AusCo is permitted to sell the subscriptions. Under the agreement, CloudCo grants AusCo the right to enter into cloud services agreements with customers specifying the terms on which the customer can use the software. AusCo acknowledges that it does not otherwise have the right to do anything that is the exclusive right of CloudCo as the copyright owner.*

27. *In return for the grant of these rights, AusCo pays a monthly cloud distributor fee to CloudCo which is calculated by reference to subscription sales and renewals over the preceding month.*

28. *When purchasing a subscription, customers confirm (by clicking a box on CloudCo's website) that they agree to the terms of the cloud services agreement with AusCo. If a customer does not renew its subscription at the end of the subscription period, its access to the cloud services is cancelled.*

29. *Under the cloud services agreement, AusCo grants the customer a non-exclusive, non-transferrable licence to access the software and use it for its intended purpose. The agreement otherwise limits the customer's use of the software.*

30. *The monthly cloud distributor fee which AusCo pays to CloudCo is a royalty under paragraph (a) of the definition in subsection 6(1) of the ITAA 1936. This is because the fee secures the grant of the right to distribute the software by way of sub-licensing the use of the software to customers. Licensing the use of the software is the exclusive right of CloudCo as the copyright owner and AusCo would not be permitted to do this without the permission of CloudCo.*

Example 6 – software distribution agreement not conferring copyright

31. *GamesHeaven is a retailer of computer games. It enters into a distribution agreement with GamesCo, a leading games developer, under which it is granted the non-exclusive right to distribute GamesCo's computer games as a flagship partner.*

32. *The distribution agreement permits GamesHeaven to sell packaged games at its retail outlets across Australia. The packaged games contain 'shrink-wrap' end-user licence agreements which customers agree to be bound by when opening the games. The end-user licence agreements are between GamesCo and customers. GamesHeaven is not a party to the agreements.*

33. *The fees paid by GamesHeaven under the distribution agreement are not royalties under paragraph (a) of the definition of royalty in subsection 6(1) of the ITAA 1936. This is because the fees secure the grant of distribution rights that do not involve the use of copyright by GamesHeaven. That is, the fees are not paid for the right to do anything in relation to the games that is the exclusive right of the copyright owner.*

Example 7 – services ancillary to the modification of software

34. *Sam is a computer programmer who has an agreement with CopyCo, the owner of custom operating system software, which permits her to reproduce and modify the software.*

35. *For an additional fee, CopyCo agrees to provide Sam such assistance as is necessary for her to understand the logic of the software so that she can update and modify it on an ongoing basis.*

36. *The assistance provided by CopyCo relates to the right to reproduce and modify the software. The additional fee which Sam pays to CopyCo is therefore a royalty under paragraph (d) of the definition of royalty in subsection 6(1) of the ITAA 1936.*

Example 8 – services ancillary to the simple use of software

37. *John purchases a subscription to SolutionCo's cloud-based retail management software to manage point of sale, inventory and customer relationships at his homewares store. John chooses SolutionCo's premium package under which he pays an additional fee for 24-hour help desk support.*

38. *The assistance provided by SolutionCo relates to the simple use of the retail management software. The additional fee which John pays for the help desk support is therefore not a royalty under paragraph (d) of the definition of royalty in subsection 6(1) of the ITAA 1936.*

Status: **draft only – for comment**

Date of effect

39. 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*). TR 93/12 applied to some arrangements covered by this draft Ruling. The proposed date of effect for the final Ruling does not prevent TR 93/12 applying prior to its withdrawal to the extent that it has been relied upon.

Commissioner of Taxation
25 June 2021

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.

40. 'Software' is a generic term for computer programs consisting of code that has the ability to cause a computer or device to perform a particular function or produce a particular result. A particular item of software may consist of anything from a few to a large number of computer programs.

41. Software, as distinct from its physical carrying medium, is in essence knowledge or information. It is an item of intellectual property. The carrying medium is tangible property, but the software embodied on the carrying medium is intangible property.

