TR 93/12 - Income tax: computer software

This ruling contains references to repealed provisions, some of which may have been rewritten. The ruling still has effect. Paragraph 32 in TR 2006/10 provides further guidance on the status and binding effect of public rulings where the law has been repealed or repealed and rewritten. The legislative references at the end of the ruling indicate the repealed provisions and, where applicable, the rewritten provisions.

Taxation Ruling
Income tax: computer software

This Ruling, to the extent that it is capable of being a 'public ruling' in terms of Part IVAAA of the ***Taxation Administration Act 1953****, is a public ruling for the purposes of that Part . Taxation Ruling TR 92/1 explains when a Ruling is a public ruling and how it is binding on the Commissioner.*

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What this Ruling is about

1. This Ruling looks at the income tax implications arising from the development and marketing of computer software.

2. The Ruling canvasses:

   (a) the nature and assessability of receipts from the marketing of computer software, with particular reference to whether or not such payments are royalties; and

   (b) whether computer software is trading stock for income tax purposes.

Ruling

(a) Nature and assessability of receipts

3. The nature of amounts received in respect of computer software depends on the terms of the particular agreement between the parties, having regard to all the circumstances of the case. A payment is considered to be a royalty for purposes of the *Income Tax Assessment Act 1936* (the Act) where the payment is:

(a) consideration for the granting of a licence to reproduce or modify the computer program in a manner that would, without such licence, constitute an infringement of copyright (paragraph (a) of the definition of royalty). Examples include payments for the right to manufacture copies of a program from a master-copy for distribution, and payments for the right to modify or adapt a program.

(b) consideration for the supply of know-how (paragraph (c) of the definition of royalty). Payments for the supply of the source

code or algorithms of a program are, prima facie, considered to come within this paragraph.

4. The following payments are generally not royalties for income tax purposes:

(a) payments for the transfer of all rights relating to copyright in the program;

(b) payments for the granting of a licence which allows only simple use of the software, i.e. allows the end-user to run the software on a single computer or a computer network but does not otherwise permit any use of the copyright in the program;

(c) proceeds from a sale of goods. Receipts for software are proceeds of a sale of goods where:

(i) hardware and software are sold in an integrated form without being priced separately, i.e. without being unbundled; or

(ii) property in tangible goods, such as a disk, diskette or magnetic tape on which software is embodied, is transferred to the consumer; and

(d) payments for the provision of services in the modification or creation of software.

5. Whether payments described in the preceding paragraph are assessable income depends on the operation of subsection 25(1), having regard to any double taxation agreement that might be relevant. Where the software is not trading stock, the capital gains provisions in Part IIIA of the Act may also apply in certain cases. In most cases however the capital gain will be nil by reason of subsection 160ZA(4), which has the effect of reducing the capital gain by the amount included as assessable income under subsection 25(1).

(b) Trading stock

6. Computer software acquired for sale by a distributor in the course of business is 'trading stock' as defined in subsection 6(1). Computer software produced or developed for sale by a software manufacturer or developer and remaining on hand at the end of a year of income is also considered to be trading stock. Such software must be brought to account as trading stock in calculating the taxable income of the software manufacturer, developer or distributor.

7. Where software is produced or developed for licence rather than for sale, i.e. where title to the software remains with the software developer or supplier, and the developer or supplier carries on a business of trading in software licences, the licences are considered to

be trading stock and should be brought to account as such in calculating the taxable income of the software manufacturer, developer or distributor.

Date of effect

8. This Ruling applies (subject to any limitations imposed by statute) for years of income commencing both before and after the day on which it is issued. However, if a taxpayer has a private ruling which is inconsistent with this Ruling, then this Ruling will only apply to that taxpayer from and including the 1992-93 year of income unless the taxpayer asks that it apply to earlier income years.

9. Where audit settlements have been reached with taxpayers based on a taxation treatment of computer software inconsistent with this Ruling, this Office does not propose to disturb assessments made before the issue of this Ruling. However, in relation to those taxpayers, this Ruling applies from and including the 1992-93 year of income, even though the audit settlement provided for the continued operation of the basis of the settlement.

Explanations

10. Computer software is generally described as computer programs consisting of encoded instructions designed to cause a computer to perform a particular task or to produce a particular result. A computer can only execute instructions written in 'machine language'. For purposes of enabling a computer to utilise a program, the program is generally stored in 'object code' or machine-readable language on some carrying medium, e.g. magnetic tapes, disks, diskettes etc. The program may also be written in human-readable language or 'source code' but, to protect the program as much as possible from unauthorised imitation or copying, this is seldom made available to the end-user of the software.

