

[Interpretation guideline issued by Adjudication & Rulings on 14/10/03, previously released as exposure draft IG0007]

NON-RESIDENT SOFTWARE SUPPLIERS' PAYMENTS DERIVED FROM NEW ZEALAND—INCOME TAX TREATMENT

Introduction

The income tax treatment of computer software transactions is important in view of the rapid development of computer software technology (including the means by which it is transferred) in recent years, the increase in the importation of such technology into New Zealand, and the international trend towards more consistent tax treatment.

This Interpretation Guideline deals with the income tax treatment, under New Zealand domestic law and double tax agreements, of payments derived from New Zealand by non-resident suppliers of computer software. It considers the tax implications, for non-resident suppliers, of the most common types of computer software transactions.

In particular, the following transactions are discussed:

1. a sale of the copyright in a computer program
2. a licence of a copyright right in a computer program
3. a sale of a copy of a computer program subject to copyright
4. a lease of a copy of a computer program
5. a supply of services for the development or modification of a computer program
6. the supply of know-how relating to a computer program.

The Guideline addresses the following income tax issues:

- The proper character, for income tax purposes, of payments made to non-residents for supplies of computer programs – in particular, whether the payments are royalties, business or rental income, for services, or non-taxable receipts; and
- The possible income tax treatments for each payment type under domestic law (including non-resident withholding tax) and double taxation agreements.

This Guideline takes account of the international trend toward conformity in the tax treatment of computer software transactions. The conclusions reached in this Guideline are consistent with the conclusions of the Organisation for Economic Co-operation and Development, *Model Tax Conventions: Four Related Studies*, Issues in International Taxation No. 4 (1992 OECD Report) which have now been adopted in the Commentary to Article 12 (Royalties) of the OECD Model Tax Convention.

In addition, the conclusions reached in this Guideline are also consistent with the regulations issued by the United States Internal Revenue Service, [Treasury Regulation §1.861-18 Classification of transactions involving computer programs]. These regulations were reviewed because of the fact that the United States is more advanced than any other single jurisdiction in considering the legal ramifications of

computer related transactions. The approach adopted by the Internal Revenue Service is, in many respects, similar to that adopted in this Guideline. Due to this similarity, a series of illustrative examples has been included based on examples included by the Internal Revenue Service in its regulations.

This Guideline supersedes the item relating to payments for the use of computer software contained in *Public Information Bulletin 168* (published in January 1988 and subsequently withdrawn in *Taxation Information Bulletin*, Vol 10, No 7, July 1998) and applies to transactions occurring on or after the date of publication.

This Guideline applies equally to related and unrelated parties where the parties are dealing on arm's length terms and no avoidance issues arise.

All legislative references in this item are to the Income Tax Act 1994 unless otherwise indicated.

Legislation

The legislative provisions relevant to the supply of computer software by a non-resident include:

- Section CD 2, which provides that the gross income of any person includes all royalties.
- The definition of the term “royalty” in section OB 1, which includes:

a payment of any kind, whether periodical or not and however described or computed, to the extent to which it is derived as consideration for—

- (a) The use of, or the right to use, any copyright, patent, trademark, design or model, plan, secret formula or process, or other like property or right:
- (b) ...
- (c) ...
- (d) ...
- (e) The supply of scientific, technical, industrial, or commercial knowledge or information:
- (f) The supply of any assistance which is furnished as a means of enabling the application or enjoyment of anything referred to in any of paragraphs (a) to (e):
- (g) ...

whether or not that payment is an instalment of the purchase price of any real or personal property:

- Section NG 2, which imposes non-resident withholding tax (NRWT) on every person who derives non-resident withholding income. Such income includes royalties derived from New Zealand by a non-resident. NRWT is imposed at the rate of 15 percent on such royalties. However, this rate may be modified to a rate of 10 percent by a double taxation agreement.
- Section OE 4(1), which sets out the classes of income deemed to be derived from New Zealand, and includes:
 - (a) Income derived from any business wholly or partly carried on in New Zealand:
 - (b) Income derived from any business carried on out of New Zealand to the extent that that income consists of [certain classes of income, including royalties]:
 - ...

- (l) Income derived from the sale or other disposition of any property, corporeal or incorporeal, situated in New Zealand:
 - ...
 - (q) Income derived from contracts made or wholly or partly performed in New Zealand:
 - (r) Royalties ... :
 - (s) Payments of any kind to the extent to which they are paid as consideration for the use of, or the right to use, in New Zealand, any personal property, ... :
- Double taxation agreements (DTAs) that reduce New Zealand tax on certain New Zealand-sourced income derived by a non-resident. The relief available depends on the non-resident's country of residence and the nature of the income derived from New Zealand. In this Guideline the following two principal types of income, covered in DTAs, are discussed:
 - **Business profits**
Business profits (or income) from the sale of goods or services, with a New Zealand source, are not normally taxed in New Zealand if relief exists under a relevant DTA, unless the non-resident has a permanent establishment in New Zealand (as defined in the applicable DTA) and the particular business profit is attributable to the permanent establishment.
 - **Royalties**
Each DTA has a royalty article that defines the term "royalty". Generally, the article limits the New Zealand income tax rate on royalty income derived by a non-resident.

Terminology for computer software

The term "computer program" is not defined in the Income Tax Act 1994 or any of New Zealand's DTAs. For the purposes of this Guideline "computer program" means:

encoded instructions that cause a computer to perform a particular task or produce a particular result.

The term "computer software" is used in this Guideline to encompass both the singular and plural of "computer program".

To be consistent with the terminology of the computer industry, the word "program" will be spelt the American way throughout this Guideline.

Software transaction categories

The tax treatment of any computer software transaction depends on the terms of the particular agreement between the parties, having regard to all the circumstances of the case.

Computer software transactions can generally be classified into two types – those relating to the copyright rights in the computer program and those relating to copies of the program protected by copyright. Functionally, the two types of transaction relate to the use of copyright and the use of a copy of the program respectively.

In most situations it will be clear whether the transaction relates to aspects of copyright or to the use of a copy of the program. However, there are situations where the true character of the transaction is difficult to determine. For example, some pre-packaged software products include “licensing” agreements that make it difficult to decide whether the transaction is dealing with copyright, or the sale of a product subject to copyright. From a tax perspective the answer is important, as consideration received from a transaction involving use of, or right to use, a copyright is a royalty, whereas consideration received from a transaction involving the use of, or the right to use, a computer program is not.

Software copyright protection

The Copyright Act 1994 provides software with copyright protection by specifying that computer programs are treated as literary works (see the definition of “literary work” in section 2 of that Act). The protection given by copyright law is a principal source of value of a computer program to the owner of the copyright.

Under the Copyright Act, copyright is a property right that exists, in accordance with the Act, in **original works** including literary works (section 14). The copyright owner is given **exclusive rights** to do acts that have the copyright protection (section 16). Accordingly, where a copy of a book is purchased, subject to copyright protection, the buyer is bound to comply with the restrictions inherent in copyright protection.

Copyright is concerned with the negative right of preventing the unauthorised copying of physical material. In providing copyright protection, the distinction between transactions involving copyright and transactions involving works subject to copyright is recognised. This distinction applies to all literary works protected by copyright and, for present purposes, is relevant when considering the nature of transactions involving computer programs.

Copyright rights

The Copyright Act 1994 sets out certain “restricted acts” that infringe copyright. The Copyright Act makes it clear that the owner of the copyright has the exclusive right to do any of the listed restricted actions.

The inclusion of a computer program as a “literary work”, under copyright law, assists in developing the proper tax treatment of software. In terms of copyright law, a computer program is treated like any other copyrighted product; for example a book, video or sound recording.

When copyrighted products, such as books or recordings, are acquired from non-resident suppliers for personal use or for use within the purchaser’s business, the transaction generates business profits. It is also generally agreed internationally that the sale of a book, video cassette, or compact disc for personal or business use does not generate royalties. However, if the transferee acquires the right to exploit the underlying copyright in the product, as when a publisher acquires the right to print a

book, then the transaction generates royalties. The critical difference in this latter transaction is that, in commercial terms, the transaction concerns the use of copyright.

Internationally, there is a trend to align the treatment of computer software to that of other copyrighted products. In the 1992 OECD Report, the OECD concluded, when interpreting Article 12 of the Model Convention (the Royalties article), in relation to software that:

Payments made in connection with software represent royalties within the meaning of Article 12 only in circumstances where there is a limited grant of rights (not amounting to a change in ownership) for the commercial development or exploitation of the software. Payments for software, whether “bundled” or not, which is acquired for the personal or business use of the purchaser do not represent royalties.