42. The concept and nature of software is continually evolving with technological change. Software can take many forms including:

- operating system software installed on an end-user's computer or device, which activates and is essential for the operation of the computer or device regardless of the use for which it is required
- application software which provides a computer or device with encoded instructions to perform a specific task, for example, payroll, inventory, word processing, spreadsheets, or games. Application software can be used with different types of computers and devices and may be supplied by an independent software developer or distributor. It may also be developed by the user of a computer or device
- software which controls physical equipment other than computers or devices, or which facilitates the transfer of data relating to such equipment, for example, industrial machinery, smart meters, and networked household appliances
- programming tools such as compilers which take complex code and convert it into machine-readable language, for example, software companies may produce development software which takes human-readable source code and converts it into object code.

43. Software may be developed and marketed as a standard product or as a custom product designed for a specific end-user. Non-custom software may sometimes need to be modified or have unique modules of programs added to it to suit the needs of a particular end-user. Such modifications may be made by the software developer or, with the licence of the copyright owner, by the manufacturer or distributor of the software or by some other person with programming expertise.

44. For many years, software was distributed to end-users predominantly by way of physical carrying media. The particular types of carrying media used have changed over time and currently compact discs and USB drives are commonly used.

45. The distribution of software by way of digital download is commonly used as it can be more convenient and involves significantly lower costs than using physical carrying media. Digital download refers to the distribution of software by means of an electronic channel rather than a physical carrying medium. The most common forms of electronic distribution are via the internet (which is common among computer users) and telecommunications cellular networks (which is common among handheld mobile phone and tablet users).

46. End-users may also access and use software remotely over the internet without downloading and installing it on a particular computer or device. This is often referred to as 'cloud computing' and it covers various forms of arrangements including software-as-a-service. Under such arrangements, software is generally stored and executed remotely on one or more devices that are under the control of the software developer.

47. An arrangement for the provision of software may involve any combination of the technologies described. For example, a particular software-as-a-service arrangement may give an end-user the option of downloading and installing a copy of software on the end-user's computer or device to facilitate the use of the software offline.

48. The *Copyright Act 1968* (Copyright Act) protects software as a literary work[4] and prescribes the nature and scope of that protection having regard to the distinctive features of software.

Legislative context

49. The definition of royalty in subsection 6(1) of the ITAA 1936 covers amounts which are royalties within the ordinary meaning of that term. It also covers certain other amounts which are listed in the definition and which may not be royalties within the ordinary meaning. The amounts which are listed in the definition include amounts paid or credited for:

- 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 (paragraph (a) of the definition)
- the supply of scientific, technical, industrial or commercial knowledge or information (paragraph (c) of the definition), and
- 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) of the definition, or any such knowledge or information as is mentioned in paragraph (c) of the definition (paragraph (d) of the definition).

50. The words 'the extent to which' in the definition make it clear that apportionment is required in appropriate cases to ascertain the extent to which a receipt in respect of software is a royalty. Apportionment is to be done on a fair and reasonable basis taking into account all the facts and circumstances of the particular case. Each situation has to be resolved according to its own particular facts and the particular factors to be taken into account may vary from case to case.

51. The term royalty is defined in Australia's double-tax agreements in similar terms to the definition in subsection 6(1) of the ITAA 1936, except that the list of amounts which are defined as royalties is intended to be exhaustive. Royalties within the ordinary meaning of the term which do not come within the definition in a double-tax agreement are not royalties for the purposes of that double-tax agreement.

52. Where there is an inconsistency between the definition of royalty in subsection 6(1) of the ITAA 1936 and the definition in a particular double-tax agreement, the definition in the double-tax agreement prevails over the definition in subsection 6(1) of the ITAA 1936 to the extent of the inconsistency.[5]

[4] See the definition of 'literary work' in subsection 10(1) of the Copyright Act.
[5] Paragraph 6 of Taxation Ruling TR 2001/13 *Income tax: Interpreting Australia's Double Tax Agreements*.

53. Where an agreement concerning the licensing or distribution of software provides for the payment of a royalty to a non-resident, or to a resident carrying on business at or through a permanent establishment outside Australia, the recipient may be liable to royalty withholding tax under subsections 128B(2B) or (2C) of the ITAA 1936. This is subject to any applicable double-tax agreement.

