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ARTICLE

The Character of Payments in Respect of Software Distribution Arrangements: Should New Zealand Follow Australia?

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Rapid advances in the software industry exerted significant pressure on domestic and international tax systems. While various countries and international bodies explore ways to tax software payments, the Australian Taxation Office (ATO) released a draft taxation ruling considering when an amount paid under a software arrangement is subject to royalty withholding tax. The ATO's stance on characterising software distribution payments as royalties is broader than Inland Revenue's (IRD) 2003 guidance, subjecting more transactions to withholding tax. The ATO's broader strategy ensure arrangements involving intangible assets are appropriately recognised and characterised. New Zealand proposed a review of software payment taxation, raising a pivotal question: should IRD adopt the ATO's characterisation of software distribution payments as royalties for withholding tax purposes? This article examines ATO's characterisation of payments from a distributor to the copyright owner within the Australian copyright and royalty law framework, and how this aligns with the ATO's broader focus on intangibles. While the Australian approach deviates from the approach in New Zealand, United States and India, it finds support from other jurisdictions such as Malaysia, and more broadly, the United Nations tax policy. This article concludes that the Australian approach does not entirely deserve its criticisms and warrants deeper examination. While the decision to wholly adopt it in New Zealand lies with the legislature and IRD, the commendable aspects of the ATO's approach make it a compelling candidate for thorough deliberation and potential adoption in New Zealand.

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I Introduction

Technological advancement continues to revolutionise the software industry. As software developers embrace innovative models for the development and distribution of software, traditional tax systems now confront the complexities posed by these rapid changes. As identified by the Organisation for Economic Co-operation and Development (OECD), there is now a heavy reliance on intangible assets, and policymakers must evolve their tax regimes alongside technological progress to prevent software payments from becoming an opportunity for base erosion and profit shifting.[1]

Inland Revenue (IRD) has not updated its guidance on the taxation of software payments since 2003, highlighting a critical gap in New Zealand's tax regime. Although the "Public Rulings Work Programme for 2016–2017" proposed reviewing IRD's guidance, no further update has been provided.[2] The Australian Taxation Office (ATO) has since taken proactive steps to explain the Commissioner of Taxation's (the Commissioner) preliminary views on the taxation of software payments in draft taxation rulings *Income tax: royalties – character of receipts in respect of software* (*TR 2021/D4*), now replaced by *Income tax: royalties – character of payments in respect of software and intellectual property rights* (*TR 2024/D1*).[3] Generally, the ATO adopts the stance that a distributor's right to sublicense software, even where the end-user does not obtain any right to use the copyright in the software, is itself a use of the copyright, amounting to a royalty.[4] The ATO's stance contrasts with IRD's approach, which characterises a distributor's payments for such a right as business profits.[5] The ATO has attracted criticism as its guidance is a significant departure from the approach of IRD and other major jurisdictions such as the United States, India and the Commentaries on the OECD *Model Tax Convention on Income and on Capital* (*Model Tax Convention*).[6] Due to this deviation, the extent to which IRD will adopt the ATO's approach remains to be seen.

The ATO's characterisation of software distribution payments is an integral component of its strategy to strengthen the enforcement of royalty withholding tax in Australia. This is evident from the recent judicial developments involving PepsiCo Inc (PepsiCo) and the Commissioner. These developments demonstrate that *TR 2024/D1* is not the sole avenue through which the ATO extends the boundaries of traditional royalty characterisations.[7] The ATO also focuses on transfer pricing considerations for when a distributor enhances the value of related-party marketing intangibles, such as trademarks.[8] While the ATO has

1 OECD *Action Plan on Base Erosion and Profit Shifting* (OECD Publishing, Paris, 2013) at 10.

2 Inland Revenue "Public Rulings Unit Work Programme 2016-17" (30 June 2017) <www.taxtechnical.ird.govt.nz>.

3 Australian Taxation Office *Income tax: royalties – character of payments in respect of software and intellectual property rights* (Draft Taxation Ruling TR 2024/D1, 17 January 2024) [*TR 2024/D1*]; and Australian Taxation Office *Income tax: royalties – character of receipts in respect of software* (Draft Taxation Ruling TR 2021/D4, 25 June 2021) [*TR 2021/D4*].

4 *TR 2024/D1*, above n 3, at [14].

5 Inland Revenue "Non-Resident Software Suppliers' Payments Derived from New Zealand – Income Tax Treatment" (2003) 15(11) Tax Information Bulletin 8 [IG0007] at 12.

6 OECD *Model Tax Convention on Income and on Capital: Full Version (as it read on 21 November 2017)* (OECD Publishing, Paris, 2019).

7 *PepsiCo Inc v Commissioner of Taxation* [2023] FCA 1490, (2023) 184 IPR 66 [*PepsiCo* (2023)] at [18]; *PepsiCo Inc v Commissioner of Taxation* [2024] FCAFC 86, (2024) 303 FCR 1 [*PepsiCo* (2024)]; and *Commissioner of Taxation v PepsiCo Inc* [2025] HCA 30 [*PepsiCo* (2025)].

8 Australian Taxation Office *International Transfer Pricing: Marketing intangibles* (NAT 14586-11.2005, November 2005).

been grappling with the concept of marketing intangibles since as early as 2005, the recent release of practical compliance guideline "PCG 2024/1: Intangibles migration arrangements" (PCG 2024/1) reignites the ATO's attention to the matter. The guide sets out how the ATO intends to recognise and characterise transactions involving intangible assets properly.[9]

This article is structured as follows. Part II describes how the ATO's approach in characterising software distribution payments as royalties has shifted from the universally accepted *Income tax: computer software* (*TR 93/12*) to *TR 2021/D4* and *TR 2024/D1*. Part III examines how *TR 2024/D1* aligns with the broader efforts of the ATO concerning the characterisation and taxation of arrangements involving intangible assets. Parts IV and V examine international approaches and developments regarding the taxation of software distribution payments, demonstrating that while the ATO's approach diverges significantly from the international norm, it is not without international support. Part VI delves into whether New Zealand should adopt the ATO's approach. While addressing the criticisms of the ATO's approach, this article challenges that such criticism is wholly justified. This analysis concludes that the ATO's approach merits serious consideration in New Zealand. Although this article does not advocate for IRD to adopt the ATO's approach entirely, it does advocate for it as a viable option for reform in New Zealand.

This article does not address payments made by end-users to the copyright owner or distributor. Rather, it focuses solely on software distribution arrangements and payments from the distributor to the copyright owner, acknowledging the prevalence of intermediaries and distributors in facilitating transactions between copyright owners and end-users.

II ATO's Approach

A *Legislative background*

To understand the ATO's approach, it is important to understand the statutory landscape in which it operates.[10] Section 6(1) of the Income Tax Assessment Act 1936 (Cth) (ITAA 1936) defines a royalty to include:

> … any amount paid or credited, however described or computed, and whether the payment or credit is periodical or not, to the extent to which it is paid or credited, as the case may be, as consideration for:
>
> (a) the use of, or the right to use, any copyright, patent, design or model, plan, secret formula or process, trade mark, or other like property or right; …

Article 12(2) of the *Model Tax Convention*, commonly applied in Australia's double tax agreements (DTA), defines royalties similarly:[11]

> The term "royalties" as used in this Article means payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or

9 Australian Taxation Office "PCG 2024/1: Intangibles migration arrangements" (17 January 2024) <www.ato.gov.au>.

10 This is relevant as the Commissioner does not make the law, but instead applies the law as enacted by Parliament.

11 OECD, above n 6, at M-41.

> scientific work including cinematograph films, any patent, trade mark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience.

Although both definitions are materially similar, the DTA definition prevails over the Australian definition if there is an inconsistency.[12] Given the inclusive nature of the Australian definition, any amount that qualifies as royalty under Australia's DTAs will also be a royalty under domestic law.[13]

The expression "use of, or the right to use, any copyright" is not defined in the ITAA 1936 or the *Model Tax Convention*. However, it is generally construed to mean the right to do something in relation to the copyright, which is the exclusive right of the copyright owner.[14] Section 31(1) of the Copyright Act 1968 (Cth) provides that the exclusive rights of the copyright owner include:[15]

> (a) in the case of a literary, dramatic or musical work, to do all or any of the following acts:
>
> (i) to reproduce the work in a material form;
> (ii) to publish the work;
> (iii) to perform the work in public;
> (iv) to communicate the work to the public;
> (v) to make an adaptation of the work;
> (vi) to do, in relation to a work that is an adaptation of the first-mentioned work, any of the acts specified in relation to the first-mentioned work in subparagraphs (i) to (iv), inclusive; and
>
> ...
>
> (d) in the case of a computer program, to enter into a commercial rental arrangement in respect of the program.

Additionally, s 13(2) of the Copyright Act (Cth) provides that authorising a person to perform an exclusive right is itself an exclusive right.