This view as to the proper application of the royalty article in relation to software is consistent with the view taken in the Guideline. While the OECD view is not binding domestically in New Zealand, it is still relevant in relation to the view adopted in the Guideline as in all material respects the domestic law definition, as it applies to software, is not different to the various definitions used in New Zealand’s DTAs.

For the purposes of this Guideline, the distinction between acquiring a program for personal or business use and acquiring it for commercial exploitation through the use of one or more of the copyright rights will be an essential determinant in identifying the category in to which a transaction falls. In circumstances where a supplier grants a customer the ability to exploit the supplier’s copyright rights in a program, the transaction will be a copyright right transaction. Where a customer is not granted the ability to exploit the copyright rights in the program, but merely acquires the right to use a copy of the program for personal or business use, the transaction will be a copyrighted article transaction. The distinction will be most relevant in circumstances such as where there is a grant of a restricted copyright right. In those circumstances a consideration of whether an ability to exploit the copyright in the program has been granted will enable a determination of whether the transaction is actually a copyright right transaction or the supply of an article subject to copyright. Obviously where there is the grant of an unrestricted copyright right in the program, there will have been the grant of the ability to exploit the copyright and the transaction will be a copyright right transaction.

For the purposes of this Guideline, the following rights of the copyright owner are the most relevant in the context of computer programs:

- the right to copy the program;
- the right to issue copies of the program to the public, whether by sale or otherwise; and
- the right to adapt the program.

Nature and tax treatment of receipts

For income tax purposes the critical issue, in respect of any computer software transaction, is determining what is in fact transferred. In this part of the Guideline the

most common types of computer software transactions are examined and some of the possible tax implications are discussed under the following headings:

1. Sale of a copyright right in a computer program.
2. Licence of a copyright right in a computer program.
3. Sale of a copy of a computer program (also referred to in this Guideline as a “copyrighted article”).
4. Lease of a copy of a computer program.
5. Supply of services for the development or modification of a computer program.
6. Supply of know-how relating to a computer program.

1. *Sale of copyright rights*

Copyright, like any asset, can be disposed of for value by the owner. A sale or assignment of copyright results in the ownership of the copyright rights being alienated either permanently or for a limited period. This alienation of the ownership of the rights means that the consideration derived is not for “the use of the rights” and therefore is not treated as a royalty. This view accords with that of the High Court in *DB Group Ltd v CIR* (1996) 17 NZTC 12,446, which confirmed that a payment for the outright sale of copyright rights does not fall within the definition of royalty in section OB 1 of the Income Tax Act 1994. In this situation the purchaser has bought the rights to the copyright as distinct from the “right to use” the copyright. (See also the Court of Appeal decision in *The Trustees of the CB Simkin Trust v CIR* (2003) 21 NZTC 18,117, for a discussion on the distinction between the right to intellectual property and the right to use intellectual property.)

Tax implications

The tax implications of any particular transaction will depend upon the facts of that transaction. However, as it is not a royalty for the purposes of section CD 2, the consideration derived by a non-resident supplier from a sale or assignment of copyright rights in a computer program will generally be a non-taxable receipt, unless the income is otherwise deemed to be derived from New Zealand under section OE 4(1). The most likely situation where this will occur is where the non-resident supplier is carrying on a business in New Zealand which includes supplying such copyright rights. If the supplier is in such a business, the payment will be business income of the supplier.

However, any New Zealand tax implications may be mitigated by the application of a relevant DTA. For example, in the case of a non-resident supplier who is carrying on a business in New Zealand which includes supplying copyright rights, if the supplier is resident in a country with which New Zealand has a DTA, any business income will generally not be taxable in New Zealand under the business profits article of the applicable DTA, provided the supplier does not have a “permanent establishment” in New Zealand.

2. *Licence of a copyright right*

If a computer software transaction involves the transfer of some but not **all** the substantial rights in the copyright (i.e. a transfer of partial rights) to a New Zealand recipient, it will generally be a licence. A licence “provides an excuse for an act which would otherwise be unlawful as, for example, ... the infringement of a copyright. It is an authority to do something which would otherwise be wrongful, illegal or inoperative” (per Latham CJ in *FCT v United Aircraft Corporation* [1943] 2 AITR 458, at 464). For the purposes of this Guideline, in a licence transaction a transfer of partial rights is granted by the holder of the respective rights to the licensee. This may be compared to an alienation of a portion of the ownership of the copyright rights which would be treated as a sale or an assignment.

A licence to use software copyright generates royalty income under paragraph (a) of the royalty definition in section OB 1 [consideration for the use of, or the right to use, any copyright].

Under a normal licensing agreement, the licensee has the right to use the copyright in the program (as distinct from simply using a copy of the computer program which is subject to copyright protection). Usually this right is used to make copies of the computer program for the purpose of public distribution. For the purposes of this Guideline such licences are referred to as “reproduction licences”.

Tax implications – non-resident withholding tax

As stated above, the tax implications of any particular transaction will depend upon the facts of that transaction. However, non-residents are liable to New Zealand income tax on royalties derived from New Zealand. Under section OE 4(1)(r) royalties are deemed to be derived from New Zealand if they are:

- paid by a person who is resident in New Zealand and not paid in respect of a business carried on by the person outside New Zealand through a fixed establishment outside New Zealand; or
- paid by a person who is not resident in New Zealand and are allowed as a deduction to the person for the purposes of tax in New Zealand.

Such royalties, derived from New Zealand by a non-resident, are deemed to be non-resident withholding income by section NG 1(2)(a) and are liable to NRWT at a rate of 15 percent on the gross payments (section NG 2(1)(c)). This rate is generally reduced to 10 percent if the non-resident recipient is resident in a country with which New Zealand has a DTA.

A person paying royalties to a non-resident is required, at the time of making the payment, to deduct the NRWT from the amount of the royalty (section NG 8) and pay the amount of the deduction to the Commissioner.

In the case of copyright royalties, NRWT is a final tax. No separate income tax liability is imposed under an annual assessment (see section NG 3(1)(b)).

3. *Sale of a copyrighted article*

A supply of a copyrighted program (i.e. a copy of a computer program subject to copyright) generally does not include a supply of copyright. The copyright remains with the owner of the original work. The supply of a copyrighted program essentially gives the recipient the right to use the program for personal or business use. This right is separate from a right to use the copyright for commercial exploitation. Generally the program is supplied in perpetuity, and usually the only condition is that the purchaser complies with the copyright protection.

The sale of a copy of a computer program is analogous to the sale of other copyrighted works such as books and video tapes. When a copy of a literary work in which intellectual property such as copyright resides is sold, it is clear that the sale of the article does not affect the intellectual property in it; the ownership of the article is distinct from the ownership of the intellectual property. For example, when a copy of a book is purchased, the purchaser does not also acquire copyright rights. This Guideline takes a similar approach to the sale of copies of computer programs when there is no accompanying transfer of any copyright rights. An important distinction is therefore drawn between the use of the copyright in a computer program (discussed above) and the use of a copy of the computer program subject to copyright.

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.

End-user licences

Many software transactions involve some form of end-user licence or user agreement. One common example of this is what is often referred to as a “shrink-wrap” licence. Shrink-wrap licences are generally issued for mass produced software, where the software is sold to an end-user via a distributor. In those circumstances, there is little scope for the software author, or copyright owner, to insist that end-users sign a licence agreement prior to them acquiring the software. The copyright owner’s response to this has been to develop the use of “tear-me-open” or “shrink-wrap” licences.

The volume of programs produced makes it physically and commercially impractical for the copyright owner and the ultimate purchaser to deal directly with each other. The copyright owner attempts to bind the ultimate purchaser to the terms of a software licence by stipulating that if the purchaser undertakes a specified act, such as opening the cellophane wrapper which covers the box which encloses the software, or uses the program for the first time then the terms of the licence are accepted.

A shrink-wrap licence is a specialised form of end-user licence, which is only used when the copyright owner and the end-user do not deal directly with each other. In other software supply contracts, the copyright owner is in a direct contractual relationship with the ultimate purchaser and a software licence is also issued to protect the owner’s copyright interests. Usually these licences are restrictive in nature

and allow the purchaser to use the program on only one computer at a time. Other restrictions may exist that prohibit renting or leasing the program.

In most situations, these restrictions are intended to protect the copyright interest in the program. Prior to explicit recognition of computer programs as “literary works” in the Copyright Act 1994, copyright owners were compelled to ensure their rights were fully protected. The main function of an end-user licence is to provide the owner with protection against piracy and unauthorised exploitation of its copyright.

