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Agenda item 3 (a) (v)
Article 12 (Royalties):
a.) The meaning of "industrial, commercial and scientific equipment"
b.) Software payment-related issues

Introduction

1. At the 7th session of the Committee in 2011, when the 2011 Update to the Model was finalized, the Committee acknowledged that article 12 (Royalties) would need further consideration. It was agreed that article 12 would be included in the catalogue of issues for future discussions (E/2011/45-E/C.18/2011/6, para. 47). In the 9th session of the Committee in 2013, the Committee took up the issue and requested the Secretariat to draft a paper covering specific relevant aspects, including equipment-related issues as well as issues that could have an impact on technical services provisions (E/2013/45-E/C.18/2013/6, para. 42). The Secretariat presented this paper in the 10th session of the Committee (E/C.18/2014/3). After a brief discussion, the Committee asked the Secretariat to prepare a note with a proposed text aimed at clarifying the meaning of the term "industrial, commercial or scientific equipment" in the commentary on article 12, as well as dealing with the issue of coverage or otherwise of software-related payments under the article (E/2014/45-E/C.18/2014/6, para. 51).

2. In order to address the request of the Committee, two papers were prepared: Mr. Scott Wilkie, on the one hand, kindly offered to prepare a paper with a view to scrutinizing the character and purpose of article 12 and, on the other hand, the Secretariat prepared a paper on potential ad hoc "fixes" to the article and the Commentary and uncovering issues in need for further discussions.[1]

3. This note by the Secretariat was prepared following the request of the Committee to propose a text aimed at clarifying the meaning of the term "industrial, commercial or scientific equipment" and to look at software-related payments. The note is not intended

[1] The work of Anna Binder, an intern from the Institute of Austrian and International Tax Law, WU Vienna, in preparing this note is especially acknowledged.

to derogate from the note prepared by Mr. Wilkie, but to suggest ways of approaching some royalties issues in the context of the 2016/17 update of the UN Model, without limiting the goals of broader and deeper consideration contemplated in Mr. Wilkie's paper. The following issues are suggested as possible areas for changes to the Model and/or the Commentary:

a. The addition of a paragraph 13.1 to the Commentary on article 12 to clarify the meaning of the term "industrial, commercial or scientific equipment";
b. the addition of a paragraph 13.2 to the Commentary on article 12 on the difference between a lease and a sale of "industrial, commercial or scientific equipment";
c. the addition of one or more paragraphs to the Commentary on article 12 on the treatment of an agreement over transmission capacity; and
d. the clarification of the relation between article 8 and article 12, either through an amendment to the text of article 12(1) or article 12(3) or the addition of a further paragraph to the Commentary on article 12.

4. In addition, the following issues might be considered by the Committee for further discussions:

a. The inclusion of the use of, or the right to use, software in article 12(3);
b. whether the objections to paragraph 14.4 of the OECD Commentary on article 12 regarding distribution intermediaries from the UN Commentary can be addressed;
c. the reasons for the objection to paragraph 15 of the OECD Commentary on article 12 and whether the objection still stands or can at least be further elaborated; and
d. the treatment of digital products.

5. In preparing this note, the Secretariat recognizes that some Members may be concerned that further defining terms used in article 12 might inherently disfavor the retention of source country taxation rights and favor residence country taxing rights. While there is no inherent reason why clarifications should favor one taxing right over the other, this is a concern to be kept in mind in any further works. In any case, where the OECD Commentary is disagreed with by some Members, the Secretariat does see value in further articulating the reasons for this disagreement.

a.) Article 12: The meaning of "industrial, commercial and scientific equipment"

Existing paragraphs in the Commentary referring to industrial, commercial and scientific equipment ("ICS equipment")

6. At the moment, there is only one paragraph in the Commentary on article 12 which refers to ICS equipment. The paragraph (paragraph 13) reads as follows:

> 13. Paragraph 2 of Article 12 of the OECD Model Convention (corresponding to paragraph 3 of Article 12 of the United Nations Model Convention) was amended by deleting the words "or the use of, or the right to use, industrial, commercial and scientific equipment" by the Report entitled "The Revision of the Model

Convention" adopted by the Council of the OECD on 23 July 1992. However, a number of OECD member countries have entered reservations on this point.

Definition of the term "equipment"

7. Article 12(3) of the UN Models states what is covered by the term "royalties". According to this provision, "*[t]he term "royalties" as used in this Article means payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work including cinematograph films, or films or tapes used for radio or television broadcasting, any patent, trademark, design or model, plan, secret formula or process, or for the use of, or the right to use, industrial, commercial or scientific equipment or for information concerning industrial, commercial or scientific experience.*" There is no guidance in the Commentary on article 12(3) with respect to the meaning of the terms "industrial, commercial or scientific equipment" and Contracting States may interpret these terms in different ways. Therefore, a definition of "industrial, commercial or scientific equipment" could be included in the Commentary.

8. There was no sample of a specific definition of "industrial, commercial or scientific equipment" found in an existing treaty. However, the following definition is found in the Oxford Dictionaries, whereas equipment is understood as "the necessary items for a particular purpose"[2]. For the sake of a definition, it is suggested to focus on three different characteristics of equipment, whereas equipment needs to be (1) tangible, (2) movable and/or (3) used to perform a task.

9. Except for equipment, all items listed in article 12(3) will be typically referred to as intangibles. Therein lays a major difference between equipment and the rest of the items listed in article 12(3). It might be useful to explicitly mention this difference by clarifying that equipment does indeed denote a tangible item.

10. It is further submitted that only a movable item – as opposed to immovable property which is taxable according to article 6 – falls within the understanding of "equipment".

11. It might be considered useful to include a non-exhaustive and exemplary catalogue of items which the Committee considers to be equipment. While there is no sample of an abstract definition of "industrial, commercial or scientific equipment" in an existing treaty, the question of whether a specific item constitutes "industrial, commercial or scientific equipment" has already been subject to court decisions in many countries. The following items have been qualified as "industrial, commercial or scientific equipment" and the use thereof as yielding income from royalties:

    a. aircraft[3];
    b. cranes[4]; and

[2] http://www.oxforddictionaries.com/us/definition/american_english/equipment (access 8 September 2015).

[3] See for example Turkey: Supreme Administrative Court of 10 April 2013, E.2011/1367, K.2013/1281 re DTC Turkey/USA, as cited in Yalit, B., *Turkey: Leasing of Aircraft – Characterization of Leasing Payments as Royalties*, in Lang, M. et al. (eds) *Tax Treaty Case Law Around the Globe 2014* (2014) at 161 et seq.

c. ships[5] (the relation between article 8 and article 12 will be covered in a separate section of this note, however, letting aside this issue, ships do generally fall within the definition of "equipment").

12. In one instance, the Mexican Federal Judicial Court defined ICS equipment as "*items used for the transformation of goods or for providing of services*". Furthermore, the Court found that helicopters would not fall within this definition and consequently, payments for the lease of helicopters did not constitute royalties.[6]

13. If the Committee choses to add a catalogue of items, the issue of containers should be considered as well. It is submitted that containers, being tangible and movable items used to perform a task, fall under the definition of equipment. However, this might not be apparent for some countries. When Greece, Italy, Mexico, Poland, New Zealand and Portugal (see paragraphs 40 et seq. of the OECD Commentary on article 12) entered reservations against the deletion of "industrial, commercial or scientific equipment" from the OECD Model, these countries explicitly reserved the right to include income from the lease of "industrial, commercial or scientific equipment" on the one hand and the lease of containers on the other, in article 12. The same holds true for Argentina, Brazil, Gabon, Ivory Coast, Morocco, Russia, Thailand, Tunisia, Serbia and Malaysia, which have lodged positions in relation to the OECD Commentary (see paragraphs 5 et seq. of the positions on the OECD Commentary on article 12). Interestingly, equipment and containers are mentioned separately in these reservations and positions. This might be due to the fact that for these countries, containers do not fall within the definition of equipment, or simply because these countries wanted to put additional emphasis on containers, even though they are perceived to be covered by the term "equipment". The Committee might wish to consider this issue before adding "containers" as an example of equipment to the new paragraph 13.1.