Therefore, payments for performing, or granting the right to perform, any exclusive right of the copyright owner constitute a royalty. A royalty paid to a non-resident or an Australian resident conducting business through a permanent establishment outside Australia is subject to royalty withholding tax and any applicable DTA.[16]

Cross-border software payments may alternatively be classified as business profits. However, under the majority of Australia's DTAs, business profits are not taxable in Australia unless the non-resident carries on business through an Australian permanent establishment.[17] As software businesses and distributors typically maintain minimal

12 International Tax Agreements Act 1953 (Cth), ss 4(2) and 5.
13 *TR 2024/D1*, above n 3, at [11].
14 At [125].
15 Section 10(1) of the Copyright Act 1968 (Cth) defines "literary work" to include a computer program.
16 Income Tax Assessment Act 1936 (Cth), ss 128B(1)–(2) and 128B(5A).
17 See generally Convention between Australia and New Zealand for the Avoidance of Double Taxation with respect to Taxes on Income and Fringe Benefits and the Prevention of Fiscal Evasion [2010] ATS 10 (signed 26 June 2009, entered into force 19 March 2010), art 7(1); and Convention between the Government of Australia and the Government of the United Kingdom of Great Britain and Northern Ireland for the Avoidance of Double Taxation and the Prevention

physical presence, they often fail to meet the traditional permanent establishment criteria. As a result, royalty withholding tax is the more likely method of taxation.[18]

B *Draft taxation rulings*

The following three taxation rulings set out the ATO's evolving guidance on the taxation of software payments. Taxation rulings aim to provide a comprehensive understanding of how transactions will be treated under current laws.

(1) *TR 93/12*

TR 93/12, published in 1993, was the first ruling outlining the Commissioner's views on the characterisation of software distribution payments.[19] At the time, software was commonly sold alongside hardware and distributed under shrink-wrap licences, which, as stated in *TR 93/12*, "typically provides that by opening the package the end-user agrees to be bound by the licence agreement".[20]

TR 93/12 asserted that where a distributor has a licence to use the copyright in the software, which "allows the licensee to modify, adapt or copy, or otherwise do what would ordinarily be the exclusive right of the copyright owner", the distributor's payments for this licence constitute a royalty.[21] This encompassed a distributor's right to make copies of the software from the master copy.[22] If the distributor does not have a licence to use the copyright, payments for importing and distributing software relate only to the right to use the software, not the copyright, and do not amount to a royalty.[23]

TR 93/12 also discussed sublicensing arrangements. It stated that where a distributor sublicenses software to end-users holding simple use licences, payments from the end-user would not be characterised as a royalty.[24] *TR 93/12* acknowledged that a portion of the payment could strictly be a royalty, providing the example that loading a program onto a device is a copyright infringement without the copyright owner's permission.[25] However, while it would strictly be a royalty, the amount, if quantifiable, would be minimal and would not warrant apportionment.[26] Nevertheless, if the end-user acquires a licence to use the copyright in the software, which is no longer a simple use, the distributor is seen as the copyright owner's agent. Thus, payments by the distributor to the copyright owner would include a royalty for the right to use the copyright.[27] Here, *TR 93/12* focuses on the distributor passing on end-user royalty payments to the copyright owner, but does not explicitly recognise that when an end-user acquires a licence to use the copyright from a

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of Fiscal Evasion with respect to Taxes on Income and on Capital Gains [2003] ATS 22 (signed 21 August 2003, entered into force 17 December 2003), art 7(1).

18 Celeste M Black "Digitalisation and Broadcasting: Evaluating the Application of Royalty Withholding Tax to Digitalised Business Models" (2019) 48 AT Rev 264 at 266.

19 Australian Taxation Office *Income tax: computer software* (Taxation Ruling TR 93/12, 13 May 1993) [*TR 93/12*].

20 At [26].

21 At [20].

22 At [20].

23 At [20].

24 At [29] and [30]. See at [27] which provides that the simple use of software is where the end-user has the right to use the program as intended without any copyright rights in the software.

25 At [27].

26 At [27].

27 At [21].

distributor, the distributor's exclusive right to authorise an exclusive right generates an independent royalty to be paid to the copyright owner.

Since 1993, software distribution has evolved significantly, transitioning from traditional methods, such as selling hardware in physical retail shops, to more contemporary avenues like digital downloads and cloud computing. Consequently, *TR 93/12* was withdrawn from 1 July 2021 due to failing to reflect these technological advancements.[28]

(2) *TR 2021/D4*

TR 2021/D4, released on 25 June 2021, sparked controversy due to its inconsistency with *TR 93/12* and general international practices.

The Commissioner maintained the stance from *TR 93/12* that where the distributor uses the copyright in the software, such as by making copies of the software from the master copy prior to distribution, the payment for that right would be a royalty.[29]

Departing from *TR 93/12*, *TR 2021/D4* stated that where the distributor has the right to sublicense software, even when granting end-users simple use rights, the payment by the distributor to the copyright owner may be characterised as a royalty. When an end-user acquires software, it is reproduced when copied during the installation or downloading process.[30] Where the software is made available online via cloud-based technology, although there is no reproduction through downloading, the software is nonetheless communicated.[31] *TR 2021/D4* provides that since reproduction and communication are exclusive rights of the copyright owner, when the distributor enters into an agreement with an end-user, they authorise the end-user to perform these rights, which itself is an exclusive right.[32] *TR 2021/D4* clarifies that this position applies regardless of whether the end-user obtains simple use rights or more extensive rights such as the right to modify the software.[33]

TR 2021/D4 contrasts with *TR 93/12*, which recognised that the end-users' simple use of software may involve using such rights but disregarded them as the amount attributable to the right would be minimal, and therefore no authorisation rights were considered. Inversely, *TR 2021/D4* provides that if the distributor is granted the right to market and distribute packaged software or make it available online without any sublicensing of the software or otherwise use of the copyright, the payment from the distributor may not constitute a royalty.[34] This stance is also extended to embedded software, where software is embodied in physical carrying media.[35] Therefore, one of the controversies, as will be discussed in Part VI, is that payments from a distributor to a copyright owner for the ability to sublicense simple use rights would give rise to a royalty. In contrast, it would not be a royalty if the copyright owner licensed it directly to the end-user.

28 *TR 2021/D4*, above n 3, at [2].
29 At [74].
30 At [58].
31 At [62].
32 At [77].
33 At [75].
34 At [80] and [81].
35 At [86].

Examples 4 and 5 in *TR 2021/D4* illustrate the Commissioner's approach. In Example 4, an Australian subsidiary distributes its parent company's software under end-user licence agreements (EULA).[36] EULAs permit customers to download, install, create a backup copy and use the software, while disallowing other rights such as reproduction and modification. Upon a customer's order, the subsidiary informs its parent, who then issues a licence key that the customer can use to download the software from a website owned and controlled by the parent company. The Commissioner considers payments from the subsidiary to the parent a royalty because they are for the right to sublicense the software. As explained above, this involves authorising the right to reproduce and communicate the software.[37]

In Example 5, a parent company offers its software online through a subscription model.[38] The subsidiary sells subscriptions in Australia by entering into agreements with end-users specifying their usage terms. The subsidiary is restricted from undertaking any other action. When customers purchase subscriptions, they agree to the terms of the agreement with the subsidiary, which grants them a licence to access and use the software for its intended purpose. The Commissioner considers the subsidiary's payment a royalty as it is for the right to distribute the software by way of sublicensing to customers, and that "[l]icensing the use of the software is the exclusive right of" the copyright owner.[39] Although sublicensing software is not explicitly an exclusive right in s 31(1) of the Copyright Act (Cth), the Commissioner seems to be referring to it as encompassing the right to authorise the reproduction and communication of software.

Since *TR 2021/D4* was released in draft form, it was open for submissions until 30 July 2021.[40] The ATO revised the ruling following the submission period, resulting in an updated draft ruling.

(3) *TR 2024/D1*

On 17 January 2024, the ATO released *TR 2024/D1*, which materially maintains the same position as in *TR 2021/D4* but provided further guidance.[41] The Commissioner reaffirms that payments by a distributor for the sublicensing of software, including when granting simple use rights, may constitute a royalty. *TR 2024/D1* further clarifies the relevant exclusive rights.

First, *TR 2024/D1* reaffirms that when an end-user acquires software under a licence, the software is reproduced during installation or downloading.[42] Section 43B of the Copyright Act (Cth) provides that when software is temporarily reproduced as an incidental and necessary part of the technical processing of using it, it is not an infringement of copyright. However, *TR 2024/D1* provides that the distributor's authorisation right does not depend on whether the act would be an infringement of copyright or if it is excluded from constituting an infringement.[43] Therefore, authorising software iso an exclusive right, provided the software is reproduced, which is also an exclusive right.

36 At [19]–[24].
37 At [23].
38 At [25]–[30].
39 At [30].
40 At [99].
41 Australian Taxation Office *Public advice and guidance compendium* (Ruling Compendium TR 2021/D4EC, 17 January 2024) at 2.
42 *TR 2024/D1*, above n 3, at [136].
43 At [170].