11. A computer program - as distinct from its carrying medium - is in essence knowledge or information; it is an item of intellectual property. The carrying medium is tangible property, but the computer program is intangible property. It is strictly not the carrying medium but what is stored on the carrying medium (i.e. the computer program) which constitutes software. Software stored on a magnetic tape, disk or diskette is a copy of the program, in the same way that a printed book is a copy of the information contained within it.

12. Software can be classified as either system software (also known as operating software) or application software. System

software activates the computer itself and is essential for its operation regardless of the use for which the computer is required. These programs are normally supplied by the manufacturer of the computer in which they are to be used. Application software provides the computer with instructions as to the specific tasks required of it by the users e.g., payroll, inventory, debtors, word processing, creation of data bases, spreadsheets, games etc. These programs can be used with different types of computers and may be supplied either by the computer manufacturer or distributor or by an independent software house, or may be developed by the computer user.

13. Both system software and application software may be developed and marketed as standard software packages ('packaged' or 'canned' software) by the industry. These software packages contain not only the computer program embodied on the tangible carrying media but also educational material, manuals and operating instructions. Programs contained in standard software packages at times need to be modified or unique modules of programs have to be added to the package to suit the particular processing needs of an individual computer user. Such modifications may be done by the software developer or, under licence from the copyright holder, by the manufacturer or distributor of the software or other person with programming expertise.

14. Custom-designed or tailored application software (or 'custom software') may also be developed by software developers in the computer industry for individual users. Such software may also be developed by individual computer users who possess or obtain programming expertise.

15. By the *Copyright Amendment Act 1984*, assented to on 15 June 1984, the *Copyright Act 1968* (the Copyright Act) was amended to protect computer software as a literary work and to clarify the nature and scope of that protection having regard to the distinctive features of computer software. The amendment specifically includes computer programs in the existing copyright category of 'literary works' and gives to computer programs the protection now applied to literary works.

(a) Nature and assessability of receipts

16. There are several methods by which computer software may be acquired. They include:

(i) by licence to use the copyright;

(ii) by assignment of copyright;

(iii) by licence to use the software;

(iv) by purchase of a copy of a software program; and

(v) by contract for the creation or modification of a software program.

17. Each type of contract, and the income tax consequences attaching to amounts received under the various types of contract, are outlined below.

(i) Licence to use copyright

18. Under the Copyright Act, a number of rights, including rights to reproduce (other than the making of a back-up copy), modify or adapt a computer program, are exclusive rights of the copyright owner. The copyright owner may, however, authorise another person to do what would otherwise be an infringement of copyright.

19. Payments for the right to do acts comprised in the copyright are considered to come within paragraph (a) of the definition of 'royalty', being amounts paid as consideration for the use of, or the right to use, copyright in the computer program. The term 'copyright' is not defined in the Act and, for purposes of the definition of 'royalty' in subsection 6(1) of the Act, is taken to have the same meaning as it has under the Copyright Act. Thus acts comprised in the copyright means those acts which are referred to in paragraph 31(1)(a) of the Copyright Act.

20. In determining whether or not a payment is for the use of copyright, it is important to distinguish between a payment for the right to use the copyright in a program and the right to use the program itself. A payment for the right to use the program itself only allows the licensee to operate or run the program on a computer. On the other hand, a payment for the right to use the copyright in a program allows the licensee to modify, adapt or copy, or otherwise do what would ordinarily be the exclusive right of the copyright owner. Thus a payment by a distributor for the right to make copies of a program from a master-copy, whether the payment is a one-time or periodical payment or a fee calculated by reference to the number of times the program is reproduced, is a royalty. So too is a payment to the copyright owner by a software house or a computer programmer for the right to modify or adapt a program to meet the individual needs of a computer user. Payments received as damages for infringement of copyright in a computer program are also considered to be amounts received by way of consideration for the use of copyright and are therefore royalties under this paragraph. However, payments solely for the right to import and/or distribute software, without any licence to use the copyright, are not royalties. Such payments are not for the right to do any act comprised in the copyright, notwithstanding that

the importation without the copyright owner's permission would constitute an infringement of copyright.