14. The following paragraph 13.1 could be added immediately after paragraph 13 of the Commentary on article 12(3):

13.1 Equipment is any tangible, movable item used to perform a task. Examples of industrial, commercial and scientific equipment therefore may include, for example:

- **aircraft;**
- **cranes;**
- **cars;**

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4 The respective case was cited in Teck, H. & Oei, J., *Singapore Applicability of the Domestic General Anti-Avoidance Rule to Concluded Tax Treaties*, Asia-Pacific Tax Bulletin 2012, 337 at 341 re DTC Singapore/Malaysia.

5 See for example Malaysia: Commissioners for Her Majesty's Revenue and Customs of 30 May 1996, OA Pte Ltd v. DGIR, Case No. PKR 651, IBFD Case Law re DTC Malaysia/Singapore; India: Income Tax Appellate Tribunal Chennai of 19 May 2006, West Asia Maritime Ltd. v. DIT, (2008) 111 ITD 155 (Chennai), IBFD Case Law Summary, re DTC India/Cyrpus; China: People's Court of Huancui District of Weihai City, Shandong Province of 3 September 2010, *Dongwha Industrial Corporation*, Case No. weihuan xingchuzi No. 31 (2010) IBDF Case Law Summery re DTC China/South Korea.

6 See Mexico: Décimo Tercer Tribunal Colegiado en Materia Administrativa del Primer Circuito of 20 August, 2012, D.A. 562/2011-9995, re DTC Mexico/Canada, as cited in Ruiz Jiménez, C. A., *Mexico: The application of Article 12 to income derived by the lease of Industrial, Commercial and Scientific Equipment*, in M. Lang et al (eds) *Tax Treaty Case Law Around the Globe 2013* (2014) at 189 et seq.

- **containers;**
- **satellites (see paragraph 13.3 for further details); or**
- **ships.**

15. The Committee might wish to consider: (1) whether the above-mentioned way of giving further meaning to the term – or any other more specific "definition" – of "industrial, commercial or scientific equipment" might be useful to include in the Commentary, (2) whether such a definition should also include a catalogue of items such as the catalogue suggested above and (3) which of the above-mentioned items (or other items not mentioned above) should finally be included in such a catalogue.

The deletion of ICS equipment rental from the OECD Model and its relevance or otherwise for the UN Model

Reasons for the deletion of ICS equipment rental from the OECD Model

16. In the 1977 version of the OECD Model, the definition of "royalties" included consideration for the use of, or the right to use, industrial, commercial or scientific equipment. In paragraph 23 of its 1983 report entitled "The taxation of income derived from the leasing of industrial, commercial or scientific equipment", however, the OECD concluded that the inclusion of income from the leasing of industrial, commercial or scientific equipment in the royalty definition would not be advisable, could lead to misinterpretation of the objectives of the OECD Model Convention and might even create difficulties in the negotiation of bilateral tax treaties. Subsequently, in the 1992 revision of the OECD Model, consideration for the use of or the right to use equipment was deleted from the definition of "royalties".

17. According to the 1983 OECD report, the Committee on Fiscal Affairs examined whether it seemed appropriate to subject income from the leasing of the use of industrial, commercial or scientific equipment to taxation at source and found that:

    a. Income from the leasing of industrial, commercial or scientific equipment was usually of a different nature than royalties proper for which article 12 had been designed;
    b. Article 12 of the OECD Model Convention provided for a zero-rate of tax for industrial, commercial or scientific equipment at source to protect it from source taxation. The inclusion of industrial, commercial or scientific equipment in the definition of royalties was therefore not meant to imply that where there was a tax on royalties at source it should extend to industrial, commercial or scientific equipment;
    c. When extending taxation at source of royalties proper to income from the leasing of industrial, commercial or scientific equipment, such income would be subject to taxation on a gross basis, which might lead to an excessive tax at the expense of the lessor. Additionally, the tax at source might not be fully credited in the residence country;
    d. Given that taxation on a gross basis would occur only in the absence of a permanent establishment, taxation where a permanent establishment did not exist might be far more burdensome than where it did;

e. Taxation would in any case occur in those States that considered the residence of the payer as the source of the royalty even if the equipment was not situated in that State.

18. The considerations above will be examined in the next paragraphs with a view to questioning their relevance or otherwise for the UN Model. If a consideration also holds true for the UN Model, remedies for this issue will be proposed.

Different nature of ICS equipment and other types of royalties (a)

19. It might be true that in common language usage, the term royalty is understood to denote payments for the right to use intangibles such as copyrights, patents and trademarks (for further elaborations on this topic see the note by Mr. Wilkie). However, it must be stressed that the authors of the UN Model and treaty negotiators are not bound to common language usage. It is at the discretion of the legislators to expand a term beyond common language usage. If it seems fit to also include equipment in the definition of royalties – and there are apt reasons for doing so (see the considerations by Mr. Wilkie) – from a legal perspective, common language usage should not prevent this inclusion.

20. An inclusion of the proposed paragraph 13.1 (see paragraph 14), stating that equipment is tangible, might help to further clarify that the definition of royalties in article 12(3) does indeed go beyond the common language usage of the term, and might avoid misunderstandings. Of course the best approach, if ICS equipment is retained, is to explain in greater depth why it might be considered appropriate to apply coverage of ICS equipment.

ICS equipment rental unintendedly triggers source taxation below a PE threshold (b)

21. The OECD Model generally does not provide for source taxation of royalties. ICS equipment was intended to remain untaxed in the source country unless there was a PE or fixed base (see note prepared by Mr. Wilkie). However, many member countries had entered reservations against this provision and had nevertheless concluded treaties which stipulated source taxation of royalties, leading to source taxation of ICS equipment rental even in cases where there was no PE or fixed base in the source country. This result was not intended by the OECD and led, among other reasons, to the deletion of "industrial, commercial or scientific equipment" from the OECD Model. This argumentation, however, cannot be applied to the UN Model, since the UN Model aimed at source taxation of royalties including ICS equipment rental from the start.

Taxation of ICS equipment rental under article 12 might lead to excessive gross taxation (c), (d)

22. The inclusion of ICS equipment rental was perceived to be problematic by the OECD, since it leads to taxation on a gross basis of income which – were there a PE or fixed base in the source country – would otherwise be taxed on a net basis. While this holds generally true for withholding taxes at source, the Commentary on article 12 of the UN Model acknowledges this issue and contains instructions for the calculation of the withholding tax rate so as to avoid the result of excessive gross taxation (see paragraphs 2 and 8-9 on article 12).

The country of the payer is not necessary the country of situs (e)

23. One reason behind source country taxation of ICS equipment rental is to give the country where the equipment is put to use the right to taxation. However, according to article 12(5) "*[r]oyalties shall be deemed to arise in a Contracting State when the payer is a resident of that State*". Consequently, the taxation right is not precisely given to the country of situs but to the country where the payer is a resident.