Second, the ruling reiterates that software acquired under a licence is communicated per s 31(1)(a)(iv) of the Copyright Act (Cth). It references s 22(6), which states that a communication is taken to have been made by the person responsible for determining the content of the communication. This responsibility lies with the entity controlling the server and any distributor who enters a licence with the end-user specifying the terms of their use, as the distributor has the power to prevent the distribution.[44]

Regarding the authorisation of the two rights above, the Commissioner views that the distributor does not need the right to perform the acts they authorise.[45] Therefore, it is irrelevant to determine whether the distributor holds the right themselves when authorising the end-user to reproduce the software. Additionally, *TR 2024/D1* cites *University of New South Wales v Moorhouse* to give three further propositions of what constitutes authorisation:[46]

(1) A distributor cannot authorise an act unless they have the power to prevent it.
(2) Explicit authorisation is not required as it can be inferred.
(3) An act is not authorised if the authoriser lacks knowledge or suspicion that the act will be done.

The Commissioner's position regarding embedded software is consistent with *TR 93/12* and *TR 2021/D4*. Specifically, the Commissioner maintains that if the distributor sells the hardware without using, or being granted the right to use, any copyright or other intellectual property right in the software, the payment will not be a royalty.[47]

TR 2024/D1 illustrates its concepts with new examples, overriding Examples 4 and 5 in *TR 2021/D4*. In Scenario 1, as a non-exclusive distributor, an Australian entity enters into EULAs with end-users.[48] End-users can use the software through electronic download, cloud computing or physical carrying media. The Commissioner considers that the entire payment from the distributor is a royalty for two reasons.[49] First, although the software's communication originates from the copyright owner, the distributor, by entering into the EULA, can prevent the communication and is therefore responsible for determining the content of the communication. Second, the distributor authorises the reproduction of the software when the end-user downloads it.

In Scenario 2, an Australian entity is granted the right to resell the software.[50] Customers enter sales contracts with the Australian entity, and the copyright owner grants a licence to the customers directly to access the software via download or cloud computing. The Commissioner's view is that the payment is a royalty because customers pay the Australian entity to use the software, and these rights cannot be provided without the distributor's authorisation.[51]

TR 2024/D1 was released in draft form and open for public consultation until 1 March 2024. However, given the Commissioner's consistent stance across *TR 2021/D4* and *TR 2024/D1*, it is unlikely that the Commissioner will significantly alter their views if this

44 At [152].
45 At [170].
46 *University of New South Wales v Moorhouse* [1975] HCA 26, (1975) 133 CLR 1 at [12] as cited in *TR 2024/D1*, above n 3, at note 162.
47 *TR 2024/D1*, above n 3, at [180].
48 At [23]–[35].
49 At [27]–[33].
50 At [36]–[41].
51 At [40].

ruling is finalised.[52] The ATO has deferred finalisation of the draft ruling pending the High Court of Australia's decision in the PepsiCo litigation.[53]

III Australia's Broader Focus on Intangible Assets

While representing a radical change, the ATO's characterisation of software distribution payments fits within a broader initiative to scrutinise more transactions involving intangible assets, which encompasses the ATO's initial success in the PepsiCo litigation and the evolving treatment of marketing intangibles and related activities.

A *TA 2018/2 and* PepsiCo Inc v Commissioner of Taxation

In 2018, the ATO released *Mischaracterisation of activities or payments in connection with intangible assets* (*TA 2018/2*).[54] *TA 2018/2* acknowledged that the ATO would review cross-border arrangements to ensure they are appropriately characterised for royalty withholding tax purposes.[55] The ATO was concerned with transactions where an Australian entity purchased goods from a foreign entity, used the foreign entity's intangible assets in further activities, yet treated the payment as unrelated to those intangibles.[56] *PepsiCo Inc v Commissioner of Taxation* involved such an arrangement, with the Deputy Commissioner, Rebecca Saint, stating, "[t]he Pepsi matter is a lead case for our strategy to target arrangements where royalty withholding tax should have been paid."[57]

PepsiCo and Stokely-Van Camp Inc (SVC), both incorporated in the United States, own the Pepsi and Mountain Dew, and Gatorade brands, respectively.[58] Both companies entered into Exclusive Bottling Agreements (EBA) with Schweppes Australia Pty Ltd (SAPL), an unrelated Australian company.[59] The EBAs permitted PepsiCo and SVC to nominate PepsiCo Beverage Singapore Pty Ltd (PBS), a related Australian company, to sell beverage concentrate to SAPL, allowing SAPL to manufacture and sell beverages with the respective branding.[60] PBS itself received the concentrate from Concentrate Manufacturing (Singapore) Pte Ltd (CMSPL), a member of the PepsiCo group in Singapore.[61] SAPL paid PBS, and PBS transferred most of the funds to CMSPL.[62]

The EBA between SVC and SAPL expressly stated there was a royalty-free licence to use SVC's intellectual property when manufacturing and distributing the bottles.[63] The EBA between PepsiCo and SAPL implied a licence allowing the use of PepsiCo's intellectual

52 At [187].
53 Australian Taxation Office "ATO seeks special leave to appeal to the High Court in PepsiCo Inc v Commissioner of Taxation" (media release, 9 August 2024).
54 Australian Taxation Office *Mischaracterisation of activities or payments in connection with intangible assets* (Taxpayer Alert TA 2018/2, 20 November 2018).
55 At 1.
56 At 1–2.
57 Australian Taxation Office "ATO welcomes decision in Pepsi vs Commissioner of Taxation" (1 December 2023) <www.ato.gov.au>.
58 *PepsiCo* (2023), above n 7; *PepsiCo* (2024), above n 7; and *PepsiCo* (2025), above n 7.
59 *PepsiCo* (2023), above n 7, at [4].
60 At [5].
61 At [7].
62 At [7].
63 At [91].

property.[64] The Federal Court of Australia accepted the Commissioner's primary argument that a portion of payments made by SAPL, although expressed to be for the concentrate, were royalties per s 6(1) of the ITAA 1936 and art 12 of the DTA between Australia and the United States.[65]

The Court arrived at this conclusion based on the following significant factors. First, although the payments were expressed to be for the concentrate, the seller of the concentrate was not a party to the EBAs.[66] Second, PepsiCo had granted an implied licence for the use of its intellectual property, while SVC had granted an express licence.[67] Such a licence was required for SAPL to use the respective branding on the bottles without infringing on any intellectual property rights. If SAPL failed to pay, the licence would terminate due to the termination of the agreement.[68] Additionally, given the scale of the respective brands, it is doubtful that PepsiCo and SVC would license their intellectual property for free.[69] Therefore, SAPL's payments were linked to the licence to use the intellectual property.[70] Third, the licence was integral to the EBAs, supported by evidence from the President of the PepsiCo Group's Global Beverage Group and Franchise Team, Andrew Williams, stating that concentrate was always provided with an accompanying licence to use the intellectual property.[71] Therefore, the Court held that royalties were embedded in SAPL's payments. Royalty withholding tax applied because, although the payments were made to PBS and transferred to CMPSL, PepsiCo and SVC were parties to the EBA. As such, the payments were owed to them and dealt with as they directed.[72] Additionally, the Court held that if royalty withholding tax did not apply to the payments, Diverted Profits Tax (DPT) would have applied. DPT is a novel issue and is outside the scope of this article.[73]

The case was overturned on appeal to the Full Court of the Federal Court of Australia and the High Court of Australia. Nonetheless, it demonstrates the ATO's strategy to broaden the transactions subject to royalty withholding tax.[74] If the ruling is upheld on appeal, it could significantly impact industries with valuable intellectual property.

Additionally, although in *PepsiCo Inc*, PBS performed both manufacturing and distribution functions, it is unclear if this approach would also apply merely to the distribution of finished goods. One industry that could be impacted is high-value luxury consumer goods, such as Gucci. Manufacturers would require a licence to use Gucci's trademarks and intellectual property to manufacture and distribute goods. Applying a similar argument as in *PepsiCo Inc*, the high selling price and demand of Gucci products can largely be attributed to the value of its trademarked logos and designs. It is improbable that Gucci would license its intellectual property for free. Therefore, a portion of the payments by the manufacturer to Gucci may constitute royalties for the right to use Gucci's trademarks. The Australian luxury goods market was estimated to generate

64 At [57].
65 At [18].
66 At [245(a)].
67 At [245(b)] and [245(c)].
68 At [245(d)].
69 At [248].
70 At [245(d)].
71 At [247].
72 At [255], [258] and [264].
73 At [466].
74 *PepsiCo* (2023), above n 7; *PepsiCo* (2024), above n 7; and *PepsiCo* (2025), above n 7.

USD 7.35 billion in revenue in 2024.[75] While this article accepts that not all of this entire amount is made up of taxable arrangements, it gives insight into the many transactions that could now be subject to withholding tax. If so, the number of transactions subject to withholding tax would further increase. Therefore, the ATO's initial success in *PepsiCo Inc* demonstrates the significant expansion of the application of royalty withholding tax.

B *Marketing intangibles*

The ATO's characterisation of software distribution payments by a distributor should also be understood within the context of the complexities surrounding marketing intangibles. In 2005, the ATO released *International Transfer Pricing: Marketing intangibles*, illustrating the application of its principles on the matter.[76] The ATO's guidance is based on the OECD's *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 1995*.[77] There has been no material change in the guideline's analysis of marketing intangibles despite its revision in 2022. The revised guidelines define a marketing intangible as:[78]

> An intangible … that relates to marketing activities, aids in the commercial exploitation of a product or service, and/or has an important promotional value for the product concerned. Depending on the context, marketing intangibles may include, for example, trademarks, trade names, customer lists, customer relationships, and proprietary market and customer data that is used or aids in marketing and selling goods or services to customers.

