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**Committee of Experts on International Cooperation in Tax Matters**
**Twelfth Session**
Geneva, 11-14 October 2016
Agenda item 3 (a) (iii)
Article 12 (Royalties): possible amendments to the commentary on Article 12

# Possible Amendments to the Commentary on Article 12 (Royalties) (Note by the Coordinator, Ms. Pragya Saksena)

## Background

Upon finalization of the 2011 Update to the UN Tax Treaty Model (UN Model), 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.

At the ninth 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. The Secretariat presented a paper at the tenth session of the Committee in 2014 (E/C.18/2014/3), addressing in particular the differences between the UN and OECD Model Conventions on Royalties.

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 of article 12, as well as dealing with the issue of coverage or otherwise of software-related payments under the article. At the eleventh session of the Committee in 2015, the Secretariat's note (E/C.18/2015/CRP.7), as well as a paper prepared and presented by Mr. Scott Wilkie at the Secretariat's request (E/C.18/2015/CRP.6), were taken up by the Committee

and the Subcommittee on Royalties (Subcommittee) was formed to further investigate those issues.

**The Mandate**

The mandate given to the Subcommittee is as follows:

> "The Subcommittee is to consider and report on possible improvements to the commentary on Article 12 (Royalties) of the Model, and if required, the text of that Article. It is mandated to initially report to the Committee at the October session of the Committee in 2016, addressing as its initial priority such improvements to the commentary discussion on industrial, commercial and scientific equipment and software related payments as are most likely to be accepted by the Committee for its inclusion in the next version of the UN model."

**Subcommittee Membership**

The Subcommittee was created at the eleventh session of the Committee of Experts. The Subcommittee is comprised of Members from tax administrations as well as Members from academia and advisers. Membership is assumed on a personal capacity. The Members are:

**Members of the UN Tax Committee who are also Subcommittee Members**

Ms. Pragya Saksena, coordinator (India)
Mr. Andrew Dawson (UK)
Ms. Carmel Peters (New Zealand)
Mr. Cezary Krysiak (Poland)
Mr. Christoph Schelling (Switzerland)
Mr. Henry Louie (USA)
Mr. Eric Mensah (Ghana)
Ms. Noor Azian Abdul Hamid (Malaysia)
Mr. Armando Lara Yaffar (Chevez Ruiz Zamarripa, Mexico)
Mr. Jorge Rachid (Brazil)
Mr. Al Khalifa (Qatar)
Mr. El Hadji Ibrahima Diop (Senegal)
Mr. Johan de la Rey (South Africa)
Ms. Xiaoyue Wang (China)
Mr. Ignatius Mvula (Zambia)
Mr. Mohammed Baina (Morocco)

**Other Members:**
Ms. Anna Binder (Vienna University of Economics and Business, Austria)
Mr. Scott Wilkie (Osgoode Hall Law School, Canada)
Mr. Claudio Souza (Brazil)

**Possible Amendments**

Possible amendments to the Model's Commentary are attached, and are divided into two parts:

- Part I deals with issues in relation with the characterization of consideration derived from leasing of rent of "industrial, commercial and scientific equipment" (hereby referenced as **Annex I**); and

- Part II deals with issues related to software payments (hereby referenced as **Annex II**).

The attached proposals do not purport to represent consensus positions of the Subcommittee at this stage. The Subcommittee proposes an initial discussion by the Committee, at its twelfth session, of possible amendments to Article 12 of the UN Model's Commentary on Article 12. The Subcommittee will then seek to meet and further discuss the issues and to propose revisions for consideration and approval at the Committee's thirteenth session.

# Annex I

## Proposal for modification of Commentary on Article 12 of the UN Model Tax Convention the meaning of "industrial, commercial and scientific equipment."

## Mandate

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 a 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. Subsequently, a note was prepared by the Secretariat (E/C.18/2015/CRP.7) while another note was prepared by Mr. Scott Wilkie (E/C.18/2015/CRP.6) to suggest ways of approaching some royalties issues in the context of the *2016/17* update of the UN Model. In the Eleventh Session of the Committee of Experts on International Cooperation in Tax Matters held in Geneva, 19-23 October 2015, this was taken up as item 3 (a) (v), and a sub-committee was formed to consider the issues and prepare a proposal for the consideration of the Committee. The mandate given to the Sub- committee in the Eleventh Session is as under:

