IT 2660 - Income tax: definition of royalties

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There is an Addendum notice for this document.

This ruling contains references to repealed provisions, some of which may have been re-enacted or remade. The ruling has effect in relation to the re-enacted or remade provisions. Paragraph 32 in TR 2006/10 provides further guidance on the status and binding effect of public rulings where the law has been repealed or repealed and rewritten.
Australia's tax treaties and other agreements except for the Taipei Agreement are set out in the Australian Treaty Series. The citation for each is in a note to the applicable defined term in sections 3AAA or 3AAB of the International Tax Agreements Act 1953.

TAXATION RULING IT 2660

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FOI INDEX DETAIL

Reference no.:	Subject refs:	Legislative refs:
I 1012945	**DOUBLE TAX** **ROYALTY DEFINITION** **PAYMENTS FOR KNOW HOW** **MANAGEMENT AND SERVICE FEES**	**6(1)** **26(f)**

OTHER RULINGS ON THIS TOPIC: CITCM 862, CITCM 875

TITLE: INCOME TAX: DEFINITION OF ROYALTIES

NOTE:
- Income Tax Rulings do not have the force of law.
- Each decision made by the Australian Taxation Office is made on the merits of each individual case having regard to any relevant Ruling.

PREAMBLE

The purpose of this Ruling is to state the Commissioner's views on the definition of "royalty" and "royalties" in subsection 6(1) of the Income Tax Assessment Act 1936 (the Assessment Act) and the various double tax agreements in the Schedules to the Income Tax (International Agreements) Act 1953. The Ruling also provides guidelines to distinguish between royalty payments and payments for services. With respect to payments for the acquisition of computer software, the general principles expressed in this Ruling will apply. However, a separate Ruling dealing with specific issues relating to computer software will be issued.

2. The definition of "royalty" or "royalties" in subsection 6(1) lists certain types of payments that are to be treated as royalties for purposes of the Income Tax Assessment Act. The definition is inclusive. Payments that are "royalties" within the ordinary meaning of that term come within its scope. So too do the types of payments listed in the subsection.

3. The expanded definition will apply for all purposes of the Assessment Act, including section 6C, paragraph 26(f) and Division 3B of Part VI. The provisions concerning the collection of tax on royalties paid to non-residents (Division 3B) are the subject of a Ruling which is expected to issue shortly.

4. The term "royalty" is also defined in Australia's double tax agreements in similar terms to the subsection 6(1) definition, except that the list of payments which are defined as royalties is intended to be exhaustive. Hence royalties within the ordinary meaning of the term which do not also come within the treaty definition are not royalties for purposes of the double tax agreements. Thus, for example, natural resource royalties are not treated as royalties under the double tax agreements.

5. To the extent that the treaty definition and the definition in subsection 6(1) are the same, the views expressed in this Ruling in relation to the domestic law definition will apply equally to the definition in double tax agreements.

6. Where there is a conflict between the definition of royalties for purposes of Australia's domestic tax law and that in a particular double tax agreement, the definition in the relevant double tax agreement will override subsection 6(1) of the Assessment Act (subsection 3(9), Income Tax (International Agreements) Act).

SUMMARY

7. As a general proposition, a payment for services does not constitute the payment of a royalty. However, a payment for services that are ancillary to, or part and parcel of, enabling relevant technology, information, know-how, copyright, machinery or equipment to be transferred or used will constitute a royalty payment. Whether the payment is a royalty payment or a payment for services depends on the nature and purpose of the arrangement having regard to all the circumstances of the particular case. While it is not practicable to exhaustively cover the issue, this Ruling provides some guidelines.

RULING

8. This Ruling examines the distinction between royalty payments and payments for services in three stages:

(i) by considering the ordinary meaning of the term "royalty";

(ii) then, by looking at how the definition in subsection 6(1) extends the ordinary meaning; and finally

(iii) by focussing on the differences between royalty payments and payments for services.

Ordinary Meaning of Royalty

9. The ordinary meaning of a royalty has been considered by the Courts on many occasions. In Stanton v. F.C. of T. (1955) 92 CLR 630; 11 ATD 1 the Full Court of the High Court of Australia

described the essence of a royalty. The Court said at CLR page 641 (ATD page 4) that :

"... the modern applications of the term seem to fall under two heads, namely the payments which the grantees of monopolies such as patents and copyrights receive under licences and payments which the owner of the soil obtains in respect of the taking of some special thing forming part of it or attached to it which he suffers to be taken".