24. This issue has been previously acknowledged by the authors of the Commentary in paragraph 19 of the Commentary on article 12:

> 19. As in the case of interest, some members suggested that some countries may wish to substitute a rule that would identify the source of a royalty as the State in which the property or right giving rise to the royalty (the patent etc.) is used. Where, in bilateral negotiations, the two parties differ on the appropriate rule, a possible solution would be a rule which, in general, would accept the payer's place of residence as the source of royalty; but where the right or property for which the royalty was paid was used in the State having a place of use rule, the royalty would be deemed to arise in that State.

25. There does not seem to be a need for further Commentary guidance on this issue. However, the Committee might wish to consider whether such provision, stipulating that the source country is the country where the equipment is used, shall be the general rule rather than an alternative.

Difference between lease and sale

26. Before the deletion of ICS equipment from the OECD Model, the OECD Commentary on article 12 contained a provision regarding the treatment of ICS equipment. The provision was primarily concerned with the distinction between a lease and a sale. The following paragraph used to form part of the Commentary to the OECD Model on article 12:

> 9. A clear distinction must be made between royalties paid for the use of equipment, which fall under Article 12, and payments constituting consideration for the sale of equipment, which may, depending on the case, fall under Articles 7, 13, 14 or 21. Some contracts combine the hire element and the sale element, so that it sometimes proves difficult to determine their true legal import. In the case of credit sale agreements and hire purchase agreements, it seems clear that the sale element is the paramount use, because the parties have from the outset agreed that the ownership of the property in question shall be transferred from one to the other, although they have made this dependent upon the payment of the last instalment. Consequently, the instalments paid by the purchaser/hirer do not, in principle, constitute royalties. In the case, however, of lend-lease, and of leasing in particular, the sole, or at least the principal, purpose of the contract is normally that of hire, even of the hirer has the right thereunder to opt during its term to purchase the equipment in question outright. Article 12 therefore applies in the

normal case to the rentals paid by the hirer, including all rentals paid by him up to the date he exercises any right to purchase.

27. It is submitted that a lease of equipment is within the scope of article 12 while a sale of equipment is not covered by article 12. The distinction between a lease and a sale is therefore relevant for the correct application of the article. This can be difficult, as the aim behind many leasing agreements is rather the transfer of ownership ("finance leases") than the rental of property ("operating leases"), with only the latter being covered by article 12. If the Committee shares this view, it might wish to add a paragraph regarding this issue (possibly paragraph 13.2).

28. It is suggested, if such a discussion is seen as desirable, to take the former paragraph 9 of the OECD Commentary as a model, but to depart from it in the following points which are underlined in the proposed text:

a. The former paragraph 9 of the OECD Commentary on article 12 made the qualification of a mixed agreement as lease or sale agreement dependent on the "*true legal import*". This was criticized in literature as being a too narrow, formalistic approach which would not contain a full economic perspective (see M. Valta, in Reimer, E., & Rust, A. [eds] *Klaus Vogel on Double Taxation Conventions* [4th ed, 2015] Art 12 at m.n. 95). The Committee might wish to consider replacing "*true legal import*" with "economic substance".
b. The terms "financial lease" and "operating lease" are introduced to the text.
c. In addition, the Committee might wish to include indications of when an agreement is deemed to be a sale rather than a lease. A suggested list of examples, taken from various academic papers on that matter[7], is therefore included in the draft for the new paragraph 13.2. The Committee might wish to include some or all of the criteria included below and also other criteria. However, the Committee might alternatively decide not to include this list so to leave leeway for the contracting states in determining which criteria need to be met to for an arrangement to constitute an operating lease.

29. The result is the following paragraph, which the Committee might wish to consider adding to the Commentary on article 12:

13.2 A clear distinction must be made between royalties paid for the use of equipment, which fall under Article 12, and payments constituting consideration for the sale of equipment, which may, depending on the case, fall under Articles 7, 13, 14 or 21. Some contracts combine the lease element and the sale element, so that it sometimes proves difficult to determine their <u>true legal import / economic substance</u>. In the case of credit sale agreements, hire purchase agreements <u>and other forms of</u> <u>finance leases</u>, it seems clear that the sale element is the paramount use, because the parties have from the outset agreed that the ownership of the property in question shall be transferred from

[7] 24. Valta, in Reimer, E., & Rust, A. (eds) *Klaus Vogel on Double Taxation Conventions* (4th ed, 2015) Art 12 at m.nos 97 et seq who refers upon a US: Revenue Ruling 55-540 of 1995; Villar Ezcurra, M., *State Aid and Tax Lease Regimes in the Shipbuilding Industry:Lessons Learned from a Spanish Case*, ET 2014, 439 at 440; Tan A., Tan J., Wan, E., *Cross-Border Leasing*, Asia-Pacific Tax Bulletin 2014, 150 at 150 et seq.; Ponniah, A., *Taxation of Income from Equipment Leases*, Asia-Pacific Tax Bulletin 2002, 130 at 130 et seq.

one to the other, although they have made this dependent upon the payment of the last instalment. Consequently, the instalments paid by the purchaser/hirer do not, in principle, constitute royalties. In the case, however, of a lend-lease or operating lease, the sole, or at least the principal, purpose of the contract is normally that of lease, even of the lessee has the right thereunder to opt during its term to purchase the equipment in question outright. Article 12 therefore applies in the normal case to the rentals paid by the lessee, including all rentals paid by him up to the date he exercises any right to purchase. Indications for a finance lease rather than an operating lease might include, for example:

- **the lease is long term and non-cancellable;**
- **the term of the lease is likely to cover a substantial part (or all) of the equipment's useful life;**
- **there is no other user of the equipment, or it is not feasible for the equipment to be leased to another lessee;**
- **the lessor of the equipment behaves as owner;**
- **the lessor carries positive and/or negative residual value risk in respect of the equipment;**
- **the leasing rates are so high at the beginning that they constitute an inordinately large proportion of the amount needed to secure the acquisition;**
- **payments materially exceed the current fair rental value and thus compensate for more than just the use of property; and**
- **some portion of the payments is specifically designated as interest or is otherwise readily recognizable as the equivalent of interest.**

Treatment of transmission capacity

30. In the 10th session of the Meeting of Experts on International Cooperation in Tax Matters the issue of satellites was raised: Satellite operators frequently enter into agreements with their customers under which the satellite operator allows the customer to utilize the transmission capacity of the satellite but the customers do not gain physical possession or control over the satellite itself. It is subject to debate whether or not payments for such agreements qualify as payments for the "*use, or right to use, industrial, commercial or scientific equipment*". The same issue arises in connection with cables, pipelines and any other items whose physical possession is not a prerequisite for using their capacity and functions and whose capacity and functions can be subject to contracts of their own.

31. For the OECD, such transactions do not yield royalties according to article 12, because payments for the use of transmission capacity were neither payments for the use, or the right to use of property, nor payments for information or for the use of, or right to use a secret process. Furthermore, payments for the use of transmission capacity would not constitute payments for the use, or right to use ICS equipment, because the customer would not gain physical possession over the equipment. In the same manner, the OECD deals with the issue of roaming and the use of a radio frequency spectrum. The relevant paragraphs of the OECD Commentary on article 12 reads as follows:

9.1 Satellite operators and their customers (including broadcasting and telecommunication enterprises) frequently enter into "transponder leasing" agreements under which the satellite operator allows the customer to utilise the capacity of a satellite transponder to transmit over large geographical areas. Payments made by customers under typical "transponder leasing" agreements are made for the use of the transponder transmitting capacity and will not constitute royalties under the definition of paragraph 2: these payments are not made in consideration for the use of, or right to use, property, or for information, that is referred to in the definition (they cannot be viewed, for instance, as payments for information or for the use of, or right to use, a secret process since the satellite technology is not transferred to the customer). As regards treaties that include the leasing of industrial, commercial or scientific (ICS) equipment in the definition of royalties, the characterisation of the payment will depend to a large extent on the relevant contractual arrangements. Whilst the relevant contracts often refer to the "lease" of a transponder, in most cases the customer does not acquire the physical possession of the transponder but simply its transmission capacity: the satellite is operated by the lessor and the lessee has no access to the transponder that has been assigned to it. In such cases, the payments made by the customers would therefore be in the nature of payments for services, to which Article 7 applies, rather than payments for the use, or right to use, ICS equipment. A different, but much less frequent, transaction would be where the owner of the satellite leases it to another party so that the latter may operate it and either use it for its own purposes or offer its data transmission capacity to third parties. In such a case, the payment made by the satellite operator to the satellite owner could well be considered as a payment for the leasing of industrial, commercial or scientific equipment. Similar considerations apply to payments made to lease or purchase the capacity of cables for the transmission of electrical power or communications (e.g. through a contract granting an indefeasible right of use of such capacity) or pipelines (e.g. for the transportation of gas or oil).