The existence of a “licensing” agreement suggests that an end-user licence transaction involves some kind of “a right to use”, but, on further examination, a different conclusion may be drawn.

In *Buckley & Young v CIR* (1978) NZTC 61,271 the Court of Appeal set out the relevant steps to take in deciding the character of payments made and benefits provided in a transaction. The Court considered that the starting point in any examination of a transaction is the documentation embodying the transaction. However, the Court continued:

Analysis of the documentation may not determine the true character of the payments made. Indeed, the contract may be silent or equivocal as to the quality which ought to be attributed to the payment in question. In that situation evidence of surrounding circumstances may be of particular significance in determining what the contractual expenditure is calculated to effect from a practical and business point of view.

The critical issue with a computer software transaction that includes any form of end-user licence, is determining what the contract between the parties is trying to achieve from a practical and business perspective. Is the consideration paid for the copy of the copyrighted program or for a licence to use the copyright?

The correct answer emerges when one examines, from a commercial perspective, the purpose of an end-user licence. A reproduction licence gives the licensee the valuable right to exploit the software copyright by reproducing the software for external distribution. An end-user licence does not. Generally the terms of an end-user licence, such as a shrink-wrap licence, are an assertion of the rights of the copyright owner. Rather than allowing exploitation of the copyright, the terms make it clear that such exploitation is prohibited.

The licence in such situations generally provides that:

- (a) The user acquires a perpetual, non-exclusive, non-transferable licence which authorises the licensee to use the software, and
- (b) The licensee is permitted to make back-up copies of the software for operational and security purposes.

The purpose of the licence is to contractually restrict the purchaser from exploiting any of the rights protected by the copyright. The licence is **not** for the use of, or the right to use, any copyright (as in the case of a reproduction licence), but to prohibit use of the copyright. The licence is a vehicle to further assert the copyright owner’s rights. There is no transfer of the copyright. From a practical and business

perspective, the contract between the parties is for the provision of a copy of a copyrighted article.

This approach to pre-packaged or shrink-wrap software is consistent with the 1992 OECD Report that considered that the “purchaser has done no more than purchase a product”. Further, the OECD did not consider it relevant that the product was protected by copyright and that there were restrictions on the use to which it could be put by the purchaser.

Accordingly, any transaction involving end-user licences of the nature described above, should be treated as a sale of a copyrighted article. On the basis of this view, if computer software is supplied for personal or business use, the purchaser is generally buying a copy of the computer program. Provided there has been no transfer of accompanying copyright rights and the copy has not been transferred for a finite period (and therefore is not hired), the transaction is properly characterised as a sale of a copyrighted article. The accompanying licence is for the purpose of providing further protection to the owner of the copyright. The purchaser is not paying for the right to use the copyright, and accordingly there is no royalty derived by the non-resident.

Tax implications

Once again it is important to note that the tax implications of any particular transaction will depend upon the facts of that transaction. However, the payments will not be a “royalty” for the purposes of section CD 2. Payments derived from sales of computer programs may be treated as business income of the non-resident supplier from the sale of trading stock where the supplier carries on business in New Zealand. If the supplier is resident in a country with which New Zealand has a DTA, such business income will generally not be taxable in New Zealand under the business profits article of the applicable DTA, unless the non-resident has a permanent establishment in New Zealand. If the payments received by the non-resident supplier are not deemed to be derived from New Zealand under any of the source rules in section OE 4(1), then the payments will be non-taxable receipts for the non-resident supplier.

4. “Lease” of a copyrighted article

If a computer program copy has been supplied for a finite period without accompanying copyright rights in the program, the supply will generate rental income.

It is common for this type of transaction to be called a “lease”. While the transaction has attributes common to a lease – the legal right of exclusive possession for a stipulated period of time – in law, it is better characterised as a bailment or hire as it does not relate to land.

A bailment can take many forms, but it is normal for it to be a hire of goods or a chattel lease. A hire of goods is a contract by which the hirer obtains the right to use the chattel hired, in return for payment to the owner of the price of the hiring. Such payments are referred to as rental payments. A chattel lease, on the other hand, has

been introduced by modern commercial methods. While not technically a “lease”, as it does not relate to an interest in land, a chattel lease is a contract which, depending on its terms, does create an equitable right of some kind in the subject of the lease (*Bristol Airport plc v Powdrill* [1990] 2 All ER 493, 502). Payments made pursuant to a chattel lease are referred to in this Guideline as rental payments.

Where parties enter into a transaction for the right to use software for a finite period (as opposed to a right to commercially exploit the copyright rights) then the respective rights and obligations of such a transaction are equivalent to those in a lease. Accordingly, it is the Commissioner’s view that such transactions be treated equivalently for income tax purposes.

Tax implications

The tax implications of any particular transaction will depend upon the facts of that transaction. In the case of rental payments made in relation to a chattel lease there may be several possible tax implications.

Rental payments may be deemed to be derived from New Zealand by the operation of section OE 4(1)(s) which states:

Payments of any kind to the extent to which they are paid as consideration for the use of, or the right to use, in New Zealand, any personal property, being payments—

- (i) That are paid by a person who is resident in New Zealand; or
- (ii) That are paid by a person who is not a resident in New Zealand and are allowed as a deduction to the person for the purposes of tax in New Zealand:

Provided that this paragraph shall not apply to income which is deemed to be derived from New Zealand by virtue of paragraph (r): [note that paragraph (r) deals with royalties]

It is also possible that section OE 4(1)(q), which provides that income derived from contracts made or wholly or partly performed in New Zealand is deemed to be derived from New Zealand, may apply.

Under Part E of the Schedule to the Income Tax (Withholding Payments) Regulations 1979, contract payments made to non-resident contractors are subject to withholding tax at a rate of 15 percent. A contract payment is defined as “...any payment...made for the contract activity to the non-resident contractor...”. A contract activity includes “[t]he granting, providing, or supplying of the use, or the right to use, in New Zealand, ... any personal property...” (regulation 2). Such withholding tax deductions are not a minimum or a final tax liability, but merely a payment on account of the contractor’s annual New Zealand income tax liability.

Payments made may constitute business income of the non-resident “lessor”. Where the non-resident is resident in a country with which New Zealand has a DTA, generally such business income will not be taxable in New Zealand under the business profits article of the applicable DTA, unless the non-resident has a permanent establishment in New Zealand.

Rental payments derived by non-resident “lessors” of computer programs may fall under the royalty articles of New Zealand’s DTAs. Most of New Zealand’s DTAs include, in the definition of the term royalties, payments made, “... as a consideration

for the use of, or the right to use, ... industrial, commercial, or scientific equipment...”. The Commissioner accepts that leased computer software will not by itself constitute equipment, but considers that it can be part of equipment, within this royalty definition, where it is an integral part of an identifiable item of industrial, scientific or commercial equipment. The Commissioner considers that in order to determine whether software is an *integral* part of an identifiable item of industrial, scientific or commercial equipment, a functionality test should be applied. Where the software is critical or essential to the function of the equipment, i.e., the software is necessary to enable the equipment to perform its primary function, the software will be an integral part of the equipment. Questions to ask are whether the software is part of the means by which the equipment performs its function? Does the equipment run the software, or is the software required to run the equipment? In the Commissioner’s opinion it is only where the software satisfies this test of functionality in relation to an item of equipment that it will be considered to be an integral part of that equipment. Software which is embedded in an identifiable item of equipment, and is essential to the function of that equipment, will be an integral part of that equipment. However, the Commissioner considers that the fact that software is not embedded in an item of equipment will not automatically preclude that software from being an integral part of that equipment.

A hire or lease of a copy of a computer program from a non-resident supplier may also come within the definition of a “finance lease” in section OB 1. Payments made under such leases are subject to the finance lease regime in sections FC 8A to FC 8I. Under this regime the finance lease is effectively treated as a sale and loan back transaction, with each lease payment apportioned between a principal repayment and an interest component. Income derived by the non-resident supplier from the loan under the finance lease is treated as interest (section FC 8F).

Under section CE 1(1)(a) interest is included in a person’s gross income. Section NG 2 imposes NRWT on interest income derived from New Zealand by a non-resident. NRWT will be imposed at a rate of 15 percent on such interest, unless the approved issuer levy is paid. However, the 15 percent rate may be modified by a DTA to 10 percent.

