

# FEDERAL COURT OF AUSTRALIA

## International Business Machines Corporation v Commissioner of Taxation [2011] FCA 335

Citation: International Business Machines Corporation v  
Commissioner of Taxation [2011] FCA 335

Parties: **INTERNATIONAL BUSINESS MACHINES  
CORPORATION and IBM WORLD TRADE  
CORPORATION v COMMISSIONER OF  
TAXATION**

File number: NSD 661 of 2009

Judge: **BENNETT J**

Date of judgment: 12 April 2011

Catchwords: **TAXATION** – payments made from resident company to  
non-resident company pursuant to Software Licence  
Agreement – whether full amount of payments liable to  
withholding tax as royalties – whether payments are  
royalties pursuant to Article 12(4) of the “Convention  
between the Government of Australia and the Government  
of the United States of America for the Avoidance of  
Double Taxation and the Prevention of Fiscal Evasion with  
respect to Taxes on Income” in Schedule 2 of the  
*International Tax Agreements Act 1953* (Cth)

**INTELLECTUAL PROPERTY** – whether rights granted  
under Software Licence Agreement are intellectual  
property rights – whether rights granted under Software  
Licence Agreement are for the supply of scientific,  
technical, industrial or commercial knowledge or  
information owned by any person – whether rights granted  
under Software Licence Agreement are rights to use,  
distribute and market computer programs

**CONTRACTS** – whether ambiguity

Words & Phrases: “royalties”, “under copyrights, mask work rights, and  
patents”

Legislation: *International Tax Agreements Act 1953* (Cth) s 4(2),  
Article 12(4) of Schedule 2  
*Income Tax Assessment Act 1936* (Cth) ss 128B(5A), 128C  
  
*Federal Court Rules* O 29 r 2

Cases cited:	<i>McDermott Industries (Aust) Pty Ltd v Commissioner of Taxation</i> (2005) 142 FCR 134 cited
Date of hearing:	7-8 March 2011
Place:	Sydney
Division:	GENERAL DIVISION
Category:	Catchwords
Number of paragraphs:	64
Counsel for the Applicants:	Mr D Catterns QC with Mr M Richmond SC
Solicitor for the Applicants:	Allens Arthur Robinson
Counsel for the Respondent:	Mr B Caine SC with Ms D Harding and Mr J Hmelnitsky
Solicitor for the Respondent:	Australian Government Solicitor

**IN THE FEDERAL COURT OF AUSTRALIA  
NEW SOUTH WALES DISTRICT REGISTRY  
GENERAL DIVISION**

**NSD 661 of 2009**

**BETWEEN:** **INTERNATIONAL BUSINESS MACHINES CORPORATION**  
**First Applicant**

**AND:** **IBM WORLD TRADE CORPORATION**  
**Second Applicant**  
**COMMISSIONER OF TAXATION**  
**Respondent**

**JUDGE:** **BENNETT J**

**DATE OF ORDER:** **12 APRIL 2011**

**WHERE MADE:** **SYDNEY**

**THE COURT ORDERS THAT:**

1. The preliminary question of whether the applicants are entitled to declarations that they are not liable to withholding tax under ss 128B(5A) and 128C of the *Income Tax Assessment Act 1936* (Cth) on the full amount of the fees paid under clause 6 of the Software Licence Agreement dated 1 April 1987 between the first applicant and IBM Australia Limited (as amended and novated):
  - (a) for the first applicant, during the periods from 1 January 1997 to 31 December 2002 and 1 January 2005 to 31 December 2006; and
  - (b) for the second applicant, during the period from 1 January 2007 to 30 June 2009;be answered “no”.
2. The application be dismissed.
3. The applicants pay the respondent’s costs.

Note: Settlement and entry of orders is dealt with in Order 36 of the Federal Court Rules. The text of entered orders can be located using Federal Law Search on the Court’s website.

IN THE FEDERAL COURT OF AUSTRALIA  
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**BETWEEN:** INTERNATIONAL BUSINESS MACHINES CORPORATION  
First Applicant

IBM WORLD TRADE CORPORATION  
Second Applicant

**AND:** COMMISSIONER OF TAXATION  
Respondent

**JUDGE:** BENNETT J

**DATE:** 12 APRIL 2011

**PLACE:** SYDNEY

**REASONS FOR JUDGMENT**

1        These proceedings concern the liability to withholding tax of two non-residents, International Business Machines Corporation (**IBM**) and IBM World Trade Corporation (**World Trade**) (together, **the Corporations**) in respect of payments made to each of them from 1 January 1997 to 31 December 2002 and from 1 January 2005 to 30 June 2009 by a resident company, IBM Australia Ltd (**IBMA**) under clause 6 of the Software Licence Agreement (**SLA**) (**the Payments**). The SLA is dated 1 April 1987 and was made between IBM and IBMA. It was later novated from IBM to World Trade.