Later, at CLR page 642 (ATD page 4) the Court stated:

"In the case of monopolies and the like the essential idea seems to be payment for each thing produced or sold or each performance or exhibition in pursuance of the licence. In the same way in the case of things taken from the land the essential notion seems to be that the payment is made in respect of the taking of something which otherwise might be considered to belong to the owner of the land in virtue of his ownership. In other words it is inherent in the conception expressed by the word that the payments should be made in respect of the particular exercise of the right to take the substance and therefore should be calculated either in respect of the quantity or value taken on the occasions upon which the right is exercised."

10. The key characteristics of a common law royalty (i.e. a royalty within the ordinary meaning of the term) were outlined by R. H. Woellner, T.J. Vella and R.S. Chippendale in Australian Taxation Law, CCH Australia Ltd, 1989 at pages 272-273. They identified that a common law royalty will normally have all of the following features :

(a) It is a payment made in return for the right to exercise a beneficial privilege or right (e.g. to remove minerals or natural resources such as timber, to use a copyright, or to produce a play) - McCauley v. F.C. of T. (1944) 69 CLR 235; 7 ATD 427; F.C. of T. v. Sherritt Gordon Mines Ltd (1977) 137 CLR 612; 77 ATC 4365; 7 ATR 726. Amongst other things, copyright can cover music, literary and artistic works, various forms of mechanical, electronic and biological knowledge, equipment and processes. Where, for example, the copyright is licensed to someone to manufacture and sell records, compact discs, books, prints of art works, motor vehicle engines, packaged computer software etc., for an amount based on the number of units produced or sold, the amount paid would be a royalty.

(b) The payment is made to the person who owns the right to confer that beneficial privilege or right - Barrett v. F.C. of T. (1968) 118 CLR 666; Sherritt Gordon Mines Ltd; Case H9 76 ATC 39; 20 CTBR(NS) Case 64. However, the payment would still be a royalty if paid to another person or otherwise applied or dealt with at the direction of the owner. Moreover, payments for the use of the right that are made to a person who has been licensed or sub-licensed

to deal with the right will also be regarded as royalty payments.

(c) The consideration payable is determined on the basis of the amount of use made of the right acquired - McCauley; Stanton; Sherritt Gordon Mines; Case H9.

(d) The consideration payable will usually be paid as and when the right acquired is exercised - McCauley; Stanton; Case H9. However, a lump sum payment will be a royalty where it is a pre-estimate or an after the event recognition of the amount of use made of the right acquired - I.R. Commissioners v. Longmans Green & Co Ltd (1932) 17 TC 272; Mills v. Jones (1929) 14 TC 769; Constantinesco v. R (1927) 11 TC 730.

How Subsection 6(1) Extends the Meaning of Royalty

11. Subsection 6(1) expands the meaning of royalty to include certain amounts which may not be royalties within the ordinary meaning of that term. Many payments covered by the definition will be royalties on general principles, e.g., a payment for use of a patent. Others, however, are royalties only by reason of their inclusion in the definition, e.g., payments for use of scientific equipment.

12. The definition includes as royalties amounts paid or credited 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 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 (e.g. know-how payments);

(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);

(e) the use of, or the right to use, motion picture films, films or video tapes for use in connection with television, or tapes for use in connection with radio broadcasting; or

(f) a total or partial forbearance in respect of the use of, or the granting of the right to use property of any of the kinds referred to in paragraphs (a), (b) or (e), or the

supply of knowledge, information or assistance of any of the kinds referred to in paragraphs (c) or (d).

13. The definition requires the dissection or apportionment of a payment made partly as a royalty and partly as something else, to ascertain how much of the payment is to be classified as a royalty. For example, a lump sum payment made under an agreement providing both for the outright sale of machinery used to produce certain articles and for the right to manufacture and sell those articles under a brand name would be a royalty to the extent that it was attributable to the right to use the brand name. No hard and fast rules can be applied in determining how much of a payment represents a royalty. Each situation has to be resolved on its own particular facts.

