

1 March 2024

Mr Elliott Wilson

By email: Elliott.wilson2@ato.gov.au

Dear Mr Wilson,

Thank you for the opportunity to discuss Draft Ruling, TR 2024/D1 (“the Draft”) and to comment on it. The Australian Taxation Office’s continued public engagement on such topics is to be commended. It is also reassuring to see elements of previous submissions reflected in this latest draft.

I believe there are a number of areas of the document that would still benefit from clarification.

Significance of changes: Commencement date

The ruling is described as “a further draft” and replaces the withdrawn TR2021/D4.

That draft was 17 pages long, with the “ruling” being 7 of those pages. TR2024/D1 is now, three years later, 41 pages long, with the “ruling” composing 12 of these.

These changes are significant and extensive and have taken three years to develop. It is submitted that changes this significant should have resulted in a more extensive consultation period than the 6 weeks allowed. The copyright law analysis in the Draft, alone, warrants a significantly more detailed response than has been possible in the time available.

In addition, the changes from TR98/12W and TR2021/D4 are so significant and extensive that a date of effect prior to the date of finalisation of the ruling is inappropriate. This is particularly the case since the most significant positions taken by the Commissioner rest on propositions that have not yet been tested before a court. The ruling should not be applied retrospectively.

Structure

Section 358-5 Tax Administration Act 1953 states the Commissioner may make a “ruling” on how a provision “applies or would apply to entities generally, or a class of entities”. So taxpayers will naturally ask “exactly what is the ruling” or rulings contained in the Draft.

Footnotes 22, 23 and 28 of the Draft refer to material in the Appendix, in fact about 30 paragraphs of the Appendix. The Appendix however is clearly not a ruling (see also paragraph 10 of TR2006/10). And it must be concluded that reference to the appendix does not make those parts of the appendix part of the ruling. This is because much of the material referred to involves an analysis of copyright law, and the Commissioner is not in a position to issue a binding ruling on an issue of copyright law (section 357-55 Tax Administration Act 1953).

It seems likely that paragraphs 11 to 19 would satisfy the requirements in section 358-5 TAA. Paragraphs 20 to 22 are a statement of the Commissioner's views on the significance of the IBM decision without a clear statement of particular application to a taxpayer or group of taxpayers. It is less clear whether they constitute a ruling. It is submitted that paragraphs 23 to 41 would likely not be a ruling. In addition, the "scenarios" given here and in paragraphs 116 and 117 do not acknowledge that the conclusions expressed are built on untested conclusions of intellectual property law, or that such business models have significant variations in their fact patterns.

To give two examples in connection with this last point, paragraph 27 appears to be an expression of opinion on copyright law: "the rights...include rights to do things that constitute rights to use copyright". It may be possible to restate it as an opinion on tax law by perhaps saying, "if the rights were found to include rights to do things that constitute rights to use copyright " then taxation consequences will follow. Paragraph 29 also appears to be a copyright law opinion. "therefore, OBA is one of the entities responsible for determining the content of the communication". Determination of content of communication is a copyright law expression.

It is clear that the structure of the Draft, a "Ruling" with a non-ruling "Appendix" is an acknowledgement of the difficulty this area presents. This is because taxation consequences can only follow after conclusions on copyright law are reached. It appears the Draft then seeks to make what rulings the Commissioner can while also, helpfully, giving greater insight into the advice he has received on the issues of copyright law. In addition, the use of "examples" in the previous draft, and "scenarios" in the present highlights the issue that the outcomes in such matters are extremely fact dependent and that the facts of two taxpayers in these industries are rarely identical.

It would seem, then, that all the material from, and including, the scenarios would in fact be better published as some other form of guidance, perhaps a PCG. In essence it indicates areas that the Commissioner considers require attention in reviews. And it would easily lend itself to a "traffic light" approach such as that in PCG 2024/1.

Conclusions of domestic tax law

Apportionment

It is submitted that the essential conclusions put forward in paragraphs 20 to 22 and 103 to 117 are not at all explicit in the IBM judgement.

The ruling says in paragraph 22 (emphasis added):

Taking the whole of the agreement into account, the Court found that the non-residents granted such IP rights as were necessary for the use, marketing and distribution of the relevant products by the resident company. The agreement was not simply a distribution agreement which conferred distribution rights independently of

the grant of IP rights. No apportionment was necessary, meaning that all the amounts paid under the agreement for the bundle of rights were royalties under the USA tax treaty. As a consequence, royalty withholding tax was payable on all the amounts paid under the agreement.

It is submitted that the underlined text (and a similar comment in paragraph 113) does not accurately reflect the court's conclusion. In fact, the judgement makes it clear that the agreement there was drafted in such a manner that the consideration given was clearly and expressly given for the relevant intellectual property rights (see for example paragraphs 14, 18 and 51 of the judgement). This means that in cases where the consideration is not simply and expressly for the use of, or grant of, IP rights apportionment remains appropriate.