2        From 1987 until 31 December 2002, IBMA remitted royalty withholding tax to the Australian Tax Office (**ATO**) on the full amount of the Payments made in that period at the applicable rate of 10%. For the period from 1 January 2003 to 31 December 2004, IBMA remitted royalty withholding tax to the ATO on only part of the payments made under the SLA during that period (at the reduced rate of 5% which applied from 1 July 2003) in accordance with a binding private ruling issued by the ATO to IBMA in 2004 (**the Private Ruling**). Following the expiry of the Private Ruling, IBMA continued to remit royalty withholding tax on the Payments on the same basis as in the Private Ruling.

3        On 12 May 2006, IBMA sought a refund of part of the royalty withholding tax paid to the ATO on the Payments made from 1 January 1997 to 31 December 2002. The Commissioner of Taxation (**the Commissioner**) refused to make the refund. The Commissioner has since asserted that IBMA should be liable on the full amount of the Payments made from 1 January 2005 to 30 June 2009.

4        The Corporations seek declarations that IBM and World Trade are **not** liable to withholding tax under ss 128B(5A) and 128C of the *Income Tax Assessment Act 1936* (Cth) (**the 1936 Act**) on the **full amount** of the Payments. By an order of the Court made 11 March 2010, pursuant to O 29 r 2 of the *Federal Court Rules*, the question of whether the

Corporations are entitled to such declarations was heard separately to any hearing determining the amount of withholding tax payable on the Payments.

5 Whether the Corporations are liable to withholding tax on the full amount of the Payments turns on whether the Payments are wholly royalties or only in part royalties. “Royalties” are defined in Article 12(4) of the “Convention between the Government of Australia and the Government of the United States of America for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income” in Schedule 2 of the *International Tax Agreements Act 1953* (Cth) (**the Treaty**).

6 It is not in dispute that:

- IBMA is an indirect, wholly-owned subsidiary of IBM.
- At all material times, IBMA acted as IBM’s Australian distributor of computer software protected by intellectual property (**IP**) owned by IBM pursuant to the SLA.
- IBMA is a resident.
- IBMA does not have a permanent establishment in a foreign country, so that s 128B(2B) of the 1936 Act does not apply.
- IBM and World Trade are both non-residents.
- To the extent that the Payments are within Article 12 of the Treaty as “royalties”, Australia as the country of source is permitted to tax the Payments subject to the exceptions within Article 12.

## LEGAL PRINCIPLES

7 There is no need to consider further the statutory context of the 1936 Act as there is no dispute that at least some amount of withholding tax is due and payable by the Corporations pursuant to s 128C of the 1936 Act, or that the Corporations are liable to pay income tax for a payment for income that consists of a royalty (s 128B(5A) of the 1936 Act). It is also not in dispute that the definition of “royalties” in Article 12(4) of the Treaty is given primacy by s 4(2) of the *International Tax Agreements Act 1953* (Cth) and it is that definition that applies for the purposes of determining the extent to which the Treaty limits the operation of s 128B of the 1936 Act.

### Meaning of Royalties

8 Royalties are dealt with in Article 12 of the Treaty. Article 12(2) provides that royalties may be taxed in the Contracting State in which they have their source and according to the law of that Contracting State but the tax so charged shall not exceed 10% of the gross amount of the royalties.

9 The term “royalties” is defined in Article 12(4) of the Treaty to mean:

- (a) *payments or credits of any kind **to the extent** to which they are consideration for **the use of or the right to use any**;*
  - (i) *copyright, patent, design or model, plan, secret formula or process,*

*trademark or other like property or right;*

- (ii) *industrial, commercial or scientific equipment, other than equipment let under a hire purchase agreement;*
  - (iii) *motion picture films; or*
  - (iv) *films or video tapes for use in connection with television or tapes for use in connection with radio broadcasting.*
- (b) *payments or credits of any kind to the extent to which they are consideration for:*
- (i) *the supply of scientific, technical, industrial or commercial knowledge or information owned by any person;*
  - (ii) *the supply of any assistance of an ancillary and subsidiary nature furnished as a means of enabling the application or enjoyment of knowledge or information referred to in sub-paragraph (b)(i) or of any other property or right to which this Article applies;*

...

[emphasis added]

10 There is no dispute as to the relevant principles to be applied in the interpretation of the Treaty and the primacy to be given to the text. Regard is to be had to the context, object and purpose of the Treaty provisions (*McDermott Industries (Aust) Pty Ltd v Commissioner of Taxation* (2005) 142 FCR 134 at [38]).

11 Included within the term “royalties” in Article 12(4) of the Treaty is a payment of any kind, to the extent to which the payment is consideration for the use of **or** the right to use any specified IP right ‘*or other like property or right*’. Clearly all rights that can be characterised as IP rights are thereby included. It should also be noted that a royalty includes consideration for the use of, or the right to use, certain equipment, motion picture films or films or video tapes used in connection with radio broadcasting. Thus, royalties are not limited to payments for IP rights.