14. It is important to note that the definition encompasses a payment for the use of, or the right to use, a right or property, or for the supply of knowledge or information or assistance, even though the right, property or knowledge etc., is not used physically by the person making the payment or is not supplied directly by the person to whom the payment is made. For example, payment by a film distributor to a non-resident for the distributor's right to exploit a film by allowing cinema owners to exhibit it will be a royalty. Similarly, a payment by an Australian parent company to a United States' corporation for know-how will be a royalty as defined whether the know-how and any connected rights were to be used by the Australian parent company or by its manufacturing subsidiary, and whether the know-how was to be supplied directly by the United States' corporation itself, or by a local or foreign company associated with that corporation.

15. The form of a payment and the way in which it is computed will not be conclusive in determining whether or not the payment is a royalty under the definition. Nor will the description given to a payment in any agreement between the parties be conclusive. If, having regard to the substance of the contract, a payment falls within the scope of the definition, it will be a royalty whether it is paid in a lump sum or periodically. Unlike the ordinary meaning of royalty, it is not necessary for the payment to be calculated by reference to the degree of use of the property, right or know-how. For example, in the case of a film, a payment will be a royalty whether it represents so much for each showing, a lump sum to cover an agreed number of showings or is a share of the gross or net takings for exhibition of the film.

. <u>Paragraph (a) of Royalty Definition:</u>

16. Payments of the kinds described in paragraph (a) of the definition do not require a great deal of explanation. The concept of payment "for the use of, or the right to use" covers all forms of exploitation of a right or property short of outright sale of the right or property. As to copyright, a payment for the right to produce, reproduce or exploit a work or other subject matter in which copyright subsists will be a payment for the use of the copyright, whether or not the right is actually used by the person paying the royalty. For example, payments for the right to

reproduce audio or video tapes, or laser or compact discs, will come within paragraph (a). Other examples of payments for the use of, or the right to use, copyright would include payments to the owner of a famous painting to produce prints, or payments to the owner to produce books of original literary works.

17. The reference in the definition to "other like property or right" is a reference to property or a right that is alike to any of the previously named items. A payment for a licence or franchise to use a trade name or distinctive shape or appearance which is protected in equity by way of a passing off suit is one example. A number of beverages are manufactured in Australia under licence and the payments for those licences are royalties.

. Paragraph (b) of Royalty Definition:

18. Payments for the use of or the right to use industrial, commercial or scientific equipment form the second category of amounts that will be royalties. In this context 'equipment' does not have a narrow meaning and includes such things as machinery and apparatus. A payment for the rental of confectionary wrapping plant would be a royalty under this head, as would a payment for the hire of a computer.

. Paragraph (c) of Royalty Definition:

19. Under paragraph (c) of the definition, payments for the supply of scientific, technical, industrial or commercial knowledge or information are royalties. In this context, the main type of knowledge or information intended to be covered by this paragraph is what is generally referred to as "know-how", i.e., undivulged technical knowledge, information, experience or technique that is necessary for the industrial reproduction of a product or process. Examples of this would include technical data, samples or patterns, or details of processing or production methods.

20. The scope of paragraph (c) of the definition is not entirely clear. Payments for know-how come within the definition. So too do payments for access to unpublished knowledge or information gained through scientific, technical etc. experience. For example, payments for the supply of information on markets or fashion trends would come within the definition, as would payments for information concerning future technological advances or payments for access to unpublished information contained in a database. On the other hand, payments for published knowledge or information, e.g. payments for technical books or journals or subscriptions to commercial publications, would not be considered to be royalties.

21. The words "the supply of ... knowledge or information" are used in their usual sense and imply the communication or imparting of knowledge or information gained in any way - whether by purchase, experience, learning, research, or otherwise. The definition does not require that any special means of communication be employed. It will be effective whether the knowledge or information is supplied in a verbal, written,

electronic or other form, whether it is supplied directly or through an agent or employee, and whether it is supplied at regular or irregular intervals or on an ad hoc or once and for all basis.