The focus on marketing intangibles is relevant in software distribution arrangements because, as explicitly recognised in *TR 2024/D1*, software distribution involves using other intellectual property, such as trademarks.[79] The concept of marketing intangibles hinges on whether a distributor, a related party to the owner of the intellectual property, undertakes advertising, marketing and promotional (AMP) expenses to such an extent that the distributor should be paid for their services or be entitled to a portion of the additional return generated by the marketing intangible.[80] The ATO and OECD provide that where the owner of the marketing intangible controls and reimburses the distributor for any AMP expenses, the distributor is not entitled to any payment, as it is not exercising any control or bearing risk.[81] Whereas, if the distributor bears the cost of the AMP expenses, the analysis turns to other factors such as whether the AMP costs exceed a normal arm's length amount incurred by independent distributors, the extent of shared benefits (for example, through a greater market share) and the agreement duration.[82] While the ATO's guidance does not expressly state how it determines whether the distributor's AMP expenses exceed those of independent distributors, the ATO likely takes insight from

75 Statista "Luxury Goods – Australia" (March 2024) <www.statista.com>.
76 Australian Taxation Office, above n 8.
77 At 3.
78 OECD *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2022* (OECD Publishing, Paris, 2022) at 23.
79 *TR 2024/D1*, above n 3, at [177].
80 OECD, above n 78, at [6.76].
81 At [6.77].
82 Australian Taxation Office, above n 8, at 3.

international approaches, such as India's bright-line test in comparing the distributor's ratio of AMP expenses to net sales.[83]

In 2018, the Australian Treasury released a discussion paper titled *The Digital Economy and Australia's Corporate Tax System*. It raised the question:[84]

> Is the value of intangible assets including 'marketing intangibles' appropriately recognised by the current international corporate tax system? If not, how should value associated with intangibles be quantified and how should it be taxed?

However, no further comments were made on marketing intangibles after the submission period.[85] Nonetheless, the recent release of PCG 2024/1 demonstrates the ATO's continuing focus on distributor activities.

C *PCG 2024/1*

The release of *TR 2024/D1* was accompanied by the release of PCG 2024/1, which concerns whether Australian entities are appropriately compensated for their development, enhancement, maintenance, protection and exploitation (DEMPE) activities concerning a related foreign entity's intangible assets.[86] As DEMPE activities include marketing and installation activities, PCG 2024/1 relates closely to marketing intangible development. While it does not explain the technical application of the law, it creates various risk categories guiding taxpayers on when the Commissioner may use their resources to investigate the arrangements.[87]

PCG 2024/1 operates by asking various questions, where different answers are assigned a point value. The questions relate to matters including the circumstances of the owner of the intangible assets, such as their capacity to undertake DEMPE activities, and relevant tax considerations, such as whether the foreign company has a tax exemption.[88] The points are totalled and classified into risk categories ranging from green (where the ATO will not apply any resources to audit the arrangement) to red (where the ATO will prioritise reviewing the arrangement).[89]

While PCG 2024/1 has exceptions, these broadly apply to tangible finished goods, where any rights granted are to allow the entity to distribute the goods without any sub-licensing.[90] Therefore, software distribution arrangements are generally not exempt from PCG 2024/1. Whether PCG 2024/1 applies ultimately depends on the type and extent of the distributor's activities. It is likely that many distributors' levels of AMP and DEMPE expenses will not trigger any discussion. However, PCG 2024/1's potential applicability

83 But see *Sony Ericsson Mobile Communications India Pvt Ltd v Commissioner of Income Tax* (2015) 374 ITR 118 (Del), where the Delhi High Court rejected the use of the brightline test to conclusively identify an international transaction that creates or maintains a marketing intangible. However, this does not prevent the bright line test from being used as one factor in comparing the distributor's activities to independent distributors.

84 Australian Government the Treasury *The digital economy and Australia's corporate tax system* (Treasury Discussion Paper, October 2018) at 17.

85 Josh Frydenberg "Government response to digital economy consultation" (press release, 20 March 2019).

86 Australian Taxation Office, above n 9, at [1].

87 At [18].

88 At [58].

89 At [19]–[23].

90 At [42]–[43].

demonstrates the complexity of intangible assets. Additionally, by expanding the scope of what constitutes a royalty in *TR 2024/D1*, there may be more intensive debate over the proper compensation for a distributor's marketing activities to combat the increased royalties. The interplay between royalties, marketing intangibles and transfer pricing could lead to more comprehensive consultations between the ATO and taxpayers.

To conclude Part III, the ATO's characterisation of software distribution payments as royalties is consistent with its focus on intangible assets. The aforementioned strategies demonstrate the ATO's dedication to addressing international tax arrangements involving intangible assets that should be subject to royalty withholding tax.

IV International Approaches Contrary to Australia

Returning to the ATO's characterisation of software distribution arrangements, Part IV of this article contrasts the ATO's approach with international jurisdictions that adopt an opposing stance. It also examines the rationale of such jurisdictions, where provided, in adopting their respective positions.

A *New Zealand*

IRD initially issued guidance in the *Public Information Bulletin 168* in 1988, characterising all software payments as royalties, irrespective of the specific terms and conditions of the contract.[91] However, in July 1998, IRD withdrew this guidance, and issued revised guidelines in 2003 as interpretation guideline "Non-resident Software Suppliers' Payments Derived from New Zealand—Income Tax Treatment" (IG0007).[92] IG0007 states that it aligns with the conclusions outlined in the United States Treasury Regulations concerning software and the 1992 OECD publication, *Model Tax Convention: Four Related Studies*,[93] and is integrated into the Commentary on Article 12 of the *Model Tax Convention*.[94]

Relative to *TR 2024/D1*, IG0007 offers limited discussion regarding distributors. It highlights that when distributors purchase software and resell existing copies to end-users, the distributor has no right to exploit the software's copyright commercially, and distributors' payments are not characterised as royalties.[95] By contrast, illustrated in Example 6 of *TR 2021/D4*,[96] if the distributor has been granted copyright rights (for example, the right to reproduce software from a disk before distributing it), payments by the distributor will be characterised as a royalty due to the use of the copyright owner's exclusive right of reproduction.[97] Both stances align with the ATO's position. However, given the outdated nature of IRD's guidance, IG0007 fails to discuss whether such a characterisation would apply to the distribution of software without physical hardware, such as through internet downloads or cloud computing.

Furthermore, IRD does not address the distributor's right to authorise any exclusive rights the end-user exercises when using the software. While not directly analogous, the closest example in IG0007 is where the recipient has a site or network license, the right

91 Inland Revenue *Public Information Bulletin 168* (January 1988) at 1.
92 IG0007, above n 5.
93 OECD *Model Tax Convention: Four Related Studies* (December 1992).
94 IG0007, above n 5, at 8; and see OECD, above n 6, at C(12)-1.
95 IG0007, above n 5, at 17.
96 *TR 2024/D1*, above n 3, at [31]–[33].
97 IG0007, above n 5, at 20.

to make multiple copies of the software for operation in their business. IG0007 provides that although the recipient can create multiple copies of the software, it is solely for the recipient to use the software on the business's devices and does not entail the right to exploit the copyright.[98] Consequently, even if any quantifiable amount of the payment is in consideration for copyright rights, it is likely to be minimal and should be disregarded.[99]

This article infers that IRD would apply a similar position in assessing a distributor's right to sublicense software. The position would be that where the end-user has the right to reproduce the software to install or download it, there is no commercial exploitation, and it is not to be regarded as the use of, or authorisation of, an exclusive right. This position differs from the ATO's approach, which would characterise the transaction as a royalty due to the distributor's right to authorise the end-users' reproduction.

In characterising payments as royalties, IG0007 prioritises the exclusive rights to copy and adapt the software, therefore overlooking the rights to communicate the software and authorise exclusive rights. Consequently, comparing IRD's approach with the ATO's approach becomes challenging, particularly given that IG0007 does not address modern distribution methods.

B *United States*

The United States' framework for characterising software payments is outlined in ss 1.861-18 and 1.861-19 of the Treasury Regulations.[100]

Section 1.861-18, released in 2000, characterises software transactions into four categories, of which the two relevant categories are:[101]

(1) A transfer of a copyright right in the software, potentially amounting to a royalty.
(2) A transfer of a copyrighted article, being a transfer of a copy of the software, without the right to use the underlying copyright, not amounting to a royalty.

The transfer will fall into the first category, being a transfer of a copyright right, if the recipient acquires at least one of the following rights:[102]

(1) the right to make copies of the software for public distribution;
(2) the right to prepare derivative software based on the copyrighted software;
(3) the right to publicly perform the software; or
(4) the right to publicly display the software.

These rights correspond to the exclusive rights of the copyright owner under the Copyright Act 1976 (US), which is substantially similar to the Australian legislative framework. A notable difference, however, is that the rights to make copies of and publicly distribute the software are combined in s 1.861-18 of the Treasury Regulations, despite being independent rights in both the Australian and United States Copyright Acts. Similar to IG0007, the right to authorise, although exclusive under s 106 of the Copyright Act (US), is not considered in the regulations.

