TR 2014/1 - Income tax: commercial software licencing and hosted agreements: derivation of income from agreements for the right to use proprietary software and the provision of related services

There is a Compendium for this document: **TR 2014/1EC** .

Taxation Ruling

Income tax: commercial software licencing and hosted agreements: derivation of income from agreements for the right to use proprietary software and the provision of related services

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What this Ruling is about

1. This Ruling deals with when commercial software developers derive income for the purpose of section 6-5 of the *Income Tax Assessment Act* 1997 (ITAA 1997) from:

   (i) licence agreements for proprietary software; and

   (ii) 'hosted' or 'cloud' arrangements for use of proprietary software.

2. Specifically, this Ruling considers the point of derivation of income in respect of the contractual fee for:

   (i) the granting of the proprietary licence;

   (ii) the hosted arrangement; and/or

   (iii) other 'additional services' which may or may not be bundled together with (i) or (ii) in contract.

3. Where there is bundling of 'additional services', this Ruling also considers the proper apportionment of the contractual fee between the licence or access fee and/or the additional services.

4. 'Additional services' include:

   (a) software updates, upgrades and maintenance

(b) user support including implementation; and

(c) user training.

Ruling

Derivation

5. Where an amount properly attributable to a contractual obligation is subject to a 'contingency of repayment', the amount is derived for the purposes of section 6-5 of the ITAA 1997 when the obligation is fully performed or the contingency of repayment otherwise lapses.

6. In this Ruling, a 'contingency of repayment' in the event of future non-performance refers to there being either:

(i) a contractual obligation to make a refund;

(ii) a demonstrated commercial practice to make a refund; or

(iii) contractual exposure exists for damages in respect of the non-performance.

7. It is only in circumstances where a 'contingency of repayment' exists, that deferral of all or part of the contractual fee for:

(i) the granting of the proprietary licence;

(ii) the hosted arrangement; and/or

(iii) other 'additional services' which may or may not be bundled together with (i) or (ii) in contract;

may be valid for income tax purposes.

8. When the underlying obligation is fully performed, or the contingency of repayment otherwise lapses, the amount properly allocated to the obligation converts from 'unearned' income' to 'earned income' in the sense contemplated in *Arthur Murray (NSW) Pty Ltd v. FCT* (1965) 114 CLR 314; (1965) 14 ATD 98; 9 AITR 673 (*Arthur Murray*).

9. Where no 'contingency of repayment' exists, the amount is derived when a recoverable debt arises in respect of the contractual fee.

10. Potential exposure to:

- damages pursuant to consumer protection law; or
- damages in tort;

do not result in there being a 'contingency of repayment'.

Accounting Principles

11. Established accounting practices and principles, such as that prescribed in paragraph 11 of Appendix 1 to Australian Accounting Standard AASB 118 *Revenue*, does not determine the incidence or quantum of derivation of the contractual fee for tax purposes.

Allocation of the contractual fee

12. Where a contract:

(i) bundles the proprietary licence (or hosted access) together with additional services; or

(ii) merely bundles multiple additional services;

the contractual fee must be allocated across the discrete obligations in order to determine the point of derivation.

13. The allocation should be undertaken on a fair and reasonable basis and be evidence based. Records must be kept which support and explain the method employed.

14. What is a reasonable method of apportioning the consideration for a bundled contract depends on the circumstances of each case. In some cases, there will be only one reasonable method which may be used.

15. The price allocated by the contracting parties in the licence agreement will be the most appropriate measure of value of the respective obligations for the purposes of apportionment if such prices are agreed on commercial terms and at arm's length.

16. If the prices allocated in the contract do not represent fair commercial value for the component obligations, such prices may not be used as a basis for apportionment.

17. Where discrete prices are not allocated in the contract, but the bundled obligations are also sold by the software developer individually, those individual prices may be employed.

18. Where discrete prices are not allocated in the contract and the bundled obligations are not also sold by the software developer individually, reference may be had to comparable market prices.

19. Where discrete prices are not allocated in the contract and the software developer neither sells the bundled obligations individually, nor are comparable market prices available, the software developer should determine fair commercial prices for the individual obligations on the basis they were offered separately for sale by the software developer.

Examples

Proprietary Licence Derivation Examples

Example 1: Proprietary licence provided in a discrete contract

20. Software Coy is an Australian software development company. It employs the accruals method of recognising income.

21. On 1 July 2012, Software Coy enters into an agreement which provides ABC Coy with the right to use a proprietary software product for a period of three years in consideration for the payment of a licence fee of $15,000. The terms of the agreement do not require Software Coy to provide any additional services. That is, Software Coy is required only to provide ABC Coy with a copy of the software product. It is not required under the agreement to provide any updates, upgrades or maintenance, user support services or user training.

22. Once the proprietary software is delivered to ABC Coy, Software Coy has fulfilled its full contractual obligations. The contract does not contemplate any refund to be made to ABC Coy in any circumstances and neither does Software Coy have a commercial practice of making such refunds.

23. In circumstances such as these, there is no contingency of repayment in respect of the licence fee of $15,000. Software Coy has undertaken all that is required under the contract with ABC Coy upon delivery of the software and, therefore, the licence fee is derived at the time a recoverable debt arises in respect of the contractual fee (that is, the 2012-13 income year).

Example 2: Proprietary licence and technical support provided under a bundled contract

24. Richard Coy is an Australian software development company. It employs the accruals method of recognising income.

25. On 1 July 2012, Richard Coy enters into an agreement with XYZ Coy which provides for:

(a) the right to use a proprietary software product for a period of three years in consideration for the payment of a licence fee of $15,000, and

(b) the provision of technical support for a period of 18 months in consideration for the payment of $5,000.

26. Once the proprietary software is delivered to XYZ Coy, Richard Coy has fulfilled its full contractual obligations in respect of that part of the agreement. The contract does not contemplate any refund to be made in any circumstances and neither does Richard Coy have a commercial practice of making such refunds.