. Paragraph (d) of Royalty Definition:

22. Paragraph (d) of the definition extends the meaning of royalty to cover payments that are for 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 property or right referred to in paragraph (a), any equipment referred to in paragraph (b), or any knowledge or information referred to in paragraph (c). For example, in a contract for the supply of relevant property or know-how, payments under the contract covering ancillary assistance given as a means of enabling the application or enjoyment of the property or know-how are royalties irrespective of the extent of such payments in relation to the "pure" property or know-how payment. Ancillary and subsidiary services could be performed, for example, in promoting the transaction by demonstrating and explaining the use of the property, or by assisting in the effective implementation of the property transferred, or by performing services under a guarantee relating to such effective implementation.

. Paragraph (e) of Royalty Definition:

23. Paragraph (e) of the definition ensures that any payments for the use of, or the right to use, motion picture films, films or video tapes for use in connection with television, and tapes for use in connection with radio broadcasting are royalties. Where these include original works, copyright would exist and paragraph (a) of the definition would also apply.

. Paragraph (f) of Royalty Definition:

24. Paragraph (f) extends the definition to cover amounts paid or credited for a total or partial forbearance in respect of the use of, or the right to use, property of any of the kinds referred to in paragraphs (a) to (e). An example of this would be where a person who has acquired the right to use an industrial process or technology that is protected by patent or copyright, pays the owner of the process or technology not to make the process or technology available to any other person. Payments to prevent another person obtaining a dealer franchise are another example. Paragraph (f) was added to the definition to remedy a defect exposed by the Victorian Supreme Court's decision in Acktiebolaget Volvo v. F.C. of T. 78 ATC 4316; 8 ATR 747. Without paragraph (f), transactions could be implemented in a way that might result in payments not being regarded as royalties because they are paid for forbearance rather than for the use of the relevant property.

. Distinction between Royalties and Payments for Services Rendered

25. Payments for services rendered and work done are not royalties unless the services are ancillary to, or part and parcel of,

enabling relevant technology, information, know-how, copyright, machinery or equipment to be transferred or used. Whether the payment is a royalty payment or a payment for services depends on the nature and purpose of the arrangement giving rise to the payment. Only those payments which are for the use of, or the right to use, property or a right belonging to another person are "royalties" within the definition.

26. Most commonly, it is the distinction between payments for services rendered and payments for the supply of know-how that causes concern. Examples of the types of payments where this issue arises include payments made for preparing or developing designs, models, plans, drawings or other like property, or for performing engineering, research, testing, experimental or other like services. Paragraphs 28-36 below set out some guidelines for distinguishing between payments for services and payments for the supply of know-how.

27. The general characteristics of know-how have been described by the courts in Moriarty v. Evans Medical Supplies Ltd (1957) 3 All ER 718, Rolls Royce v. Jeffrey (1962) 1 A11 ER 801 and J. Gadsden & Co Ltd v. Commr of I.R. (N.Z.) (1964) 14 ATD 18. They have described know-how as:

(a) not property in the usual sense;

(b) an asset, but not necessarily a capital asset; and

(c) something which can be disposed of for value;

which can be exploited by its owner in one of the following ways:

(d) by using it himself in the process of his own trade;

(e) by communicating it to others by :

(i) outright sale; or

(ii) imparting it to some other trader, perhaps retaining the right to use it in his own business or to share it with others; or

(f) by retaining the asset intact and exploiting it by applying it in the course of rendering services to others.

. Distinguishing Elements

28. Three important elements emerge which can be used as a basis for distinguishing between a contract for the supply of know-how and one involving the rendering of services. These are that under a contract for the supply of know-how :

(a) a "product" (i.e. knowledge, information, technique, formula, skills, process, plan etc.) which has already

been created or developed or is already in existence is transferred;

(b) the product which is the subject of the contract is transferred for use by the buyer (i.e. it is supplied); and

(c) except in the case of a disposition where the seller divests himself completely of any further interest in the product, the property in the product remains with the seller. All that is obtained by the buyer is the right to use the product. Subject to the terms of the contract, the seller retains the right to use the product himself and to transfer it to others.