98 At 16.
99 At 16.
100 The Treasury Regulations for federal tax law can be found on "Title 26: Internal Revenue" of the United States' Code of Federal Regulations (26 CFR).
101 26 CFR §1.861-18(b)(1)(i)–(iv).
102 §1.861-18(c)(2)(i)–(iv).

If there has been a transfer of copyright rights in the software, the subsequent consideration is whether the transfer constitutes a sale, resulting in a taxable gain, or a licence, generating royalty income. The transfer is a sale if, based on all the facts and circumstances, all substantial rights in the copyright have been transferred.[103] Conversely, the transfer constitutes a licence if the rights transferred are less than "all substantial rights".[104]

As stated above, IRD's IG0007 characterisation was influenced by, and is consistent with, s 1.861-18 of the Treasury Regulations. Therefore, the United States approach is identical to the New Zealand approach described above. To reiterate, the United States takes the approach that payments for the right to sublicense the simple use of software do not constitute a royalty. The difference between the Australian and United States approaches, and the broader political sensitivity surrounding the issue, is highlighted in a letter sent by the United States Treasury Department to the Australian Treasury in August 2022, following *TR 2021/D4*'s release, expressing concerns about the ATO's approach. The letter states:[105]

> Because these two examples involve solely the right to distribute copies of the software, without the right to reproduce or modify the software or any other right of the software owner, the interpretation that the payments are royalties would be contrary to long-standing internationally accepted treaty interpretation, including paragraph 14.4 of the Commentary to art 12 (Royalties) of the OECD Model Tax Convention, which is also endorsed in the United Nations Model Tax Convention.

Following the release of *TR 2024/D1*, another letter was sent on 5 April 2024, which stated:[106]

> We were hopeful that the comments expressed in Mr. Murillo's letter of August 23, 2022, would have been reflected in the next version, and we are very disappointed that, as I explain below, TR2024/D1 continues to advocate interpretations of the Australia-US tax treaty that conflict with both the terms of the treaty as well as the Commentaries to the OECD Model Tax Convention.
>
> …
>
> The United States does not agree with the analysis and conclusions of the two scenarios. In our view, these two examples involve solely the right to distribute copies of the software. The distributors in the examples do not have the right "to use" the copyrights in the sense intended by the treaty, i.e. to exploit the copyright. Any copyright rights acquired are limited to those necessary to distribute the copies of the software and does not change the nature of the distribution activities in the examples.

103 §1.861-18(f)(1).

104 §1.861-18(f)(1).

105 Letter from Jose E Murillo (US Treasury Deputy Assistant Secretary, International Tax Affairs) to Marty Robinson (Australian Treasury First Assistant Secretary, Corporate and International Tax Division) regarding *TR 2021/D4*, above n 3.

106 Letter from Scott Levine (US Treasury Deputy Assistant Secretary, International Tax Affairs) to Marty Robinson (Australian Treasury First Assistant Secretary) regarding *TR 2024 D1*, above n 3.

A relevant development, since New Zealand adopted its guidelines based on the United States approach, has been the release of final regulations relating to the classification of digital content and cloud transactions in 2025.[107] The new proposed regulations extend s 1.861-18 of the Treasury Regulations from applying to "computer programs" to transfers of "digital content", which is defined to mean:[108]

> … a computer program or any other content … in digital format that is—
> (A) Protected by copyright law; or
> (B) no longer protected by copyright law solely—
> (1) Due to the passage of time; or
> (2) Because the creator dedicated the content to the public domain.

It also covers cloud computing, which is defined as a "transaction through which a person obtains on-demand network access to computer hardware, digital content … or other similar resources".[109] The Regulations provide that where cloud-computing and software transactions overlap, s 1.861-18 of the Treasury Regulations would continue to govern the transaction.[110] Therefore, for the purposes of this article, the Regulations do not result in any material change to the characterisation of software distribution payments.

C *Commentary on Article 12 of the* Model Tax Convention

As indicated in the letters from the United States Treasury Department, the ATO's approach departs from the approach taken in the Commentary on Article 12 of the *Model Tax Convention*. While the Commentary is not binding in Australia, it has significant influence and is a widely respected reference point for tax matters.

The Commentary provides that any rights the end-user obtains to use the software, such as the right to reproduce the software when installing it, should be disregarded when characterising the transaction as such rights do "no more than enable the effective operation of the program by the user".[111] This article infers that this position remains when the software is obtained from a distributor. As the right to reproduce is disregarded, the distributor's right to authorise the reproduction does not arise. The Commentary further supports this inference by providing that if the distributor has the right to distribute software without the right to reproduce it, then its rights are "limited to those necessary for the commercial intermediary to distribute copies of the software program".[112] Consequently, payments made by the distributor are not deemed to be for the exploitation of any copyright rights and do not constitute a royalty.

Appendix 2 in *TR 2024/D1* addresses this perspective, providing that by focusing solely on the rights to reproduce and modify the software, the OECD overlooks additional rights that may have been granted to the distributor.[113] These rights include the right to communicate the software and the distributor's right to authorise exclusive rights.

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107 Internal Revenue Service "Classification of Digital Content Transactions and Cloud Transactions" (2025) 90(8) Federal Register 2977 (codified at 26 CFR Part 1).
108 26 CFR §1.861-18(a)(2).
109 §1.861-19(b).
110 See Examples 5 and 6: *TR 2021/D4*, above n 3, at [25]–[33].
111 OECD, above n 11, at [14].
112 At [14.4].
113 *TR 2024/D1*, above n 3, at [185].

Additionally, the ATO notes that the OECD's approach relates specifically to cases where the distributor distributes pre-existing copies of the software, and that the rationale does not extend beyond that context, for example, when sublicensing through the internet.[114] With no further guidance from the OECD, it is difficult to ascertain whether the OECD intended its characterisation to apply to a wider variety of transactions.

D *India*

Indian domestic tax laws differ from those in Australia because they provide a broader definition of royalties. Explanations 2 and 4 to s 9(1)(vi) of the Income Tax Act 1961 (India) define a royalty to include the transfer of rights for the use of, or right to use, software, instead of merely the copyright in the software.[115]

India is a relevant jurisdiction for comparison because, despite its expansive statutory language, its judicial interpretation in *Engineering Analysis Centre of Excellence Pvt Ltd v The Commissioner of Income Tax* remains narrower than Australia's current approach.[116] This divergence highlights the extent to which the ATO's interpretation under *TR 2024/D1* departs from even broadly worded statutory regimes. The case considered a distribution agreement granting the distributor a non-exclusive, non-transferable licence to resell software to end-users for simple use, expressly providing that no copyright in the software is transferred to the distributor.[117] Relevant to this article, the Supreme Court held that payments from a resident distributor to a non-resident supplier for the purposes of resale to resident end-users do not constitute a payment for the use of, or right to use, copyright, as the transaction does not involve any copyright rights and is more akin to the sale of goods.[118] This ratio applies irrespective of the medium through which the software is distributed, including online download and delivery of software in a physical item.[119]

Regarding the end-user's ability to copy the software to use it, the Court stated this does not amount to reproduction, and would not constitute an infringement of copyright under s 52(1)(aa) of the Copyright Act 1957 (India).[120] This differs from the ATO, which adopts the approach that the use of copyright does not require it to infringe copyright, but rather only requires the use of an exclusive right. Once again, the Supreme Court does not explicitly discuss the distributor's right to authorise in s 14(b) of the Copyright Act (India). However, as the provision of simple use of software from the copyright owner to the end-user directly does not involve the right to reproduce per s 52(1)(aa) of the Copyright Act (India), thereby not amounting to a royalty, this characterisation does not change when a distributor is involved.

The ATO maintains that *Engineering Analysis Centre of Excellence Pvt Ltd* lacks relevance as a precedent due to the difference in the definition of royalties in domestic law.[121] While this article acknowledges the differences in the definition of royalties, the ATO's assertion appears to disregard the Court's interpretation of the legislation. The ATO's assertion would have been justified if the Court used the legislation to justify broader

114 At [66].
115 Income Tax Act 1961 (India), s 9(1)(iv).
116 *Engineering Analysis Centre of Excellence Pvt Ltd v The Commissioner of Income Tax* LL 2021 SC 124.
117 At [45].
118 At [169].
119 Bijal Ajinkya, Ashish Mehta and Jugal Mundra "Cross-border payments for purchase of software – an overview of direct tax aspects" (2021) IV The Chamber's International Tax Journal 1 at 6.
120 *Engineering Analysis Centre of Excellence Pvt Ltd*, above n 116, at [38].
121 Australian Taxation Office, above n 41, at 15.

characterisations than Australia. However, the Court narrowly construed the legislative framework consistent with Australia's legislation. As both countries share materially similar copyright legislation, Australia's dismissal of the case is unjustified.

V International Approaches Supporting Australia

While the ATO's approach deviates from some major jurisdictions, elements of the approach find support in other jurisdictions.