5. Supply of services for the development or modification of computer programs

For many reasons computer programs may need to be modified, enhanced, or developed over their useful commercial life. Non-residents may be engaged to perform these tasks. Usually the non-resident is supplying a service to the owner or user of the program. However, in some situations the non-resident supplies know-how (discussed in the following section), and the correct nature of the supply in any situation depends on the facts and surrounding circumstances of the supply and the agreement made between the parties.

A service is generally considered to be some activity that helps or benefits, or conduct tending to the advantage of another, e.g. professional assistance. The underlying theme of a service is that the provider (supplier) is doing something **for** the recipient. This view accords with the concept of supplying a service for the purposes of the

Goods and Services Tax Act 1985 (see, for example, *Case S65* (1996) 17 NZTC 7,408).

It is not practical to list all the types of services that can be supplied by a non-resident, but certain indicators may exist that lend support to there being a supply of services. For example, a service is supplied when the benefit of the modification, enhancement, development, etc., is **for** the recipient. Evidence showing that the ownership of the result or product of the service resides with the recipient supports the view that services have been provided. In a similar vein, if the supply involves an additional modification of the computer program and the copyright in the modification resides with the recipient, then this factor also supports a finding that a service has been provided.

Tax implications

The tax implications of a transaction involving the supply of services will depend upon the facts of the particular transaction. In general, payments for the supply of services for the development or modification of computer programs [not connected with a licence of copyright rights or know-how] will be treated as business income of a non-resident supplier. This income will have a New Zealand source to the extent of the value of the services performed in New Zealand under section OE 4(1)(a) [income derived from any business wholly or partly carried on in New Zealand] or section OE 4(1)(q) [income derived from any contract made or wholly or partly performed in New Zealand], and will therefore be liable to New Zealand income tax.

Such payments for services performed in New Zealand are generally subject to non-resident contractors' withholding tax under Part E of the Schedule to the Income Tax (Withholding Payments) Regulations 1979 at a rate of 15 percent. This tax operates as an interim tax on behalf of the non-resident supplier's New Zealand income tax liability.

However, under a relevant DTA, a payment for the supply of services normally will fall under either the "business profits" article or the "independent personal services" article. Generally, under the business profits article such payments will not be taxable in New Zealand if the supplier is resident in a country with which New Zealand has a DTA and the supplier does not have a permanent establishment in New Zealand. Where the independent personal services article applies, the payments will generally not be taxable in New Zealand provided the supplier is not present in New Zealand for a period or periods exceeding in the aggregate 183 days in the income year or the supplier does not have a "fixed base" regularly available in New Zealand to perform the service.

6. *Supply of know-how relating to computer programs*

A payment derived as consideration for the supply of "scientific, technical, industrial, or commercial knowledge or information" (generally referred to as "know-how") is a royalty under paragraph (e) of the royalty definition in section OB 1. [Note that the following discussion is a general discussion of the concept of know-how as it relates

to computer programs and is not intended to be a definitive statement on the scope of paragraph (e) of the royalty definition.]

The term “know-how” is difficult to define with any precision. One leading description was given by Lord Radcliffe in *Rolls-Royce v Jeffrey* [1962] 1 All ER 801. This description has been usefully summarised in *Stroud’s Judicial Dictionary of Words and Phrases* (5th ed, Sweet and Maxwell) at p 1,395 as follows:

“Know-how” is the fund of technical knowledge and experience acquired by a highly specialised production organisation; although it may be, and usually is, noted down in documents, drawings, etc., it is itself an intangible entity whose category may vary according to, and may even be determined by, its use. Like office or factory buildings, patents and trademarks, and goodwill, it may be described as a “capital asset” while it is retained by a manufacturer for his own purposes, but, unlike these, its supply to another is not a transfer of a fixed capital asset because it is not lost to the supplying manufacturer (*Rolls-Royce v Jeffrey*; *Rolls-Royce v I.R.C.* [1962] 1 All E.R. 801).

Know-how is an intangible asset and, from a practical perspective, can be viewed as undivulged knowledge or information residing with the supplier that enables the product or process to be replicated. In a sense, know-how is that knowledge or information that cannot be gleaned by a mere examination of a product or mere knowledge of the process or technique. In the computer context know-how can perhaps best be described as information relating to computer programming techniques.

Due to its nature, know-how cannot be sold outright, in the sense that the supplier loses the right to use the special knowledge that has been supplied. The supplier of know-how always remains entitled to use it (*Moriarty v Evans Medical Supplies Ltd* [1957] 3 All ER 718, 735). Further, it is important to distinguish know-how from the physical (or electronic) means by which it is transferred. While know-how may subsist in a computer program, that, of itself, does not constitute a supply. In a supply of know-how the seller is passing to the buyer the seller’s special knowledge or information that remains unknown to the public. Accordingly, if the contract between a non-resident supplier and a resident buyer does not purport to transfer the relevant know-how, however it is comprised, the transaction is not a supply of know-how simply because the software has been transferred. In addition, as the know-how is an intangible asset of the seller, who is receiving value from the buyer in exchange for its disclosure, generally know-how will be furnished under conditions which prevent unauthorised disclosure by the buyer. Any unauthorised disclosure would constitute a breach of confidence.

Payments for know-how do not include payments for services. In practice, however, the distinction between know-how and services is not always easy, and much will depend on the facts of a particular case. As mentioned above, in a know-how transaction the supplier is passing on to the buyer special knowledge or information. In a provision of services, the supplier is not passing on special knowledge or information to the buyer, but is instead using knowledge or information in order to develop, enhance, or modify a computer program. In a sense, the difference between a supply of know-how and a supply of services is that know-how enables the buyer to use the know-how for his or her own benefit, whereas in a supply of services the supplier uses his or her know-how for the benefit of the buyer.

In summary, therefore, the provision of information with respect to a computer program will be treated as the provision of know-how only if the information is:

- Information relating to computer programming techniques;
- Furnished under conditions preventing unauthorised disclosure;
- Specifically contracted for between the parties; and
- Considered property subject to trade secret protection, (i.e., that unauthorised disclosure constitutes a breach of confidence).

Tax implications

The income tax treatment of royalties derived from New Zealand by non-resident suppliers of know-how is the same as that described above for the licensing of copyright rights, except that with a know-how royalty the NRWT of 15 percent represents a minimum New Zealand income tax only (see section NG 4 which sets out the categories of non-resident withholding income in which the liability to NRWT is a minimum tax). If an income tax assessment would produce a greater amount of income tax than NRWT, the amount of income tax imposed under such an annual assessment will apply – with a credit being given for any NRWT imposed. Again, the tax rate on know-how royalties is subject to the provisions of any relevant DTA, which generally reduce the rate to 10 percent on the gross payments.

Additional considerations

Transactional analysis approach

In order to determine whether there has been a sale of copyright rights or the granting of a licence, or whether there has been the sale of a copyrighted article or merely a lease, the approach adopted in New Zealand case law is the transactional analysis approach, as set out in several leading New Zealand cases (see, for example, *Buckley & Young Ltd v CIR* (1978) 3 NZTC 61,271, *Finnigan v CIR* (1995) 17 NZTC 12,170). The transactional analysis approach examines the legal rights and obligations of the parties to determine whether there has been a sale, licence or lease transaction.

It is paramount to determine the legal rights and obligations flowing from the transactions entered into. The legal effect of the transaction is what matters, not the form or language used to express it. Thus, in determining whether a transaction is a sale or licence of copyright rights, it is necessary to consider the particular transaction carefully to identify the legal rights and obligations of the parties flowing from the transaction – do these rights and obligations indicate that the transaction is a sale or simply a licence of the copyright rights? Equally, the same applies when determining whether there has been a sale or lease of a copyrighted article.

In determining whether there has been a sale or licence of copyright rights, matters such as whether all substantial copyright rights, or merely limited rights, have been transferred will be relevant. The sale of copyright rights will ensure the permanent transfer to the transferee of all the rights under copyright law which the transferor previously exercised. In the case of a licence of copyright rights the licensee will generally only have permission to exercise those copyright rights in accordance with

the licence granted. Any exercise of the rights beyond the authority of the licence will be unlawful. In distinguishing a sale of copyrighted article transaction from a lease transaction, matters such as whether the transfer of the copyrighted article involves the complete alienation of the article from transferor to transferee, or merely transfer of possession of the article for a defined period, may be relevant.

For the purposes of the transactional analysis approach, in the context of computer programs none of the following factors are relevant in determining the true nature of a transaction:

- (i) The method of delivery;
- (ii) The form of consideration; or
- (iii) The labels given to the transaction by the parties.