9.2 Also, payments made by a telecommunications network operator to another network operator under a typical "roaming" agreement (see paragraph 9.1 of the Commentary on Article 5) will not constitute royalties under the definition of paragraph 2 since these payments are not made in consideration for the use of, or right to use, property, or for information, referred to in the definition (they cannot be viewed, for instance, as payments for the use of, or right to use, a secret process since no secret technology is used or transferred to the operator). This conclusion holds true even in the case of treaties that include the leasing of industrial, commercial or scientific (ICS) equipment in the definition of royalties since the operator that pays a charge under a roaming agreement is not paying for the use, or the right to use, the visited network, to which it does not have physical access, but rather for the telecommunications services provided by the foreign network operator. (Added on 22 July 2010; see HISTORY)

9.3 Payments for the use of, or the right to use, some or all of part of the radio frequency spectrum (e.g. pursuant to a so-called "spectrum license" that allows the holder to transmit media content over designated frequency ranges of the electromagnetic spectrum) do not constitute payments for the use of, or the right to use, property, or for information, that is referred in the definition of royalties in

paragraph 2. This conclusion holds true even in the case of treaties that include the leasing of industrial, commercial or scientific (ICS) equipment in the definition of royalties since the payment is not for the use, or the right to use, any equipment. (Added on 22 July 2010; see HISTORY)

32. It is understood that not all countries share the approach put forth in the OECD Commentary. Of the OECD countries, at least Greece and Germany take a different view. Greece has reserved "*the right to include the payments referred to in paragraphs 9.1, 9.2 and 9.3 in the definition of royalties*" (see paragraph 38 of the OECD Commentary on article 12). Germany has made an observation concerning the aforementioned paragraph 9.1 of the OECD Commentary. According to paragraph 31.1 of the OECD Commentary on article 12, "*Germany reserves its position on whether and under which circumstances payments made for the acquisition of the right of disposal over the transport capacity of pipelines or the capacity of technical installations, lines or cables for the transmission of electrical power or communications (including the distribution of radio and television programs) could be regarded as payments made for the leasing of industrial, commercial or scientific equipment.*"

33. Of the non-OECD countries, India takes a firm position against the treatment of payments as suggested in paragraphs 9.1-9.3 of the OECD Commentary on article 12 (see paragraph 20-22 of the positions to the OECD Commentary on article 12):

> 20. India does not agree with the interpretation in paragraph 9.1 of the Commentary on Article 12 according to which a payment for transponder leasing will not constitute royalty. This notion is contrary to the Indian position that income from transponder leasing constitutes an equipment royalty taxable both under India's domestic law and its treaties with many countries. It is also contrary to India's position that a payment for the use of a transponder is a payment for the use of a process resulting in a royalty under Article 12. India also does not agree with the conclusion included in the paragraph concerning undersea cables and pipelines as it considers that undersea cables and pipelines are industrial, commercial or scientific equipment and that payments made for their use constitute equipment royalties.
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> 21. India does not agree with the interpretation in paragraph 9.2 of the Commentary on Article 12. It considers that a roaming call constitutes the use of a process. Accordingly, the payment made for the use of that process constitutes a royalty for the purposes of Article 12. It is also the position of India that a payment for a roaming call constitutes a royalty since it is a payment for the use of industrial, commercial or scientific equipment.
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> 22. India does not agree with the interpretation in paragraph 9.3 of the Commentary on Article 12. It considers that a payment for spectrum license constitutes a royalty taxable both under India's domestic law and its treaties with many countries.

34. The OECD's view is based on two premises: First, payments for the use of capacity or functions alone do not fall under the definition of royalties in article 12, since they

constitute neither copyrights, nor patents, trademarks, models, plans, secret formulas or processes nor information or equipment. Second, in order to qualify as payments for the use, or right to use, ICS equipment (where that provision is used), physical possession of the equipment must be obtained. Since the physical possession of transmission capacity cannot be transferred separately, only a transfer of the whole object constitutes ICS equipment use.

35. Also those who support the OECD's view (e.g. Vogel, K., *Klaus Vogel on Double Taxation Conventions* [3th ed, 1993] Art 12 at m.n. 71 and M. Valta, in Reimer, E., & Rust, A. [eds] *Klaus Vogel on Double Taxation Conventions* [4th ed, 2015] Art 12 at m.n. 106) stress that whoever entered into an agreement for the use of transmission capacity does not obtain the control over the equipment as such but that the term "use" suggests that there must be some positive act of utilization (see also Authority for Advance Rulings [New Delhi] of 18 July 2008, *Dell International Services India [P.] Ltd.*, AAR No. 735 of 2006 at m.n. 13.2).

36. There also exist jurisprudence and rulings which support the OECD's view. Regarding the leasing of transponder capacity, there is advance ruling issues by the Authority for Advance Rulings (New Delhi) ("AAR") on *ISRO Satellite Centre* of 22 October 2008, AAR No. 765 of 2007 where the AAR did not qualify transponder leasing as equipment use, on the grounds that the taxpayer neither received possession or control of the equipment, nor could it use or operate the equipment. In its decision of 31 January 2011 on *Asia Satellite Telecommunications Co. Ltd v. DIT*, ITA No. 131 (2003) with ITA no. 134 (2003) the High Court of Delhi, for example, has explicitly relied on the arguments by Klaus Vogel and on the treatment proposed in paragraph 9.1 of the OECD Commentary on article 12.[8]

37. The requirement for physical possession and control could be questioned by those disagreeing with the OECD's view, however. Article 12(3) neither defines "use of, or right to use" nor does it explicitly confine "use, or right to use, industrial, commercial or scientific equipment" to cases where physical possession or control of the equipment is obtained. Also, the term "use" is nowhere limited to the legal concepts of rent or lease, which do require obtaining the power to dispose over an item and to use it exclusively. This was also the notion adopted by the Indian AAR in a latter case of 24 August 2012, *Dishnet Wireless Limited*, AAR No. 863 of 2010 where it was seen as sufficient – in order to qualify as "use" – to access a particular segment of a larger (telecommunication cable) system and to use the capacity of this system.[9]

38. In fact, equipment can be used in many different ways and one view is that behind every use of equipment is the desire to use its capacity and functions. Logically, the use of equipment cannot be separated from the use of its capacity and functions. In some cases, the use of an item's capacity and functions will require physical possession of the item (e.g. in order to use a car's transportation function, physical possession of the car

8 It should be noted that in 2012, India retroactively added an explanation to its income tax act, stating the following: "*For the removal of doubts, it is hereby clarified that the expression "process" includes and shall be deemed to have always included transmission by satellite (including up-linking, amplification, conversion for down-linking of any signal), cable, optic fibre or by any other similar technology, whether or not such process is secret*".