12 Article 12(4)(b) includes as a royalty a payment to the extent to which it is consideration for:

- the supply of scientific, technical, industrial or commercial knowledge or information; or
- the supply of any assistance of an ancillary and subsidiary nature, furnished as a means of enabling:
  - the application and enjoyment of scientific, technical, industrial or commercial knowledge or information owned by any person; or
  - the property/rights of Article 12, which relevantly includes the IP rights of Article 12(4)(a)(i).

13 In summary and relevantly to this case, a payment is a royalty for the purposes of Article 12 if it is:

- for the use of an IP right;
- for the right to use an IP right;
- for the use or right to use an other like property or right;
- for the supply of certain knowledge/information;
- for assistance furnished to enable the application or enjoyment of an IP right or certain knowledge/information.

14 Article 12(4) of the Treaty does anticipate apportionment. However, the apportionment contemplated turns on the characterisation of the payment made. The Corporations emphasise that the definition of “royalties” in Article 12 draws a distinction between payments which are consideration for the use of IP on one hand and payments which are for the right to use IP on the other. The Commissioner contends that the expression ‘*for the use of or the right to use*’ means a grant, whether exercised or not (the right to use) or a grant as exercised (the use). I agree with the Commissioner’s interpretation; the definition of “royalties” applies to payments both for the use of IP, that is, the exercise of the right granted, and also for the grant of the right to use the IP. This is consistent with the proposition that the use of an IP right involves the use of subject matter which, if no right to use had been granted, would infringe the IP right.

15 If a payment is not consideration for the use of or the right to use an IP right within Article 12(4)(a) or consideration for supply as in 12(4)(b), the payment is not a royalty.

### **Relevant principles of New York law**

16 The interpretation of the SLA is fundamental to the characterisation of the Payments. The SLA, by clause 11, is deemed to be made under, governed by and construed in accordance with the laws of the State of New York. The parties agree that the relevant law as to the construction of contracts in that jurisdiction is as set out in an opinion by Judge Albert M Rosenblatt, a retired judge of the New York Court of Appeals. There is no dispute that, as set out in Judge Rosenblatt’s opinion:

- a contract must be construed in accordance with the intent of the contracting parties;
- the Court must treat the contract as a whole and interpret every part with reference to the whole, so as to give effect to its general purpose. The Court must assume that the parties intended each clause to have a purpose;
- a court will first determine whether the contract is amenable to enforcement based on language plain enough to admit of no ambiguity or need for further edification. Extrinsic evidence is not admissible to create an ambiguity in a written agreement which is complete and clear and unambiguous on its face;
- whether ambiguity exists is the exclusive province of the court;
- if at the outset the Court finds the contract unambiguous, that will preclude any extrinsic evidence as to meaning or intent;

- ambiguity is determined by looking within the four corners of the document and not to outside sources;
- a contract or term is ambiguous if reasonable minds could differ as to the meaning or implication of the disputed provision;
- recitals furnish a background to determine the meaning and intent of the operative clauses. They may have a material influence in construing the instrument and determining the intent of the parties. If the recitals are clear and the operative part is ambiguous, the recitals govern the construction. If the recitals are ambiguous and the operative part is clear, the operative part must prevail. If both the recitals and the operative part are clear but they are inconsistent with each other, the operative part is to be preferred;
- following a judicial determination of ambiguity, a party may introduce extrinsic evidence as to the purpose or object of the contract and the conduct of the parties leading up to the execution of the contract;
- if the Court finds ambiguity in a contract, it may, in resolving the ambiguity, consider the post-contractual conduct of the parties.

## ISSUES

17 The Commissioner contends that the whole of the Payments are royalties. The Corporations contend that only part of the Payments are of that kind.

18 There is no dispute that, to the extent that IP licences are the subject matter of the SLA and to the extent that the Payments are for those licences, they may properly be characterised as royalties. The Corporations emphasise, however, that it is only to that extent. If only part of the Payments are characterised as being for IP licences, the parties accept that it would be necessary to make an allocation of the Payments as between that part relating to IP rights, being rights the exercise of which would without a licence infringe the Corporations' IP, and that part relating to rights the exercise of which would not fall within that category. This is because Article 12(4) provides that royalties mean payments or credits of any kind *'to the extent to which they are consideration for the use of or the right to use'* an IP right.

19 The Corporations' IP rights are rights that encompass IBM's patents, trade marks and copyright. As the Corporations point out, the Payments must be "for" the use of or the right to use IP rights. That is determined by the construction of the SLA.

## THE SLA AS AT 1 APRIL 1987

20 In summary and relevantly, the recitals refer to the facts that:

- the programming industry **has** gone through major changes driven by technological progress and this has resulted in a substantial growth of the number and complexity of programs offered to customers;
- the rapid changes in customer and technology environments **now require** maximum flexibility for IBMA to accommodate new and changing business offerings and result in the need for more appropriate and flexible payment terms;



- the use, distribution and marketing of programs by IBMA **require** that the rights granted to IBMA **include** rights under IBM's patents, trade marks, copyrights, mask work rights, knowledge and technical know-how related thereto and, in addition, rights under the patents, registered designs, registered utility models, trade marks and copyrights of third parties as are necessary for IBMA to use, distribute and market programs;
- IBMA desires to reduce its business risks by paying IBM at the time revenue is due to IBMA;
- World Trade has previously granted certain rights to IBMA with respect to programs as part of an agreement dated 1 January 1955.

