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1 March 2024

Elliott Wilson
Australian Taxation Office
Commonwealth of Australia

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

RE: Draft Ruling Characterizing Payments for IP and Software (TR 2024/D1)

Dear Mr. Wilson:

On January 17, 2024, the Australian Taxation Office ("ATO") issued a draft taxation ruling (TR 2024/D1) (the "Draft Ruling") proposing a significant change to the definition of a "royalty" in respect of certain payments for software (among other things). The draft ruling has wide-reaching implications for certain software related payments made by distributors and resellers by recharacterizing certain payments as a royalty in a new view adopted by the ATO, which is contrary to globally accepted and agreed tax norms and principles.

The ATO requested public comments on the Draft Ruling by 1 March 2024. On behalf of Tax Executives Institute, Inc. ("TEI"),[1] I am pleased to respond to the ATO's request for comments.

About TEI

TEI was founded in 1944 to serve the needs of in-house tax professionals. Today, the organization spans the globe with 56 chapters, including membership in Australia. As the preeminent association of in-house tax professionals worldwide, TEI has a significant interest in promoting fair tax policy at all levels of government. Our nearly 6,500 members represent 2,800 of the largest companies in Australia, Asia, Europe, and North and South America

TEI Comments

TEI commends the ATO for seeking public input on the Draft Ruling and we welcome the opportunity to share our views. The Draft Ruling raises

[1] TEI is organized under the Not-For-Profit Corporation Law of the State of New York. TEI is exempt from U.S. Federal Income Tax under section 501(c)(6) of the Internal Revenue Code of 1986, as amended.

concerning issues in respect of internationally agreed tax norms, and the uncertainty that would follow from finalizing the Draft Ruling would lead to increased disputes and double taxation, since the ATO's approach in the Ruling is not followed by other countries. In addition, given that the Draft Ruling would apply retroactively, it will also increase uncertainty about transactions conducted over the past several decades under the previous ATO guidance. We kindly ask the ATO to carefully consider our comments below before finalizing the Draft Ruling.

The Draft Ruling is Contrary to Longstanding and Internationally Accepted Tax Rules

Australia's longstanding, and now withdrawn, guidance (T*R 93/12 – Income Tax: computer software*) makes clear that a payment by a distributor for a license of a "simple use" of software does not constitute a royalty if it is licensed to end-users, as the distributor is not "stepping in the shoes" of the copyright owner and exploiting a software copyright right. The "simple use" of software means that a licensee or end-user is using the product as intended and not using the copyright rights to the software.

This accords with the approach adopted in the OECD Model Tax Convention on Income and on Capital (the "OECD Model Convention") and related commentary ("OECD Commentary"), which acknowledges that "distributors are paying only for the acquisition of the software copies and not to exploit any right in the software copyrights" and therefore relevant transactions should not be treated as royalties.[2] A key principle in the OECD Commentary is that use of copyright necessary to facilitate the use of the copy or a service as a functional product (in the case of an end-user), or to facilitate the distribution of the software copy or provide access to a software as a service ("SaaS") application (in the case of a reseller), should be disregarded in determining whether a relevant payment constitutes a royalty for tax purposes. It also confirms that the mode of delivery of the software (e.g., through tangible media or electronically delivered) should not impact the conclusion as to whether the payment constitutes a royalty.

However, TR 2024/D1 conflicts with both the previously stated ATO view and the related OECD Commentary. The Draft Ruling provides that the above OECD interpretation of royalty does not apply to modern types of software distribution, such as cloud software, because the ATO asserts that this implicates other uses of copyright (such as "communication" or "authorization" in the ATO's interpretation of Australian copyright law) by the reseller. This view drastically broadens the interpretation of royalty payments for software distributors and brings certain payments within the scope of Australian withholding tax, which was not the case under TR93/12.

The Draft Ruling appears to be based on an unprecedented interpretation of the software royalty definition under international tax principles. Further, the Draft Ruling does not appropriately distinguish the income tax treatment of payments for acquiring copyrighted articles from payments for exploiting copyright rights. Finally, the Draft Ruling overstates the technical and commercial significance of various provisions of the Copyright Act and takes an incorrect view of the extent to which

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2 *See* OECD Commentary on Article 12 of the OECD Model Convention, paragraph 14.4.

the reproduction right and communication right may be exercised by end-users in the context of their access to and enjoyment of a software product.

Moreover, it is unusual for Australia to advance a unilateral tax ruling that would contravene the globally accepted model for the characterization of software payments considering that Australia has always taken a leading role in multilateral tax coordination. It is also at odds with the continued coordinated efforts of tax administrations and taxpayers to prepare for or adopt the OECD's Inclusive Framework's changes to the global tax system generally, and in particular to address the digitalized economy.