There is also, it is submitted an inconsistency between this part of the Draft and the conclusion of paragraph 74. Paragraph 74 would seem to be based on the decision in PepsiCo, and it seems likely that the topic will be a focus of the current appeal in that matter. If the propositions which rest on PepsiCo are to remain in the Draft there must be a question of whether the Draft should be further delayed pending the PepsiCo appeal and the likely proceedings in relation to Coca Cola.

The last sentence of paragraph 107 would also seem inconsistent with the decision in PepsiCo.

There is an apparent tension between the IBM and PepsiCo decisions of the Federal Court on this issue. It is to be hoped that the appeal in the latter provides greater clarity. But significant parts of the ruling then deal with issues before the courts in the PepsiCo appeal and the Coca Cola matter which is currently awaiting hearing.

Consideration and the GST cases

Paragraph 89, with respect, does not acknowledge the significant factual variation that exists in "distribution" arrangements. One of the key points of controversy between the Commissioner and many in the industry is in fact whether the "distributor is making a supply of software", and even what is meant by those words. The definitions of "distributor" and "software arrangement" in the Draft are certainly not limited to arrangements where the distributor actually delivers software. It would seem (to paraphrase) from a reading of paragraphs 90 to 102 that the Commissioner seeks to make the argument that:

"Supply for consideration" in the GST legislation gives guidance on the meaning of "amount paid...as consideration for...the use of or the right to use"

GST cases indicate that the courts will conflate the obligations undertaken by a distributor to an end user with the services performed by a licensor to the end user.

The precise consequence of this is not spelt out. But there seems to be an implication that the distributor may somehow be taken to have done acts reserved to (and in these cases actually done by) the copyright holder (the licensor).

This would be a controversial view, and a novel application of the principles in the GST decision.

Treaty concepts

TR2024/D1 explicitly refers to and discusses the operation of Australia's International Tax Treaties in a number of areas. This is an important improvement over TR2021/D4.

Simple use

One treaty concept which is no longer found in TR2024/D1, but was found in TR2021/D4 and in TR98/12 is the “de minimus” principle of “simple use”. That concept can be traced to the OECD “Software” paper of 1992, “The Tax Treatment of Software¹”. It was there used to refer to the proposition that an “outright acquisition of a product (eg a computer programme) for simple use by the purchaser could not ...give rise to a royalty within the meaning of Article 12”. This was because a “substantial majority” of the Committee felt that “use” where it was used in the expression “use of a copyright” must refer to “an acquirer who seeks to exploit commercially the intellectual property of another”. As distinct from “the mere purchase of a product protected by copyright or a patent²”.

These propositions in the report, adopted by the OECD Council in 1992 have not been resiled from by the OECD, or indeed Australia, in the model treaty commentary. The 1992 OECD software report recommended against specifically amending the commentary to deal with the issues it raised. As a result, the expression “simple use” was not included in the OECD model commentary. But it may be inferred from the commentary at paragraphs 14, 17.2 and 17.3. In any event, having been adopted by the OECD Council it is likely the 1992 software report is itself a relevant aid to interpretation of Australia's treaties.

If the concept of simple use is to be read down or dismissed (as it is outside the Ruling in para 183), it should be done so in the context of an explicit discussion of its history and role, and the principle of “form over substance” discussed in the next paragraph. Particularly after its inclusion in the previous rulings on the subject.

The paragraphs referred to above in the OECD commentary (and the simple use concept itself) signal a fundamental difference between the Commissioner's approach in TR224/D1 and, it is submitted, the approach of the OECD is its guidance on the Model Convention. Simply put, it is the difference between a “form over substance” approach in TR2024/D1 and a “substance over form” approach revealed in the OECD commentary, particularly in 14.4. Australia was a part of the working group for 14.4 and lodged no reservations. In fact SaaS models were in existence after about 1999 and were prevalent quickly afterwards.

This means the Draft will create significant uncertainty about the impact of the OECD commentary on parts such as

Paragraph 14 (e), where simple use may mean some examples would not give rise to a royalty.

Paragraph 19, which appears to dismiss the application of the “simple use” concept entirely.

Paragraphs 62 to 70, where the Draft reads paragraphs 12, and 14 to 14.2 as describing precisely the only factual situations where their principles have application,

¹ https://read.oecd-ilibrary.org/taxation/model-tax-convention-on-income-and-on-capital-2014-full-version/r-10-the-tax-treatment-of-software_9789264239081-103-en#page14: at para 44. Located at this address 25 February 2024.

² This is consistent with the principle in paragraph 10.1 of the commentary to Article 12.

rather than as setting out general principles and giving examples of their application (see for example the “essential character” test described in paragraph 12). It is arguable, for instance, that these paragraphs make it clear that a distributor who has no rights other than those “necessary for the purpose of enabling the operation of the program on the licensee’s computers or network” will not be seen to pay a royalty. Rather than standing for the proposition implied in the draft, that the commentary cannot give guidance on the treatment of all distributors who do not actually acquire a copy of the software in the distribution process.