21 The SLA defines a number of terms, in particular:

- "Programs", which has a broad definition;
- "IBM's Patents", which means any and all patents, registered designs, registered utility models and applications filed and therefore having effect in Australia under which IBM has or hereafter shall receive the right to license or sub-license a subsidiary;
- "IBM's Copyrights", which means any and all copyrights in or to IBM Programs having effect in Australia in respect of which IBM has or hereafter shall receive the right to license or sub-license a subsidiary;
- "[IBMA's] Patents";
- "[IBMA's] Copyrights";
- "Subsidiary";
- "IBM Programs", which means programs protected by IBM's IP rights other than or in addition to IBMA's IP rights which are marketed by IBM or its subsidiaries and which are licensed, authorised or otherwise provided to IBMA pursuant to the SLA (I will adopt the expression **IBM Programs** as defined in the SLA where relevant in my reasons);
- "[IBMA] Programs";
- "IBM's Trademarks", which means all trade marks having effect in Australia now or hereafter owned or registered by IBM;
- "IBM's Mask Work Rights", which means all rights now or hereafter owned or registered by IBM for which IBM hereafter shall receive the right to license or sub-license a subsidiary; and
- "[IBMA's] Mask Work Rights".

22 Clause 2 provides:

*IBM, insofar as it may lawfully do so and for the term of this [SLA] **grants** to [IBMA] **under** IBM's Copyrights, Mask Work Rights, and Patents the non-exclusive rights (i) to license and distribute copies of IBM Programs for their ultimate use by customers, (ii) to use such IBM Programs in revenue producing activities, (iii) to use such IBM Programs internally, (iv) to make or have made copies for the purposes described above, for distribution to affiliated companies, and for translation or*

*modification of such IBM Programs, and (v) to allow [IBMA's] customers to use, make copies of and modify IBM Programs pursuant to the terms of [IBMA's] agreements with its customers.*

*[IBMA] agrees to comply with all applicable existing and future laws and formalities necessary to preserve and maintain IBM's Copyrights.*

*In the event Programs are or hereafter become the subject of protection other than that specified herein, either by legislation or otherwise, the pertinent provisions of the [SLA] shall apply, mutatis mutandis, to any such other protection, without amendment to this [SLA].*

*[emphasis added]*

23

Clause 3 provides:

*IBM, insofar as it may lawfully do so, grants to [IBMA], for the term of this [SLA], the right to use all of IBM's Trademarks on or in association with IBM Programs and [IBMA] Programs; provided, however, that:*

- (I) IBM shall establish standards for the nature and quality of Programs on which such Trademarks are used, and shall have the right at all times to make or have made any inspections or examinations necessary or desirable to make such standards effective;*
- (II) use of such Trademarks shall comply with any standards established by or on behalf of IBM and with any local laws or customs;*
- (III) except with the written permission of IBM, the only trademarks to be used in association with IBM Programs, and with Programs protected by [IBMA's] Patents, Mask Works Rights or Copyrights, marketed by [IBMA] shall be IBM's Trademarks; and*
- (IV) any goodwill generated by the use of IBM's Trademarks shall accrue to the sole benefit of IBM.*

*If... IBM elects to terminate this [SLA], [IBMA] shall immediately discontinue its use of IBM's Trademarks under this [SLA].*

24

Clause 4 provides:

*IBM agrees, to the extent it may lawfully do so, to allow [IBMA] for the term of this [SLA] access to and use of all knowledge and technical know-how, both confidential and other, that it may have available at any given time relating to the reproduction, use, modification, marketability, education of users, service and maintenance of IBM Programs and to make such knowledge and technical know-how available to [IBMA] in the United States of America without separate charge. However, nothing herein contained shall prevent IBM or any Subsidiary from making reasonable charges for any goods supplied or services rendered to [IBMA] including but not limited to any assistance in connection with the conduct of its business.*

*[IBMA] agrees to take appropriate steps to ensure that any confidential information obtained by it from IBM or any Subsidiary will be disclosed only to [IBMA's] employees with a need to know such information, except in accordance with*

*standards and procedures established by IBM from time to time.*

25

Clause 5 provides:

*With respect to IBM Programs:*

- (a) *IBM will obtain such licenses, releases, immunities or other rights under the patents, registered designs, registered utility models, trademarks, mask work rights and copyrights of third parties as are necessary for [IBMA] to use, copy, license, authorize or distribute such Programs.*
- (b) *IBM agrees to indemnify [IBMA] against all costs, claims, demands or damages incurred or suffered by it arising out of any proceedings for infringement of any patents, registered designs, registered utility models, mask works, copyrights and trademarks.*
- (c) *IBM shall assume the payment of all expenses including taxes and fees in connection with the filing and prosecution of any and all applications made by IBM or any Subsidiary for the grant or registration of patents, designs, utility models, trademarks, mask works and copyrights granted on such applications in Australia and in other countries chosen by IBM.*