27. No contractual obligation exists for Richard Coy to make a refund in the event of non-use of the additional services or for any other reason, and Richard Coy has no commercial practice of giving a refund in any circumstances.

28. However, Richard Coy may have contractual exposure to damages in the event the technical support services are not provided upon request.

29. In circumstances such as these, there is no contingency of repayment in relation to that part of the agreement which represents the licence fee and, therefore, the income from the agreement that relates to the licence fee is derived at the time a recoverable debt arises in respect of the contractual fee (that is, the 2012-13 income year).

30. However, a contingency of repayment does exist in relation to the amount payable under the agreement that relates to the provision of technical support. Accordingly, the point of derivation for that amount will occur progressively as the contingency of repayment lapses. The quantum of exposure to contractual damages might be expected to diminish progressively on a straight line basis over the terms of the agreement. Therefore, the consideration for those services should also be recognised as derived for income tax purposes on that same basis.

Example 3: Software updates to be provided only if developed during the course of the licence agreement

31. Max Coy is an Australian software development company. It employs the accruals method of recognising income.

32. On 1 July 2012, Max Coy enters into a bundled agreement which provides BCD Coy with the right to use a proprietary software product for a period of two years and certain software updates in consideration for the payment of a contractual fee of $15,000.

33. Once the proprietary software is delivered, Max Coy has fulfilled its full contractual obligations in respect of that part of the agreement. The contract does not contemplate any refund to be made in any circumstances and neither does Max Coy have a commercial practice of making such refunds.

34. In terms of the software updates the contract provides that these will be made available to BCD Coy only if developed and released during the course of the agreement. The terms of the contract ensure that Max Coy is not exposed to contractual damages should an update be produced during the licence period but not released.

35. On the facts here, there is no contingency of repayment in relation to the contractual fee of $15,000 in terms of the proprietary software or updates. Accordingly, the contractual fee is derived in full at the time a recoverable debt arises in respect of the contractual fee (that is, the 2012-13 income year).

Example 4: Software updates to be provided as developed during the course of the licence agreement

36. Maxine Coy is an Australian software development company. It employs the accruals method of recognising income.

37. On 1 July 2012, Maxine Coy enters into a bundled agreement which provides Norman Coy with the right to use a proprietary software product for a period of two years and certain software updates in consideration for the payment of a contractual fee of $15,000.

38. Once the proprietary software is delivered, Maxine Coy has fulfilled its full contractual obligations in respect of that part of the agreement. The contract does not contemplate any refund to be made in any circumstances and neither does Maxine Coy have a commercial practice of making such refunds.

39. In terms of the software updates, the contract provides that these will be made available to Norman Coy immediately upon development and Maxine Coy has a history of developing an annual update and making this immediately available to customers. The terms of the contract are such that Maxine Coy is exposed to contractual damages should an update be produced during the licence period but not immediately made available to Norman Coy.

40. On the facts, there is no contingency of repayment in relation to that part of the contractual fee which is properly allocated to the proprietary software. Accordingly, that part of the contractual fee is derived in full at the time a recoverable debt arises in respect of the contractual fee (that is, the 2012-13 income year). However, a contingency of repayment does exist in relation to that part of the contractual fee which is properly allocated to the software updates and which will coincide with the quantum of exposure to contractual damages should the annual updates not be provided. That part of the contractual fee properly allocated to software updates will be derived progressively as each update is provided.

Example 5: Where regular upgrades are the essence of the agreement

41. Gavin Coy is an Australian software development company. It employs the accruals method of recognising income.

42. On 1 July 2012, Gavin Coy enters into an agreement which provides XYZ Coy with the right to use a proprietary software product for a period of five years in consideration for a fee in the sum of $20,000.

43. The proprietary software provides high level virus, spyware, crimeware, malware and intrusion protection for large corporations.

44. The essence of the agreement is therefore the provision of the ongoing security protection which necessitates software updates on a continuous and regular basis. In the event updates were not provided, Gavin Coy would be exposed to damages for contractual breach.

45. In circumstances such as these, there is a contingency of repayment in relation to the fee for the proprietary software. On the facts here, the quantum of exposure to contractual damages might be expected to diminish progressively on a straight line basis over the terms of the agreement. Therefore, the consideration for those services should also be recognised as derived for income tax purposes on that same basis.

Example 6: Where additional services are provided voluntarily

46. John Coy is an Australian software development company. It employs the accruals method of recognising income.

47. On 1 July 2012, John Coy enters into an agreement with PQR Coy which, in consideration for the payment of $15,000, provides PQR Coy with the right to use a proprietary software product for a period of three years.

48. No part of the agreement between John Coy and PQR Coy concerns the provision of product updates or upgrades.

49. However, although not contractually obliged to do so, John Coy, as part of its business strategy for customer retention and marketing, provides customers with product updates as and when available.

50. John Coy has no contractual exposure to damages for any reason following the granting of the right to use the proprietary software to PQR Coy. Further, John Coy has no commercial practice of providing a refund to licence holders under any circumstances.

51. On the facts here, there is no contingency of repayment in relation to any part of the agreement between John Coy and PGR Coy. Therefore, the income from the agreement is derived at the time a recoverable debt arises (that is, the 2012-13 income year).

Proprietary Licence Allocation/Apportionment Examples

Example 7: The contractual fee is not dissected and the proprietary licence and/or additional services are also provided as stand-alone products

52. Jim Coy is an Australian software development company. It employs the accruals method of recognising income.

53. On 1 July 2012, Jim Coy enters into an agreement with CDE Coy which, in consideration for the payment of $22,000, provides CDE Coy with:

(a) the right to use a proprietary software product for a period of three years;

(b) the provision of technical support for a period of 18 months; and

(c) the provision of in-house one-off user-training upon commencement.

54. As part of their business model, Jim Coy also sells each of these products or services individually. The market price of each product sold individually is as follows:

(a) three year proprietary software licence: $15,000

(b) 18 month technical support: $5,000

(c) one-off user training: $2,000

55. In circumstances such as these, it is fair and reasonable to apportion the total contractual fee of $22,000 in accordance with the individual market price of each product or service.