Paragraph 106, which appears to dismiss the application of the “simple use” concept entirely.

The underlying approach of the OECD, “substance over form”, means that even in cases where a black letter analysis of copyright law leads to a conclusion that some rights of the copyright holder are exercised by a distributor, the overlay of treaty analysis will prevent a conclusion that a royalty exists.

This aspect of the OECD commentary is not acknowledged at all in the draft, which itself subjects the text of the OECD commentary to a textual, rather than a purposive, analysis.

Conclusions of copyright law.

The scenarios and appendix express several views in relation to copyright law which are difficult to reconcile with the case law. In addition, many of the conclusions are themselves based on broad statements as to how taxpayers in various sectors operate, rather than acknowledging that there is significant variation in facts, and that even the propositions argued for may only have application to particular facts. SaaS enterprises, for instance, operate with a wide variation of business models, from those where there is no download by the end user of the relevant software to those where a significant part of it is. It is submitted that, while all the analysis given in relation to distributors in SaaS models is controversial, that in relation to the first type is particularly so.

Communication

For example, the propositions in paragraphs 142 to 144 do not recognise this significant variation in the facts of SaaS models, and that in many cases there will not be a download of software, and there will not then be a communication for the purposes of the Copyright Act.

Likewise, the reference in paragraphs 147 and 149 to the decision in Roadshow does not acknowledge that Roadshow involved the transmission and reconstruction of parts of a copyright work. While in many SaaS models there is no actual transmission of source code nor object code to the end user.

Statements such as those in paragraph 174 contain generalisations which will not be true for a significant number of taxpayers, such as:

“...this act of sublicensing will generally constitute the authorisation of an act that is the exclusive right of the copyright owner”.

Authorisation

The general discussion of “authorising” in paragraphs 163 to 174 does not recognise that authorisation in this context must be the authorisation of an act which is the right of copyright owner. Where there is no reproduction of the source or object code by the distributor, for instance, there is no relevant “authorisation” under the Copyright Act and the payment by the distributor cannot be a royalty. Paragraph 170 in particular is an analysis of the law that is not supported by case law and must be viewed as extremely controversial and untested. The authorisation right does not “stand alone” in the manner suggested by the Draft.

There is a similar conceptual difficulty in relation to the assertions about the significance of access control technological control measures.

Clerical points:

In the definition of “software arrangement”, the phrase to “for the right to be in a position” may be better expressed as “which enable it”. There is no singular “right” which creates such an outcome. It is a product of often complex contractual rights. Expressing it as “the right” is simplistic.

The expression “of this ruling” is used several times in the “Ruling” part of the document to refer to material in the Appendix, which is not a ruling for the reasons given above. See for instance footnote 11, which directs the reader to “paragraph 86 of this Ruling (*emphasis added*)”.

Paragraph 14 opens by referring to “The following payments”. But the examples given are not of “payments” as such, but the rights given as consideration for the payments. Perhaps the opening words in paragraph 14 could be replaced with “Payments for the following”.

In paragraph 14 (c) may I suggest the first line should read “the supply of know-how referred to”. The relevant “industrial commercial knowledge or information” in the treaty is not required to be “in relation to an IP right”. If it were in relation to an IP right it might also fall under paragraph (d).

Also in paragraph 14 in (d), the second occurrence of the word “supply” is ambiguous as it is not defined in the ruling. “IP rights” might be clearer.

Paragraph 56 appears to use the expression “IP right” inconsistently. That expression is defined for the purposes of the ruling to include specified rights relating to defined intellectual property and “other like property or rights”. But paragraph 56 appears to refer to two separate categories, “IP rights” and “other like property or rights”. The third dot point, for instance could be omitted. Since the definition in the ruling means it is already included in the expression ‘IP rights’ used in the first two dot points. The opening sentences also embody this confusion regarding whether the expression “IP rights” (when used) is actually the definition set out at the beginning of the ruling, or some more limited concept. There is also an implication that when considering “other like property or rights” the question is whether they can be categorised as “IP rights”. Rather than spelling out the full enquiry which emerges from the first instance and full court judgements in Seven. Which is “is there a statutory right relating to a subject matter falling within the genus of Australian intellectual property law”, in which case it can be said to be an “other like property or right”.

I believe that the reference to “the High Court” in paragraph 87 should be to the “Full Federal Court”.

It is submitted that the discussion in paragraphs 75 to 79 would benefit from a simple opening paragraph to give a simple explanation of the point. As I understand it, the Draft is saying that the question of “what is the consideration given for the payment” must include not only the actual services to be given but also promises made. There could, perhaps, be an example showing the role of the concept of executory consideration.

Please do not hesitate to contact me if you would like further information on any of these issues.

A handwritten signature in black ink, appearing to read 'Paul McNab', with a long, sweeping flourish extending upwards and to the right.

Paul McNab
Principal