26

Clause 6 provides:

- (a) *In consideration of the rights granted to it herein [IBMA] agrees, insofar as it may lawfully do so, to pay in lawful money of the United States of America to IBM or its designees:*
  - (I) *a fee of forty percent (40%) of all revenue, including discounts and other allowances, billed or accrued during each calendar month by [IBMA] for each copy of an IBM Program which [IBMA] authorized, licensed, or distributed to any non-affiliated party;*
  - (II) *a fee of forty percent (40%) of the unit of one price that [IBMA] would bill a third party for the licensing or authorizing to use IBM Programs for each copy of an IBM Program that [IBMA] uses internally; and*
- (b) *Such fees shall become due:*
  - (I) *for IBM Programs licensed, authorized or distributed, on the day the charges are billed or revenue accrued by [IBMA];*
  - (II) *for IBM Programs used internally by [IBMA], on the day they are delivered to the internal user for installation.*
- (c) *When [IBMA] is requested to provide IBM Program(s) to an affiliated company and [IBMA] elects to do so, upon IBM's request a fee determined by IBM or its designee from time to time shall be included by [IBMA's] charge to the affiliated company, and subsequently remitted to IBM upon collection.*
- (d) *[IBMA] agrees to pay the fees due each month under this [Clause] 6 within five work days of the beginning of the following month at a rate of exchange in effect on the date of payment or in the event of delay, the rate of exchange in effect on the fifth working day.*

## Amendments to the SLA

27           The SLA has been amended from time to time, most recently by amendments in 2002.

28           The fees payable in accordance with clause 6(a) have been amended so as to vary the percentage and the methodology used to calculate the fees. Also, under amendments made as of 1 January 1994, the introductory words to clause 6(a) were replaced, relevantly, with the words '*in consideration of the licenses and other rights granted to it hereunder, [IBMA] agrees*'.

29           No amendments have been made to the rights granted by IBM to IBMA, save that under the amendments made as of 1 January 1994, the right of IBMA pursuant to clause 3 of the SLA to use IBM's trade marks was extended to include the right to use those trade marks '*on or in associations with...[IBMA] Programs*'.

30           In each of the amendments, IBM and IBMA confirmed that in all other respects the SLA remained in full force and effect.

## THE PARTIES' CONSTRUCTION OF THE SLA

### The Corporations

31           The Corporations contend that, in essence, the SLA is a distributorship agreement under which the principal right granted to IBMA is the right to '*use, distribute and market*' IBM computer programs. In return for this IBMA pays a fee of 40% (varied to 60%) of revenue. Alternatively, in return for its efforts in marketing and distribution, IBM or World Trade retain 40% (varied to 60%) of revenue. The Corporations submit that the structure of the SLA is that it grants such rights, including IP licences, as are necessary for IBMA to carry out its function of use, distribution and marketing.

32           The Corporations submit that clause 2 of the SLA should be construed within the context of a distributorship agreement such that, pursuant to that agreement, it grants necessary IP rights. The Corporations say that the subject matter of clause 2 includes but is not limited to such rights. The Corporations rely upon the expression '*grants to [IBMA] under*' the IP rights as indicating an umbrella of such rights and the transfer of what is necessary, in a context where the rights granted are to do the matters set out in clause 2(i)–(v). The Corporations contend that:

- In regard to clause 2(i), the right '*to license and distribute copies*' of IBM Programs should be read disjunctively. That is, it is a right to license **or** distribute copies, the latter not being an IP right.
- In regard to clause 2(ii), the right to use IBM Programs in revenue producing activities is not an IP right.
- In regard to clause 2(iii), the right to use IBM Programs internally is not an IP right.
- In regard to clause 2(iv), the right to make copies is an IP right and was an IP right as at 1987.

- In regard to clause 2(v), the right to allow IBMA's customers to use, make copies of and modify IBM Programs is not an IP right.

33 The Corporations further submit that as clause 2 is not limited to the grant of IP rights, where the law changes so that IP rights no longer apply to programs, or where copyright otherwise ceases to exist in programs, or where practices change so that copies are not made and distributed to customers or used internally, the Payments made, to the extent that they are made for those rights, cease to be royalties and should be construed as overarching rights granted by clause 2 which are not limited to IP rights.

34 Insofar as clause 3 of the SLA grants to IBMA the right to use all of IBM's trade marks, the Corporations say that this, together with clause 4, which allows IBMA to use knowledge and technical know-how, is merely incidental to the rights conveyed by clause 2. Consistently with the submission on any cessation of copyright, if IBMA's dealings with the products would not infringe those trade marks, for example by reason of s 123 of the *Trade Marks Act 1995* (Cth), the Payments, to the extent they are made for those rights, cease to be payments for the grant of such an IP right. That is, the Payments cease to be for the grant to use the trade marks in a way that would infringe IBM's IP rights.