56. Were a package discount is available *vis a vis* stand-alone prices, the amount allocated to each package component would be proportionately reduced to take account of the discount.

Example 8: Where the contractual fee is dissected into discrete prices for each of the proprietary licence and the additional services

57. Peter Coy is an Australian software development company. It employs the accruals method of recognising income.

58. On 1 July 2012, Peter Coy enters into an agreement with MNO Coy which, in consideration for the payment of $22,000, provides MNO Coy with:

(a) the right to use a proprietary software product for a period of three years (allocated a contractual value of $15,000);

(b) the provision of technical support for a period of 18 months (allocated a contractual value of $5,000); and

(c) the provision of in-house one-off user-training upon commencement (allocated a contractual value of $2,000).

59. In the particular circumstances of Peter Coy and MNO Coy, the discrete prices allocated in the contract represent fair commercial value for each of the respective obligations and have not been artificially set to achieve tax outcomes. The amounts allocated to the various obligations are within a commercial range charged by competitor businesses for comparable services.

60. In circumstances such as these, it is fair and reasonable to allocate the contractual fee of $22,000 in accordance with the discrete prices allocated in the contract.

Example 9: Where the contractual fee is not dissected and the proprietary licence and/or additional services are not provided as stand-alone products

61. Program Coy is an Australian software development company. It employs the accruals method of recognising income.

62. On 1 July 2012, Program Coy enters into an agreement with XYZ Coy which, in consideration for the payment of $15,000, provides for:

(a) the right to use a proprietary software product for a period of three years; and

(b) the provision of technical support for a period of 18 months.

63. Program Coy does not sell each of these component products or services individually as part of their business model.

64. However, market competitors do enter into stand-alone agreements in relation to virtually identical products to that sold by Program Coy.

65. The market price for the right to use a virtually identical software product over 3 years is $12,000 and for technical support over 18 months, $3,000. These prices also align with fair commercial price settings of the discrete obligations in the view of Program Coy's management were the obligations offered separately.

66. In these circumstances it is fair and reasonable to allocate the $15,000 contractual fee in the sum of $12,000 to the right to use the proprietary software and in the sum of $3,000 for the provision of the technical support.

Example 10: Where additional services are rarely called upon under a bundled contract

67. Mason Coy is an Australian software development company. It employs the accruals method of recognising income.

68. On 1 July 2012, Mason Coy enters into an agreement with XYZ Coy which provides for:

(a) the right to use a proprietary software product for a period of three years; and

(b) the provision of technical support for a period of three years.

69. The fee payable by XYZ Coy is $43,000 which is not dissected into separate amounts for each of (a) and (b).

70. For accounting purposes, Mason Coy recognises the contractual fee on a straight line basis over the term of the licence agreement.

71. As part of their business model, Mason Coy does not also sell each of these products or services individually and neither do comparable competitor products exist.

72. The proprietary software product is highly developed and has been in the market place for 15 years. No updates or upgrades have been released during the past 4 years and none are currently in development. New users of the software find it highly intuitive and user friendly resulting in very infrequent requests for technical support.

73. In order to allocate the contractual fee, the management of Mason Coy determines on a fair commercial basis the pricing of (b) assuming it were to be offered as a stand-alone product in the market place as $3,000. In this regard, management considered the cost to business of holding itself ready to provide technical support was minimal. Management further considered the commercial essence of the contract was the granting of the right to use the commercial software and the balance of the contractual fee was appropriately allocated to the software licence ($40,000). That amount also corresponded to the price management envisaged could be commanded for the proprietary software were it offered as a stand-alone product.

74. In these circumstances it is fair and reasonable to allocate the $43,000 contractual fee in the sum of $40,000 to the right to use the proprietary software and in the sum of $3,000 for the provision of the technical support.

Hosted Access/Cloud Derivation Examples

Example 11: Where the access fee is for the hosted access only and no contingency of repayment exists in relation to the access fee

75. Cloud Coy is an Australian hosted access provider. It employs the accruals method of recognising income.

76. On 1 July 2012, Cloud Coy enters into an agreement which provides ABC Coy with the right to access and use a proprietary software product, remotely hosted by Cloud Coy, for a six month period in consideration for a $20,000 access fee.

77. The terms of the agreement do not require Cloud Coy to provide any additional services. That is, Cloud Coy is required only to provide ABC Coy with access to the hosted software and it is not required under the agreement to provide any user support services or user training. Further, the contract expressly provides that ABC Coy will not be entitled to any refund for any down time during the hosted access period. The contract in this regard is sufficient for no remedy in contractual damages to be available for such downtime.

78. Once the hosted access is made available to ABC Coy, Cloud Coy has fulfilled its contractual obligations. The contract does not contemplate any refund to be made to ABC Coy in any circumstances and neither does Cloud Coy have a commercial practice of making such refunds.

79. In circumstances such as these, there is no contingency of repayment in respect of the hosted access fee of $20,000. Cloud Coy has undertaken all that is required under the contract to retain the fee and therefore it is derived at the time a recoverable debt arises (that is, the 2012-13 income year).

Example 12: Where the access fee is for the hosted access only and a contingency of repayment exists in relation to the access fee

80. Hazy Coy is an Australian hosted access provider. It employs the accruals method of recognising income.

81. On 1 July 2012, Hazy Coy enters into an agreement which provides Greg Coy with the right to access and use a proprietary software product, remotely hosted by Hazy Coy, for a six month period in consideration for a $20,000 access fee.

82. The terms of the agreement do not require Hazy Coy to provide any additional services. That is, Hazy Coy is required only to provide Greg Coy with access to the hosted software and it is not required under the agreement to provide any user support services or user training. The contract is silent on entitlement to a refund for any down time during the hosted access. That is, Hazy Coy may be exposed to contractual damages to the extent such down time occurs.