9 Note: This Ruling was given after the change in legislation as mentioned in footnote 8.

is required; in order to use the lifting function of a crane, physical possession of the crane is required), but in other cases, an item and thus an item's capacity and functions can be used without physical possession of the item, as is the case with satellites, cables and pipelines. Hence, the use of equipment's capacity and functions equals the use of "equipment". The wording of article 12(3) of the UN Model does not preclude an interpretation such as that also payments for the use of transmission capacity of satellites, cables or pipelines constitute payments for the use of equipment.

39. This type of approach has, for example, been taken by the Higher People's Court of Beijing of 20 December 2002, in the Case *Gaoxingzhongzi* (2002) No. 24 where payments for the provision of satellite transmission services were qualified as royalties because the use of transmission functions of the satellites and ground facilities fell within the Court's understanding of equipment use.

40. Another argument that those in disagreement with the OECD's view might put forth is that an interpretation of the term "*use, ore right to use, of industrial, commercial or scientific equipment*" as also covering payments for the use of an equipment's capacity and functions is consistent with the interpretation of the term "use, or right to use" as used throughout article 12(3). After all, the physical possession and control of the other items covered by the provision such as copyrights, patents, trademarks, designs or models, plans, secret formulas or processes, is not key to qualifying payments for their use as royalties. In fact, the concept of physical possession and control is alien to many such items.

41. Those in favor of the OECD's view will stress the fine line between the use of an owner's equipment by the payer and between the use of equipment by the owner for providing services to the payer. Payments for the latter cannot be considered payments for the use, or the right to use industrial, commercial and scientific equipment (see Vogel, K., *Klaus Vogel on Double Taxation Conventions* [3th ed, 1993] Art 12 at m.n. 44). Depending on the owner's involvement, a use of equipment can easily become a service. Any approach which does not reflect the OECD's view would therefore need to give consideration to this distinction. On the other hand, under a treaty containing a technical service provision, any service so provided is likely to be qualified as technical service, bringing about no change in source country taxing rights.

42. The Committee may want to discuss in more detail whether or not the OECD's view as regards the treatment of transmission capacity is shared. If the Committee decides that there are stronger arguments against the OECD's view, the Committee might wish to add any of the following alternatives as paragraph 13.3 to the UN Commentary on article 12, strengthening source country taxing rights for the use of transmission capacities:

Alternative A:

13.3 A payment can be said to be "for the use of, or the right to use, industrial, commercial or scientific equipment" if the payment is made for availing of the capacity and functions of a certain item to the payer.

Alternative B:

13.3 A payment can be said to be "for the use, or the right to use, industrial, commercial or scientific equipment" if the payment is made for availing of the capacity and functions of a certain item to the payer unless the payment is made to the payee for the use of equipment by the payee for providing series to the payer. The distinction will depend on the involvement of the payee in the arrangement and if possible, the arrangement could be separated into a service and an equipment use component.

43. If the Committee prefers the existing OECD's view, the Committee may wish to consider adding a reproduction of paragraph 9.1 of the OECD Commentary on article 12 to the UN Commentary. Since article 12(3) of the UN Model and article 12(2) of the OECD Model differ and only the UN Model still includes ICS equipment, paragraph 9.1 of the OECD Commentary on article 12 needs to be slightly adapted and a minority opinion could be included to reflect expected different views by the Committee Members:

13.3 Satellite operators and their customers (including broadcasting and telecommunication enterprises) frequently enter into "transponder leasing" agreements under which the satellite operator allows the customer to utilise the capacity of a satellite transponder to transmit over large geographical areas. Payments made by customers under typical "transponder leasing" agreements are made for the use of the transponder transmitting capacity and will not constitute royalties under the definition of paragraph 3; these payments are not made in consideration for the use of, or right to use, property, or for information, that is referred to in the definition (they cannot be viewed, for instance, as payments for information or for the use of, or right to use, a secret process since the satellite technology is not transferred to the customer). Whether or not the arrangement constitutes a use of equipment or the use of transponder transmitting capacity, will depend to a large extent on the relevant contractual arrangements. Whilst the relevant contracts often refer to the "lease" of a transponder, in most cases the customer does not acquire the physical possession of the transponder but simply its transmission capacity: the satellite is operated by the lessor and the lessee has no access to the transponder that has been assigned to it. In such cases, the payments made by the customers would therefore be in the nature of payments for services, to which Article 7 applies, rather than payments for the use, or right to use, industrial, commercial or scientific equipment. A different, but much less frequent, transaction would be where the owner of the satellite leases it to another party so that the latter may operate it and either use it for its own purposes or offer its data transmission capacity to third parties. In such a case, the payment made by the satellite operator to the satellite owner could well be considered as a payment for the leasing of industrial, commercial or scientific equipment. Similar considerations apply to payments made to lease or purchase the capacity of cables for the transmission of electrical power or communications (e.g. through a contract granting an indefeasible right of use of such capacity) or pipelines (e.g. for the transportation of gas or oil).

13.4 Also, payments made by a telecommunications network operator to another network operator under a typical "roaming" agreement (see paragraph 9.1 of the Commentary on Article 5) will not constitute royalties under the definition of paragraph 3 since these payments are not made in consideration for the use of, or right to use, property, or for information, referred to in the definition (they cannot be viewed, for instance, as payments for the use of, or right to use, a secret process since no secret technology is used or transferred to the operator). The operator that pays a charge under a roaming agreement is not paying for the use, or the right to use, the visited network, to which it does not have physical access, but rather for the telecommunications services provided by the foreign network operator.

13.5 Payments for the use of, or the right to use, some or all of part of the radio frequency spectrum (e.g. pursuant to a so-called "spectrum license" that allows the holder to transmit media content over designated frequency ranges of the electromagnetic spectrum) do not constitute payments for the use of, or the right to use, property, or for information, that is referred in the definition of royalties in paragraph 3.

13.6 Paragraphs 13.3-13.5 reproduce the view of the OECD Commentary on the treatment of satellites, cables for the transmission of electrical power or communications, pipelines and similar types of equipment (see paragraphs 9.1-9.3 of the OECD Commentary in article 12) with the only alterations being due to the differences between paragraph 2 of article 12 of the OECD Model and paragraph 3 of article 12 of the UN Model. This view is shared by the majority of the Committee of Experts. However, a few countries take the minority view whereas the use of transmission capacity of equipment falls within the definition of "for the use, or the right to use industrial, commercial or scientific equipment" regardless of whether or not physical possession and control of the equipment is obtained.

44. Obviously, wording such as "a few countries", "minority view" etc. would ultimately have to be matched to the level of support for this view in the Committee's discussion.

Relation between article 8 and article 12

45. Article 8 covers profits from the operation of ships or aircraft in international traffic. article 8 does not only cover the actual transportation activity, but the term "operation" also includes auxiliary activities (see paragraphs 7 et seq. of the Commentary on article 8). In paragraph 10 of the Commentary on qrticle 8, the following is stated: "*Recently, "containerisation" has come to play an increasing role in the field of international transport. Such containers frequently are also used in inland transport. Profits derived by an enterprise engaged in international transport from the lease of containers which is supplementary or incidental to its international operation of ships or aircraft fall within the scope of this Article.*" While the wording of this paragraph might be outdated – given that transportation by containers is nowadays by far the most dominant way to transport non-bulk cargo – its basic notion still applies.