35 Clause 6(a) of the SLA as made provides that '*in consideration of the rights granted to it*', IBMA will pay a fee of 40% (now amended to 60%) of all revenue for each copy of an IBM program which IBMA authorises, licences or distributes to an external party. The same fee is applicable for each copy of an IBM program that IBMA uses internally. The Corporations point out that the payment in clause 6(a) is in respect of the action of IBMA in authorising, licensing **or** distributing IBM Programs. The Corporations submit that this indicates the separate subject matter of the SLA so that it is not to be read as the granting of IP rights but rather as the additional and severable right of distribution of the IBM Programs.

36 The Corporations also point to the current version of clause 6 of the SLA, as amended in 1994, which refers to the consideration in terms of '*licenses and other rights granted*' and the fact that clause 6(a)(i)(1) refers, disjunctively, to the consequential payment in terms of each copy of an IBM Program '*authorized, licensed or distributed*' to a customer. This, the Corporations say, recognises the separate rights of authorisation, licensing and distribution granted to IBMA under the SLA.

### **The Commissioner**

37 The Commissioner proposes a different model. The Commissioner submits that the clear intent of the SLA is to give IBMA any and all of the rights to IBM's IP as are necessary to deal with IBM Programs. The Commissioner's characterisation is that the entirety of the subject matter of the SLA is the grant of IP rights, these rights being granted to the extent necessary for IBMA to carry out its function as the user, distributor and marketer of IBM goods.

38 On this basis, the Commissioner submits that clause 2 of the SLA is properly construed as granting under all of IBM's IP rights the non-exclusive rights to deal with IBM Programs, including licensing, copying by IBM and its customers and using those programs. The Commissioner says that clause 2 grants to IBMA these rights under IBM's IP in order to ensure IBMA's flexibility in marketing IBM Programs. He says that the trilogy of IP rights

includes existing and future rights and that a grant “under” those rights cannot be read down to convey only the bare rights set out in clause 2 (i)–(v). Rather, the Commissioner says, the grant is as extensive as is necessary to do the acts described in (i)–(v). As to the grant of future rights, the Commissioner points to the specific provision in the definitions of “IBM’s Patents”, “IBM’s Copyrights” and “IBM’s Trademarks” to include property that is or hereafter shall become the subject of protection, and provision for the application of the SLA to such future IP rights without the need to amend the SLA.

39           The construction of the SLA for which the Commissioner contends emerges from the text of clauses 2, 3, 4 and 6 of the SLA and from a consideration of the SLA as a whole. He draws particular attention to the following matters:

- The fourth recital to the SLA acknowledges that that the ‘*use, distribution and marketing of Programs*’ by IBMA require that the rights granted to IBMA include rights ‘*under IBM’s Patents, Trademarks, Copyrights, Mask Work Rights... as are necessary for [IBMA] to use, distribute and market Programs*’.
- This grant of rights is achieved by clauses 2, 3 and 4. Clause 2 contains a grant of a licence ‘*under IBM’s Copyrights, Mask Work Rights, and Patents*’ to do the things contemplated in sub-clauses (i) to (v). Clause 3 contains a grant of a licence in respect of trade marks and clause 4 contains a grant of a licence that is primarily in respect of confidential information.
- The consideration for these grants is specified in clause 6, which requires a percentage of IBMA’s revenue be paid over in consideration of the rights granted in the SLA.

40           In addition, the Commissioner points to clause 4 of the SLA, which provides IBMA with ‘*access to and use of all knowledge and technical know-how, both confidential and other*’ that IBM may have at any given time relating to ‘*the reproduction, use, modification, marketability, education of users, service and maintenance of IBM Programs*’. This is not limited to confidential information and is, in part, covered by copyright and patent rights. The Commissioner says that the Payments, to the extent to which they are consideration for the rights conveyed by clause 4, are royalties within the meaning of Article 12(4)(b) of the Treaty.

## CONSIDERATION

41           The Corporations submit that the true character of the Payments must be assessed, for the purposes of characterisation, at the time each of the Payments was made. It is true that the character of the Payments is based on the nature of the rights conferred and that the personality of each of the Payments can be revisited each time one was made. However, the characterisation for each of the Payments is the same because the answer is found in the SLA, which has remained relevantly the same.

42           I do not accept the Corporations’ submissions as to the construction of the SLA.

43           The words ‘*under IBM’s Copyrights, Mask Work Rights, and Patents*’ in clause 2 describe the umbrella of IP rights owned by IBM. Clause 2 then provides that “under” those rights, IBMA has the non-exclusive rights to do the matters set out in limbs (i) to (v). Each of those latter rights of use are referable to what may be done by IBMA which may otherwise

constitute an infringement of the IP rights. Clause 2 does not grant two separate and severable rights only one of which involves the use of IP rights.