83. In these circumstances, a contingency of repayment exists in relation to the access fee which lapses proportionately over the term of hosted access period. In circumstances such as these it is fair and reasonable to treat the access fee as derived proportionately on a straight line basis over the term of the access period.

Example 13: Where the access fee is for the hosted access only and a contingency of repayment does exist in relation to the access fee

84. Cloudy Coy is an Australian hosted access company. It employs the accruals method of recognising income.

85. On 1 July 2012, Cloudy Coy enters into an agreement which provides ABC Coy with the right to access and use a proprietary software product, remotely hosted by Cloudy Coy, for a period of three years in consideration for the payment by ABC Coy of an access fee of $80,000. The terms of the agreement do not require Cloudy Coy to provide any additional services. That is, Cloudy Coy is required only to provide access to the software product. Cloudy Coy is not required under the agreement to provide any user support services or user training.

86. However, under the agreement, ABC Coy is entitled to terminate the agreement with one month's notice at any time during the access period. Upon termination, ABC Coy is entitled to a refund of so much of the access fee as relates to the amount of the access period yet to elapse.

87. In circumstances such as these, a contingency of repayment exists in relation to the access fee. That contingency of repayment lapses proportionately on a monthly basis. In circumstances such as these it is fair and reasonable to treat the access fee as derived proportionately on a straight line basis over the term of the agreement.

Example 14: Where additional services are bundled with the hosted access

88. Cumulus Coy is an Australian hosted access company. It employs the accruals method of recognising income.

89. On 1 July 2012, Cumulus Coy enters into an agreement with ABC Coy which provides for:

(a) the right to access and use a proprietary software product, remotely hosted by Cumulus Coy, for a period of three years in consideration for the payment of an access fee of $80,000; and

(b) the provision of technical support for a period of 18 months in consideration for the payment of $5,000.

90. Both fees represent fair commercial value for the respective obligations.

91. The contract expressly provides that ABC Coy will not be entitled to any refund for any down time of the hosted access during the access period. The contract in this regard is sufficient for no remedy in contractual damages to be available. The access fee is derived in full at the time a recoverable debt arises (that is the 2012-13 income year).

92. However, the contract is silent on the consequences of failure of Cumulus Coy to provide the technical support. That is, Cumulus Coy may be exposed to contractual damages for non-fulfilment of this obligation.

93. In these circumstances, a contingency of repayment exists in relation to the fee for the provision of the technical support. That contingency of repayment lapses proportionately on a monthly basis for the term of the agreement. In circumstances such as these it is fair and reasonable to treat the fee for the technical support as derived proportionately on a straight line basis over the term of the agreement.

Example 15: Monthly hosted access fees and no contingency of repayment

94. Stratus Coy is an Australian hosted access company. It employs the accruals method of recognising income.

95. Stratus Coy provides ABC Coy with the right to access and use a remotely hosted proprietary software product for a fee of $5,000 per month which may be terminated by ABC Coy at the end of any given month. Stratus Coy is not exposed to contractual damages for downtime and does not provide a refund of the access fees under any circumstances.

96. In these circumstances, a contingency of repayment does not exist in relation to the monthly access fees. Each fee is derived as a recoverable debt arises.

Hosted Access/Cloud Allocation/Apportionment Examples

Example 16: Where the hosted access is bundled with additional services, and the access fee is contractually dissected between the hosted access and the additional services

97. Sunny Coy is an Australian hosted access company. It employs the accruals method of recognising income.

98. On 1 July 2012, Sunny Coy enters into an agreement with ABC Coy which provides for :

(a) the right to access and use a proprietary software product, remotely hosted by Sunny Coy, for a period of three years in consideration for the payment of an access fee of $5,000 for the entirety of the three years; and

(b) the provision of technical support for a period of 36 months for a fee in the sum of $60,000.

99. The contract expressly provides that ABC Coy will not be entitled to any refund for any down time of the hosted access during the access period. The contract in this regard is sufficient for no remedy in contractual damages to be available. Sunny Coy also has no commercial practice of providing a refund.

100. As there is no contingency of repayment in respect of the hosted access fee, the amount properly allocated to that obligation is derived in full at the time a recoverable debt arises (that is the 2012-13 income year).

101. The contract is silent on the failure of Sunny Coy to provide the technical support. That is, Sunny Coy will be exposed to contractual damages for non-fulfilment of that obligation.

102. A contingency of repayment exists in relation to the amount properly allocated to the provision of the technical support which lapses proportionately on a monthly basis for the term of the agreement. In circumstances such as these it is fair and reasonable to treat the fee properly allocated for the technical support as derived proportionately on a straight line basis over the term of the agreement.

103. As part of their business model, Sunny Coy also sells each of these products or services individually. The market price for each product sold individually is as follows:

(a) access fee at $1,666 per month;

(b) 36-months of technical support: $5,000.

104. The question which requires resolution in this case is what amounts are properly allocated to the respective obligations given the divergence between the amounts specified in the contract and the amounts charged by Sunny Coy for the same obligations when sold separately.

105. In these circumstances it might reasonably be inferred that the allocation of the contractual fee between access and technical support do not reflect the true bargain between the parties. Therefore, it is appropriate to depart from the amounts specified in the contract and allocate the contractual fee on the basis of the commercial prices for which Sunny Coy sells the same obligations individually in the market place.

106. In these circumstances, an amount of $5000 representing commercial fair value for technical support should be treated as derived proportionately on a straight line basis over the term of the agreement. An amount of $60,000 representing commercial fair value for the hosted access should be treated as derived in the 2013 income year.

Example 17: Where the hosted access is bundled with additional services, the access fee is not dissected and the additional services are available as stand-alone products

107. Nimbus Coy is an Australian hosted access company. It employs the accruals method of recognising income.

108. On 1 July 2012, Nimbus Coy enters into an agreement with ABC Coy which provides for:

(a) the right to access and use a proprietary software product, remotely hosted by Nimbus Coy, for a period of three years;

(b) the provision of technical support for a period of 18 months; and

(c) the provision of in-house one-off user-training upon commencement.