46. In the 10th session of the Meeting of Experts on International Cooperation in Tax Matters, a subcommittee on Article 8 was formed to evaluate what falls under auxiliary activities to international transport. If the Committee maintains the understanding as currently put forth in paragraph 10 of the Commentary on article 8, so that article 8 is understood to also cover the lease of containers if it is supplementary or incidental to international operations of ships or aircrafts, the relation between article 8 and article 12 needs to be addressed, because containers, being tangible and movable items used to perform a task, also fall under the definition of equipment in article 12. The same deliberations can be made as regards the lease of ships, aircraft and others.

47. It is submitted that payments for the use of containers, ships and aircraft fall within the definition of royalties in article 12(3). Payments under a leasing agreement in consideration for the use, or right to use of containers, ships and aircraft are therefore in their terms taxable in the residence country of the payer according to article 12. However, such activities might also be taxable in accordance with article 8. A lease of containers, ships and aircraft might be seen as auxiliary activity to international traffic, which is covered by Article 8. In certain circumstances, the lease of ships or aircraft might be seen as an Article 8 transportation activity itself. This is the view put forth by the OECD in paragraph 5 of the OECD Commentary on article 8 whereas "*[p]rofits obtained by leasing a ship or aircraft on charter fully equipped, crewed and supplied must be treated like the profits from the carriage of passengers or cargo. Otherwise, a great deal of business of shipping or air transport would not come within the scope of the provision. However, Article 7, and not Article 8, applies to profits from leasing a ship or aircraft on a bare boat charter basis except when it is an ancillary activity of an enterprise engaged in the international operation of ships or aircraft.*" Note that this paragraph has not been included in the UN Commentary.

48. The issue can be illustrated with the following case brought before the People's Court of Huancui District of Weihai City, Shandong Province, China. Subject for assessment was the lease of a ship by Donghwa Industrial Corporation ("Donghwa"), a South Korean company for operation between China and South Korea to Chinese taxpayers. Donghwa paid the costs for crew and maintenance, which is called a "wet lease" (as opposed to a "dry lease" covering only the ships itself). Donghwa wanted the profits from this wet lease to be treated as income from the operations in international traffic, which is in accordance with paragraph 5 of the OECD Commentary on article 8. For Donghwa and according to the OECD's view, it was a case of international traffic. However, the Chinese tax authorities and the respective Court did not rely on the OECD Commentary but on a Chinese Circular whereas "*rental income derived from the lease of a ship or plane (including all equipments, staff and supplies) under a wet lease*" was only covered by article 8, if it was auxiliary to the operation in international traffic. The Court, however, decided that because this was the only activity of Donghwa, the wet lease was not auxiliary to any operation in international traffic and that the income was income from the use of equipment, for which China could levy a withholding tax.[10]

[10] Similarly, the Turkish Supreme Administrative Court did not qualify the lease of aircraft from a US company to a Turkish company as income according to article 8, because the US company had no other business in international traffic to which the lease could be auxiliary; see Supreme Administrative Court of 10 April 2013, E.2011/1367, K.2013/1281, cited in Yalit, B., *Turkey: Leasing of Aircraft – Characterization of Leasing Payments as Royalties*, in Lang, M. et al. (eds) *Tax Treaty Case Law Around the Globe 2014* (2014) at 165 et seq. re DTC Turkey/USA.

49. Since there might be cases where both, the application of article 8 and the application of article 12 might be possible, the Committee might wish to consider which provision should prevail.

50. Were article 8 to be given priority, taxation rights would be shifted from the source country to the country of effective management of the enterprise operating the ship or aircraft. However, it must be kept in mind that the country of effective management will only obtain the right to exclusive taxation if the lease is an auxiliary activity to international traffic (unless it is a wet lease and the OECD's view is followed). This requirement in itself restricts the potential for applying article 8 to an agreement for the use of equipment. In this case, the lease would be connected with an "active" business operation and the application of article 8 as opposed to article 12 might be consistent also with the scope of article 12, since article 12 was designed to cover "passive" activities.

51. This approach was chosen in the treaty between the United States and India which includes the following article 12(3):

> 3. The term "royalties" as used in this Article means:
>
> (a) payments of any kind received as a consideration for the use of, or the right to use, any copyright of a literary, artistic, or scientific work, including cinematography films or work on film, tape or other means of reproduction for use in connection with radio or television broadcasting, any patent, trademark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience, including gains derived from the alienation of any such right or property which are contingent on the productivity, use, or disposition thereof; and
>
> (b) payments of any kind received as consideration for the use of, or the right to use, any industrial, commercial, or scientific equipment, other than payments derived by an enterprise described in paragraph 1 of Article 8 (Shipping and air transport) from activities described in paragraph 2(c) or 3 of Article 8.

52. Note that the treaty between the United States and India includes the following article 8(2)(c) and article 8(3):

> 2. For the purposes of this Article, profits from the operation of ships or aircraft in international traffic shall mean profits derived by an enterprise described in paragraph 1 from the transportation by sea or air respectively of passengers, mail, livestock or goods carried on by the owners or lessees or charterers of ships or aircraft including:
> […]
> (c) the rental of ships or aircraft incidental to any activity directly connected with such transportation.

3. Profits of an enterprise of a Contracting State described in paragraph 1 from the use, maintenance, or rental of containers (including trailers, barges, and related equipment for the transport of containers) used in connection with the operation of ships or aircraft in international traffic shall be taxable only in that State.

53. If the Committee were to conclude that article 8 should take precedence over article 12 as the more specific provision in relation to the transportation component, the Committee might wish to make any of the following changes to the text of article 12 (changes are underlined):

Alternative A – change to paragraph 1 of article 12:

1. <u>Subject to the provision of Article 8</u>, royalties arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other State.

Alternative B – change to paragraph 3 of article 12:

3. The term "royalties" as used in this Article means

(a) payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work including cinematograph films, or films or tapes used for radio or television broadcasting, any patent, trademark, design or model, plan, secret formula or process, or <u>for information concerning industrial, commercial or scientific experience; and</u>

<u>(b) payments of any kind received as a consideration for the use of, or the right to use, industrial, commercial or scientific equipment other than payments derived by an enterprise described in paragraph 1 of Article 8 (Shipping, Inland Waterways Transport and Air Transport).</u>

54. Alternatively, if the Committee had decided to include a paragraph 13.1 as proposed in this note including a catalogue of possible equipment items, the Committee could chose to clarify the relation between article 8 and article 12 in the text of this newly added paragraph 13.1:

13.1 Equipment is any tangible, movable item used to perform a task. Examples of industrial, commercial and scientific equipment therefore may include, for example:

- **aircraft (<u>subject to the application of Article 8);</u>**
- **cranes;**
- **cars;**
- **containers <u>(subject to the application of Article 8)</u>;**
- **satellites (see paragraph 13.3 for further details); or**
- **ships <u>(subject to the application of Article 8)</u>.**

55. The other option would be to give priority to article 12 on the basis that it is the more specific provision as to type of payment. This would limit the possibilities for the application of article 8. However, as article 8 was designed to be a concession and an exception (therefore arguably to be construed narrowly), narrowing the possibilities for its application would, arguably, be in line with its concept, too.

56. In this case, the Committee might wish to make any of the following changes to the text of article 12 (changes are underlined):

Alternative A – change to paragraph 1 of article 12:

1. <u>Notwithstanding Article 8</u>, royalties arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other State.