*"The Sub-committee is to consider and report on possible improvements to the*

*Commentary on Article* 12 *(Royalties) of the Model, and if required, the text of that Article. It is mandated to initially report to the Committee at the October session of the Committee in 2016, addressing as its initial priority such improvements to the commentary discussion on industrial, commercial and scientific equipment and software related payments as are most likely to be accepted by the Committee for its inclusion in the next version of the UN model."*

3. Accordingly, these papers as well as other relevant materials including the references in these papers and the inputs given by the Sub-committee members and the
members of the civil society were examined, and their recommendations are summarized in this paper. This part of the paper deals with issues related to the characterization of consideration derived from leasing of rent of "industrial, commercial and scientific equipment". Part II of the paper deals with issues related to Software payment-related issues.

## Definition of the term 'Royalties'

4. Paragraph 3 of Article 12 of UN Model defines the term "royalties" as under:-

1. The 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 copy-right 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.

## The Difference between the UN Model and the OECD Model

5. The scope of Article 12 of the UN Model, is wider than that of the OECD Model. The difference appears to be for the reason to permit "source" countries to

retain taxing rights over income arising from activities that involve a meaningful engagement of a non-resident with the source country in many of the same ways that would prompt and sustain taxation contemplated by Articles 5 and 7.

6. The UN Model preserves the interests of developing countries as "source" countries in a number of respects, allowing those countries to tax income earned by non-residents who make substantial use of source countries' infrastructure, resources and labour etc., that is, the non-residents are commercially active in the "source" country in the same way as a similarly situated resident of the "source" country.

7. In the absence of suitable provisions for protecting the interests of developing countries, non-residents would be able to earn "profits" that in business and economic terms arise in, i.e., have a "source" in, those countries but may not be taxed by those countries. Accordingly, for example, the UN Model, compared to the OECD Model, contemplates the existence of a source country "permanent establishment for building and like sites of six rather than twelve months duration; and unlike the OECD Model source countries retain the right to tax "royalties" that consist of payments for the use of various types of "intangible" property and also other business property described as "industrial, commercial or scientific equipment" in the definition of royalties in Article 12 of the Model.

8. After 1946 and before the adoption of the 1963 OECD Model, the Fiscal Committee of the OEEC, considered including "equipment" in the definition of royalties and allowing for source country taxing rights. However, OECD considered that so far as "equipment" is concerned, it is more generally identified with business profits and the returns in the nature of business profits should only be taxable by a residence country. At the same time it was also concerned about base erosion and, in that regard, treaty shopping. In short the decision to prefer residence country taxation in the OECD model was not without a residual concern that business profits with substantial economic proximity to a source country would escape source country taxation, and possibly taxation at all, because of the requirements for a permanent establishment to exist. The resultant double non taxation was proposed to be addressed through Commentary to Article 1 of the OECD Model.

9. Article 12 of the UN Model is more cautious about any justification for allowing the potential loss of source country taxing rights. In this regard, the UN Model serves other interests, where retained source taxation is conceivably very important otherwise conceivably would be easily avoided.

10. 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. However, in the 1983 report of OECD entitled "The taxation of income derived from the leasing of industrial, commercial or scientific equipment", the OECD concluded that the inclusion of income from the leasing of ICS equipment in the royalty definition would not be advisable, could lead to misinterpretation of the objectives of the OECD Model Convention and might even cause 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 removed from the definition of "royalties". The reasoning given for such removal is as follows.

a. Income from the leasing of ICS 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 ICS 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 ICS equipment;
c. When taxation at source of royalties proper is extended to income from the leasing of ICS 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 as expenses including depreciation are disregarded. 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.

11. The OECD Model generally does not provide for source based taxation of royalties. ICS equipment was intended to remain untaxed in the source country unless there was a Permanent Establishment or a fixed base (CRP 6 note prepared by Mr. Scott Wilkie). However, many member countries had entered reservations against this provision and had also concluded treaties which provided for source based taxation of royalties, leading to source based taxation of rental income from ICS equipment even in cases where there was no PE or fixed base in the source country. This result was not intended by the OECD and resulted in, among other reasons, 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 based taxation of royalties including ICS equipment rental from the very beginning.

12. The inclusion of ICS equipment rental was perceived to be problematic by the OECD, on the ground that it leads to taxation on a gross basis of income which, in the event of 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 (refer to paragraphs 2 and 8-9 on article 12).

