

Committee of Experts
on International Cooperation in Tax Matters
11th Session: Geneva, 19-23 October 2015

Agenda Item 3(a)(v): Article 12 (Royalties)

- a) The meaning of “industrial, commercial and scientific equipment”
- b) Software payment-related issues

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Aim of CRP.7

Tasks (set in the 10th session)

- Clarify the meaning of “industrial, commercial and scientific equipment” (“ICS equipment”)
- Deal with the issue of coverage or otherwise of software-related payments

Possible “areas for action”

- Definition of ICS equipment
- Difference: lease and sale
- Treatment of transmission capacity
- Relation: Art 8 and Art 12
- Inclusion of software in Art 12(3)
- Clarify reasons for dissenting views

1) Definition of ICS equipment

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;*
- *containers;*
- *satellites; or*
- *ships.*

- **Advantages:**

- Facilitates application of Art 12
- Certainty for taxpayer
- Discloses assessment of countries

- **Disadvantage:**

- Limits leeway in application

2) Difference between lease and sale

- Premises:
 - Art 12 does not apply to transfer of ownership
 - Distinction – especially in leasing cases – not always easy
 - Leasing contracts often combine lease and sale element
 - Hence, guidance welcome
- Proposal: Add paragraph to Commentary (see CRP.7 para. 29)
 - Adapted version of former OECD paragraph
 - Financial lease = sale
 - Operating lease = lease
 - Decisive factor: true legal import vs. economic substance
 - Catalogue of factors
 - Disadvantage: Limits leeway in application

3) Treatment of transmission capacity

OECD view

- Use of transmission capacity \neq use of equipment
- Reasons:
 - No physical possession of equipment
 - Term “use” suggests positive act of utilization
 - Rather service provided to payer by the owner
- Suggestion:
 - Include OECD (and possibly, dissenting) view in Commentary (see CRP.7 para 43)

Alternative view

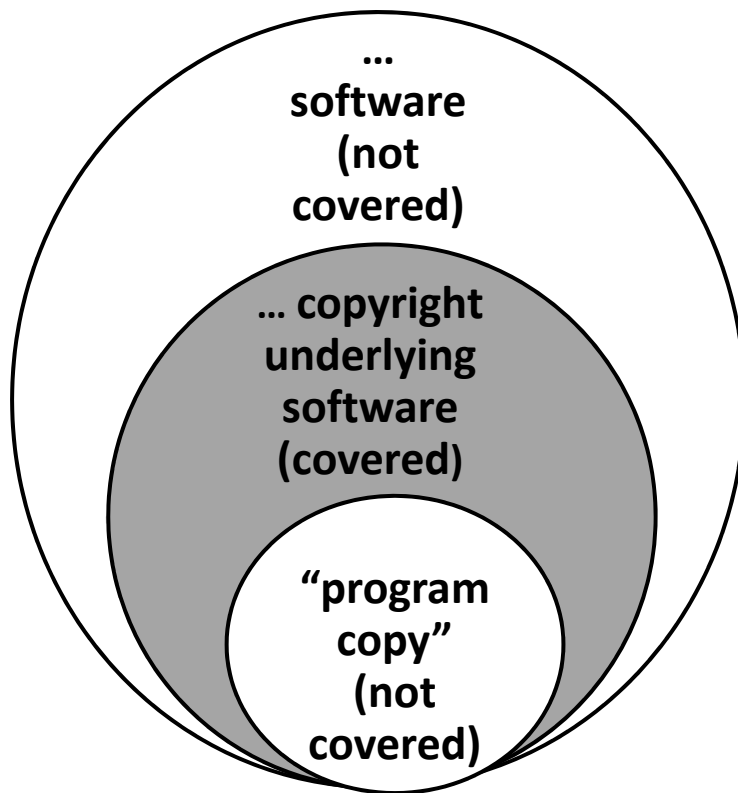
- Use of transmission capacity = use of equipment
- Reasons:
 - Notion of use does not require physical possession and control
 - Concept is alien to other items covered by Art 12(3)
- Suggestion:
 - Include provision reflecting this view in Commentary (see CRP.7 para 42)
 - (Diligence re relation to provision of services required)

4) Relation between Art 8 and Art 12

- Premise: Aircraft, ships and containers are covered by Art 8 and Art 12 → potential for conflict
- Solution: Explicitly state order of priority
- Two possibilities (change either Article or Commentary):
 - **Art 12 prevails over Art 8**
 - More specific provision in relation to type of p'ment
 - Limits application of Art 8 (arguably in line with exemption character)
 - Draft provision: CRP.7 para 56-57
 - **Art 8 prevails over Art 12**
 - More specific provision in relation to transportation component
 - Limits source country taxing rights
 - Draft provision: CRP.7 para 53-54

5) Inclusion of software in Art 12(3)

- Payments for the use of, or right to use...



- Current treatment:
 - Source: Paras 14-14.2 OECD Commentary on Art 12; incorporated into UN Commentary
 - Dissenting opinion re relevant paragraphs also incorporated into UN Commentary
 - Distinction → difficult!
- Radical approach: Inclusion of software into Art 12(3)
- Broadens scope of Art 12
- Alternative: Give guidance on dissenting view

6) Clarify reasons for dissenting views

- Treatment of distribution intermediary
 - Para 14.4 OECD Commentary
- Distinction between use and transfer of ownership
 - para 15 OECD Commentary
 - Para 16 OECD Commentary
- Treatment of digital products
 - para 17.2-17.3 of OECD Commentary
- Reasons for suggestion:
 - NOT because reaction to OECD's view is necessary
 - BUT to comprehend and anticipate the application of Art 12

Conclusion

- Several “areas for action” re ICS equipment and software
 - Definition of ICS equipment
 - Difference: lease and sale
 - Treatment of transmission capacity
 - Relation: Art 8 and Art 12
 - Inclusion of software in definition of royalties
 - Clarify reasons for dissenting views
- Each needs careful discussion among Committee Members

Annex: CRP.7 paragraph 29

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 true legal import / economic substance. In the case of credit sale agreements, hire purchase agreements and other forms of finance leases, 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 a lend-lease or operating lease, the sole, or at least the principal, purpose of the contract is normally that of lease, even if 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.

CRP.7 paragraph 29 (cont'd)

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.

CRP.7 paragraph 42: Alt' view on treatment of transmission capacity

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

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.

CRP.7 paragraph 43: Dissenting view on OECD view

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. .

CRP.7 paragraph 53/56: Possible changes to Article 12

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

ALTERNATIVE

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 for information concerning industrial, commercial or scientific experience; and

(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 / notwithstanding** payments derived by an enterprise described in paragraph 1 of Article 8 (Shipping, Inland Waterways Transport and Air Transport).

CRP.7 paragraph 54/57: Possible changes to Commentary

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