Paragraph (a) of the definition

54. Paragraph (a) of the definition of royalty in subsection 6(1) of ITAA 1936 covers any amount to the extent to which it is paid or credited as consideration for the use of, or the right to use, any copyright.

55. The expression 'the use of, or the right to use,' is not defined in the ITAA 1936 or the ITAA 1997. An amount is considered to be for the use of or the right to use copyright if it is paid or credited as consideration for right to do something in relation to copyright that is the exclusive right of the owner of that copyright.

56. Under subsection 31(1) of the Copyright Act, the exclusive rights of the owner of copyright in a literary work (including software) include the right to:

- reproduce the work in a material form
- make an adaptation of the work, and
- communicate the work to the public.

57. The concept of reproduction in subsection 31(1) of the Copyright Act connotes the copying of a work in which copyright subsists. A reproduction may be of the whole or a substantial part of a work and may include any form of storage of the work whether visible or not.[6]

58. 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.[7]

59. An adaptation of software is a special form or variant of the software that is not a reproduction.[8] Where a licensee modifies software in a particular way in order to accommodate a particular user or produce some different result to the copyright work, there is an adaptation of the software for the purposes of subsection 31(1) of the Copyright Act if the new version is not so similar to the original as to be properly regarded as a reproduction.

60. The third exclusive right, to communicate a copyright work to the public, covers two classes of acts.[9]

61. The first class of acts involves sending or receiving a work (including software) by way of electronic transmission. An electronic transmission may occur via a combination of paths. For example, a communication over the internet may involve transmission over copper wire and optic fibre cables. Software acquired under licence is communicated for

[6] See the definition of 'material form' in subsection 10(1) of the Copyright Act.
[7] *Dyason, M.P. & Ors v Autodesk Inc & Autodesk Australia Pty Ltd* [1990] FCA 499, per Sheppard J.
[8] See the definition of 'adaptation' in subsection 10(1) of the Copyright Act.
[9] See the definitions of 'communicate' and 'to the public' in subsection 10(1) of the Copyright Act. The High Court of Australia 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, per Dawson and Gaudron JJ.

the purposes of subsection 31(1) of the Copyright Act when it is downloaded onto a computer or device.

62. The second class of acts covered by the concept of communication involves the making of 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.[10] A communication may occur in the relevant sense when software is made accessible to or is used by an end-user via cloud-based technology such as software-as-a-service, that is, without being downloaded on the end-user's computer or device. Depending on the circumstances of the particular case the communication may be taken to have been made by any number of people including the end-user and the software distributor.[11] The extension of copyright to the making of works available online seeks to address the challenges of copyright in the digital age by improving copyright protection in an online environment.

63. By virtue of subsection 13(2) of the Copyright Act, the exclusive rights of the owner of the copyright in software include the right to authorise another person to do any of the things mentioned in subsection 31(1) of the Copyright Act. Authorisation may involve the giving of express or formal permission, or less formal conduct such as approving and countenancing.[12]

Licence to use copyright

64. Subject to what is said in paragraph 67 of this Ruling about the simple use of software, a payment to the owner of the copyright in software for a licence which permits the licensee to copy, modify or adapt the software, or to otherwise do something in relation to the software that is the exclusive right of the copyright owner, is a royalty (see Examples 1 and 2 of this Ruling).

65. A payment for the right to make copies of and distribute software is therefore a royalty irrespective of whether the payment is a one-time or periodical payment or calculated by reference to the number of times the program is reproduced.

66. A payment by a software developer or a computer programmer for the right to modify or adapt software is also a royalty.

Simple use of software

67. In determining whether a payment in respect of software is a royalty, it is necessary to distinguish between payments such as those described in this Ruling and payments for the simple use of software. Payments for the simple use of software are not royalties (see Example 3 of this Ruling).

