

Committee of Experts on International Cooperation in Tax Matters

Article 12 (Royalties)
“Industrial, Commercial or Scientific
Equipment” and Software Payments

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Article 12

- UN Model vs. OECD Model
 - OECD Model adopts a “residence” state orientation
 - UN Model preserves “source” state entitlement where property is used “in” and payments arise from the source state
- What particular interests are served by the UN Model?
- What is the significance of preserving source country tax rights?

Two Questions

- What is / should be the meaning of “industrial, commercial or scientific equipment”?
- How should payments for access to software be treated?

Significance of the Questions Affects Inquiry and Answers

- Fundamentally, the questions deal with the allocation of taxing rights for *business income* where the recipient lacks a typical Article 5 (“Permanent Establishment”) presence in the “source” state
- Two complementary approaches
 - Define / preserve tax rights in terms of *particular* property and payments; jurisdictional scope is the *result*
 - Express “industrial, commercial or scientific equipment” and software payments in jurisdictional terms first, to establish by description rather than prescription the intended / desirable scope of Article 12 regarding business income

The UN vs. OECD Models

- Interests of “developing” and “developed” countries
- Source state scope of Article 12 of the UN Model is deliberate, and has a long history, including with respect to base erosion and profit shifting
- Connection between Article 12, and Articles 5 and 7, and proposed treatment of “technical services”

Interpreting the Two Questions

- Not merely definitional, prescriptive
- Important to consider whether Article 12 of the UN Model is meant to have a residence or source state orientation – that is, to operate within the typical parameters of Articles 5 and 7 or effectively to extend them as:
 - A proxy for taxing business profits regardless of whether a PE exists
 - A proxy for a (constructive) PE to which business profits (royalties for the use of business property) would naturally be associated

Restating the Questions

- Whether business profits earned by a non-resident by making its business property (other than financial property) available for use by or at the direction of another in a source state should be treated as equivalent to the property owner carrying on its business and earning profits “through” the medium of the property and vicariously its use

Exploring the Restated Questions

- Clues from the history of Article 12
 - League of Nations
 - 1927, 1928
 - 1930s
 - 1943 Mexico Model and 1946 London Model
 - OEEC
 - OECD: 1963, 1977, 1983, 1992
- Allocating (limiting) tax rights under Article 12 may specifically or by implication transfer them to make Article 12 more in the nature of a “residence” rather than a “source” Article
- Implications, concerning how treaties tax business income – essentially on a source basis (favoring retained tax rights by the state where business income arises via a business presence consistent with the nature of the income earning activity)

A BEPS Aside

- Consider the direction and scope of BEPS Actions 1, 5, 6, 7 and 8 – 10
- Focus is on how income is earned according to the functional and financial competence / resources of the earner

A Perspective on Article 12

- A companion to Articles 5 and 7?
- An extension of Articles 5 and 7?
- Private law notions of “royalty” and property types less important than tendency to preserve tax rights over business income where a property owner is constructively present through the property user, in jurisdictional terms, as much as if the property owner carried on its business in the source state via more “typical” PE
- Particularizing “equipment” and “software payments” by prescription rather than description could be limiting

Options to Consider

- Option A: Limit relevant scope of Article 12 to profit participations
- Option B: Cast Article 12 (possibly via the Commentary) to preserve tax rights for a modified “net basis” measure of income
- What does the history of Article 12, and the UN Model’s approach to this Article suggest?
 - Historical consistency
 - Consistent with the nature of affected income
 - Consistent with tendencies of key BEPS reports
 - Limiting over-reliance on particular kinds of property / payments preserves jurisdictional elasticity in context of source states’ entitlement to adopt tax regimes that are consistent with their interests and administrative resources