44 In their submissions, the Corporations draw attention to the ability of IBMA to distribute or use an IBM Program without infringing any IP rights. That is not the point of clause 2. Clause 2 purports to grant to IBMA whatever IP rights may be necessary. If such a right is not required to enable an activity – so be it. The SLA is drafted to ensure that any such rights as are necessary are thereby granted. The Payments, to the extent that they are for the rights granted by Clause 2, fall within Article 12(4)(a)(i) of the Treaty.

45 The Corporations further submit that (ii) and (iii) of clause 2, which refer to the use of IBM Programs, do not refer to IP rights. The Corporations’ submissions focus on the fact that such use does not infringe any copyright held in the IBM Programs. However, taking into account the generality of the rights asserted and the fact that clause 2 refers not only to copyright but also to patent rights, the insertion of (ii) and (iii) is consistent with the possible infringing use of a patent right.

46 Clause 3 of the SLA involves the grant of the right to use IBM’s trade marks. For the reasons above in relation to Clause 2, to the extent that the Payments are for the rights granted under Clause 3, they fall within Article 12(4)(a)(i) of the Treaty.

47 To the extent that the Payments are for the content of clause 4 of the SLA, which allows IBMA access to the ‘*knowledge and technical know-how*’ of IBM, they fall within Article 12(4)(b)(i) of the Treaty, which provides that payments are “royalties” where they are for ‘*the supply of scientific, technical, industrial or commercial knowledge or information owned by any person*’.

48 Clause 5 of the SLA deals with matters ancillary to IP rights. Clause 5(a) provides that IBM obtains third party IP rights that are necessary for IBMA to ‘*use, copy, license, authorize or distribute*’ IBM Programs. Clause 5(b) provides that IBM will indemnify IBMA against all costs arising out of proceedings for infringement of IP rights. Clause 5(c) provides that IBM will pay all expenses in connection with the filing and prosecution of applications by IBM or IBMA for the grant of IP rights. Article 12(4)(b)(ii) relates to the supply of assistance of an ‘*ancillary and subsidiary nature*’ furnished as a means of enabling the application or enjoyment of knowledge/information or rights. To the extent that the Payments are for the content of clause 5 of the SLA, they fall within Article 12(4)(b)(ii) of the Treaty.

49 The Corporations submit that the SLA does not ‘*look like a pure copyright licence*’. However it is also fair to say that it does not “look like a distributor licence”.

50 There is no reference in the SLA to the Payments being for the exercise of general distributorship rights. Rather, the Payments are described as being for the acquisition of the stated rights. The recitals make it clear that the SLA was intended by the parties to provide flexibility to accommodate changing business offerings as a result of changing technology. The detailed definitions are consistent with the centrality to the SLA of IBM’s IP rights. The fourth recital states that the use, distribution and marketing of IBM Programs by IBMA requires that the rights granted to IBMA include the IP rights, related knowledge and

technical know-how necessary for IBMA to use, distribute and market programs. The subject matter is the grant of IP rights rather than the grant of use, distribution and market rights. The fourth recital is consistent with a pre-existing or separate right to use, distribute and market programs.

51 Clause 6(a) of the SLA provides that the fees payable are ‘*in consideration of the rights granted to it herein*’. Those words were changed by amendment on 1 January 1994 to ‘*in consideration of the licenses and other rights granted to it hereunder*’. Whether or not the phrase “license and distribute” used in the SLA can be read as “license or distribute” or “license and/or distribute” does not change the construction of clauses 2 and 3 as a grant of so much of IBM’s IP rights as permit either or both of the licensing and distribution of copies of IBM Programs for use by third parties. I accept the Commissioner’s submission that clause 6(a) unambiguously indicates that the Payments are for the bundle of rights granted by IBM to IBMA. This is apparent when the words of clause 6(a) are considered. The Corporations’ submission that the SLA provides for a separate “right to distribute” is not sustained by the language of clause 2 or by the SLA as a whole. The language of the recitals, the definitions in clause 1 and the grants in clauses 2, 3, 4 and 5 are consistent with the meaning of “royalties” in Article 12(4) of the Treaty.

52 Taking the whole of the SLA into account, it is in my view clear that the SLA grants to IBMA such IP rights as are necessary for distribution of the relevant products by IBMA. It is not a distribution agreement which confers distribution rights independently of the grant of IP rights. The detail of the SLA concerns the definition of IP and IP rights. There is no such detail with respect to distribution rights.

53 In the language of Article 12(4) of the Treaty, the Payments are either ‘*consideration for...the right to use any copyright, patent, design or model, plan, secret formula or process, trademark or other like property or right*’ within the meaning of Article 12(4)(a)(i) or, to the extent that the Payments do not fall within Article 12(4)(a)(i), the Payments are for either ‘*technical... or commercial knowledge or information*’ supplied by IBM (Article 12(4)(b)(i)) or for ‘*the supply of any assistance of an ancillary and subsidiary nature*’ to enable the application of the rights referred to in Article 12(4)(a)(i) or the knowledge/information referred to in Article 12(4)(b)(i) (Article 12(4)(b)(ii)). The rights/content granted by the SLA are, in each case, rights/content of a kind contemplated by Article 12(4).