68. Simple use is the process of using software for the purpose for which the software was designed or intended to be used, provided that the licensee or end-user has only been granted the right to use the copyright in the software to the extent necessary to facilitate that intended use.[13] The concept of simple use does not cover situations where the end-

[10] *Roadshow Films Pty Limited v iiNet Limited* [2011] FCAFC 23 at [661].
[11] *Universal Music Australia Pty Ltd v Cooper* [2005] FCA 972 at [73].
[12] *University of New South Wales v Moorhouse* [1975] HCA 26, per Jacobs J.
[13] Simple use necessarily involves the use of copyright. For example, and as discussed in paragraphs 57 to 62 of this Ruling, for the purposes of subsection 31(1) of the Copyright Act, the process of installing software on a computer involves the reproduction of the software; the process of downloading software involves both the reproduction and the communication of the software; and the process of using software over the internet under a software-as-a-service arrangement involves the communication of the software.

user has been granted more extensive rights in respect of software, for example, the right to modify or adapt the software.

69. It is considered that payments for the simple use of software are for the right to use the software itself. The use of copyright, while necessary to facilitate the use of the software as a functional product, is merely incidental to that end.

70. Whether a payment is for the simple use of software is a question of fact and degree and is to be determined having regard to all the circumstances of the particular case, including the purpose for which the software was designed and intended to be used.

71. Payments for the simple use of software are typically made under standard licencing arrangements known as 'click-wrap', 'click-through' or 'browse-wrap' end-user licence agreements, where, as part of the download and installation process, the end-user either accepts or rejects the terms by selecting 'accept' or 'cancel'. These agreements are similar to traditional 'shrink-wrap' end-user licence agreements used for packaged software where, by opening the packaged software, the end-user agrees to be bound by the terms of the agreement. Similarly, under a standard 'cloud services' licence agreement the end-user agrees to be bound by the terms of the agreement in order to access and use software over the internet, that is, without downloading and installing it.

72. Under these types of agreements, a licence is granted which allows the end-user to use the software either on a single computer or device or on a specified number of computers or devices, and where relevant to download, install and make backup copies of the software for that purpose. While permitting the end-user to use the software for the purpose for which it was designed, the licence limits the rights of the end-user to otherwise deal with the software. For instance, the software cannot be transferred or hired without the permission of the licensor, and the licensee is prohibited from modifying the software and from reproducing it, except to the extent necessary to facilitate its simple use.

Software distribution agreements conferring copyright

73. An agreement between a software developer and a software distributor can take a variety of forms. In determining whether a payment made by a software distributor is a royalty, it is the nature of the rights granted to the distributor and the context in which they are granted that informs the character of the payment.

74. Where a software distributor is granted the right to do something in relation to software that is the exclusive right of the copyright owner, the payment made for that right will be a royalty.[14] For example, and as mentioned in paragraph 65 of this Ruling, a payment for the right to make copies of and distribute software is a royalty. Similarly, where a software distributor is granted broad distribution rights which include the use of any intellectual property necessary to perform its distribution function, a payment for those rights will be a royalty.[15]

75. A payment by a software distributor for the right to sub-licence the use of software is a royalty. This is the case whether the software is distributed by way of physical carrying media, digital download or cloud-based technology such as software-as-a-service. It is also the case whether the payment by the distributor is for the right to grant licences for the simple use of the software or to grant licences which confer more extensive rights, for example, the right to modify or adapt the software (see Examples 4 and 5 of this Ruling).

76. Such a payment is considered to be a royalty because it is for the right to do something in relation to software that is the exclusive right of the copyright owner. That is,

[14] *Task Technology Pty Ltd v Commissioner of Taxation* [2014] FCAFC 113 at [15–22].
[15] *International Business Machines Corporation v Commissioner of Taxation* [2011] FCA 335 at [50–53].

it is a payment by the distributor for the right to use the copyright in the software or to authorise another person (the end-user) to use the copyright in the software.

77. For example, when a software distributor enters into a licence agreement with an end-user, the software distributor authorises the end-user to reproduce or copy the software as part of the technical process of installing the software on the end-user's computer. Similarly, when a software distributor enters into a cloud services agreement with an end-user, the software distributor authorises the end-user to access and use the software over the internet which, as discussed in paragraph 62 of this Ruling, involves the communication of the software for the purposes of subsection 31(1) of the Copyright Act.

78. In such cases, the distributor is paying for the right to stand in the shoes of the copyright owner and exploit the copyright in the software in order to derive income. It does this by granting licences that specify the terms upon which end-users may use the software. Because the distributor would not be permitted to do this without the licence of the copyright owner, the payment by the distributor is a royalty.

