Australia Royalty Ruling Zooms in on Multinationals, Intangibles

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The Australian Taxation Office has shifted gears in its approach to royalties. After several years of developing a comprehensive position on how its royalty rules apply to intangibles in the context of modern business models — a position that has attracted criticism — Tax Ruling 2026/2 and draft Practical Compliance Guideline 2026/D4 provide a platform for the ATO to intensify its review of cross-border arrangements involving intangibles.

The Sept. 4 ruling takes a broad view of when software payments include a royalty, focusing on rights to use or exploit intellectual property rather than contractual labels. These principles may also apply to other arrangements involving intangibles.

The ruling is a road map for how the ATO intends to stress-test arrangements by examining the whole commercial bargain, while the draft PCG adds an additional layer of complexity by expecting taxpayers to self-assess within the ATO's risk framework and document that assessment, with lower risk ratings available where royalty treatment is adopted.

In practical terms, the ATO is trying to shift the question from "Is there a royalty?" to "How much is the royalty?" Together, the ruling and guidance offer some key takeaways, including that:

The ATO's view isn't the law. In Australia, tax rulings are a record of the ATO's view of the law, but they don't establish the law. However, they are relevant to taxpayers' governance, risk assessment, and provisioning for tax exposure. The High Court of Australia's 2025 decision in the PepsiCo case held that its sales of beverage concentrate to a third party bottler in Australia didn't contain taxable embedded royalties. Some aspects of the ATO's position, as outlined in the ruling, aren't easy to reconcile with that decision.

The ruling isn't limited to software. The views underlying the ruling can apply to arrangements beyond software, extending to industries such as pharmaceuticals, cosmetics, gaming, and streaming, to name a few.

There are double tax risks and dead ends. Divergence between the ATO and key treaty partners heightens the risk of double tax due to delayed or denied foreign tax credits, difficult or deadlocked mutual agreement procedure outcomes, and broader tax and trade friction. If the ATO uses its broad anti-avoidance powers (as flagged in the tax ruling), MAP would be unavailable because of a domestic treaty override.

Businesses must manage ATO engagement. One of the ATO's primary considerations in deciding review outcomes will be the taxpayer's ability to prove its defense. Outcomes will depend highly on individual facts and circumstances and the available evidence. Early evaluation, preparation, and stakeholder alignment will be critical.

According to the ATO, written agreements are just a starting point. As was the case for PepsiCo, many commercial agreements are either silent on royalties or expressly state that there is no monetary compensation for intellectual property rights. The ATO's analysis will include examining express and implied terms, rights granted, broader economic benefits, and the parties' conduct and performance. With the burden of proof on the taxpayer, the ATO is likely to closely test key factual assertions, which can be an elaborate and intensive exercise.

Although there is no legal requirement to self-assess royalty characterization, a decision not to do so would be at odds with the draft PCG and likely produce more intensive ATO compliance activity. This places the onus on multinationals, creating additional governance expectations while providing the ATO with a framework to interrogate the taxpayer's self-assessment.

The decision to adopt a particular treatment shouldn't be viewed exclusively through an Australian lens. It may affect treaty positions, positions taken in non-treaty jurisdictions, and the availability of foreign tax credits. This is particularly relevant for US groups, as the US Treasury Department has twice expressed concerns about the position taken by the ATO, which is inconsistent with the approach reflected in 2025 US Treasury regulations on software and cloud transactions.

Further, the decision to recognize a royalty in Australia may affect entitlement to US foreign tax credits, given the requirement to exhaust effective and practical remedies for non-compulsory foreign tax paid.

The ATO has drawn a clear line in the sand, which will likely be tested in the courts. In the short term, current audits are likely to accelerate, and new ones are likely to begin. Many multinationals have already started undertaking prudential reviews to test their positions, assess risk, and establish a strong factual foundation.

There are many advantages to adopting a proactive approach, particularly when it comes to evidence. Doing so means taxpayers are better prepared and able to manage the intensity and timing pressures of an audit. It also allows internal tax functions to engage key stakeholders and ensure the business is aligned and prepared for what may be a lengthy and resource-intensive ATO review.

Ultimately, the strength of a taxpayer's evidence and preparation will be key to navigating the road ahead.

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