21. Where the licence to use the copyright is acquired by the end-user from a distributor or retailer, the distributor or retailer is considered to be acting as agent for the copyright owner. In such cases, payments made by the distributor or retailer in respect of software which has been licenced through his agency will include an amount in the nature of royalty for the right to use copyright.

22. The royalties are required to be included in the assessable income of the copyright owner under subsection 25(1) or paragraph 26(f). Where the agreement provides for the payment of an Australian sourced royalty to a non-resident, the payer of the royalty must, if the payment was made prior to the commencement of the 1993-94 year of income, comply with the requirements of sections 221YHZB and 221YHZC and remit tax to the Commissioner in accordance with section 221YHZD. These provisions are discussed further in Taxation Ruling IT 2669. If royalty payments are made after the commencement of the 1993-94 income year, royalty withholding tax deductions must be made in accordance with section 221YL.

(ii) Assignment of copyright

23. A software developer or supplier may assign all rights relating to the copyright in a software program to a customer. Such rights may be assigned either permanently or for a limited period, and for world-wide rights or within a specified geographical area. The customer then has the right to copy, adapt or dispose of the program. This most commonly occurs in relation to custom software which has been developed to meet the specific needs of the customer.

24. Copyright in a computer program is an asset which can be disposed of for value by the copyright owner. If a software developer or supplier in the course of carrying on a business transfers to a customer all the rights in the copyright in a program, then the receipts from the assignment of copyright are income according to ordinary concepts. Such receipts, where derived by an Australian resident or from an Australian source, are assessable in the hands of the software developer or supplier in terms of subsection 25(1), subject to the provisions of any relevant double taxation agreement.

25. Where the copyright has come into existence or been acquired after 25 September 1985, the assignment of copyright in a computer program may give rise to a capital gain which is required to be included in assessable income by Part IIIA. In most cases however the capital gain will be nil by reason of subsection 160ZA(4), which has the effect of reducing the capital gain by the amount included as assessable income under subsection 25(1).

(iii) Licence to use the software

26. A copy of a software program, embodied on disk, diskette, magnetic tape or other carrying media, is frequently acquired under a licencing arrangement, the most common of which is known as a 'shrink-wrap' licence. Under these arrangements the end-user is granted a licence to use the software, i.e. to run the program and to make a back-up copy of the program. A shrink-wrap licence typically provides that by opening the package the end-user agrees to be bound by the licence agreement. A licence is granted to use the software either on a single computer, or on a specified number of the licensee's computers or network servers. The licence may also specify that the software may only be used on the licensee's computers at certain locations (Site Licence) or may limit the number of simultaneous users. The licence also purports to limit the end-user's powers to deal with the software, e.g. it cannot be transferred or hired without the permission of the licensor. Under such licence agreements, neither copyright in the program nor property in the tangible carrying media is transferred to the end-user; the software and all copies made of it remain the property of the software manufacturer or developer.

27. Payments for any licence for simple use of computer software (i.e. where the end-user acquires only the right to run the program, whether on a single computer only or on the licensee's computer network, and does not acquire any rights to use the copyright in the program) are not royalties for purposes of income tax law. It is arguable that some part of the amount paid for the acquisition of computer software under a licencing arrangement is attributable to an express or implied licence to use the copyright in the program. For example, it may be that the act of loading a program onto the hard disk of a computer would, without permission from the copyright owner, be an infringement of copyright (see Sheppard J in *Dyason and Ors v. Autodesk Inc and Anor* (1990) 96 ALR 57 at p. 88). Although the amount attributable to such express or implied licence would strictly be a royalty, being an amount paid 'for the use of, or the right to use, any copyright' (paragraph (a) of the definition), it is accepted that the amount, if quantifiable, is likely to be minimal. For this reason, it has been decided that no apportionment of the licence fee paid in respect of the software is necessary to take account of this amount.

28. It is also accepted that, in the case of packaged software, payments for the acquisition of software under a licencing arrangement does not ordinarily involve the supply of technical knowledge or information for purposes of paragraph (c) of the definition of royalties. Where the purchaser or licensee obtains nothing more than a set of coded computer instructions, without the underlying source code, it cannot be said that knowledge or

information about the program in the relevant sense of know-how has been transferred.

29. Payments for a licence for simple use only of computer software are not royalties, irrespective of whether the software is acquired by a distributor for sub-licencing to end-users (e.g. where packaged software is acquired by the distributor under licence and is sub-licenced to the end-user) or by end-users directly.