79. Where a software distributor makes a single undissected payment that is partly for the right to use the copyright in software and partly to secure other rights, the payment must be apportioned on a fair and reasonable basis taking into account all the facts and circumstances of the particular case. As a general proposition, where the grant of the right to use the copyright in software is central to the rights the distributor is given to perform its distribution function, and the other rights granted are ancillary in comparison, it is considered that the whole of the payment will constitute a royalty.

Software distribution agreements not conferring copyright

80. It is not always the case that payments made by a software distributor for distribution rights will be royalties. There may be instances in which a software distributor makes payments to a copyright owner for the grant of distribution rights which do not involve the right to do anything that is the exclusive right of the copyright owner. For example, a distributor may enter into a distribution agreement under which it is granted the right to market and distribute packaged software but not to sub-licence the use of the software to end-users or to otherwise use the copyright in the software. In such cases the licence to use the software is granted directly to end-users by the software developer (see Example 6 of this Ruling).

81. This may also be the case where software is distributed by way of digital download or cloud-based technology. That is, depending on the circumstances of the particular case the distributor may not be granted the right to sub-licence the use of the software or to otherwise use the copyright in the software. In such cases the payments made by the distributor will not be royalties.

Assignment of copyright

82. A software developer may assign rights relating to the copyright in software. Such rights may be assigned either permanently or for a limited period and may cover a specified geographical area. This commonly occurs in relation to custom software developed to meet the specific needs of a customer.

83. All amounts paid or credited as consideration for the assignment of the copyright in software are royalties unless the assignment can be properly characterised as an outright

sale or transfer of the copyright. Payments for the outright sale or transfer of the copyright in software are not royalties.[16]

Sale of goods

84. Software may be sold under a contract for the sale of a complete product consisting of both hardware and software, without being unbundled or separately priced. In such cases the payment for the product will generally constitute proceeds from the sale of goods and will generally not be a royalty. For example, the proceeds from the sale of a mobile handset which comes pre-installed with operating system software is not a royalty.

85. 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 similar to the type described in paragraph 71 of this Ruling. 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.

86. Where property in physical carrying media on which software is embodied passes to an end-user, the whole of the purchase price will constitute proceeds from sale of goods in the hands of the software developer or distributor, provided that the end-user is only granted simple use rights. This is also the case for payments by a distributor for the purchase of software for resale to end-users, provided that the distributor is not paying for the right to sub-licence the use of the software or to otherwise use the copyright in the software.

Paragraph (c) of the definition

87. Paragraph (c) of the definition of royalty in subsection 6(1) of ITAA 1936 covers consideration for the supply of know-how in relation to software.

88. The types of information that fall within the scope of paragraph (c) of the definition are discussed at paragraphs 19 to 21 of Taxation Ruling IT 2660 *Income tax: definition of royalties*. In relation to software, there will be a supply of scientific, technical, industrial or commercial knowledge or information where the subject matter of the software imparts unpublished technical information or where technical information about the software itself is disclosed.

89. Whether or not know-how is supplied in the subject matter of software is a question that can only be determined on a case by case basis. The supply of know-how in the subject matter of software may occur where a company acquires custom software which is designed to solve project management problems and the software provides undivulged specialist technical knowledge on that subject.

90. The supply of know-how about software itself may occur where a software developer, in addition to supplying software to a licensee, agrees to transfer to the licensee some or all of the underlying source code in the software which enables the licensee to modify the software. Where the agreement provides for the transfer of source code, this may point toward a supply of know-how about the software which comes within paragraph (c) of the definition (see Example 2 of this Ruling).

91. The acquisition of software under a simple use licence does not ordinarily involve the supply of know-how for the purposes of paragraph (c) of the definition. Where an end-user acquires software for simple use and is not permitted to access the underlying source

[16] See Taxation Ruling TR 2008/7 *Income tax: royalty withholding tax and the assignment of copyright*.

code in the software, it cannot be said that knowledge or information about the software in the relevant sense of know-how has been transferred (see Example 3 of this Ruling).