Alternative B – change to paragraph 3 pf article 12:

3. The term "royalties" as used in this Article means

(a) payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work including cinematograph films, or films or tapes used for radio or television broadcasting, any patent, trademark, design or model, plan, secret formula or process, or <u>for information concerning industrial, commercial or scientific experience; and</u>

<u>(b) payments of any kind received as a consideration for the use of, or the right to use, industrial, commercial or scientific equipment notwithstanding payments derived by an enterprise described in paragraph 1 of Article 8 (Shipping, Inland Waterways Transport and Air Transport).</u>

57. Alternatively, if the Committee had decided to include a paragraph 13.1 as proposed in this note including a catalogue of possible equipment items, the Committee could chose to clarify the relation between article 8 and article 12 in the text of this newly added paragraph 13.1:

13.1 Equipment is any tangible, movable item used to perform a task. Examples of industrial, commercial and scientific equipment therefore may include, for example:

- **aircraft (<u>notwithstanding the application of Article 8);</u>**
- **cranes;**
- **cars;**
- **containers <u>(notwithstanding the application of Article 8)</u>;**
- **satellites (see paragraph 13.3 for further details); or**
- **ships <u>(notwithstanding the application of Article 8)</u>.**

b.) Article 12: Software payment-related issues

Issues in Dispute

58. Regarding the treatment of payments for software, the UN Commentary largely reproduces the OECD Commentary. However, there are some paragraphs in the OECD Commentary which have not met with unanimous agreement among the Committee Members. A paragraph was included in the UN Commentary on article 12 owing to this disagreement (see paragraph 12 of the UN Commentary on article 12):

    Some members of the Committee of Experts are of the view that the payments referred to in paragraphs 14, 14.1, 14.2, 14.4, 15, 16, 17.2 and 17.3 of the OECD Commentary extracted above may constitute royalties.

59. In the next section of this note, these issues will be laid out again for the Committee Members to discuss to see if consensus is possible, or, if not, whether greater elaboration of the reasons for the different views are possible. In addition, some possible ways forward to resolve the conflicts will be proposed.

Distinction between the use of, or the right to use, software from the use of, or the right to use, copyright underlying software and the use of, or the right to use, a "program copy"

60. It needs to be noted that article 12 does not cover payments for the use of, or the right to use, software *per se*. The catalogue in article 12(3) does not explicitly mention software. Neither is software a copyright, a patent, trademark, design or model, plan, secret formula or process, nor information or equipment (as long as the notion of equipment being tangible and movable is accepted). However, payments for the rights in copyright underlying software can qualify as royalties (subject to the issue brought forth in paragraph 13.1 of the OECD Commentary on article 12 and reproduced in the UN Commentary) since copyrights are listed in article 12(3). Therefore, the use of, or the right to use software must be distinguished from the use of, or the right to use copyrights underlying software. Only payments for the latter are covered by article 12.

61. Further, the OECD takes the view that not any payment for the use of or the right to use copyright underlying software will constitute royalties. Only the granting of comprehensive rights in the underlying software will be covered by article 12. According to the OECD, "*[p]ayments made for the acquisition of partial rights in the copyright (without the transferor fully alienating the copyright rights) will represent a royalty where the consideration is for granting of rights to use the program in a manner that would, without such license, constitute an infringement of copyright*" (see paragraph 13.1 of the OECD Commentary on article 12 and reproduced in the UN Commentary). Article 12 is perceived, in this view, as not covering transactions where the copyright is only transferred insofar as to enable the operation of the software. For these transactions, the OECD uses the term "*rights in the copy of the program*" instead of "*rights in the underlying software*". In the view of the OECD, the rights in the copy of the program are considered to comprise too few entitlements to be regarded as full copyright and therefore payments for the rights in the copy of a program are not

automatically royalties. The notion is that for these transactions, there are just enough rights in the copy of a program transferred to enable the operation of the program (such as the right to copy a program onto a hard drive or the right to make copies for one's whole business). Therefore, these rights should be disregarded for the purpose of categorizing the arrangement. In this latter case, the copyright is seen as somewhat ancillary to the use of the software, and the "software use" element prevails over the "copyright use" element. The relevant paragraphs are paragraphs 14, 14.1, and 14.2 of the OECD Commentary, which have also been included in the UN Commentary (though as noted, with disagreement with them by some Members recognized):

> 14. In other types of transactions, the rights acquired in relation to the copyright are limited to those necessary to enable the user to operate the program, for example, where the transferee is granted limited rights to reproduce the program. This would be the common situation in transactions for the acquisition of a program copy. The rights transferred in these cases are specific to the nature of computer programs. They allow the user to copy the program, for example onto the user's computer hard drive or for archival purposes. In this context, it is important to note that the protection afforded in relation to computer programs under copyright law may differ from country to country. In some countries the act of copying the program onto the hard drive or random access memory of a computer would, without a license, constitute a breach of copyright. However, the copyright laws of many countries automatically grant this right to the owner of software which incorporates a computer program. Regardless of whether this right is granted under law or under a license agreement with the copyright holder, copying the program onto the computer's hard drive or random access memory or making an archival copy is an essential step in utilising the program. Therefore, rights in relation to these acts of copying, where they do no more than enable the effective operation of the program by the user, should be disregarded in analysing the character of the transaction for tax purposes. Payments in these types of transactions would be dealt with as commercial income in accordance with Article 7.
>
> 14.1 The method of transferring the computer program to the transferee is not relevant. For example, it does not matter whether the transferee acquires a computer disk containing a copy of the program or directly receives a copy on the hard disk of her computer via a modem connection. It is also of no relevance that there may be restrictions on the use to which the transferee can put the software.
>
> 14.2 The ease of reproducing computer programs has resulted in distribution arrangements in which the transferee 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", "enterprise licenses", or "network licences". Although these arrangements permit the making of multiple copies of the program, such rights are generally limited to those necessary for the purpose of enabling the operation of the program on the licensee's computers or network, and reproduction for any other purpose is not permitted under the license. Payments under such arrangements will in most cases be dealt with as business profits in accordance with Article 7.

62. The view expressed by the OECD aims at limiting the scope for application of article 12 to software. It has not been unanimously shared by the Committee. Voices opposing this view might say that the distinction between the use of copyright underlying software (royalties) and the use of just enough copyright to operate the software (no royalties) is not straightforward and difficult to draw and may unfavorably impose on source state taxing rights. In addition, the need for this distinction must not necessarily be derived from the wording of article 12(3). Furthermore, a limitation of the scope might not be in every country's interest. Due to the dissenting opinions of the Committee, a paragraph was added, stating that "*[s]ome members of the Committee of Experts are of the view that the payments referred to in paragraphs 14, 14.1, 14.2, […] of the OECD Commentary extracted above may constitute royalties.*"

63. In view of the above, the application of article 12 and the Commentary thereto on software in their current state is not self-explanatory. A further limitation of the scope seems not within reach, given the opposition already manifested in the Commentary. Another – and radically different – option to facilitate the application of article 12 in relation to software would be to explicitly include payments for software in article 12. Consequently, already the use of, or the right to use software would trigger withholding tax and the difficult distinction between the use of, or the right to use software and the use of, or the right to use copyright underlying software would become obsolete. This would, however, broaden the scope of article 12. It would probably need to be an optional provision provided in the Commentary rather than in the text of article 12, but that would depend on the level of Members' support.

64. The European Union's Council Directive 2003/49/EC of 3 June 2003 on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States ("Interest and Royalty Directive") could serve as an example. The definition found therein reproduces article 12 of the OECD Model, but adding payments for software and ICS equipment. Admittedly, the Interest and Royalty Directive was established to limit the EU member states' right to levy withholding tax on interest and royalties. Therefore, a broad definition of royalties was chosen. However, this is a further case in point to show how the definition of royalties has been adapted to serve various purposes and that it is only in the legislator's discretion – and not subject to a dictate of common language usage – how broad or narrow to draw a definition. In article 2(b) of the Interest and Royalty Directive, royalties are defined as follows:

> (b) the term "royalties" means payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work, including cinematograph films and software, any patent, trade mark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience; payments for the use of, or the right to use, industrial, commercial or scientific equipment shall be regarded as royalties.