**Definition of the term "equipment"**

13. There is no guidance in the Commentary on article 12(3) with respect to the meaning of the terms "industrial, commercial or scientific equipment". Therefore, Contracting States may interpret these terms in different ways. Therefore, there is a need to provide for a definition of "industrial, commercial or scientific equipment" in the Commentary.

14. A specific definition of "industrial, commercial or scientific equipment" is not available in any existing treaty. However, as found in the Oxford Dictionaries,

equipment is understood as "the necessary items for a particular purpose"[1]. However, it would be appropriate to use the word 'property' instead of 'item' as the term 'property' is consistent with other provisions of the model. Thus equipment would mean a tangible property.

15. With an exception for equipment, all other items listed in article 12(3) are in nature of intangibles. Therein a major difference between equipment and the rest of the properties which are covered in article 12(3). Therefore, it would be appropriate to explicitly mention this difference by clarifying that equipment denotes a tangible property.

16. Further, since the immovable property is taxable according to article 6 – only the moveable property falls within the meaning of "equipment".

17. It has been suggested in the Secretariat Paper (E/c.18/2015/CRP.7) that 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 have been qualified as "industrial, commercial or scientific equipment" and the use thereof as yielding income from royalties:

a. aircraft[2];
b. cranes[3]; and
c. ships[4]

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1 E/C.18/2015/CRP.7.page 3.

2 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.

3 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.

4 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;

18. In one case, the Mexican Federal Judicial Court defined ICS equipment as "*items used for the transformation of goods or for providing of services*". However, the Court found that helicopters would not fall within this definition and as a result the payments for the lease of helicopters did not constitute royalties.[5]

19. One option is to consider adding a catalogue of properties. If that option is exercised, the issue of containers should also be considered. It may be noted that containers, being tangible and movable property used to perform a task, would fall under the definition of equipment. However, when Greece, Italy, Mexico, Poland, New Zealand and Portugal (paragraphs 40 of the OECD Commentary on article 12) entered reservations against the deletion of "industrial, commercial or scientific equipment" from the OECD Model, these countries not only categorically reserved the right to include income from the lease of "industrial, commercial or scientific equipment" but also the lease of containers, in article 12. Similarly, Argentina, Brazil, Gabon, Ivory Coast, Morocco, Russia, Thailand, Tunisia, Serbia and Malaysia, entered their positions in relation to the OECD Commentary or both i.e. the right to include income from leasing of ICS equipment and inclusion of lease of container therein (paragraph 5 of the positions on the OECD Commentary on article 12). It has been noticed that, equipment and containers are mentioned separately in these reservations and positions. This might be for the reason that these countries, wanted to put additional emphasis on containers, even though they are perceived to be covered by the term "equipment".

20. The discussions in Paragraphs 6, 7 and 8 may be one way to address the issue of defining the terms "industrial, commercial and scientific" equipment. However, another argument could be that if it is accepted that a tangible property qualifies as an "equipment", one has to determine whether such property is "industrial", "commercial" or "scientific". This determination could be subjective and could lead to litigation, although the terms "industrial, commercial and

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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.

[5] 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.

scientific" appear to have a very wide scope. As highlighted in Paragraphs 6 and 7 that this determination has resulted in court decisions in many countries and hence, there is a need to give a proper meaning.

21. The broad purpose of the Model and Article 12 is to distribute taxing rights between two countries. There does not appear to be any specific reason why the distribution rule should be restricted to only the income arising from that equipment which qualify as "industrial, commercial and scientific" equipment. Assuming that some compelling reason existed in the past to restrict the distributive role only to such equipment, there does not appear to be any compelling reason presently for which this distributive role should not be applied to all tangible movable assets.

Accordingly, the following approach may also be evaluated by the Committee:

- Amend the text of Article 12(3) to replace the words "industrial, commercial or scientific equipment".
- This will result in desired distribution of taxing rights in respect of all tangible movable assets, as against only certain categories of assets.
- Amendment to the Commentary would provide immediate guidance.

**Situs of payer vs. situs of equipment**

22. As per article 12(5), 'royalties' shall be deemed to arise in a contracting state where the payer is a resident of that State. However, in the case of taxation of rental income from ICS equipment, the country of the payer may not necessarily be the country of situs of the equipment. However, this issue has been dealt with in paragraph 19 of the Commentary on Article 12 which is reproduced below:-

> "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."

23. In view of the above, there does not seem to be any need for further guidance in the commentary on this issue.

**Requirement of control/possession of the equipment**

The issue which often arises is whether it is necessary that the equipment should be in the possession of the person making payment of such consideration? Or whether such payer must control or operate the equipment?