109. The contractual fee payable by ABC Coy is $43,000 which is not dissected into separate amounts for each of (a), (b) and (c).

110. As part of their business model, Nimbus Coy also sells each of these individually. The market price of each is as follows:

(a) access fee at $1,000 per month;

(b) 18 month technical support: $5,000;

(c) one-off user training: $2,000.

111. In these circumstances the contractual fee should be allocated on the basis of the commercial prices for which Nimbus Coy sells the same obligations individually in the market place. That is, $36,000 should be allocated to the hosted access, $5,000 to the technical support and $2,000 to the user training.

112. Where a package discount is available vis a vis stand-alone prices, the amount allocated to each package component would be proportionately reduced to take account of the discount.

Example 18: Where the hosted access is bundled with additional services, the access fee is not dissected, and the additional services are not also available as stand-alone products

113. Altostratus Coy is an Australian hosted access company. It employs the accruals method of recognising income.

114. On 1 July 2012, Altostratus Coy enters into an agreement with ABC Coy which provides for:

(a) the right to access and use a proprietary software product, remotely hosted by Altostratus Coy, for a period of three years;

(b) the provision of technical support for a period of 18 months; and

(c) the provision of in-house one-off user-training upon commencement.

115. The fee payable by ABC Coy is $43,000 which is not dissected into separate amounts for each of (a), (b) and (c).

116. As part of their business model, Altostratus Coy does not also sell each of these products or services individually and neither do comparable competitor products exist.

117. In order to allocate the contractual fee across each of (a), (b) and (c), the management of Altostratus Coy determines on a fair commercial basis, the pricing of each of (a), (b) and (c) assuming they were to be offered as stand-alone products in the market place. The prices determined on a bona fide commercial basis were:

(a) access fee at $1,000 per month;

(b) 18 month technical support: $5,000;

(c) one-off user training: $2,000.

118. In these circumstances it is fair and reasonable to allocate the $43,000 contractual fee in the sum of $36,000 to 3 years of hosted access, in the sum of $5,000 for the provision of the technical support and in the sum of $2,000 for the one off user training.

Example 19: Where additional services are provided voluntarily

119. Stormy Coy is an Australian software development company. It employs the accruals method of recognising income.

120. On 1 July 2012, Stormy Coy enters into an agreement with ABC Coy which provides the right to access and use a remotely hosted proprietary software product for a period of three years in consideration for the payment by ABC Coy of an access fee of $17,000.

121. No part of the agreement between Stormy Coy and ABC Coy concerns the provision of technical support or user training.

122. Although not contractually obliged to do so, Stormy Coy, as part of its business strategy for customer retention and marketing, provides customers with technical support and user training on an ex gratia basis.

123. On the facts here, all of the $17,000 access fee is properly allocated to the provision of the hosted access. No part may be allocated to the provision of technical support and user training and therefore no part may be deferred for income tax purposes on that basis.

Date of effect

124. This Ruling applies to years of income commencing both before and after its date of issue. However, this Ruling will not apply to taxpayers to the extent that it conflicts with the terms of a settlement of a dispute agreed to before the date of issue of this Ruling (see paragraphs 75 and 76 of Taxation Ruling TR 2006/10).

Commissioner of Taxation
12 March 2014

Appendix 1 – Explanation

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

Background

125. Software developers historically have contracted with customers by means of granting a licence for installation and use of software on a customer's computer hardware. The software is made available for installation on the customer's hardware by means of CD ROM or internet download. A contractual fee is payable by the customer in consideration for the grant of the licence.

126. An obligation to provide 'additional services' may be bundled with the proprietary licence or provided under separate contract.

127. In either case, the contractual fee may or may not expressly be allocated across the different obligations.

128. Additional services include such things as the provision of updates or upgrades to the software, user support and training.

129. An alternative to acquiring a proprietary licence for installation and execution on a buyer's hardware is remote accessing of software hosted on the software company's server. Such access is commonly achieved via the customer's internet browser but other means are technically possible. The mechanism by which access is obtained is not a material difference for the purposes of determining the point of derivation for income tax purposes.

130. Ordinarily, the access fee is charged on a usage basis for periods of relatively short duration (daily, weekly or monthly) or strictly on a pay as you go basis (that is, an hourly charge for actual use).

131. Hosting arrangements may expressly contemplate the provision of support services by the software company on request or such services may merely be provided on a voluntary basis as a client goodwill gesture. Such support services ordinarily relate only to training or help services as it is an inherent feature of hosted services that upgrades and updates are only necessary to the software on the host's server.

132. Hosting arrangements may amount to 'take it or leave it' contracts whereby no remedy is available to the client for the hosted access being unavailable ('downtime'). Even in cases where both parties have equality of bargaining power, downtime may or may not be a matter expressly contemplated in contract. It suffices to say that contracts exist where remedies do and do not exist for downtime. Where a remedy exists it is ordinarily a refund of a portion of the access fee reflecting the downtime and/or general exposure to damages for contractual breach.

The nature of a licence for granting the right to use proprietary software

133. An agreement for the right to use proprietary software gives the end user a licence to access and use the proprietary software in a way that would otherwise breach the copyright owner's intellectual property rights (*Young v. Odeon Music House Pty Ltd* (1976) 10 ALR 153).

The nature of a contract for hosted access of proprietary software

134. The precise nature of hosted access is yet to be judicially considered. Hosted access might be thought to be more akin to the provision of a service rather than a licence. However, it is unnecessary to determine whether it is a service or a licence as this does not alter the point of derivation of the access fee for income tax purposes.

Derivation

Section 6-5 of the ITAA 1997

135. Section 6-5 of the ITAA 1997 provides that a taxpayer's assessable income includes the ordinary income derived by the taxpayer during the income year.