Special characteristics of computer programs

A feature of computer programs is the ease with which perfect copies can be made. Distribution arrangements are often entered into in which the recipient obtains rights to make multiple copies of the program for operation only within its own business. Such arrangements are commonly referred to as “site licences” or “network licences”. Although these arrangements permit the making of multiple copies of the program, these rights are generally limited to those copies necessary for the purpose of simply enabling the program to operate on the recipient’s computers or network. Reproduction for any other purpose is not permitted.

The point here is that the right granted is a restricted right to copy the program. A consideration of the facts and circumstances indicates that the recipient has not been granted the ability to exploit the supplier’s copyright rights, but rather has been granted the right to use the program for its own personal or business use. Any consideration attributable to the copying rights, if quantifiable, is likely to be minimal in value, and it is correct that it should be disregarded in assessing the character of the transaction for income tax purposes. For example, for income tax purposes, a transaction in which the software recipient has the right to make 50 copies of a program for its employees’ use at one location (a site licence) is treated the same as a transaction in which 50 individual disks are purchased, provided no copyright rights are supplied in either case. Assuming the right to use the copy of the computer program in either case is permanent, both transactions are treated as the sale of copyrighted articles.

While at first glance this may appear to be advocating a substance over form approach, it is important to appreciate that the determination is not one of substance over form, but rather whether there has been the grant of a right to commercially exploit a copyright right. In the context of determining whether the right to copy has been granted for commercial exploitation purposes, or whether it has been granted for personal or business use, the fact that the transaction is equivalent to the purchase of copyrighted articles is a relevant consideration.

Special note should be made of the situation of “enterprise licences” in this context. Enterprise licences generally provide for bulk purchasing or copying for multiple sites

distributed throughout the multiple legal entities in an affiliated group. An “enterprise licence” is, in one sense, simply a form of multiple site licence. The software recipient is still simply given the right to make so many copies of a program for its employees’ use – the only difference being that the employees are at more than one location. In other words, rather than being given the right to copy the program the required number of times for the number of employees at one site, the recipient is given the right to copy the program the required number of times for the number of employees in the recipient’s business, regardless of location.

The obvious distinction between an enterprise licence and even a multiple site licence is that, in the case of an enterprise licence, the distribution is wider as it generally extends beyond a single legal entity to cover multiple legal entities within an affiliated group. However, despite this wider distribution, the principle behind the licence is the same as with a site or network licence. Provided there is no ability to commercially exploit the program granted and the right to copy is provided only for the business use of the enterprise, the transaction is a copyrighted article transaction and not a copyright transaction. In practical terms the transaction is the equivalent to a transaction whereby the software recipient bought the required number of copies of the software from the supplier and simply distributed them within its group.

Note that the fact that the software recipient chooses to recover its costs plus a margin from members of its group will not affect the character of the transaction between the software supplier and the software recipient as being treated as a copyrighted article transaction. The software supplier has not granted the software recipient the ability to commercially exploit its rights. Rather, the ability of the software recipient to collect an intra-group internal charge or mark-up arises as a result of the relationship between the software recipient and the members of its group.

The same analysis applies equally to an enterprise licence as to a site or network licence. Provided the right to copy the program is limited to those copies necessary for the purpose of simply enabling the program to operate on the computers or network of the enterprise, regardless of the number of locations or entities involved, and there is no ability to commercially exploit that right to copy granted, then the transaction should be treated as the sale of copyrighted articles.

Approach to mixed transactions

A computer program transaction may include more than one of the transactions described in 1-6 above. In such situations it may be necessary to treat each part of the transaction as a separate transaction, with the appropriate treatment described in this Guideline being applied to each separate transaction. This Guideline is concerned with characterising transactions and is not intended to provide rules for allocating income arising from mixed transactions. Mixed transactions occur in many circumstances outside of transactions involving computer programs. Bearing this in mind, the following paragraphs provide some brief guidance on dealing with mixed transactions.

In *A Taxpayer v Commissioner of Inland Revenue* (1997) 18 NZTC 13,350, at p. 13,366, Tipping J said:

In New Zealand liability to tax depends ... on statutory construction applied to legal rights and obligations.

This accords with longstanding New Zealand authorities such as *Buckley & Young Ltd v CIR* (1978) 3 NZTC 61,271 and *Europa Oil (NZ) Ltd v CIR (No 2)* (1976) 2 NZTC 61,066.

Accordingly, as discussed above, it is necessary in analysing a transaction to identify correctly its true nature as found in the existing legal rights and obligations. If a transaction can be broken down into separate transactions, the appropriate tax treatment (as described above) should be applied to each separate transaction.

The test to be applied is whether a part of the transaction is merely ancillary or incidental to another part of the transaction such that it can simply be treated in a similar manner to that other part. If this is the case, then that ancillary part of the transaction is to be treated in the same fashion as the rest of the transaction. However, this does not preclude there being a transaction which has several different parts, some or all of which are not ancillary or incidental to any other part of the transaction. In those circumstances the different parts of the transaction will be treated as separate transactions and characterised accordingly.

One area where this discussion is particularly relevant is that of software development tools. For example, these products frequently include libraries of standard routines that software developers are granted the right to distribute as part of the software products they develop and sell. Typically the software developer pays a one time fee for the software development product and does not make contingent payments upon sales of its own software products. In these circumstances the right to distribute the libraries in conjunction with any programs created using the development program is an ancillary or incidental part of the overall transaction with the supplier, which is the transfer of the copyrighted product, i.e., the software development program. Therefore, the transaction will be treated solely as the supply of a copyrighted article and not the supply of a copyright right.

Market intermediaries

The case of market intermediaries should also be noted. These are distributors who purchase software products from manufacturers and in turn resell them to other distributors or end-users. Although the agreement between the parties will often be referred to as a "licence", generally the distributor has not been granted the right to commercially exploit any copyright right in the program. The distributor simply purchases copyrighted articles and then on-sells these goods. The right to distribute previously existing copies of programs is not a right to commercially exploit any copyright rights for income tax purposes. Accordingly, the transaction will be a copyrighted article transaction rather than a copyright transaction and the payments made by the distributor are not royalties.

Ancillary services provided by the supplier

Under paragraph (f) of the royalty definition, a payment derived as consideration for the supply of any assistance, furnished as a means of enabling the application or enjoyment of anything referred to in the preceding paragraphs of the definition, is also a royalty. Accordingly, payments for services connected with a licence of copyright rights or the supply of know-how are royalties subject to NRWT.

However, this treatment of payments for ancillary services may be subject to DTA provisions if the supplier is resident in a country with which New Zealand has a DTA. If the applicable DTA does not include such ancillary services in its royalties definition, the related payments may be treated as business income of the non-resident software supplier if the supplier carries on business in New Zealand. In those circumstances, the payments will generally not be taxable in New Zealand under the business profits article of the DTA, unless the supplier has a permanent establishment in New Zealand.

One of the most common types of ancillary services provided is that of helpdesk services. In most cases paragraph (f) of the royalty definition will have no application as the helpdesk services will not be provided in relation to a transaction concerning copyright rights, but rather in relation to a transaction concerning a copyrighted article, i.e., the program itself. In addition, the tax implications of a transaction concerning helpdesk services would depend heavily on the facts in any particular case, e.g., are the services provided in New Zealand or from a location outside New Zealand, are the services provided by the non-resident supplier or an agent, are the services contracted out?

Integrated software

If a copy of a computer program embodied in any carrying medium is integrated or incorporated into any other product (for example, computer hardware or a motor vehicle), and sold together without any accompanying copyright rights, the transaction is also treated as a sale of a copyrighted article with the proceeds being business income (such software is often referred to as integrated or bundled software).

Examples

In the remainder of this Guideline a series of examples is given to provide guidance. As stated earlier, these examples are drawn substantially from the United States Internal Revenue Service regulations [Treasury Regulations, §1.861-18 Classification of transactions involving computer programs], with which this Interpretation Guideline is in substantial agreement.

The examples are in two parts. First, the transaction is analysed to ascertain whether it involves the supply of copyright rights or the supply of a copyrighted article. Then, in the case of a supply of copyright rights, it considers whether the transaction is a sale or licence of rights. In the case of a supply of a copyrighted article, the question becomes whether the transaction is a sale or a lease of that article.

As discussed in the Guideline, the tax implications of a software transaction depend upon the particular facts of each case. For example, if Foreign Co carries on business in New Zealand the consideration received from the transaction may be treated as business income of the non-resident. However, if the supplier is resident in a country with which New Zealand has a DTA, the consideration may not be taxable in New Zealand under a relevant article in a DTA, provided that the non-resident does not have a permanent establishment in New Zealand. Accordingly, it is important to be aware that the tax implications discussed in the different examples of computer software transactions are indicative only of the types of tax implications which may arise. There are various issues which are relevant in making the appropriate determination.

