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Via email: Elliot.Wilson2@ato.gov.au

Mr Elliot Wilson
Australian Taxation Office

12 March 2024

Dear Sir/Madam

BDO SUBMISSION - TR 2024/D1 - INCOME TAX: ROYALTIES - CHARACTER OF PAYMENTS IN RESPECT OF SOFTWARE AND INTELLECTUAL PROPERTY RIGHTS

BDO refers to the invitation by the Australian Taxation Office (ATO) to provide feedback following the recent release of draft ruling TR 2024/D1 (Draft Ruling). Our feedback in relation to the ATO's views as set out in draft ruling TR 2024/D1 is set out in the Appendix that follows this letter. BDO's feedback focuses on the following:

- The ATO's views on whether payments are royalties relying heavily on a liberal interpretation of concepts set out in the *Copyright Act 1968 (Cth) and other Intellectual property (IP) law that may be contestable and without adequate explanation of alternative views on the interpretation of the copyright and other IP law*;
- The lack of comments in the Draft Ruling on whether payments for the simple use of software by end-users are royalties subject to withholding tax could potentially cause confusion over whether these simple uses of software by end users have any royalty withholding tax obligations, which could create an unforeseen compliance burden for these simple users, including individuals and small business;
- Payments by software distributors to the software owners is one of the main focuses of the Draft Ruling but there is very little comment in the Draft Ruling on how to determine how much of that payment is for the use of copyright or other intellectual property;
- As a result of the change in view by the ATO compared to TR93/12 and TR 2021/D4 based on the broad application of copyright law, the potential application of the Draft Ruling is broad with far reaching consequences for taxpayers that may have previously structured arrangements in line with historical rulings;
- The Draft Ruling should only apply prospectively in fairness to taxpayers who structured their affairs in good faith in line with guidance in TR 93/12 and/or TR 2021/D4, and OECD guidelines. This position is in accordance with the Commissioner's views in Practice PSLA 2011/27 Determining whether the ATO's views of the law should be applied prospectively only[1];

[1] PS LA 2011/27 | Legal database (ato.gov.au)

- The Draft ruling does not adequately deal with the apportionment of a payment by the software distributor between royalties and other payments. It should consider the extent to which the distributor merely passes on the payment from the end user for their simple use of the software and therefore to that extent it is not a royalty.

Please see the appendix for more detailed comments.

Should you have any questions or wish to discuss any of the comments made in our submission, please do not hesitate to contact me on 02 9240 9736 or via email (lance.cunningham@bdo.com.au).

Yours sincerely

Lance Cunningham

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Appendix

Application of copyright law and other IP law

The views expressed by the Commissioner in the Draft Ruling appear to focus heavily on concepts contained in the *Copyright Act 1968 (Cth)* and other IP law resulting in a broad application. Whilst BDO is not seeking to provide feedback on the Commissioner's interpretation of copyright law principles or law more broadly, BDO understands the copyright and IP comments in the Draft Ruling may be contestable. BDO also understands there are other submissions being made by organisations that have access to experts in copyright and IP law. We strongly suggest the Commissioner carefully considers the comments provided on copyright and IP law provided by these other organisations.

Departure from the simple use concept

The position adopted in both TR 93/12 and TR 2021/D4 was that payments in relation to software for the simple use by an end user would not typically be royalties. This position was adopted regardless of whether access was obtained via sale or under a licence to use the software. The basis of this position was that there was no transfer of know how in relation to the software in granting access to use the software and that whatever rights the end user had to the use of the copyright in the software were incidental to the end users use of the software as a functional product. The Draft Ruling does not specifically deal with whether the payments by end users are royalties subject to withholding tax. With the withdrawal of both TR 93/12 and TR 2021/D4 it results in uncertainty on what the ATO's current position is in relation to such end user payments for the simple use of software.

Technological developments in the time since the release of TR 93/12 mean that the views therein may not always be relevant or applicable in a modern context following technological developments including cloud software solutions. BDO acknowledges this, but we query whether the copyright law position for simple use of software by end users has changed to any material extent. If end users were subject to withholding tax on their payments to non-resident software copyright owners, it could create an unforeseen compliance burden for these simple users, which include individuals and small business.

BDO suggests that in finalising the Draft Ruling the Commissioner should confirm that end-users of the software should not have royalty withholding tax obligations where the individual and business users use software for its intended purpose with little or no ability to customise, copy, or distribute software, other than for its intended purpose or use. There should also be further examples on how payments by end users for the simple use of software are to be treated for Royalty withholding purposes.

Software Distributors payments to Software Owners

The position adopted in TR 93/12 was that payments by software distributors to software copyright owners or their subsidiaries would not be royalties. This is also the position taken in the OECD commentary and by many tax authorities in other jurisdictions. This position was adopted regardless of whether the distributor had a licence to sublicence the use of the software to the end users. In TR 2021/D4 the ATO's position changed in relation to distributors that could sub-licence the use of the software to end users by indicating that payments by these types of distributors were royalties. The

ATO position now taken in the Draft Ruling is that payments by distributors of software, whether or not the distributor has the right to sublicence the use of software to end users, will be a royalty.

The Draft Ruling specifically notes that the Commissioner no longer supports the view that any payments made by a distributor for the right to distribute software to purchasers who make simple use of the software is not a royalty as it is inconsistent with a holistic understanding of software arrangements and proper analysis of intellectual property law.