136. Ordinary income is derived when a gain has 'come home' to the taxpayer in a realised or immediately realisable form (*CT v. Executor & Trustee Agency Co of South Australia* (1938) 63 CLR 108 (*Carden's case*)).

137. For an accruals based taxpayer, a gain has 'come home' when a recoverable debt has been created. In establishing if a recoverable debt has been created it is necessary to determine whether there are further steps to be taken before the taxpayer becomes entitled to payment (*Gasparin v. Commissioner of Taxation* (1994) 50 FCR 73; 94 ATC 4280; (1994) 28 ATR 130, *Farnsworth v. Federal Commissioner of Taxation* (1949) 78 CLR 504; (1949) 9 ATD 33; *Henderson v. Federal Commissioner of Taxation* (1970) 119 CLR 612; 70 ATC 4016; (1970) 1 ATR 596; *J Rowe & Son Pty Ltd v. Federal Commissioner of Taxation* (1971) 124 CLR 421; 71 ATC 4157; (1971) 2 ATR 497).

138. Whether there is, in law, a recoverable debt is a question to be determined by reference to the contractual agreements that give rise to the legal entitlement to payment, the general law and any relevant statutory provisions.[1]

[1] TR 98/1 *Income tax: determination of income; receipts versus earnings* paragraph 11.

Contingency of repayment

139. The phrase 'contingency of repayment' as adopted in this ruling is intended to capture the principle from *Arthur Murray* in terms of when an amount received will represent unearned income. As set out at paragraph 6 of this Ruling, a contingency of repayment exists where:

(i) a contractual obligation exists for a refund;

(ii) contractual exposure exists for damages in respect of the non-performance; or

(iii) a demonstrated commercial practice exists for a refund.

140. *Arthur Murray* involved a taxpayer who received amounts in advance for a specified number of dance lessons to be given over a period of time. Whilst students did not have any contractual right to a refund, it was the general practice of the taxpayer to give refunds where not all lessons were taken. The taxpayer's books of account recognised fees as income when the lessons to which the fees related were taught.

141. In *Arthur Murray* , their Honours relevantly held:

> It is true that in a case like the present the circumstances of the receipt do not prevent the amount received from becoming immediately the beneficial property of the company; for the fact that it has been paid in advance is not enough to affect it with any trust or charge, or to place any legal impediment in the way of the recipient's dealing with it as he will. But those circumstances nevertheless make it surely necessary, as a matter of business good sense, that the recipient should treat each amount of fees received but not yet earned as subject to the contingency that the whole or some part of it may have in effect to be paid back, even if only as damages, should the agreed quid pro quo not be rendered in due course. The possibility of having to make such a payment back (we speak, of course, in practical terms) is an inherent characteristic of the receipt itself. In our opinion it would be out of accord with the realities of the situation to hold, while the possibility remains, that the amount received has the quality of income derived by the company.

142. The import of *Arthur Murray* is that once the contemplated contingencies lapse the amount may in an unqualified sense be retained by the service provider. At this point the amount converts from unearned income to earned income for income tax purposes.

143. In the present context it is possible various amounts received by commercial software developers are in whole or in part subject to relevant contingencies.

144. For example, in the case of additional services provided under a bundled contractual licence, the software developer may be exposed for non-performance, either:

(i) in terms of a contractual obligation to make a refund;

(ii) in terms of a demonstrated commercial practice to make a refund; or

(iii) because contractual exposure exists for damages.

145. A commercial practice in relation to refunds must be evidence-based and not merely an assertion. Evidence may include a demonstrated practice over time or a stated practice in corporate policy documents.

146. It is only in cases where a relevant contingency exists in relation to the unqualified retention of the fee in whole or in part, that deferral may be valid for income tax purposes. Where no relevant contingency exists, the amount is derived when a recoverable debt arises in respect of the contractual fee.

147. The context of the reference to damages in *Arthur Murray* was to contractual damages for breach. Damages pursuant to consumer protection law, or damages in tort, were not contemplated in *Arthur Murray* and are not relevant to the question of determining the incidence of derivation of 'unearned income'. *Chesire and Fifoot's Law of Contract* (9th edition) explains the distinction in the following terms at paragraph 23.8:

> Damage in Tort and under s82 of the *Trade Practices Act* 1974 (Cth) are not awarded as damages for the loss of expected performance. Rather, they are assessed so as to put the claimant in the position that he or she would have occupied had the tort or statutory contravention not been committed (Footnote: *Gates v. City Mutual Life Assurance Society Ltd* (1986) 160 CLR 1 at 11-12). This reflects a commonly accepted distinction between a cause of action based on a breach of duty imposed by law and a cause of action based on a breach of duty assumed by volition.

148. An exposure to contractual damages will exist where at the end of the licence agreement (or at some other time specified in the contract), the commercial software developer is exposed to a provable cause of action for failure to fully perform on the contract. The awarded compensation in such cases is restitutionary to the extent the contract price relates to the obligations not performed (*Chesire and Fifoot's Law of Contract* (9th edition) at paragraph 23.9).

Only contractual obligations are to be tested

149. The principle considered in *Arthur Murray* was:

> whether, in the circumstances, it may properly be held that receipt without earning makes income (*Arthur Murray* 114 CLR 314 at 317-8 per Barwick CJ, Kitto and Taylor JJ).

150. The context was whether income received for **contractual** obligations yet to be performed were income.

151. Similarly, in the present context, it is the contractual obligations of commercial software developers which require testing. Namely, whether or not the *Arthur Murray* principle applies and, if so, the incidence of derivation and quantum of 'unearned income'.

152. In cases where a software company provides additional services on a voluntary basis (for example, as a customer retention or marketing strategy), *Arthur Murray* is not authority for deferral of derivation of any part of the software licence fee. This is because the additional services do not form part of the contract and, therefore, no part of the fee is contractual consideration for the services provided. As such, the customer has no remedy in the event of non-performance of the voluntary undertakings.