24. Paragraph 3 of Article 12 says that the 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, industrial commercial or scientific equipment.

25. When the payer of the consideration is in possession of the equipment or when the payer himself operates the equipment, it results in a simple assertion that the payer is 'using the equipment'. However, this does not automatically lead to a conclusion that when the payer is not in possession or control of the equipment, he cannot be said to be using the equipment. There could be business models, where the payer uses the equipment without possessing it. For instance, a cable may be used for transmitting electricity and a pipeline may be used for transporting liquids. Likewise, a transponder may be used for transmitting signals, with or without amplifying the same.

26. The Secretariat paper (CRP 7) analyses in great detail the treatment of transmission capacity highlighting that physical possession is not a prerequisite for using the capacity and functions of equipment like satellite, cables, pipelines etc. and use of their capacity and functions can be subject to contracts of their own.

27. So far as OECD is concerned, such transactions do not yield royalties in accordance with the provisions of article 12, because payments for the use of transmission capacity were neither payments for the use, nor the right to use of property, nor payments for information or for the use of, or right to use a secret process. Further, such 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 read as follows]

> *9.1Satellite operators and their customers (including broadcasting and telecommunication enterprises) frequently enter into "transponder leasing" agreements under which the satellite operator allows the customer to utilize 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 characterization 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).*

*9.2Also, 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)*

*9.3Payments 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)*

28. As has been pointed out in CRP-7, all countries do not share the approach put forth in the OECD Commentary. Greece and Germany (OECD countries) 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*" (refer paragraph 38 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.*" (refer para 31.1 of the OECD Commentary on Article 12).

29. 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 (refer paragraph 20-22 of the positions to the OECD Commentary on article 12). India does not agree with the interpretation given in para 9.1, 9.2 and 9.3 of the OECD Commentary on Article 12.

30. According to the view adopted by OECD, the use of the capacity or function can neither be categorized as copyrights, nor patents, trademarks, models, plans, secret formulas or processes nor information or equipment. Further, physical possession of the equipment is essential for payment for the use of, or right to use, the ICS equipment to qualify to be covered under Article 12.

31. The requirement of physical possession and control does not automatically flow from Article 12(3) as it 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.

32. An equipment can be used in a number of ways. Logically, the use of an equipment cannot be separated from the use of its capacity and functions. In some cases, the use of an equipment's capacity and functions will require its physical possession and in some other cases its capacity and functions can be used without its physical possession of the equipment. The wording of Article 12(3) of the UN Model does not preclude an interpretation such that payments for the use of an

equipment without physical possession (use of transmission capacity of satellites, cable or pipelines) constitute payments for the use of equipment.

33. This approach has 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. However, there also exists jurisprudence which supports the OECD view.

34. As mentioned in the Secretariat paper an interpretation of the term "*use, or 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). In any case, 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.

35. Taking into account the language of the Paragraph 3 of Article 12, it would not be possible to adopt the OECD view in the UN commentary as it has to strike a balance between the taxing rights of residence country and source country especially when the use of an equipment cannot be segregated from its capacity and functions.

36. However, the conclusion that possession of equipment is not necessary to treat the consideration as "consideration for use or right to use equipment" triggers another issue, i.e., the need to distinguish between the "consideration for the services provided by the owner of the equipment" and the "consideration for the use or right to use the equipment". The difference between the two could be blurred in cases where the payer does not get possession or control of the equipment and it is controlled and operated by the owner (recipient of the payment or on his behalf), it may be possible to view the owner as "rendering services" to the payee.

37. Paragraph 9.1 of the OECD Commentary 2014 takes a similar view and observes that consideration for such services would be subject to tax in terms of the provisions of Article 7. In this case, the source country would not be able to exercise its taxing rights if the recipient does not have a Permanent Establishment in the source country.

38. For dealing with such situations CRP 7 suggests Alternative B of proposed paragraph 13.3 (forming part of the draft amendments to the commentary on Article 12). As per this alternative, if the payment is for rendition of services by the payee using the equipment, the consideration would not be treated as "royalties". The implications of this could be as follows:

- If the relevant treaty does not have a specific Article dealing with the "Fees for Technical Services", the source country will not be able to tax the consideration, unless the payee has a Permanent Establishment in the source country and income is attributable to such Permanent Establishment.
- If the relevant treaty contains a specific Article dealing with "Fees for Technical Services", then the applicability of that Article is required to be examined i.e. whether the services can be said to be "technical, managerial or consultancy" in nature.