29. By contrast, in a contract involving the performance of services:

(a) the contractor undertakes to perform services which will result in the creation, development or the bringing into existence of a product (which may or may not be know-how);

(b) in the course of developing a product, the contractor would apply existing knowledge, skill and expertise - there is not a transfer (i.e. supply) of know-how from the contractor to the buyer as such but a use by the contractor of his knowledge for his own purposes; and

(c) the product created as a result of the services belongs to the buyer for him to use without having to obtain any further rights in respect of the product. However, in the course of rendering services the contractor would, in most cases, also produce as a by-product a work (e.g. plan, design, specification, report, etc., - which could contain knowledge, etc. not otherwise known to the buyer and which may or may not be protected by patents, etc..) in which copyright would subsist. Unless specifically agreed otherwise, the contractor is the owner of such copyright and the buyer or any other person is, by law, precluded from using the property in which the copyright subsists for any purpose other than the purpose for which it was originally designed without first obtaining the approval of the contractor. This would not alter the nature of the contract which would remain one for the performance of services.

30. From the distinctions drawn above, another very important factor emerges which, in itself, can be used to a large extent in distinguishing between the two types of contracts. The factor concerned is the incidence of cost, i.e., both the level and the nature of the expenditure incurred by the seller in making the "product" (which is the subject of the contract) available to the buyer.

31. In most cases involving the supply of know-how which is already in existence there would appear to be very little more

which needs to be done by the supplier other than to copy existing material, except perhaps for updating or detailing certain aspects, in which case very little expenditure would be incurred. On the other hand, a contract for the performance of services would, in the majority of cases, involve a very much greater level of expenditure. However, this would vary considerably from case to case, e.g., there would probably be a very much lower level of expenditure incurred by an architect in designing a house than there would be in designing, say, a multi-storey building where much more research and detailed drawing would be needed.

32. The second aspect of the expenditure element is the nature of the expenditure incurred by the contractor. In this regard, a contract for the performance of services would, depending on the nature of the services to be rendered, involve the contractor in such items of expenditure as salaries and wages to employees engaged in researching, designing, testing, drawing and other associated activities, payments to sub-contractors for the performance of similar services, purchase of parts for testing and costs associated with site and feasibility studies, as well as management and overhead expenses of types which would normally be incurred by a contractor in the course of performing such services. The general purport of this paragraph - that in know-how cases the income recipient can be expected to have a low level of expenses whereas in cases where services are rendered expenses will usually be substantial - implies that a payment that is wholly a reimbursement of deductible expenditure is most likely <u>not</u> to be a royalty.

33. Although each of the factors mentioned in the foregoing paragraphs are particularly relevant and must, of course, be given due weight when examining the nature of any contract, they all point to the one main distinctive feature of know-how - that it is an asset and, as such, it is something which is <u>already</u> in existence and is not something brought into being in pursuance of the particular contract. In these circumstances, therefore, it is considered that in any case being examined the first question to be answered is: Is the contract one for the <u>supply</u>, for use by the "buyer", of a "product" which is already in existence (or substantially in existence), or is it one which requires the contractor to <u>apply</u> special skills and knowledge <u>for his own purposes in order to bring the "product" into existence</u> for the buyer? In the first case the contract is for the supply of know-how and will give rise to a royalty. In the second it will be a contract for services rendered.

34. Payments for design, engineering or construction of plant or buildings, feasibility studies, component design and engineering services would generally be regarded as being in respect of a contract for services, unless there is some provision in the contract for imparting techniques and skills to the "buyer".

. <u>Apportionment where Know-how and Services are Provided</u>

35. In cases where both know-how and services (other than ancilliary services) are supplied under the same contract, an

apportionment of the two elements of the contract should be made. If the contract provides for separate payments for the know-how and for the services, this apportionment may be accepted provided the amount of the payments appear reasonable in relation to the services to be performed. If no allocation is made, or if the allocation appears unreasonable, an apportionment will be fixed according to the features of the particular case.

36. One way of apportioning the price in a contract that requires payments of an undivided sum would be to proceed on the basis of details of the "sale price" of each component obtained from the transferor company. It may be necessary to apportion the total contract price on the basis of the estimated cost of providing the services. For this purpose, an accountant's certificate will generally be acceptable evidence of the estimated cost. It may be necessary in these cases to increase the estimated cost by the inclusion of a normal profit margin in order to arrive at the amount to be allocated for the "unassociated" services to be performed.

COMMISSIONER OF TAXATION
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