153. This is to be contrasted with cases where additional services do form part of the contract and the software developer is contractually obliged to provide such services even if rarely called upon by the customer. In such cases, the software developer is contractually bound to at least hold themselves ready to provide the additional services, and part of the contractual fee is properly allocated to that undertaking.

Accounting Principles

Accounting principles applicable to apportionment of a licence fee between earned and unearned income

154. The governing standard in Australia is AASB 118 - *Revenue* which provides general principle on income recognition. Limited specific guidance on income recognition for commercial software is provided at paragraph 11 of Appendix 1 to AASB 118 which provides:

> When the selling price of a product includes an identifiable amount for subsequent servicing (for example, after sales support and product enhancement on the sale of software), the amount is deferred and recognised as revenue over the period during which the service is performed. The amount deferred is that which will cover the expected costs of the services under the agreement together with a reasonable profit on those services.

155. Some commercial software developers may also have regard to the United States Accounting Standards Codification (ASC) 985-605 given symmetry between Australian and United States accounting principle. ASC 985-605 provides guidance on a broader range of relevant issues.

156. ASC 986-605 provides *inter alia* that where additional services do not entail significant production, modification, or customization of the software, the obligations are accounted for separately. Revenue is allocated to each obligation based on vendor specific objective evidence (VSOE) of the fair values of the obligations. Further, VSOE must be used regardless of whether specific prices are allocated in the contract as such prices may not reflect fair value and give rise to unreasonable apportionment.

157. VSOE of fair value is limited to:

- the price charged when the obligation is sold separately; or

- if not sold separately, the price established by management, if it is probable that the price, once established, will not change before introduction into the market place.

158. AASB 118 and ASC 986-605 are silent on cloud or hosted arrangements which are governed by standards of applicable general principle, specifically AASB 118 in Australia.

The relevance of accounting principles to apportionment of a licence fee between earned and unearned income

159. It has been argued that *Arthur Murray* is authority for the proposition that established accounting practice is determinative of the incidence or quantum of derivation of the contractual fee for the proprietary licence, hosted access and/or additional services.

160. A close reading of the judgment in *Arthur Murray*, and of later authorities,[2] shows that accounting practice is not the test for derivation of income. Were accounting practice the test, accounting standard setters would in effect determine such matters.

161. In *Arthur Murray* , their Honours relevantly stated:

> In so far as the Act lays down a test for the inclusion of particular kinds of receipts in assessable income it is likewise true that **commercial and accountancy practice cannot be substituted for the test** (*emphasis added*).

162. Further, in *BHP Billiton Petroleum (Bass Strait) Pty Ltd & ANOR v. FCT* 2002 ATC 5169, Hill and Heerey JJ observed:

> 67. Before turning to the accounting evidence in the present case it is important to note that while the earlier cases, such as *Carden*, *Arthur Murray* and *Henderson* , may be thought to have suggested that business and accounting principles are to be applied by the Court in determining questions of derivation, some later cases, for example the *Australian Gas Light Company* case in this Court have made the point that **accounting principles are not determinative** , although they may be persuasive (*emphasis added*).
>
> 68. It is not necessary in the present case to decide if there really is a difference between the emphasis put on accounting practices in the early cases and the views expressed in the later cases. It suffices here to say that on either view of the law the business and accounting practices assist the Court in working out of the principles behind the statutory language of 'income derived'.

163. The accounting treatment in paragraph 11 of the Australian Accounting Standard AASB 118 *Revenue* looks to defer income regardless of whether an unqualified right exists to retain the income from the outset.[3] This is clearly in conflict with judicial authority that for an accruals based taxpayer income has been derived for income tax purposes when a recoverable debt has been created.

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[2] *BHP Billiton Petroleum (Bass Strait) Pty Ltd & ANOR v. FCT* 2002 ATC 5169

[3] That is, no contingency of repayment.

164. For this reason, established accounting practice such as that prescribed in paragraph 11 of Appendix 1 to Australian Accounting Standard AASB 118 *Revenue* does not assist in determining the incidence or quantum of derivation of the contractual fee for the proprietary licence, hosted access and/or additional services for income tax purposes.

165. This also aligns with paragraphs 118 and 119 of Taxation Ruling TR 2009/5 *Income tax: trading stock - treatment of discounts, rebates and other trade incentives offered by sellers to buyers*, which relevantly states:

> 118. *BHP Billiton*, *St Hubert's Island* and *Philip Morris* confirm the relevance of commercial and accounting principles in resolving taxation questions in certain contexts. However, in the Commissioner's view, commercial and accounting principles are necessarily subordinate to taxation principles where they differ and where the taxation principles are clear…
>
> 119. The Commissioner's view is that there is no basis for preferring a taxation outcome based on an accounting treatment in accordance with current accounting standards over a taxation outcome based on the application of well established legal principles to a particular set of facts.

Allocation of the contractual fee

Apportionment of bundled contractual licence between additional services and licence for proprietary software or hosted access

166. The authorities that have dealt with apportionment issues accept the principle that a single payment may be apportioned where the facts permit (see for example, *Allsop v. FCT* (1965) 113 CLR 341; *McLaurin v. FCT* (1961) 104 CLR 381 (*McLaurin*); *National Mutual Life Association of Australasia v. FCT* (1959) 102 CLR 29; and *Commissioner of Taxation v. CSR Ltd* [2000] FCA 1513).

167. In *McLaurin*, the High Court stated:

> It is true that in a proper case a single payment or receipt of a mixed nature may be apportioned amongst the several heads to which it relates and an income or non-income nature attributed to portions of it accordingly (*McLaurin* (1961) 104 CLR 381 at 391).

168. What is a 'proper case' will depend upon whether as a matter of contract the single payment is consideration for a mix of discrete promises or an indivisible promise. For example, where a cause of action for breach could result only in unliquidated damages, apportionment will be unavailable (*McLaurin*).

169. Contracts for the bundled supply of a proprietary software, hosted access and/or additional services concern divisible promises and as such apportionment of the contractual fee may be undertaken for tax purposes.

