March 1, 2024

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Re: Comment Letter on TR 2024/D1 - Income tax: royalties - character of payments in respect of software and intellectual property rights

The National Foreign Trade Council (the "NFTC") is pleased to provide written comments on the Australian Taxation Office's ("ATO") Draft Ruling TR 2024/D1 "Income tax: royalties - character of payments in respect of software and intellectual property rights" (the "2024 Draft Ruling") published on January 17, 2024. The 2024 Draft Ruling replaces the draft Taxation Ruling TR 2021/D4 "Income tax: royalties character of receipts in respect of software" issued in June 2021 which in turn replaced Taxation Ruling.TR 93/12 "Income tax: computer software", which was withdrawn with effect from July 1, 2021.

The NFTC, organized in 1914, is an association of U.S. business enterprises engaged in all aspects of international trade and investment. Our membership covers the full spectrum of industrial, commercial, financial, and service activities. Our members value the work of the OECD and the Inclusive Framework in establishing and maintaining international tax norms that provide certainty to enterprises conducting cross-border operations. We appreciate Australia's intention to ensure the right to use, copyright and other intellectual property ("IP") rights, as they are considered in the characterisation of the payment and accounted for in transactions. The NFTC welcomes the opportunity to provide written comments on the 2024 Draft Ruling.

General Comments

NFTC has previously expressed concerns with the prior draft ruling TR 2021/D4. We appreciate the willingness of ATO to reconsider the overly broad approach. However, the 2024 Draft Ruling retains many of the issues with the prior draft ruling and continues to go against long standing international practice. For instance, the 2024 Draft Ruling applies to goods and services that are often a composite of multiple items, isolating the value of a possible royalty stream through an express or implied license, especially when the main purpose of granting a license, if any, is to provide legal certainty to the Australian business that it is not infringing on IP and not exploiting the IP. The approach of considering the entire payment stream a royalty to apply withholding when there are many other elements involved is

overreaching. We urge ATO to instead pursue a more balanced approach that does not overstate the inclusion of a royalty or purport to create an embedded royalty where one does not exist.

Specific Comments

The 2024 Draft Ruling adopts a broad definition of the term "distributor" and "software arrangements" that would generate significant uncertainty for taxpayers in regard to their compliance with Australian royalty withholding obligations. This is particularly problematic in the context of software rights that may be considered "embedded" in tangible products sold through an Australian member of the taxpayer's group.

The 2024 Draft Ruling focuses on arrangements for the distribution of software and adopts an extremely narrow interpretation of OECD commentary intended precisely to rule out the possibility of royalty withholding obligations in ordinary software distribution arrangements. Under that narrow interpretation, a distributor's payments for software or Software as a Service ("SaaS") sold to Australian customers who download it from the distributor's foreign parent or access it on the foreign parent's servers are treated as withholdable royalties on the basis that the distributor authorizes the exercise of a copyright in such software. It is also our view that this position is not supported by Australian copyright law. The uncertainty created by the 2024 Draft Ruling is compounded by the suggestion that the entire payment made by the distributor would be a royalty unless the taxpayer can prove that the distribution rights had substantial value independent of the right to use the copyright or other intellectual property, for a "fair and reasonable apportionment" to be applied, albeit without articulating any basis for determining such an apportionment. This will also engender lengthy disputes about apportionment for de minimis rights given, if any, that could and ought to be avoided in the interest of administrability of the tax system and providing taxpayers clear guidance on when to withhold on payments.

Furthermore, the 2024 Draft Ruling multiplies the potential scope of potentially impacted taxpayers by asserting that consideration paid for sales of tangible goods may include a royalty for "embedded" software that is subject to withholding. While we appreciate that the use of a tangible storage medium for software as compared to the electronic provision of software should not be determinative of the characterization of any payment, we believe that construing any tangible technology product (which almost necessarily will have a software element) as the equivalent of a CD-ROM or USB memory stick unnecessarily invites the potential for widespread uncertainty for taxpayers. For these reasons, we recommend excluding from the scope of the 2024 Draft Ruling the distribution of tangible products other than pure storage media or computing devices that host software that is also sold independently of such devices.

Conclusion

NFTC appreciates the opportunity to provide comments on the 2024 Draft Ruling. We previously expressed concerns with the policies contained in the 2024 Draft Ruling. Should the 2024 Draft Ruling be finalized, we strongly recommend an approach that more closely aligns with international standards. We would be pleased to provide additional details on the comments provided.