While BDO does not intend to comment specifically on copyright or other IP law, we note that in neither TR 2021/D4 or the Draft ruling does the Commissioner comment on what extent the payments made by the distributor are for the right to use intellectual property of the software copyright owner. BDO submits that while the distributor may obtain some use of copyright or other intellectual property of the software owner, the extent of the payment for this use of copyright or other intellectual property would have to be determined on a case-by-case basis. It is contended that in most cases the apportionment of the software distributor's payment to the use of the copyright or other IP would be a low percentage and would rarely, if ever, be 100% of the payment. It is submitted that in this regard the contentions in Scenarios 1 and 2 in the Draft Ruling that the payments by the software distributor is 100% a royalty for use of copyright or other IP should be reconsidered before releasing the Final Ruling.

The question of apportionment is dealt with further under the 'Reasonable Apportionment' section below.

Broad scope of application

The application of broad Copyright legal principles in the Commissioner's views in the Draft Ruling results in it being vastly different from those contained in TR 93/12 and TR 2021/D4, and increasing the scope of its application. Accordingly, the Draft Ruling is a change in the Commissioner's position in respect of payments made for many cross-border software distribution arrangements. Taxpayers who may have relied upon TR 93/12 and/or TR 2021/D4 in good faith and structured their affairs accordingly may be adversely affected by the Commissioner's revised views as expressed in the Draft Ruling.

In order to not adversely impact taxpayers who have historically acted in good faith in line with the ATO's views in TR 93/12 and/or TR 2021/D4, BDO recommends that the ATO confine the scope of royalties in relation to software distribution arrangements by providing more certain definitions in relation to distributors. In defining a distributor, consideration is required to treat differently marketing and sales hubs, and wholesale distributors whose primary business activity is the distribution of software. To the extent possible, BDO recommends that a definition of distributor for the purposes of the Draft Ruling be reached such that an entity carrying on only ancillary software distribution activities with little or no ability to exploit IP in relation to the software is excluded from this definition.

Additionally, further guidance and explanation is required of how the comments in paragraphs 65 to 68 of the Draft Ruling in relation to Article 12 of the OECD Commentary indicates that payments for the right to distribute copies of a program will not constitute a royalty and how this reconciles with the rest of the Draft Ruling and in particular Scenarios 2 and 3.

BDO recommends that the ATO provide further examples, particularly those involving payments that would not give rise to royalties as per paragraph 15 of the Draft Ruling. Further, a summary of changes between the various historical rulings concerning the application of royalties to software distribution arrangements would be helpful.

Application on both a prospective and retrospective basis

The Draft Ruling proposes that upon finalisation, the finalised Ruling will apply both retrospectively and prospectively. As outlined above, the Commissioner's views in relation to software distribution arrangements have changed substantially from those in TR 93/12 and TR 2021/D4 and relies on contestable interpretations of Copyright and other IP law. BDO suggests that in finalising the Draft Ruling the Commissioner should limit its application to after the release of the Finalised Ruling.

Following publication of TR 93/12 in May 1993, there has been little activity from the ATO on this subject matter until 28 years later in 2021 upon the release of draft TR 2021/D4 on 25 June 2021. Subsequently, very little occurred until its subsequent withdrawal on 17 January 2024 and release of the Draft Ruling on the same date. Given that taxpayers may have relied on guidance provided in TR 93/12 and/or TR 2021/D4 and the time elapsed since their inception and withdrawal, it would appear an overreach for the ATO to apply the Draft Ruling retrospectively. This is particularly true as the Commissioner has no time limit in respect of issuing assessments for withholding tax.

While it is understood that ATO positions taken in draft rulings are to be taken as its then current view, there was a common view that the ATO position in TR 2021/D4 was subject to change. This common view was supported by the length of time that has elapsed since the release of TR 2021/D4 without it being finalised. Therefore on finalisation of the draft ruling it should only apply from the date of release of the Draft Ruling. This position is in accordance with the Commissioner's views in Practice PSLA 2011/27 Determining whether the ATO's views of the law should be applied prospectively only.

Reasonable apportionment

The Draft Ruling's overall contention is that the payments by software distributors would in most cases be wholly or substantially for the use of copyright or other IP. BDO submits that the Draft Ruling does not sufficiently justify this contention. If it is accepted by the ATO that the payment by an end user of software made directly to the software owner is not for the use of copyright and if there is any use of copyright by the end user it is incidental to the use of the software, the ATO needs to explain why there is a change in the treatment of the payment by an end user of the software if it goes via a software distributor to the software owner instead of direct to the software owner. If the end user is paying the distributor for the simple use of the software and not for any incidental use of software, why does that payment change to being substantially or fully for the use of copyright or other IP by the software distributor as it passes through the software distributor to the software owner?

While the software distributor may have more use of the copyright or other IP of the software owner than the end user does, that does not necessarily mean the whole or substantially the whole of the payment by the software distributor is a royalty as contended in Scenarios 2 and 3 in the Draft Ruling. BDO submits that a substantial part of the payment by the software distributor is an on-payment from

the end user for their simple use of the software and, to that extent, should not be considered to be a royalty.

In some instances, software distribution arrangements may involve payments for a combination of services, including the provision of rights to use intellectual property associated the software. There is only one example in the Draft Ruling of apportionment of the payment by a software distributor. Example 3 in the Draft Ruling aims to demonstrate an example of a distribution arrangement involving hard copy computer games and electronic video-editing software, noting that reasonable apportionment would be expected to apportion the majority of consideration to the IP rights associated with electronic distribution of the video-editing software. BDO suggests that this example lacks detail and sufficient rationale justifying this position. BDO recommends that the Commissioner consider providing more examples and detail of payments and arrangements that would not result in substantially all of the payment being a royalty.

Additionally, consideration should be given to specific services that may require access to the software's back end and intellectual property in order to provide the services. An example is administrative and support services. BDO appreciates that the ATO has set out its views in relation to service arrangements in IT 2660 but notes that further clarity is required as to whether payments in relation to support services provided by software distributors might be considered royalties.