170. Where there is no legislative provision specifying a basis for apportionment, any reasonable method of apportioning consideration into separately identifiable parts may be used. However, the apportionment must be supportable by the facts in the particular circumstances and be undertaken as a matter of practical common sense (*Commissioner of Taxation v. Luxottica Retail Australia Pty Ltd* (*Luxottica*) (2011) 79 ATR 768 ; 2011 ATC 20 243 at [40]).

171. What is a reasonable method of apportioning the consideration for a bundled contract depends on the circumstances of each case. In some cases, there will be only one reasonable method which may be used.

172. The method used should be based on a consideration of all the circumstances and not because it gives a particular tax outcome. Different methods may need to be used, or a combination of methods, to ensure the apportionment reflects an appropriate allocation of the consideration for the bundled contractual licence.

173. Records must be kept which support and explain the method employed.

Vendor Specific Objective Evidence (VSOE) Methodologies

174. In the Commissioner's view, VSOE methodologies as set out in ASC 986-605 represent a fair and reasonable basis of apportionment in the sense contemplated in *Luxottica*.

175. As already noted at paragraph 157 of this Ruling, VSOE of fair value is limited to:

- the price charged when the obligation is sold separately; or
- if not sold separately, the price established by management, if it is probable that the price, once established, will not change before introduction into the market place.

Separately agreed prices

176. Depending on the facts and circumstances of the licence agreement, the price allocated by the contracting parties may be regarded as the most appropriate measure of value for the additional services. This is on the basis that such prices are agreed on commercial terms and at arm's length.

177. Conversely, in cases where the component prices bear no resemblance to fair commercial value it might be reasonably inferred *inter alia* that such prices do not reflect the true bargain. In such cases the contract price should be rateably allocated between the divisible promises based on commercial fair value. If the allocation of prices on a non-commercial basis is tax driven, consideration may also be given to the application of the general anti-avoidance rules in Part IVA of the ITAA 1936.

Where additional services are rarely called upon

178. In cases where additional services are rarely called upon, the above methodologies may result in a *de minimus* allocation of the bundled consideration to the additional services. These types of cases may result in a significant divergence between accounting treatment and the incidence of derivation for taxation purposes. This will particularly be the case where accounting treatment is to allocate the contractual fee on a straight line basis across the term of the bundled licence agreement.

Where regular upgrades are an essential component of the agreement

179. In cases where upgrades are an essential component of the agreement, a significant allocation of the bundled consideration to the additional services may be valid (such as, for example, where the software licence relates to virus or malware protection software and the upgrades represent the essence of what the licensee required from the software developer in entering into the contractual licence). That is, the upgrades each represent of themselves significant commercial value to the licensee.

180. In such cases, upgrades are constantly required to be delivered over the term of the agreement and each upgrade will have material commercial value of itself. In these circumstances, apportionment may more closely align with established accounting practice. However, as already noted in this ruling, accounting practice is not of itself determinative.

Where the contractual licence provides for the provision of software updates or upgrades if and only if updates or upgrades are released during the term of the licence agreement

181. As already noted, the question at issue in *Arthur Murray* was whether 'receipt without earning' makes income.

182. In cases where the governing contract provides for:

> the provision of software updates if and only if updates or upgrades are released during the term of the licence agreement;

there is no cause of action for breach if no update is released during the term of the agreement. As such, the software developer may retain the full licence fee regardless of whether or not any update is provided. There is therefore no contingency of repayment in the sense discussed in this ruling and therefore *Arthur Murray* is not authority for any part of the licence fee to be deferred for taxation purposes. That is, the licence fee is derived at the time a recoverable debt arises.

Appendix 2 – Detailed contents list

183. The following is a detailed contents list for this Ruling:

References

Previous draft:
TR 2013/D2

Related Rulings/Determinations:
TR 2009/5; TR 2006/10; TR 98/1

Subject references:
- income
- derived

Legislative references:
- ITAA 1936 Pt IVA
- ITAA 1997 6-5
- TAA 1953

Case references:
- Allsop v. Federal Commissioner of Taxation (1965) 113 CLR 341
- Arthur Murray (NSW) Pty Ltd v. Federal Commissioner Taxation (1965) 114 CLR 314; (1965) 14 ATD 98; 9 AITR 673
- BHP Billiton Petroleum (Bass Strait) Pty Ltd & Anor v. Federal Commissioner of Taxation 2002 ATC 5169; (2002) 51 ATR 520
- Commissioner of Taxation v. CSR Ltd [2000] FCA 1513; 45 ATR 559; 2000 ATC 4710
- Commissioner of Taxation v. Luxottica Retail Australia Pty Ltd (2011) 79 ATR 768; 2011 ATC 20-243
- Commissioner of Taxes v. Executor & Trustee Agency Co of South Australia (1938) 63 CLR 108
- Farnsworth v. Federal Commissioner of Taxation (1949) 78 CLR 504; (1949) 9 ATD 33
- Federal Commissioner of Taxation v. Australian Gas Light Co 83 ATC 4800; (1983) 15 ATR 105
- Gasparin v. Commissioner of Taxation (1994) 50 FCR 73; 94 ATC 4280; (1994) 28 ATR 130
- Henderson v. Federal Commissioner of Taxation (1970) 119 CLR 612; 70 ATC 4016; (1970) 1 ATR 596
- J Rowe & Son Pty Ltd v. Federal Commissioner of Taxation (1971) 124 CLR 421; 71 ATC 4157; (1971) 2 ATR 497
- McLaurin v. Federal Commissioner of Taxation (1961) 104 CLR 381
- National Mutual Life Association of Australasia v. Federal Commissioner of Taxation (1959) 102 CLR 29
- Young v. Odeon Music House Pty Ltd (1976) 10 ALR 153

Other references:
- Australian Accounting Standard AASB 118 - Revenue
- Chesire and Fifoot's Law of Contract (9th Australian edition) LexisNexus Butterworths, 2008
- United States Accounting Standards Codification (ASC) 985-605

ATO references

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