Payments for services

92. It may sometimes be necessary to distinguish between payments for the supply of know-how and payments for services in connection with the creation or modification of software. The characteristics of a contract for services, and the elements that distinguish it from a contract for the supply of know-how, are discussed at paragraphs 25 to 36 of IT 2660.

93. Because of the wide variety of software agreements that may be entered into, the question whether a contract for the provision of software is a contract for services will depend on the particular terms of the agreement. At one end of the spectrum the customer may require that software be created virtually from scratch. At the other end of the spectrum a minor modification to existing and standard software may be sufficient to meet the customer's requirements. Copyright in the resulting software may or may not pass to the customer.

94. In cases where the essence of the contract is the provision of services for the modification or creation of software, the receipts under the contract will not be royalties.

95. Where a contract provides for both the supply of know-how and the supply of services or other rights, apportionment of the payments under the contract will be necessary.

Paragraph (d) of the definition

96. Contracts for the supply of software often provide for certain ongoing assistance such as bug-fixing, training, maintenance and help desk support. Where this occurs it may be necessary to consider whether any payments for the assistance are royalties under paragraph (d) of the definition in subsection 6(1) of the ITAA 1936.

97. Paragraph (d) of the definition covers payments for the supply of assistance that is ancillary and subsidiary to, and is furnished as a means of enabling the application or enjoyment of, any such property, right, knowledge or information as is mentioned in paragraphs (a) or (c) of the definition. Payments for assistance relating to software are royalties where the assistance is subsidiary and ancillary to the right to use the copyright in the software or to the supply of know-how in relation to the software (see Example 7 of this Ruling).

98. It is important in this context to note that only payments for assistance relating to the right to use copyright or the supply of know-how are royalties under paragraph (d) of the definition. In the case of contracts for the supply of software any payments for assistance which relates to the simple use of the software, for example help desk support, will generally not be royalties (see Example 8 of this Ruling).

Appendix 2 – Your comments

99. You are invited to comment on this draft Ruling, including the proposed date of effect. Please forward your comments to the contact officer by the due date.

100. A compendium of comments is prepared when finalising this Ruling, and an edited version (with names and identifying information removed) is published to the Legal database on ato.gov.au. Please advise if you do not want your comments included in the edited version of the compendium.

Due date: **30 July 2021**

Contact officer details have been removed.

Status: **draft only – for comment**

References

Previous draft:

Not previously issued as a draft

Related Rulings/Determinations:

TR 93/12; TR 2001/13; TR 2006/10; TR 2008/7; IT 2660

Legislative references:

- ITAA 1936 6(1)
- ITAA 1936 6(1)(a)
- ITAA 1936 6(1)(c)
- ITAA 1936 6(1)(d)
- ITAA 1936 128B(2B)
- ITAA 1936 128B(2C)
- ITAA 1997 70-10(1)
- Copyright Act 1968 10(1)
- Copyright Act 1968 31(1)
- Copyright Act 1968 31(2)

Cases relied on:

- Dyason, M.P. & Ors v Autodesk Inc & Autodesk Australia [1990] FCA 499; 24 FCR 147; 96 ALR 57; 18 IPR 109; [1990] AIPC 90-697
- International Business Machines Corporation v Commissioner of Taxation [2011] FCA 335; 2011 ATC 20-256; 91 IPR 120; 83 ATR 32
- Roadshow Films Pty Limited v iiNet Limited [2011] FCAFC 23; [2011] AIPC 92-410; 89 IPR 1; 275 ALR 1; 194 FCR 285
- Task Technology Pty Ltd v Commissioner of Taxation [2014] FCAFC 113; 2014 ATC 20-467; 224 FCR 355; 99 ATR 275
- Telstra Corporation Ltd v A/asian Performing Right Association Ltd [1997] HCA 41; 191 CLR 140; 71 ALJR 1312; 146 ALR 649; 38 IPR 294; [1997] AIPC 91-344
- University of New South Wales v Moorhouse [1975] HCA 26; 133 CLR 1; 49 ALJR 267; 6 ALR 193
- Universal Music Australia Pty Ltd v Cooper [2005] FCA 972; 65 IPR 409; [2005] AIPC 92-116; 150 FCR 1

ATO references

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