Example 1: Sale of a copyrighted article

Foreign Co owns the copyright in a computer program. It copies the program on to disks. The disks are placed in boxes covered with a wrapper on which is printed what is generally referred to as a “shrink-wrap licence”. The licence is stated to be perpetual. Under the licence no reverse engineering of the computer program is permitted. The transferee receives, first, the right to use the program on two of its own computers (a laptop and a desktop) provided that only one copy is in use at any one time, and, second, the right to make one copy of the program on each machine as an essential step in the utilisation of the program. The transferee is permitted by the shrink-wrap licence to sell the copy, as long as it destroys any other copies it has made and imposes the same terms and conditions of the licence on any would-be purchaser of its copy. These disks are made available for sale to the general public in New Zealand. P, a New Zealand resident, pays for one such disk.

Analysis

The existence of the “shrink-wrap licence” is not determinative. No copyright rights, as described in this Guideline, have been supplied in this transaction. P has received a copy of the program and is therefore treated as having acquired a copyrighted article.

Taking into account all of the facts and circumstances, P is properly treated as the owner of a copyrighted article. Therefore, there has been a sale of a copyrighted article, rather than the grant of a lease.

Tax implications

In this example, if the payment received by Foreign Co is not deemed to be derived from New Zealand under any of the source rules in section OE 4(1), then the payment will be a non-taxable receipt for Foreign Co. The most likely situation where the source rules will apply will be if Foreign Co carries on business in New Zealand. If that is the case, the consideration received from the sale will be treated as business income unless it is not taxable in New Zealand under the business profits article of a relevant DTA. It is also possible that the payment may be held to have a New Zealand source on the basis that it is income from the sale of property situated in New Zealand or that it is income derived from a contract made or performed in New Zealand.

Example 2: Internet sale

The facts are as in Example 1, except that instead of selling disks, Foreign Co decides to make the program available, for a fee, on a World Wide Web home page on the Internet. P, the New Zealand resident, in return for payment made to Foreign Co, downloads the program (via modem) on to the hard drive of its computer. As part of the electronic communication, P signifies its assent to a licence agreement with terms identical to those in Example 1, except that in this case P may make a back-up copy of the program on to a disk.

Analysis

None of the copyright rights described in this Guideline have passed to P. Although P did not buy a physical copy of the disk with the program on it, the means of transferring the program is irrelevant. P has been supplied with a copyrighted article.

As in Example 1, P is properly treated as the owner of a copyrighted article. Therefore, there has been a sale of a copyrighted article rather than the grant of a lease.

Tax implications

As in Example 1, if the payment received by Foreign Co is not deemed to be derived from New Zealand under any of the source rules in section OE 4(1), then the payment will be a non-taxable receipt for Foreign Co. The most likely situation where the source rules will apply will be if Foreign Co carries on business in New Zealand. If that is the case, the consideration received from the sale will be treated as business income of the non-resident. If Foreign Co is resident in a country with which New Zealand has a DTA, this business income will generally not be taxable in New Zealand under the business profits article of the relevant DTA, provided Foreign Co does not have a permanent establishment in New Zealand.

Example 3: Lease transaction

The facts are as in Example 1, except that P, the New Zealand resident, only pays Foreign Co to use the program for two months. At the end of that period, P must return the disk with the program on it to Foreign Co. P must also destroy any copies made of the program. If P wishes to use the program for a further period, P must enter into a new agreement to use the program for an additional charge.

Analysis

No copyright rights, as described in this Guideline, have been supplied in this transaction. P has received a copy of the program and is therefore treated as having acquired a copyrighted article.

Taking into account all of the facts and circumstances, P is not properly treated as the owner of a copyrighted article. Therefore, there has been a lease of a copyrighted article, rather than a sale. Taking into account the special characteristics of computer

programs, the result would be the same if P was required to destroy the disk at the end of the two month period instead of returning it, since Foreign Co can make additional copies of the program at minimal cost.

Tax implications

In this situation the payment may be for “the use of, or the right to use, personal property in New Zealand” and on this basis the payment will have a New Zealand source and be taxable. Under the Income Tax (Withholding Payments) Regulations 1979 a withholding tax may apply. If Foreign Co is resident in a country with which New Zealand has a DTA and qualifies for DTA relief, Foreign Co may obtain an exemption from the withholding tax impost. This assumes that the payment is not for the use of, or the right to use, equipment, which is the case here.

Example 4: Electronic Lock

The facts are the same as those in Example 2, where P, the NZ resident, receives the program from Foreign Co’s home page on the Internet, except that P may only use the program for a period of two months, at the end of which an electronic lock is activated and the program can no longer be accessed. Thereafter, if P wishes to use the program it must return to the home page and pay Foreign Co to send an electronic key to reactivate the program for another period.

Analysis

As in Example 3, P has not received any copyright rights. P has received a copy of the program. The means of transmission is irrelevant. Therefore, P has received a copyrighted article.

As in Example 3, P is not properly treated as the owner of a copyrighted article. Therefore, there has been a lease of a copyrighted article rather than a sale. While P does retain the program on its computer at the end of the two month period, as a legal matter P no longer has the right to use the program (without further payment) and, indeed, cannot use the program without the electronic key. The effect is that, as far as P is concerned, it is as if the program is no longer on the hard drive of P’s computer. Although in Example 3, P was required to physically return the disk, taking into account the special characteristics of computer programs, the result in this Example 4 is the same as in Example 3.

Tax implications

The tax implications for this example will be similar to those discussed in relation to Example 3 above.

Example 5: Sale of a copyright right

Foreign Co transfers a disk containing a computer program to NZ Co, and grants NZ Co an exclusive licence for the remaining term of the copyright to:

- copy and distribute an unlimited number of copies of the program in the geographic area of New Zealand,
- prepare derivative works based upon the program.

The agreement states that NZ Co will pay Foreign Co a royalty of \$1 million a year for three years: the anticipated period for which the program will have commercially exploitable value.

Analysis

Foreign Co has transferred a disk with a copy of the program on it to NZ Co. However, the transfer of the physical copy of the program is simply an ancillary or incidental part of the overall transaction, which is the transfer of the copyright rights. Therefore, the transaction is treated as a transfer of copyright rights, not of copyrighted articles.

As all substantial copyright rights have been supplied in the transaction, Foreign Co will be treated as having sold copyright rights to NZ Co. NZ Co has acquired the copyright rights in the program for a geographic area, and has received the rights for the remaining life of the copyright in the program. In this situation, the fact that the agreement is stated as a licence is not necessarily determinative of the true nature of the transaction. In addition, the fact that the payment is called a royalty is also not determinative. For tax purposes a royalty is defined as “consideration derived for the use of or the right to use a copyright”. However, in this situation NZ Co has purchased **all** the substantial copyright rights in the program. (This conclusion would be the same if the copy of the program were transmitted electronically to NZ Co, as the means of transmission is not relevant.)

Tax implications

As this transaction does not give rise to a royalty, the consideration derived by the non-resident from the sale of the copyright rights will generally be a non-taxable receipt, unless the income is otherwise deemed to be derived from New Zealand under section OE 4(1). The most likely situation for this to occur is where the non-resident is carrying on a business in New Zealand which includes supplying such copyright rights. Where this is the case, the payment will be business income of the supplier unless the income is not taxable in New Zealand under the business profits article of an applicable DTA.

Example 6: Licence of a copyright right

Foreign Co transfers a disk containing a computer program to NZ Co. Foreign Co grants NZ Co the non-exclusive right to reproduce (either directly or by contracting with another person to do so) and distribute for sale to the public in New Zealand an unlimited number of disks, in return for a payment related to the number of disks copied and sold. The term of the agreement is two years, which is less than the remaining life of the copyright.

Analysis

As in Example 5, the transfer of the disk containing the copy of the program is not treated as the transfer of a copyrighted article. The transfer of the physical copy of the program is simply an ancillary or incidental part of the overall transaction, which is the transfer of the copyright rights. Therefore, the transaction is treated as a transfer of copyright rights, not of copyrighted articles.

In this example there has been a licensing of the program to NZ Co and the payments made by NZ Co are royalties. Unlike Example 5, there has not been a transfer of **all** substantial rights in the copyright in the program, because Foreign Co has the right to enter into other licences with respect to the copyright in the program, including in New Zealand (or even to sell that copyright, subject to NZ Co's interest). NZ Co has acquired no right itself to license the copyright rights in the program. Finally, the term of the licence is for less than the remaining life of the copyright.