A *Malaysia*

The Inland Revenue Board of Malaysia issued a draft public ruling and *Practice Note No 3/2023 Tax Treatment on Copyright and Software Payments by a Distributor and a Reseller to a Non-resident* in 2023, providing guidelines and explanations for the tax characterisation of cross-border software and intellectual property transactions.[122]

The Income Tax Act 1967 (Malaysia) defines royalties as including payments with respect to software. Therefore, any payment relating to the purchase or use of software constitutes a royalty and is subject to withholding tax.[123] As the definition does not solely link payments to copyright, a royalty can arise irrespective of whether the recipient acquires any copyright rights, such as the ability to modify or reproduce the software.[124] However, a withholding tax exemption is provided under the Income Tax (Exemption) Order (No 4) 2019 to exempt payments from a Malaysian resident to a non-resident who acquires software for personal use, therefore amounting to simple use.[125] As distributors do not acquire the software, or any rights in the software, for personal use, the exemption does not cover payments from a distributor to the copyright owner. Therefore, any payment from the distributor to the copyright owner in relation to software constitutes a royalty under Malaysian domestic law.

However, Malaysian courts have confirmed that the DTA definition will apply when the definition of a royalty in a DTA is narrower than the domestic definition in the Income Tax Act (Malaysia).[126] Due to this, if the relevant DTA does not define a royalty to include the use of, or right to use, software, payments may not be subject to withholding tax.[127] Only where the DTA also defines a royalty to include the use of, or right to use, software, will payments be subject to withholding tax.

Malaysia's domestic law has not always defined royalties to include the use of, or right to use, software. The prior approach defined royalties as including payments for the use of, or right to use, copyright. However, the Finance Act 2017 (Malaysia) amended the Income Tax Act (Malaysia), effective from 17 January 2017, expanding the definition of

122 Inland Revenue Board of Malaysia *Draft Public Ruling - Tax Treatment on Royalties for Payment of Software to a Non-resident* (2023); and Inland Revenue Board of Malaysia *Practice Note No 3/2023 Tax Treatment on Copyright and Software Payments by a Distributor and a Reseller to a Non-resident* (5 December 2023).

123 Income Tax Act 1967 (Malaysia), ss 2(1) and 109.

124 Inland Revenue Board of Malaysia *Practice Note No 3/2023*, above n 122, at [5].

125 Inland Revenue Board of Malaysia *Draft Public Ruling*, above n 122, at [16.1].

126 See generally *Director General of Inland Revenue v Euromedical Industries Ltd* [1983] CLJ (Rep) 128; and *Ketua Pengarah Hasil Dalam Negeri v Thomson Reuters Global Resources Sdn Bhd* (2016) MSTC 30-124.

127 See generally Double Taxation Relief (Malaysia) Order 1976, sch 1 art 10.

royalty to include the term "software".[128] No parliamentary material, such as Hansard, further explained the purpose of the amendment, which rendered the earlier position inapplicable.

Malaysia and Australia's approaches differ largely due to their legislative frameworks. Malaysia's broader definition of royalties, encompassing payments related to software without confining it strictly to copyright use, provides a legal basis for their wider approach. In contrast, Australia's legislation constrains the definition of royalties to the use of copyright. However, by expanding the scope of royalties in their legislation, Malaysia acknowledges the evolving nature of technology and proactively recognises more software transactions as royalties. Consequently, while Australia's legislation may be more restrictive, the ATO's approach fits into the broader trend of characterising more payments as royalties in response to technological advancements.

B *United Nations*

Article 12 of the *United Nations Model Double Taxation Convention Between Developed and Developing Countries 2021* (*UN Model*) defines royalties as "payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work".[129] This definition is materially similar to the definitions of Australian domestic and *Model Tax Convention*.

Through the United Nations Tax Committee (UN Tax Committee), developing countries advocated for an amendment to introduce the term "computer software" into the definition of royalties in art 12, expanding the definition of royalties to include consideration for the use of, or the right to use, computer software.[130] The Committee's two central rationales were that amending the definition would be a natural extension of existing legal provisions (given that many countries, such as Malaysia, have similarly defined royalties), and that the change would eliminate the distinction between payments for the use of copyright in software and for copyrighted software, therefore promoting tax certainty.[131] While the Committee rejected the proposal to amend art 12, in the 22nd session of the UN Tax Committee in April 2021, the Committee agreed to amend the Commentary.[132] The Commentary now provides that:[133]

> In the view of a large minority of the Members of the Committee … Article 12 should address circumstances in which the owner of the computer software earns profits from letting another person use that computer software … In the view of those Members, a person that is making payments for the use of, or the right to use, computer software is making a payment in consideration for the letting of that intangible property just as a person that is making payments for the use of industrial, commercial or scientific

128 Inland Revenue Board of Malaysia *Draft Public Ruling*, above n 122, at [4.2].

129 United Nations Department of Economic and Social Affairs *United Nations Model Double Taxation Convention Between Developed and Developing Countries 2021* (New York, 2021) at 21.

130 Abdul Muheet Chowdhary and Sebastien Babou Diasso "Taxation of Computer Software: Need for Clear Guidance in the UN Model Tax Convention" (2023) 31 Tax Cooperation Policy Brief South Centre 1 at 6.

131 Yvette Lind "Revisions of the UN Tax Treaty Model – An introduction to (global) inclusion and equity from the perspective of developing states" (2021) 10 Svensk Skattetidning 595 at 607.

132 *Committee of Experts on International Cooperation in Tax Matters: Report on the twenty-second session (virtual session, 19–28 April 2021)* UN Doc E/2021/45/Add.2-E/C.18/2021/2 (2021) at [19].

133 United Nations Department of Economic and Social Affairs, above n 129, at 370.

> equipment (already included in paragraph 3) is making a payment in consideration for the letting of tangible property.

From a legal standpoint, an amendment to the Commentary, which also represents the views of a minority, does not hold significant weight. However, the amendment does signify the persuasiveness of the matter. Given that the issue remains a high priority for the UN Tax Committee, it can influence future policies and amendments.[134] This characterisation treats all payments from a distributor to the copyright owner as a royalty. Although this treatment would be based on the definition of a royalty, similar to Malaysia's approach, it acknowledges the ATO's approach.

The United Nations' acknowledgment of such concepts is also seen through introducing art 12B in 2021 into the *UN Model*. Article 12B concerns income from automated digital services, which means any service provided online that requires minimal human involvement from the person providing the services.[135] Article 12B potentially covers the downloading of software, but will not apply if the income is a royalty under art 12.[136] Nonetheless, if contemporary software distribution arrangements are not taxed under art 12, art 12B provides an alternative avenue for taxing such payments. Article 12B reflects the United Nations' approach to adapting policies alongside evolving technology, signifying that the ATO proactively addressed emerging tax challenges in the digital era.

In summary, Parts IV and V have displayed how software distribution payments are taxed in various jurisdictions and how each approach aligns with, or differs from, the ATO's approach. In light of these international approaches, Part VI will assess the merits and criticisms of the ATO's approach, considering whether it is suitable for adoption by IRD.

VI Should New Zealand Follow Australia?

New Zealand intends to update its guidance on the taxation of software payments, which has not been revised since 2003. Given the close relationship between Australia and New Zealand, IRD naturally considers the ATO's approach when assessing relevant tax policies, including the taxation of software payments. However, New Zealand still faces the separate question of whether to align with Australia's approach.

The Australian and New Zealand royalty and copyright legislative framework is materially similar. Section CC 9(2) of Income Tax Act 2007 (NZ) defines a royalty consistently with the ITAA 1936:

> a payment of any kind derived as consideration for—
>
> (a) the use of, or right to use, a copyright, patent, plant variety rights, trademark, design or model, plan, secret formula or process, or other similar property or right …

134 See generally *Committee of Experts on International Cooperation in Tax Matters: Report on the twenty-seventh session (Geneva, 17–20 October 2023)* UN Doc E/2024/45*-E/C.18/2023/4* at [17] which continues to discuss proposals for the inclusion of software in the definition of royalties in the *United Nations Model Double Taxation Convention Between Developed and Developing Countries 2021*.

135 United Nations Department of Economic and Social Affairs, above n 129, at 24.

136 At 26.

Section 16(1) of Copyright Act 1994 (NZ) also provides for the same exclusive rights of the copyright owner, namely:

> (a) to copy the work:
> (b) to issue copies of the work to the public, whether by sale or otherwise:
> (c) to perform the work in public:
> (d) to play the work in public:
> (e) to show the work in public:
> (f) to communicate the work to the public:
> (g) to make an adaptation of the work:
> (h) to do any of the acts referred to in any of paragraphs (a) to (f) in relation to an adaptation of the work:
> (i) to authorise another person to do any of the acts referred to in any of paragraphs (a) to (h).

Subject to any DTA, non-resident withholding tax is a final tax when imposed on a royalty for the use of, or right to use, copyright in a literary work.[137] Given the similar legislative frameworks in both countries, prima facie, the Australian approach should be transferable to New Zealand. However, the criticisms and merits of the Australian approach will dictate whether it is appropriate for adoption in New Zealand and whether IRD can adopt it in accordance with its role of collecting tax according to the law.

A *Criticisms*

Industry commentators have heavily criticised the ATO for diverging from the widely accepted international perspective that payments made by a distributor for the right to sublicense the simple use of software should not be characterised as royalties.