As a result of this change in the ATO's applied approach to software royalty payments, various practical issues arise for taxpayers, including:

1. The need to revisit transactions that took place in prior years because the Draft Ruling is proposed to apply retrospectively to such transactions. This will require businesses to carry out an analysis based on facts and circumstances that may not have been known at the time the transaction took place, given the previous view of the ATO. This could lead to an overly burdensome exercise for many businesses brought about by the ATO's change in view, which as noted conflicts with the globally acknowledged and agreed approach to the characterization of software royalties.

2. Where services are "bundled," the Draft Ruling adopts an apportionment approach that would attempt to bifurcate a single distributor payment into those amounts characterized as royalties and those as business profits. Some or all of the payment would then be subject to royalty withholding tax. This introduces new complexities for taxpayers and imposes an additional compliance burden. This is particularly the case given the ATO's starting point is to assume the entire payment is a royalty, unless it can be proved that the relevant copyright rights are separable from other things for which the consideration is paid. In addition, the ATO does not offer any insight into what is an acceptable approach for apportionment – instead the draft ruling provides that a "fair and reasonable basis" should be used. The draft ruling lacks clarity in this regard thereby creating uncertainty.

3. Considerable uncertainty in relation to the potential treatment of certain software distribution models, not in the least because the Draft Ruling at times reads as a catch-all. For example, paragraph 144 provides that "a communication may occur in the relevant sense when software is made available through cloud-based technology such as software-as-a-service (SaaS), which is available without being downloaded on the end-user's computer or device". In contrast, paragraph 136 provides that "a reproduction of a work may also occur under cloud computing when a software component is downloaded onto a computer or device". The ATO should use global platforms, such as the OECD/G20 Inclusive Framework, to advance ideas on the qualification of software payments instead of adopting its own unilateral approach.

The Draft Ruling Will Increase Tax Disputes and Double Taxation

TEI expects an increase in tax disputes in Australia due to the Draft Ruling: (i) requiring an apportionment approach to certain software payments, and (ii) applying the new view of royalties adopted by the ATO retrospectively. Further, because the view expressed by Australia is a unilateral one that is not shared by other developed economies, we also expect that it will create many instances of double taxation. We would therefore appreciate a commitment from the ATO to accept mutual agreement procedure requests where taxpayers are unable to obtain tax credits in their resident states for the Australian withholding taxes raised under the Draft Ruling. We also encourage the Australian authorities to proactively consult with its largest treaty partners to come to a common interpretation on the definition of royalties under article 25.3 of the OECD Model Convention, as recommended in paragraph 52 of the OECD Commentary to article 25.3.

This reversal of well-understood global tax practice will impose an additional administrative burden on non-Australian tax authorities and create significant uncertainty for non-resident taxpayers doing business in Australia. The Draft Ruling would make Australia an outlier with respect to global norms regarding the tax treatment of payments by software resellers and distributors and disadvantages many non-Australian businesses.

Since the ATO's new view is not shared with most Australia business partners it will lead to instances of double taxation for non-Australian businesses. One of the primary concerns in this regard is that the Draft Ruling creates nonreciprocal treatment between many foreign jurisdictions and Australia. For instance, while Australia would now seek to tax certain payments by Australian resellers to foreign suppliers, the foreign jurisdictions where those suppliers are located would maintain the historic treatment of these transactions previously accepted by Australia and would not tax these types of payments made by foreign resellers to Australian suppliers.

Not only do we expect to see an increase in domestic disputes in Australia, but also in mutual agreement procedures with overseas tax administrations. We do not consider the approach taken in the Draft Ruling to be aligned to the intent of most Australian double-tax treaties when originally negotiated, particularly considering it is clearly a change in the ATO's historic approach to software royalties.

TEI would greatly appreciate the ATO's consideration of our concerns. We close by highlighting that multinational businesses have acted in good faith in recent years by following changes in Australian tax laws. For instance, in 2016 when multinationals were encouraged by the ATO to establish onshore resellers in response to Australia's Multinational Anti-Avoidance Law, businesses complied. At the time, taxpayers relied on the existing ATO tax ruling 93/12 and the OECD Commentary for guidance in this regard. Those same reseller structures now appear to be the target of the ATO's new view on royalties in the Draft Ruling, which were established directly as a result of the ATO's encouragement.

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TEI appreciates the opportunity to comment on the Draft Ruling. Should you have any questions regarding TEI's comments, please reach out to Benjamin R. Shreck of TEI's legal staff at bshreck@tei.org or 202.464.8353.

Respectfully submitted,

Sandhya Edupuganty

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