30. The licencing fees are income according to ordinary concepts and, where they are derived by an Australian resident or from an Australian source, the fees are assessable in the hands of the licensor under subsection 25(1). Payments received in respect of the distribution or marketing of such licences are also assessable income in the hands of the distributor or supplier.

(iv) Sale of a copy of a program

31. A copy of a software program, embodied on disk, diskette, magnetic tape or other carrying media, may be sold to a customer. In some cases, the hardware and software may be sold together in an integrated form without being unbundled, the contract of sale being for the sale of a complete computer system comprising both hardware and software. This is commonly the case with system or operating software.

32. Where the software is sold under a contract for sale of a complete computer system, the receipt constitutes the price in a sale of goods (*Toby Constructions Products Pty Ltd v. Computer Bar Sales Pty Ltd* (1983) 2 NSWLR 48). Where the software is trading stock of the supplier, the proceeds of such a sale represent assessable income in the hands of the software supplier in accordance with subsection 25(1). Where the software is not trading stock of the seller, the capital gains provisions of Part IIIA will apply. Any capital gain will however be reduced by any amount included in assessable income under subsection 25(1) in terms of subsection 160ZA(4).

33. Software may also be sold as a separate package. Property in the goods (i.e. in the carrying medium with the program embodied on it) passes to the customer although copyright in the program remains with the software developer or his assignee. The goods are generally accompanied by a 'shrink-wrap' licence similar to the type described in paragraph 26 above except that property in the carrying medium is stated to pass to the end-user. The licence nevertheless purports to limit the end-user's powers to deal with the software, e.g. it cannot be sold or hired without the permission of the licensor.

34. Where property in a copy of a software program passes to the end-user it is accepted that the whole of the purchase price should be

treated for tax purposes as the proceeds of a sale of goods in the hands of the software owner or distributor, notwithstanding that some part of that amount may be attributable to an express or implied licence to use the copyright in the program (see paragraph 27 above). This will also apply to payments by a distributor for the purchase of software for the purpose of on-selling to end-users.

(v) Contract for the creation or modification of software

35. The parties may enter into a contract for the creation or modification of software by a software house or a computer programmer. This is frequently the way in which custom software is acquired. The level of services rendered will vary with each contract. At one end of the spectrum, the customer's needs may require that a program be created virtually from scratch. At the other end of the spectrum, a minor modification to an existing or standard program may be sufficient to meet the customer's requirements. Copyright in the resulting software program may or may not pass to the customer.

36. In this type of case it is necessary to distinguish between payments for the supply of a copy of a computer program (which are not royalties), payments for the supply of know-how (which are royalties) and payments for services (which are not royalties).

37. As discussed in paragraph 28 above, the supply of packaged software for simple use by the end-user, whether by sale or under a licence to use the software, generally does not involve the transfer of know-how. In the case of custom software, however, the supply of knowledge or information of the type covered by paragraph (c) of the definition of royalties is not uncommon. The types of information which fall within the scope of that paragraph are discussed in paragraphs 19 to 21 of Taxation Ruling IT 2660. In relation to computer software, there will be a supply of scientific, technical, industrial or commercial knowledge or information giving rise to royalties either where the subject matter of the software imparts unpublished technical knowledge or where technical information about the program itself is disclosed.

38. Whether or not know-how is supplied in the subject matter of the software is a question that can only be determined on a case-by-case basis. An example of the supply of know-how in the subject matter of the software might be where a company acquires custom software which is designed to solve its project management problems, and the software provides undivulged specialist technical knowledge on that subject.

39. The supply of know-how about the program itself may occur where the software house or computer programmer, in addition to supplying a copy of a computer program, agrees to transfer to the

end-user some or all of the underlying source code of the program or significant algorithms which may allow the customer to undertake further modifications of the program. Where the agreement provides for the transfer of the source code or algorithms, it is considered that, prima facie, there is a supply of technical knowledge or information or know-how about the program which comes within the meaning of paragraph (c) of the definition.

40. The consideration attributable to the supply of know-how, whether in the subject matter of the software or about the program itself, is a royalty. If no separate price for the transfer of know-how is allocated under the contract, an allocation may be made on the basis of the difference between the market price of similar software products without the transfer of know-how and the contract price.