(1) Unwarranted importance for non-exclusive rights

As mentioned in *TR 2024/D1*, "the use of, or the right to use" means the right to do something concerning the copyright that is the copyright owner's exclusive right. Despite this, the Australian approach relies heavily on the distributor entering into an EULA with the end-user when sublicensing software. The ATO asserts that when a distributor enters into an EULA, the distributor, standing in the shoes of the copyright owner, exercises the exclusive right of authorising an end-user to use the copyright in the software. However, entry into an EULA is not one of the copyright owner's exclusive rights.

An EULA is generally a statement from the copyright owner affirming that they have not transferred any copyright in the software. It generally limits the end-user and their ability to use the software.[138] In doing this, although an EULA may grant the use of the software, the "use" is not an exclusive right of the copyright owner. Therefore, it is unclear why the distributor's authority to enter into an EULA is relevant in characterising payments as a royalty.[139]

To further support this point, withholding tax should be imposed practically. When a distributor enters into an EULA, their role is to facilitate the sale of the software more effectively than the copyright owner could. In the practical application of withholding tax,

137 Income Tax Act 2007, ss RF 2(3)(b) and 2(4). Section 2 of the Copyright Act 1994 defines "literary work" to include a computer program.

138 At 2.

139 At 3.

the distributor's ability to enter an EULA is merely incidental to the distribution process and should be disregarded.

The ATO could instead focus on the distributor's right to publish the software, which is an exclusive right.[140] Section 29(1)(a) of the Copyright Act (Cth) outlines that a literary work is considered as published if the reproductions of the work have been supplied, whether by sale or otherwise, to the public. Distributing software will involve the right to publish the software, which amounts to the use of a copyright right and results in a royalty. However, the ATO does not discuss why the publication right was ignored in *TR 2024/D1* nor provides a rationale for why the right to enter an EULA was prioritised over the right to publish.

(2) Double taxation

The ATO's approach to royalties subjects more transactions to withholding tax, even where the distributors already pay income tax, and goods and services tax.[141] To maintain similar profit margins, distributors increase the software's selling price to cover the withholding tax amount. As the provision of simple use rights from the copyright owner directly to the end-user is not a royalty, copyright owners with the ability to distribute may obtain a competitive advantage. They can distribute the software to end-users at a lower price, which does not need to cover any amount of withholding tax. However, many copyright owners cannot distribute their software on a large scale; rather, they focus on their core software development operations. In cases where the distributors cannot increase the price of the software, for example, if demand significantly reduces, distributors could decrease their payments to the copyright owner, reducing their cost, and maintaining a similar profit margin. Copyright owners who lack distribution capacity would effectively be forced to accept the distributor's lower price, possibly disincentivising development in the industry.

Additionally, the ATO's current approach does not characterise payments from the end-user to the distributor for the simple use of software as royalties. As discussed, the United Nations advocated such a position, which naturally extends the ATO's approach. For example, Ganesh Rajgopalan illustrates that this could result in double taxation.[142] The copyright owner is a resident in country A, the distributor is a resident in country B, and the end-user is a resident in country C. The ATO's approach would make the payment from B to A a royalty. The United Nations' minority approach, the natural extension of the ATO's approach, would make the payment from C to B a royalty. As the payments are between different parties in different jurisdictions, they are unlikely to obtain relief, resulting in double taxation. Such double taxation would contradict the established international principle of avoiding double taxation, a fundamental purpose of DTAs.

140 At 2.

141 Christine Chen "Experts sound alarm over 'flawed' ATO royalty ruling" (8 February 2024) Accountants Daily <www.accountantsdaily.com.au>.

142 Ganesh Rajgopalan "United Nations Model Tax Convention - Proposed inclusion of software in the definition of royalties in Article 12: Comments on the 2020 Discussion Draft" (SSRN publication, 2020) at [2.2.2].

(3) Inadequate dismissal of the OECD

In Appendix 2 of *TR 2024/D1*, the ATO explained the relevance of the Commentaries on the *Model Tax Convention*. The ATO narrowly interpreted the Commentaries on the *Model Tax Convention*, stating that it seems to ignore other rights that the distributor obtains in relation to the copyright in software.[143] However, this is an inaccurate description of the OECD's approach. The Commentaries on the *Model Tax Convention* does not overlook other rights. Rather, the Commentaries envisage that a distributor may obtain certain rights relating to the copyright through distribution activities. However, Part IV explained, the Commentaries state that, provided the rights are limited to those necessary to achieve distribution, they should be disregarded in determining the tax treatment of the transaction. For example, although an end-user reproduces the software during installations, it is a right necessary to achieve the distribution and use of the software. It should not be viewed as a use of an exclusive right. Therefore, as the end-user is not exercising an exclusive right, the distributor's authorisation of that use is not considered a copyright right. Hence, the OECD does consider other rights the distributor may obtain, but disregards them for practical reasons. The OECD's approach promotes consistency in the tax treatment of transactions, irrespective of whether an end-user obtains their simple use rights directly from a distributor or the copyright owner.

ATO's approach lacks this consistency. The ATO's position is that any reproduction, for example, during installation, is incidental and irrelevant to transactions between an end-user and the copyright owner. However, when the end-user obtains the same rights from a distributor, it is no longer merely incidental, and the end-user's reproduction right authorised by the distributor is relevant to the characterisation of the transaction.[144] The ATO explains that various delivery methods may involve different rights, but does not further explain the difference in treatment when a distributor is involved.[145]

(4) Lack of consultation with competent bodies

The ATO's approach has been released in draft form and, therefore, is currently not legally binding. Given the consistency between *TR 2021/D4* and *TR 2024/D1*, it is likely that the approach will be finalised. ATO has indicated that, given the purpose of *TR 2024/D1* was to express its own views, it has not consulted with other competent authorities.[146] While ATO has no obligation to consult with other competent authorities on the interpretation of domestic legislation, it has not provided guidance on what will occur if the other competent authorities disagree with the approach taken by the ATO. Given that the ATO's approach has significantly changed the understanding of a royalty for withholding tax purposes, the ATO should have considered engaging in comprehensive consultation with Australia's tax treaty partners to ensure a well-informed and collaborative approach. The lack of consultation has likely contributed to the political disagreement expressed by other jurisdictions, such as the United States.

143 *TR 2024/D1*, above n 3, at [185].

144 Australian Taxation Office, above n 41, at 8.

145 At 8.

146 Annemarie Wilmore, Kathryn Bertram and Don Spirason "Australian Taxation Office Continues Its Focus on Intangibles" *Bloomberg Tax* (online ed, Australia, 16 February 2024).

B *Merits*

Despite the criticisms and political issues raised, the ATO's approach has some valid justifications and benefits that warrant further consideration.

(1) Reproduction is an exclusive right

As identified by the ATO, end-users are granted the exclusive right to reproduce or copy software, enabling them to download or install it onto a device. Section 2 of the Copyright Act (NZ) defines copying as "in relation to any description of work, reproducing, recording, or storing the work in any material form (including any digital format), in any medium and by any means". When software is downloaded or installed onto a device, the existing copy is not transferred. Instead, an additional copy is created, hence the software exists on both the disk and the end-user's device.[147] New Zealand courts, for example, in *Mitre 10 (New Zealand) Ltd v Benchmark Building Supplies Ltd*, have also held that the act of downloading or loading onto a computer inherently involves copying.[148] Therefore, it is not contentious that the software is copied or reproduced when downloaded or installed. In distribution arrangements, where the end-user acquires the software from a distributor, the distributor grants authorisation for this reproduction, which is an exclusive right itself. However, Part IV displayed how other jurisdictions disregard the end-user's reproduction because it is merely incidental to the use of the software, while failing to justify how this conclusion is reached. The fact that it is essential to reproduce the software before being able to use it (in transactions not involving cloud computing) demonstrates that it is an integral part of the transaction. The disk on which the end-user receives the software, or the online platform from which it can be downloaded, does not have any value to the end-user without the actual ability to download and, therefore, reproduce.[149] Given that the end-user's reproduction is not a valueless process, it should not be disregarded. Hence, the ATO is justified in asserting that the end-user reproduces the software when downloaded or installed, and the distributor authorises this exclusive right.

Furthermore, the ATO asserts that authorisation depends on whether the end-user's exercise of a right, or right to exercise that right, constitutes an exclusive right, not whether it is an infringement of copyright. Irrespective of whether this assertion is accepted, it is not applicable in New Zealand as s 43A of the Copyright Act (NZ) only exempts transient copying from being a copyright infringement. Although the Copyright Act (NZ) does not define "transient", the Oxford Dictionary defines it to mean "temporary" or "for a short time".[150] However, when software is downloaded or installed onto a device, it remains on the device until the end of the use period or when it is deleted. It is therefore not excluded from being an infringement of copyright. Furthermore, as downloading or installing software is not precluded from being an infringement of copyright, it further justifies why it should not be disregarded as a merely incidental use of the software.

147 Felicity Hullah "Computer Software Transactions and the Income Tax Definition of a Royalty" (2014) 20 NZJTLP 251 at 262.

148 *Benchmark Building Supplies Ltd v Mitre 10 (New Zealand) Ltd* [2004] 1 NZLR 26 (CA) at [28].

149 Hullah, above n 147, at 274.

150 Catherine Soanes and Angus Stevenson (eds) *Concise Oxford English Dictionary* (11th ed, Oxford University Press, Oxford, 2008) at 1532 as cited in Hullah, above n 147, at 263.