65. It is noteworthy that there are many treaties (about 500 found on the IBFD treaty database), both treaties allowing for a withholding tax at source and treaties providing for exclusive residence state taxation that already include the use of or the right to use software in their definition of royalties or in a protocol elaborating on the definition.

66. Hence, the Committee might wish to discuss including payments for the use of or the right to use software in article 12(3) – at least as one option.

Distribution intermediaries

67. The following paragraph of the OECD Commentary on article 12 has also not been met with unanimous agreement of the whole Committee:

> 14.4 Arrangements between a software copyright holder and a distribution intermediary frequently will grant to the distribution intermediary the right to distribute copies of the program without the right to reproduce that program. In these transactions, the rights acquired in relation to the copyright are limited to those necessary for the commercial intermediary to distribute copies of the software program. In such transactions, distributors are paying only for the acquisition of the software copies and not to exploit any right in the software copyrights. Thus, in a transaction where a distributor makes payments to acquire and distribute software copies (without the right to reproduce the software), the rights in relation to these acts of distribution should be disregarded in analysing the character of the transaction for tax purposes. Payments in these types of transactions would be dealt with as business profits in accordance with Article 7. This would be the case regardless of whether the copies being distributed are delivered on tangible media or are distributed electronically (without the distributor having the right to reproduce the software), or whether the software is subject to minor customisation for the purposes of its installation.

68. The argument behind paragraph 14.4 of the OECD Commentary appears to be the same as led to a distinction between copyright underlying software and rights embedded in a program copy. Even though the distribution intermediary receives permission to distribute copies, an action that could – without prior consent by the owner – possibly constitute a copyright infringement, it is perceived that not enough rights have been granted to qualify as use of, or the right to use, a copyright.

69. In the specific case of the distribution intermediary addressed in paragraph 14.4 of the OECD Commentary, the OECD describes a distribution intermediary who does not have the right to reproduce the software. It seems as if the distribution intermediary in this case has even less leeway to use the copyright than the user of a program copy (see above). In fact, it is unclear how the distribution intermediary might be using a copyright at all. The mere re-sale of software copies without the right to reproduce the software might be closer related to the re-sale of physical goods than to the use of a copyright. After all, if the distribution intermediaries really only pay for the acquisition and distribution of software copies, there might be no payment for any copyright involved and article 12 should not be applicable. The Committee might wish to consider this issue and to discuss whether the opposition noted in paragraph 12 of the UN Commentary regarding paragraph 14.4 of the OECD Model needs to be reflected (possibly in a more elaborated form) or whether it is no longer needed.

Distinction between the use of, or the right to use copyright and the transfer of ownership

70. Paragraphs 15 and 16 of the OECD Commentary regard the differentiation between the transfer of a copyright and the transfer of ownership:

> 15. Where consideration is paid for the transfer of the full ownership of the rights in the copyright, the payment cannot represent a royalty and the provisions of the Article are not applicable. Difficulties can arise where there is a transfer of rights involving:
> - exclusive right of use of the copyright during a specific period or in a
> - limited geographical area;
> - additional consideration related to usage;
> - consideration in the form of a substantial lump sum payment.
>
> 16. Each case will depend on its particular facts but in general if the payment is in consideration for the transfer of rights that constitute a distinct and specific property (which is more likely in the case of geographically-limited than time-limited rights), such payments are likely to be business profits within Article 7 (or 14 in the case of the United Nations Model Convention) or a capital gain within Article 13 rather than royalties within Article 12. That follows from the fact that where the ownership of rights has been alienated, the consideration cannot be for the use of the rights. The essential character of the transaction as an alienation cannot be altered by the form of the consideration, the payment of the consideration in instalments or, in the view of most countries, by the fact that the payments are related to a contingency.

71. Some Members of the Committee have expressed disagreement with the guidelines put forth in paragraph 15 of the OECD Commentary. However, the need to distinguish between a transfer of full ownership of the copyrights and a transfer of the mere right to use a copyright is inherent in article 12. Paragraph 15 does no more than to state this fact (first part of the paragraph) and to mention difficult issues (second part of the paragraph). Regarding these issues, paragraph 15 is only stating difficulties and does not put forth any recommendations. The Committee might wish to clarify which reasons have led to an objection to paragraph 15 and whether the objection is directed at the first or the second part of the paragraph. Having established these reasons, the Committee might then decide to elaborate on such disagreement as may exist by drafting a separate paragraph to be inserted after paragraph 15.1. Otherwise, the Committee might wish to consider deleting the reference to paragraph 15 from the dissenting opinion put forth in paragraph 12 of the UN Commentary on article 12.

72. The controversy behind paragraph 16 of the OECD Commentary is more visible. Nevertheless, the Committee might wish to elaborate on why some Members have difficulties (if these persist) with this paragraph in more detail to assist administration and taxpayers applying the treaty.

Digital products

73. Paragraphs 17.2 and 17.3 of the OECD Commentary address the treatment of digital products:

> 17.2 Under the relevant legislation of some countries, transactions which permit the customer to electronically download digital products may give rise to use of copyright by the customer, e.g. because a right to make one or more copies of the digital content is granted under the contract. Where the consideration is essentially for something other than for the use of, or right to use, rights in the copyright (such as to acquire other types of contractual rights, data or services), and the use of copyright is limited to such rights as are required to enable downloading, storage and operation on the customer's computer, network or other storage, performance or display device, such use of copyright should not affect the analysis of the character of the payment for purposes of applying the definition of "royalties".
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> 17.3 This is the case for transactions that permit the customer (which may be an enterprise) to electronically download digital products (such as software, images, sounds or text) for that customer's own use or enjoyment. In these transactions, the payment is essentially for the acquisition of data transmitted in the form of a digital signal and therefore does not constitute royalties but falls within Article 7 or Article 13, as the case may be. To the extent that the act of copying the digital signal onto the customer's hard disk or other non-temporary media involves the use of a copyright by the customer under the relevant law and contractual arrangements, such copying is merely the means by which the digital signal is captured and stored. This use of copyright is not important for classification purposes because it does not correspond to what the payment is essentially in consideration for (i.e. to acquire data transmitted in the form of a digital signal), which is the determining factor for the purposes of the definition of royalties. There also would be no basis to classify such transactions as "royalties" if, under the relevant law and contractual arrangements, the creation of a copy is regarded as a use of copyright by the provider rather than by the customer.

74. The suggested treatment of digital products, which is put forth in paragraphs 17.2-17.3 of the OECD Commentary on article 12, follows the same pattern as the treatment of software. So any changes in the Committee's view on the treatment of software will and must affect the view on the treatment of digital products.

General Comments

75. Some of the changes proposed in the note would – if adopted – lead to a substantial broadening of the scope of article 12 and thus, source country taxation. In order to reach broader support for this outcome, the Committee might wish to reconsider gross taxation for ICS equipment as well as software and other digital products. Gross revenue taxation does not have to be the default. The Committee might consider the view brought forth by Mr. Wilkie in his paper that article 12 is a PE-less business

profits rule or alternatively a constructive PE rule and might wish to consider adopting a modified net basis taxation. This might be preferable than to further broadening the scope of article 12 and thus further adding to the complexity of its application.

76. Furthermore, it is expected that there will remain areas of disagreement on the application of article 12. However, explanations of the differences might be useful – not framed in a way that might be seen as implication that reaction to the OECD's view is always necessary but in order to better comprehend and anticipate the application of article 12 in different countries.

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