Tax implications

As the payments are royalties, non-resident withholding tax is payable at a rate of 15 percent on the gross payments. This rate may be reduced to 10 percent if Foreign Co is resident in a country with which New Zealand has a DTA.

In this situation, at the time of making each payment NZ Co is required to deduct NRWT from the amount of the royalty and to pay it to the Commissioner.

Example 7: Distributor

NZ Co, a distributor in NZ, enters into an agreement with Foreign Co to purchase as many copies of a computer program on disk as it may from time-to-time request. NZ Co will then sell these disks to retailers. The disks are shipped in boxes covered by shrink-wrap licences (identical to the licence described in Example 1).

Analysis

NZ Co has not acquired any copyright rights with respect to the program. It has acquired individual copies of the program, which it may sell to others. The use of the term licence is not dispositive. NZ Co has acquired copyrighted articles.

Taking into account all of the facts and circumstances, NZ Co is properly treated as the owner of copyrighted articles. Therefore, there has been a sale of copyrighted articles.

Tax implications

In this example, if the payments received by Foreign Co are not deemed to be derived from New Zealand under any of the source rules in section OE 4(1), then the payments will be non-taxable receipts for Foreign Co. If Foreign Co carries on business in New Zealand then the payments will have a source in New Zealand and may be taxable to Foreign Co (subject to the application of an applicable DTA). It is

also possible that the payments may be held to have a New Zealand source on the basis that they are income from the sale of property situated in New Zealand or that they are income derived from a contract made or performed in New Zealand.

Example 8: Hardware manufacturer – licence

Foreign Co transfers a disk containing a computer program to NZ Co, which is engaged in the manufacture and sale of personal computers in New Zealand. Foreign Co grants NZ Co the non-exclusive right to copy the program onto the hard drive of computers which it manufactures, and to distribute those copies (on the hard drive) to the public. The term of the agreement is two years, which is less than the remaining life of the copyright in the program. NZ Co pays Foreign Co an amount based on the number of copies of the program it loads on to computers.

Analysis

The analysis is as in Example 6. NZ Co has acquired a copyright right which it is able to exploit by copying the program on to the hard drives of the computers it manufactures and sells. The transfer of the physical copy of the program is simply an ancillary or incidental part of the overall transaction, which is the transfer of the copyright right. Therefore, the transaction is treated as a transfer of copyright rights, not of copyrighted articles. In this example, NZ Co has not acquired all substantial rights in the copyright in the program (for example, the term of the agreement is less than the remaining commercial life of the copyright). This transaction is a licensing of the copyright to NZ Co rather than a sale, and the payments made by NZ Co are royalties. The result would be the same even if NZ Co included a back-up copy of the program on a floppy disk with the computers it sells.

Tax implications

As the payments are royalties, non-resident withholding tax is payable at a rate of 15 percent on the gross payments. This rate may be reduced to 10 percent if Foreign Co is resident in a country with which New Zealand has a DTA.

In this situation, at the time of making each payment NZ Co is required to deduct NRWT from the amount of the royalty and to pay it to the Commissioner.

Example 9: Manufacturer as intermediary – sale not licence

The facts are the same as in Example 8, except that NZ Co, the NZ company, receives physical disks. The disks are shipped in boxes covered by shrink-wrap licences (identical to the licences described in Example 1). The terms of these licences do not permit NZ Co to make additional copies of the program. NZ Co uses each individual disk only once to load a single copy of the program onto each separate computer. NZ Co transfers the disk with the computer when it is sold.

Analysis

As in Example 7 (unlike Example 8) no copyright right has been transferred. NZ Co acquires the disks without the right to exploit Foreign Co's copyright rights, e.g., without the right to reproduce and distribute publicly further copies of the program. Therefore, this is the transfer of copyrighted articles.

Taking into account all of the facts and circumstances, NZ Co is properly treated as the owner of copyrighted articles. Therefore, the transaction is classified as the sale of a copyrighted article. (The result would be the same if NZ Co used a single physical disk to copy the program onto each computer, and transferred an unopened box containing the program with each computer, if NZ Co was not permitted to copy the program onto more computers than the number of individual copies purchased.)

Tax implications

As in Example 7, if the payments received by Foreign Co are not deemed to be derived from New Zealand under any of the source rules in section OE 4(1), then the payments will be non-taxable receipts for Foreign Co. If Foreign Co carries on business in New Zealand then the payments will have a source in New Zealand and may be taxable to Foreign Co (subject to the application of an applicable DTA). It is also possible that the payments may be held to have a New Zealand source on the basis that they are income from the sale of property situated in New Zealand or that they are income derived from a contract made or performed in New Zealand.

Example 10: Site, Network and Enterprise Licences

Foreign Co transfers a disk containing a computer program to NZ Co, and grants NZ Co the right to load the program on to 50 individual workstations for use only by NZ Co employees at one location, in return for a once only per-user fee (generally referred to as a site licence). If additional workstations are subsequently introduced, the program may be loaded on to those machines for additional once only per-user fees. The licence which grants the rights to operate the program on 50 workstations also prohibits NZ Co from selling the disk (or any of the 50 copies) or reverse engineering the program. The term of the licence is stated to be perpetual.

Analysis

The grant of a restricted right to copy, unaccompanied by any ability to exploit the supplier's copyright rights, is not a copyright right as described in this Guideline. Therefore, this transaction is treated as a transfer of copyrighted articles (50 copies of the program).

As NZ Co is properly treated as the owner of a copyrighted article, there has been a sale of copyrighted articles rather than the grant of a lease. Notwithstanding the restriction on sale, other factors such as, for example, the risk of loss remaining with the supplier and the right to use the copies in perpetuity outweigh, in this case, the restrictions placed on the right of alienation.

The result would be the same if NZ Co was granted either a network or enterprise licence, provided NZ Co was not also granted the ability to exploit Foreign Co's copyright rights in the program. In either case, it is not the extent of the distribution which is relevant, but the question of whether NZ Co is granted any ability to commercially exploit the copyright rights of Foreign Co.

Tax implications

In this example, if the payment received by Foreign Co is not deemed to be derived from New Zealand under any of the source rules in section OE 4(1), then the payment will be a non-taxable receipt for Foreign Co. If Foreign Co carries on business in New Zealand then the payment will have a source in New Zealand and may be taxable to Foreign Co (subject to the application of an applicable DTA). It is also possible that the payment may be held to have a New Zealand source on the basis that it is income from the sale of property situated in New Zealand or that it is income derived from a contract made or performed in New Zealand.

Example 11: Lease of program

The facts are as in Example 10, except that NZ Co pays a monthly fee to Foreign Co, calculated with reference to the permitted maximum number of users (which can be changed). In return for this monthly fee, NZ Co receives the right to receive upgrades of the program as they become available. The agreement may be terminated by either party at the end of any month. When the disk containing the upgrade is received, NZ Co must return the disk containing the earlier version of the program to Foreign Co and delete (or otherwise destroy) any copies made of that earlier version. If the contract is terminated NZ Co must delete (or otherwise destroy) all copies made of the current version of the program.

The agreement specifically provides that NZ Co has not been granted an option to purchase the program.

Analysis

NZ Co has received no copyright rights as described in this Guideline. Foreign Co has not provided any know-how or services to NZ Co. Therefore, the transaction is a supply of a copyrighted article.

It is clear that NZ Co is not the owner of the copyrighted article. NZ Co does not receive the right to use the program in perpetuity, but only for as long as it continues to make payments. NZ Co does not have the right to purchase the program on advantageous (or, indeed, any) terms once a certain amount of money has been paid to Foreign Co or a certain period of time has elapsed (which might indicate a sale). NZ Co is not permitted to on-sell the software. Once the agreement is terminated, NZ Co will no longer possess any copies of the program, current or superseded. Therefore, in reality the transaction is "a lease" of a copyrighted article (as the term "lease" is described in this Guideline).

Note that the result would be different if NZ Co, while having to return copies of previous versions of the program when upgrades were received, was entitled to keep the latest version of the program in the event the agreement was terminated. In these circumstances there would have been a sale of a copyrighted article rather than a lease.

Tax implications

In this situation the payments may be for “the use of, or the right to use, personal property in New Zealand” and on this basis the payments will have a New Zealand source and be taxable. Under the Income Tax (Withholding Payments) Regulations 1979 a withholding tax may apply. If Foreign Co is resident in a country with which New Zealand has a DTA and qualifies for DTA relief, Foreign Co may obtain an exemption from the withholding tax impost. This assumes that the payments are not for the use of, or the right to use, equipment, which is the case here.