41. The characteristics of a contract for services, and the elements that distinguish it from a contract for the supply of know-how, are discussed in paragraphs 25 to 36 of Taxation Ruling IT 2660. Because of the wide variety of contracts that may be entered into, the issue of whether a contract for the provision of custom software is or is not a contract for services will depend on the particular terms of the agreement. In cases where the essence of the contract is the provision of services for the modification or creation of software, it is accepted that the receipts are not royalties for purposes of the Act. The receipts are nevertheless assessable income of the software house or computer programmer under subsection 25(1).

42. Where the contract provides for both the supply of know-how and the provision of services, an apportionment of the payments under the contract will be necessary.

Ancillary assistance

43. Contracts for the supply of software sometimes also provide for certain on-going assistance, such as bug-fixing, training, maintenance or Hot-line services. Where this occurs, it is necessary to consider whether payments for such assistance are royalties by reason of paragraph (d) of the definition in the Act.

44. Paragraph (d) of the definition includes as royalties payments for the supply of assistance which is ancillary and subsidiary to, and furnished as a means of enabling the application or enjoyment of, any property, right or know-how covered by paragraphs (a) to (c) of the definition. Thus, payments for assistance relating to software are royalties within the meaning of the definition in subsection 6(1) where the assistance is subsidiary and ancillary to the right to use copyright or the supply of know-how.

45. In the case of contracts for the acquisition of packaged software, where there will generally be no transfer of know-how or a right to use copyright, any assistance provided by the software house or distributor will not come within the definition.

46. However, in those cases where there is a transfer of know-how or a right to use copyright in the software, it will be necessary to determine whether any payments for ancillary services are royalties. It should be noted that only those payments for assistance which relates to the supply of know-how or the right to use the copyright will be royalties. Payments for assistance which relates to the use of the software rather than the transfer of know-how or the use of the copyright will not fall within the definition in paragraph (d).

Example 1:

End-user enters into an agreement for the creation and supply of custom software (including source code) and for the provision of documentation, bug-fixing, maintenance and hot-line services. That part of the payment which is attributable to the supply of the source code is a royalty. However, the payment relating to the ancillary services do not relate to the supply of the source code. Rather, they relate to the supply and running of the software. The services are therefore not ancillary to the supply of source and do not fall within paragraph (d) of the definition.

Example 2:

Computer programmer pays the copyright owner for the right to reproduce and modify a program. The copyright owner also agrees to provide such assistance as is necessary to enable the programmer to understand the logic of the program so as to enable him to modify it. The assistance in this case relates to the right to use the copyright and therefore comes within paragraph(d) of the definition.

(b) Trading stock

47. If a software manufacturer or developer, or a distributor of software, has computer software on hand at the end of the year of income, the question arises whether the value of that software must be brought to account as trading stock in calculating taxable income.

48. The definition of 'trading stock' in subsection 6(1) of the Act includes 'anything ... acquired or purchased for purposes of ... sale or exchange'. Computer software - especially canned software - acquired for sale by a distributor in the course of business comes within the scope of the definition. The definition of 'trading stock' is not

exhaustive and it is considered to apply where a software manufacturer or developer has produced or developed computer software for sale and that software remains on hand at the end of a year of income.

49. Where ownership of the software products (i.e. the program, the carrying medium and associated manuals etc) remains at all times with the software developer or supplier and does not pass to the distributor or end-user, e.g. where software is produced or developed for licence (and not sale) to computer users, it is not so clear-cut whether this software is 'trading stock'.

50. In *F.C. of T. v Suttons Motors (Chullora) Wholesale Pty Ltd* 85 ATC 4398, 16 ATR 567 the High Court of Australia held that trading stock need not be owned by the taxpayer provided that it is legitimately in the taxpayer's possession as part of the stock to be sold or exchanged in the course of trade. Therefore, if the taxpayer is in the business of marketing software licences, which is frequently the case with software distributors, then the computer software acquired under licence should be regarded as 'trading stock' for income tax purposes. Software held for the purpose of licensing or sub-licensing would not constitute trading stock if the taxpayer is not in the business of marketing software licences.

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- Dyason and Ors v. Autodesk Inc and Anor 1990 ALR 57
- FC of T v. Suttons Motors (Chullora) Wholesale Pty Ltd 85 ATC 4398; 16 ATR 567
- Toby Constructions Products Pty Ltd v. Computer Bar Sales Pty Ltd (1983) 2 NSWLR 48