(2) Consistent with legislative provisions

The ATO's approach adopts a technical interpretation of the legislation, focusing on the use of, or right to use, copyright, as stated in the legislative provisions. In IG0007, IRD instead focuses on whether the copyright in the software is exploited, despite the Income Tax Act (NZ) not providing for the right to "exploit" the copyright.[151] Additionally, the Oxford Dictionary defines "exploit" as "to make use of", which the legislation requires in the first instance.[152] However, IRD interprets the use of copyright and the exploitation of copyright as two different concepts. This flaw is also found in the Commentaries on the *Model Tax Convention*, which focuses on commercial exploitation, despite the definition of a royalty in art 12 of the *Model Tax Convention* not requiring such an approach.

(3) Distribution is an independent right

Section 16 of the Copyright Act (NZ) sets out the various exclusive rights of the copyright owner, demonstrating that each right in the copyright can be dealt with independently of the others. Despite this, New Zealand, alongside many other jurisdictions, considers that payments by a distributor with the right to distribute copies of the software and the right to reproduce will be a royalty. However, payments for the right to distribute without the right to reproduce are not. The distribution right is evoked only when there is also a reproduction right, which fails to recognise that both rights operate independently of each other and other rights.[153] Such jurisdictions also fail to justify such an approach, which deviates from their copyright legislative framework.

IRD likely overlooked this distinction as its guidance is based on s 1.861-18 of the Treasury Regulations. As discussed in Part IV, the United States considers there to be a transfer of a copyright right when there is a right to make copies for distribution to the public by sale or otherwise. The United States' approach combines the right to copy and distribute, which are separate copyright rights in New Zealand. Therefore, as s 1.861-18 of the Treasury Regulations did not adequately consider the right to distribute, without an accompanying right to reproduce, it may have been overlooked by IRD in adopting a similar position. Rather, IRD distinguishes copying for commercial exploitation, which is a royalty, from copying for personal or business use, which is not a royalty. Section 16(1) of the Copyright Act (NZ) does not draw such a distinction.

The ATO's approach differs, rejecting such a view in Appendix 2. It recognises that the rights involved in a distributor's distribution have economic value and operate independently from the reproduction right. The ATO's approach recognises the legislative context better than IRD and the United States Internal Revenue Service.

(4) Relative to other copyrighted materials

Many commentators have critiqued the ATO's approach, stating it will result in differential treatment across various copyrighted materials. IRD also appears to be resistant to differential treatment in stating "[i]n terms of copyright law, a computer program is treated like any other copyrighted product; for example, a book, video or sound recording."[154]

151 Hullah, above n 147, at 273.
152 Soanes and Stevenson, above n 150, at 502.
153 Rajgopalan, above n 142, at [1.6.4].
154 IG0007, above n 5, at 10.

However, criticism that the ATO's approach will result in differential treatment may not be warranted because it may be what is required.

When an end-user purchases software, whether from the copyright owner directly or through a distributor, it is purchased under a licence. Therefore, it is not akin to the sale of a tangible product. When an end-user acquires software, as explained above, it may involve reproducing to download or install. Thus, the end-user requires a copyright licence to use the software. Contrastingly, a book is merely sold to the purchaser and does not involve the transfer of any copyright rights.[155]

Additionally, when a book is sold, it is often sold with copyright restrictions to prevent the end-user from undertaking further actions, for example, reproducing part of the book. IRD's guidance provides that similar restrictions exist in a software transaction:[156]

> The fact that there may be copyright restrictions on the nature of the use to which the program may be put by the recipient (for example, not to make and sell copies) is not relevant. Such restrictions do not affect the character of the transaction as a sale, in the same way as similar restrictions do not affect the treatment of a sale of a copy of a book.

While the EULA may impose restrictions on software, it also grants rights. For example, the EULA explicitly or implicitly allows for reproduction, allowing the end-user to download or install the software. Although such permissions are necessary to use the software, it is not present when selling a book. Thus, the restrictions and permissions in the EULA for software and book transactions are different, justifying the differential treatment of the transactions.[157]

The analogy may have been stronger when IRD initially released IG0007. However, since 2003, there have been technological developments, such as the increasing popularity of e-books. This raises a potential argument that a sale of a book may no longer be merely a sale of a tangible copy of a copyrighted article, without any accompanying rights.[158] Consequently, the ATO's approach, which might lead to differing treatment of various copyrighted materials, could be justified in light of technological advancements.

C *Administrative feasibility*

A key feature of traditional tax policy is administrative feasibility and simplicity. Simple tax policies minimise excessive administrative and compliance burden, strengthening compliance with tax legislation. The ATO's approach can present a substantial challenge for practical compliance, and it has failed to address this practicality issue in *TR 2024/D1*.

As software is most commonly distributed through sublicensing, with very minimal amounts of software distributed in pre-packaged and physical items, the ATO's approach would require most distributors to withhold and pay tax, which would be extremely inefficient. As the obligation to withhold and pay the tax is on the payer, distributors must implement systems to track and withhold tax on payments to the copyright owner.[159] This creates a substantial administrative burden, particularly for small and medium-sized distributors that may lack the resources to implement smart systems and manage

155 Hullah, above n 147, at 270.
156 IG0007, above n 5, at 12.
157 Hullah, above n 147, at 270.
158 At 271.
159 Income Tax Act, s RF 3; and Taxation Administration Act 1953 (Cth), s 12-280.

compliance efficiently. It will also require the ATO and IRD to expend more resources to ensure compliance with these tax obligations.

These administrative challenges would be heightened if the ATO's approach characterised all software uses as royalties, as proposed by the United Nations minority. Recharacterisation would require every resident who purchases software from a non-resident to withhold tax on the transaction. It would substantially increase the number of transactions subject to withholding tax. As many end-users acquire software for personal or household use, the withholding tax will merely be a few dollars.

Alternatively, if the ATO's approach continues to be inefficient, other methods can be implemented to address this inefficiency. One such method involves introducing a de minimis threshold, whereby only transactions exceeding a certain amount would be subject to withholding tax.[160] Such a threshold, which ultimately depends on the region and the average price of software transactions, will exclude small transactions likely to be made by small businesses, and would reduce the taxation of low-value transactions, significantly reducing the administrative workload for distributors, the ATO, and IRD. A de minimis will not result in a loss of revenue to the Government. In New Zealand, such payments by distributors are not taxed under the current regime. Therefore, even if the ATO's approach is adopted in New Zealand, with a de minimis threshold, IRD would collect more revenue than previously.

Therefore, while administrative challenges of adopting the ATO's approach in New Zealand exist, they are overstated. Alternatives such as a de minimis demonstrate the feasibility of withholding tax on software distribution arrangements, and therefore, practical compliance does not prevent the ATO's approach from being adopted in New Zealand.

D *Summary*

To summarise, Part VI examined the strengths and weaknesses inherent in the ATO's approach, focusing on its applicability within New Zealand's tax landscape. While it is justified to fault the ATO's approach on its flaws, Part VI demonstrated how it presents a viable option worthy of consideration and potential adoption in New Zealand.

VII Conclusion

To conclude, the digitalisation of the software industry continues to reshape the landscape of software access and distribution.

IRD's current approach characterises payments by a distributor for the right to sublicense the simple use of software as business profits. IRD's rationale for such a characterisation is that the distributor does not exploit any copyright rights in the software. In contrast, the ATO's approach, observed in *TR 2024/D1*, departs from this interpretation and characterises the payments as royalties. The ATO's underpinning rationale is that such payments involve using the copyright owner's exclusive rights, namely the communication of the software and the right to authorise the end-user's reproduction.

160 Hullah, above n 147, at 275.

Broad international comparisons demonstrate that various international jurisdictions support the ATO's and IRD's approaches. While the ATO's approach has attracted criticism due to its inconsistency with major international standards, it also signifies a proactive response to the changing nature of software transactions to ensure transactions involving intangible assets are appropriately characterised. Additionally, recent developments regarding marketing intangibles and activities, such as the release of PCG 2024/1, demonstrate the inherent complexities of arrangements involving intangible assets, justifying the ATO's concern and efforts in implementing a risk-based approach to best allocate resources to examine such transactions.

This article has not attempted to disguise the gaps and inconsistencies in the ATO's approach, such as its inadequate interpretation of the Commentaries on the *Model Tax Convention* and lack of consultation with component authorities. Rather, it has attempted to highlight that despite such flaws, the approach has merits that may address the limitations of the current New Zealand approach. Such merits include appropriately recognising the reproduction and distribution rights as independent, exclusive rights. Therefore, while this article does not advocate for the ATO's approach to be adopted entirely in New Zealand, it does advocate for IRD to seriously consider the approach's merits and hold it as an option worthy of potential implementation. A more meaningful solution to the issue of taxing software distribution payments will likely come from examining the complexities in the ATO's approach, instead of dismissing it due to the widespread criticism it has received.

What remains to be seen is when IRD will release its updated guidance, and if so, what it will entail. The nature and scope of the updated guidance will undoubtedly shape the future of software taxation in New Zealand, and it must reflect a nuanced understanding of the evolving digital landscape.