Example 12: Sale or lease

NZ Co enters into a contract with Foreign Co for Foreign Co to modify its program so that it can be used at NZ Co’s facility in New Zealand. Under the contract, NZ Co is to acquire one copy of the program on a disk and the right to use the program on 5,000 workstations. The contract requires Foreign Co to rewrite elements of the program so that it will conform to NZ accounting standards and states that Foreign Co retains all copyright rights in the modified program. The agreement between Foreign Co and NZ Co is otherwise identical as to rights and payment terms as the agreement described in Example 10.

Analysis

As in Example 10, no copyright rights are being transferred. In addition, since no copyright rights are being transferred to NZ Co, this transaction does not involve the provision of services by Foreign Co. This transaction will be classified, therefore, as a transfer of copyrighted articles (5,000 copies of the program).

Taking into account all the facts and circumstances, NZ Co is properly treated as the owner of copyrighted articles. There has therefore been a sale of copyrighted articles rather than the grant of a lease.

Tax implications

In this example, if the payment received by Foreign Co is not deemed to be derived from New Zealand under any of the source rules in section OE 4(1), then the payment will be a non-taxable receipt for Foreign Co. If Foreign Co carries on business in New Zealand then the payment will have a source in New Zealand and may be taxable to Foreign Co (subject to the application of an applicable DTA). It is also possible that the payment may be held to have a New Zealand source on the basis that it is income from the sale of property situated in New Zealand or that it is income derived from a contract made or performed in New Zealand.

Example 13: Provision of services

NZ Co enters into a licence agreement with Foreign Co for a new computer program. Foreign Co and NZ Co agree that Foreign Co will write the program for NZ Co and that, when the program is completed, the copyright in the program will belong to NZ Co. NZ Co gives instructions to Foreign Co programmers on required program specifications. NZ Co agrees to pay a fixed monthly sum during the program's development. If NZ Co is dissatisfied with the development of the program, it may cancel the contract at the end of any month. In the event of termination, Foreign Co will retain all payments made up to the date of termination. Any procedures, techniques, or copyrightable interests in the program will be the property of NZ Co. All the payments are referred to in the agreement as royalties. There is no provision in the agreement for any continuing relationship between the two companies, such as the furnishing of updates of the program, after completion of the work.

Analysis

In this example, Foreign Co is treated as supplying services to NZ Co. NZ Co bears all the risks of loss associated with the development of the program, and is the owner of all copyright rights in it. The fact that the agreement is labelled a licence is not determinative (nor is the fact that Foreign Co receives a sum that is labelled a royalty).

Tax implications

In this example, if the payments received by Foreign Co are not deemed to be derived from New Zealand under any of the source rules in section OE 4(1), then the payments will be non-taxable receipts for Foreign Co. If Foreign Co carries on business in New Zealand then the payments will have a source in New Zealand and may be taxable to Foreign Co. It is also possible that in this example the payments may be held to have a New Zealand source on the basis that they are income derived from a contract made or performed in New Zealand. Where the services are performed in New Zealand the payments received by Foreign Co may be liable to a withholding tax under the Income Tax (Withholding Payments) Regulations 1979. However, under a relevant DTA, a payment for the supply of services normally will fall under the "business profits" article – in which case, such payments will generally not be taxable in New Zealand if the supplier does not have a permanent establishment in New Zealand.

Example 14: Know-how

Foreign Co and NZ Co agree that Foreign Co will provide information relating to certain programming techniques which are not generally known to computer programmers, to enable NZ Co to more efficiently create computer programs. These techniques represent the product of experience gained by Foreign Co from working on many similar computer programming projects, and are furnished to NZ Co under non-disclosure conditions. The information is considered to be subject to trade secret protection.

Analysis

This transaction will be classified as the provision of know-how, as it entails the supply of confidential special knowledge and information relating to computer programming techniques under non-disclosure conditions. The payment will, therefore, constitute a royalty.

Tax implications

As the payment is a royalty, NRWT is payable at a rate of 15 percent on the gross payment. This rate may be reduced to 10 percent if Foreign Co is resident in a country with which New Zealand has a DTA.

In this situation, at the time of making payment NZ Co is required to deduct NRWT from the amount of the royalty and to pay it to the Commissioner.

Example 15: Software development tools – including libraries

Foreign Co transfers a disk containing a computer program to NZ Co in exchange for a single fixed payment. The program is a computer program development program, which is used to create other computer programs, consisting of several components, including libraries of reusable software components that serve as general building blocks in new software applications. No element of these libraries is a significant component of any overall new program. Since a computer program created with the use of the program will not operate unless the libraries are also present, the licence agreement between Foreign Co and NZ Co grants NZ Co the right to distribute copies of the libraries with any program developed using the program. The licence agreement is otherwise identical to the licence agreement in Example 1.

Analysis

NZ Co has received a copy of the program and has therefore received a copyrighted article. Taking into account the overall transaction and the surrounding facts and circumstances, the right to distribute the libraries in conjunction with any programs created using the development program is an ancillary or incidental part of the overall transaction which is the transfer of the copyrighted article. Therefore, the transaction is treated solely as a transfer of a copyrighted article and not a copyright right.

Taking into account all the facts and circumstances, NZ Co is properly treated as the owner of a copyrighted article. Therefore, there has been the sale of a copyrighted article rather than the grant of a lease.

Tax implications

In this example, if the payment received by Foreign Co is not deemed to be derived from New Zealand under any of the source rules in section OE 4(1), then the payment will be a non-taxable receipt for Foreign Co. If Foreign Co carries on business in New Zealand then the payment will have a source in New Zealand and may be taxable to Foreign Co (subject to the application of an applicable DTA). It is also

possible that the payment may be held to have a New Zealand source on the basis that it is income from the sale of property situated in New Zealand or that it is income derived from a contract made or performed in New Zealand.

Example 16: Correction software

Foreign Co transfers a disk containing a computer program to NZ Co. The disk contains both the object code and the source code to the program and the licence agreement grants NZ Co the right to:

- Modify the source code in order to correct minor errors and make minor adaptations to the program so that it will function on NZ Co's computer; and
- Recompile the modified source code.

The licence does not grant NZ Co the right to distribute the modified program to the public. The licence is otherwise identical to the licence agreement in Example 1.

Analysis

NZ Co has received a copy of the program, and has therefore received a copyrighted article. Considering the facts and surrounding circumstances, the right to modify and recompile the source code in order to create new code to correct minor errors and make minor adaptations is simply an ancillary or incidental component of the overall transaction, which is the transfer of the copyrighted article. Therefore, the transaction is properly treated solely as the transfer of a copyrighted article and not a copyright right.

Taking into account all the facts and circumstances, NZ Co is properly treated as the owner of a copyrighted article. Therefore there has been the sale of a copyrighted article rather than the grant of a lease.

Tax implications

In this example, if the payment received by Foreign Co is not deemed to be derived from New Zealand under any of the source rules in section OE 4(1), then the payment will be a non-taxable receipt for Foreign Co. If Foreign Co carries on business in New Zealand then the payment will have a source in New Zealand and may be taxable to Foreign Co (subject to the application of an applicable DTA). It is also possible that the payment may be held to have a New Zealand source on the basis that it is income from the sale of property situated in New Zealand or that it is income derived from a contract made or performed in New Zealand.

[Note as to operational implications added by Technical Standards on 15/10/03]

Application of Interpretation Guideline on Non-Resident Software Suppliers' Payments Derived from New Zealand—Income Tax Treatment

Although the guideline is intended to apply to transactions occurring on or after the date of publication, Inland Revenue is aware that the draft guideline (IG0007) which was first circulated for consultation in December 1997 has been applied in many cases.

We are also aware that in the intervening period many taxpayers chose to follow the policy set out in *Public Information Bulletin* 168 (published in January 1988 and subsequently withdrawn in *Taxation Information Bulletin* Vol.10, No. 7, July 1998). In some cases those taxpayers who applied the old policy would have paid NRWT, which would not have been payable had they followed the draft.

Inland Revenue is aware that this guideline was being applied while still in its draft stage. In order to ensure that those taxpayers who continued to apply the old policy after July 1998 are treated fairly any taxpayer who applied the old policy (and therefore paid NRWT which, in terms of either the draft guideline or the guideline as published, they should not have been liable to pay) may apply for a refund of any overpaid NRWT in relation to that period and cite this guideline as authority.