### **Ambiguity and extrinsic evidence**

54 The Corporations submit that the very fact that the parties have a separate approach to the construction of clause 2 of the SLA supports an ambiguity in that clause such that extrinsic material is admissible under New York law. That is, the Corporations say that both the historical background to the SLA and the post-contractual conduct of the parties are, on that basis, relevant to the construction of the SLA. I do not accept this submission. There is no ambiguity in the construction of the SLA and accordingly, any extrinsic evidence is inadmissible.

55 Nevertheless, I will briefly consider the construction of the SLA if there were ambiguity in the SLA. In this scenario, extrinsic evidence of pre-contractual conduct and the purpose or object of the SLA would be admissible in order to establish the common intention of the parties at the time that they entered into the SLA.



### ***Evidence of Pre-Contractual Conduct and Purpose/Object of SLA***

56 By an earlier agreement dated 1 September 1976, for the period from 1 September 1976 to 31 March 1987, IBMA:

- (a) had a non-exclusive licence to grant licences to end-users of machine readable copies of computer programs furnished to it by IBM or World Trade;
- (b) was obliged to pay a royalty equal to 10% of the gross charges, less returns and allowances, by IBMA and its subsidiaries to their customers for the sale, service, lease and installation of such computer programs.

57 In addition, during that period IBMA was required to pay a one-time intercompany charge called a “program production fee” to enable IBM to recover the underlying development and production costs of generating the computer programs.

58 In early 1987, IBM decided to change the arrangements under which its non-US affiliates (including IBMA) were entitled to distribute computer software to end-users to reflect the different roles of IBM and those non-US affiliates, being as follows:

- (a) IBM funded the total development costs of all internationally licensed software and made available its software products to its non-US affiliates as revenue earning programs which, for the most part, could be licensed to customers in their existing state;
- (b) the non-US affiliates (including IBMA) were distributors of the software who added little, if any, value to the software and bore insignificant risks;
- (c) IBM decided to achieve this objective by replacing the agreements under which the non-US affiliates (including IBMA) had previously been granted the right to distribute computer programs to their customers with a new standard form SLA under which each non-US affiliate was granted the right to distribute software products in return for a single licence fee equal to 40 per cent of its revenue from the licensing of the software to its customers and equivalent revenue from internal use of the software.

59 The available evidence to which I was referred that is relevant to the pre-SLA period includes IBM’s Proposed Software Licence Fee Tax Position Paper. The proposal to change to the new intercompany software system, which was implemented in the SLA in 1987, is explained in that paper. Reference is made to the need to provide a flexible system to accommodate changes in IBM’s business practices and which is responsive to the developing tax and legal environment. It is also said that it is necessary to provide IBM ‘*as a developer and entrepreneur, with an adequate return to reflect investments and risks it incurs in providing licensable software*’. Reference is made to developments in areas of technology and commercial practices, as well as tax, customs and legal considerations. For various reasons, it says that it was decided that all software should be licensed to subsidiaries under a separate and single licence agreement with a single fee expressed as a percentage of revenue. There is justification set forth for the 40% fee then to be charged. Part of that justification is the fact that IBM funds the total development costs of all internationally licensed software and that IBM supplies product support and know-how relating to licensed software.

60 Also in evidence is a document containing questions and answers said to have been prepared by IBM to assist in explaining details of the proposed software system. In answer to the question, ‘*What does the world trade subsidiary obtain for the license fee?*’, the answer is that ‘*[IBM] is the legal and beneficial owner of the copyrights for program products*’. The licence fee from worldwide subsidiaries is said to be intended to compensate for the right to use, reproduce and sub-license these products. The fee also compensates for other rights granted including, but not limited to:

- use of the IBM trade mark;
- indemnity against third party copyright infringement suits;
- assurance of the general marketability and serviceability of IBM program products; and
- technology and know-how relating to the use, marketing, reproduction and service of the IBM program products.

61 Even if there were ambiguity in the construction of the SLA, the Corporations have not pointed to any evidence of the conduct of the parties prior to entering into the SLA that supports the alternative construction that they have put forward.

### ***Evidence of Post-Contractual Conduct***

62 The Corporations also point to post-contractual evidence displaying a change in the business practices of each of IBM and IBMA, particularly the way in which IBMA has exercised its rights, along with changes that have occurred in IP law. However, extrinsic evidence does not assist in this case in establishing the common intention of the parties at the time that they entered into the SLA.

## **CONCLUSION**

63 The full amount of the Payments are royalties as defined in Article 12(4) of the Treaty.

64 It follows that the preliminary question, pursuant to O 29 r 2 of the *Federal Court Rules*, of whether the Court should make the declarations sought by the Corporations should be answered “no”. The application should be dismissed with costs.

I certify that the preceding sixty-four (64) numbered paragraphs are a true copy of the Reasons for Judgment herein of the Honourable Justice Bennett

Associate:

Dated: 12 April 2011