**Difference between lease and sale**

39 Prior to deletion of ICS equipment from Article 12 of the OECD Model, the OECD Commentary on article 12 contained a provision regarding the treatment of ICS equipment. The provision contained in OECD Commentary was basically concerned with the distinction between a lease and a sale. The following paragraph formed part of the OECD Commentary on article 12:

22."*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."*

40. It may be noted that a lease of equipment falls within the scope of article 12 while a sale of equipment is outside the scope of article 12. The distinction between a lease and a sale is therefore relevant for the correct application of the article.

41. Paragraph 28 of the Secretariat paper (CRP 7) states that:

*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 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 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.*

42. Since the lease agreements for transfer of ownership (finance lease) do not get covered by Article 12 and only lease agreements for rental of property (operating leases) get covered by Article 12, it is felt that the suggestion contained in Secretariat paper (para 28) may be adopted. Accordingly, draft paragraph to the commentary on Article 12 is added at the end of the paper.

43. Mr. Scott Wilkie has raised another issue in his paper that payments for the use of, or right to use, an equipment are basically attributive business profits which are getting taxed under Article 12 on gross basis. The rent from the use of an equipment being business income should, therefore, be taxed on net basis, though in the absence of a Permanent Establishment, under Article 12. An equipment is basically eligible for depreciation. It is felt that this issue can be addressed by the countries bilaterally while calibrating the rate of tax on equipment royalty on gross basis in the source country.

44 Based on the discussion in foregoing paragraphs, amendments in the commentary have been suggested below:

**Suggested amendments in commentary of Article 12**

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

- aircraft;
- cranes;
- cars;
- containers;
- satellites (see paragraph 13.3 for further details); or
- ships.

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 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 installment. Consequently, the installments

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. 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.

**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.

# Annex II

## Proposal for modification of Article 12 of the UN Model Tax Convention and its Commentary regarding characterization of Software payments as Royalty[6]

## Mandate

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 a 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). Subsequently, a note was prepared by the Secretariat (E/C.18/2015/CRP.7) while another note was prepared by Mr. Scott Wilkie (E/C.18/2015/CRP.6) to suggest ways of approaching some royalties issues

[6] Parts of the text quoted from earlier Reports having substantial bearing on this issue have been highlighted by bold fonts and underline, in this version of the draft. Double underline suggests more importance. Issues related to Industrial, Commercial and Scientific Equipment rentals are dealt in a separate paper (Annex I).

in the context of the 2016/17 update of the UN Model. In the Eleventh Session of the Committee of Experts on International Cooperation in Tax Matters held in Geneva, 19-23 October 2015, this was taken up as item 3 (a) (v), and a sub-committee was formed to consider the issues and prepare a proposal for the consideration of the Committee. The mandate given to the Sub-committee in the Eleventh Session is as under:

> *"The Sub-committee is to consider and report on possible improvements to the Commentary on Article 12 (Royalties) of the Model, and if required, the text of that Article. It is mandated to initially report to the Committee at the October session of the Committee in 2016, addressing as its initial priority such improvements to the commentary discussion on industrial, commercial and scientific equipment and software related payments as are most likely to be accepted by the Committee for its inclusion in the next version of the UN model."*

2. Accordingly, these papers as well as other relevant materials including the references in these papers and the inputs given by the Sub-committee members and the members of the civil society were examined, and their observations and recommendations are summarized in this paper. Part I of this paper deals with issues related to the characterization of consideration derived from leasing of rent of "industrial, commercial and scientific equipment". Part II of the paper deals with issues related to Software payment-related issues.

**Issues related to characterization of income derived from Software related payments as Royalty under Article 12 and its taxation**

3. The issues related to characterization of software payments arise largely from the differences in interpretation of paragraph 3 adopted by difference countries of the text defining "royalty", which does not specifically refer to software. The text adopted by the Convention is derived largely from the text as it existed in the 1977 OECD Convention, when software payments were relatively scarce and hence did not deserve a specific reference. However, with expanding use of software and its use in all spheres of commercial and personal life in the last few decades, these payments have now come to acquire a centre stage, leading to ever increasing demands for greater clarification and certainty. This is an issue that

is important not only for avoiding double taxation, but also for ensuring a fare division of taxing rights and providing greater tax certainty to the stakeholders paying taxes. The various aspects relevant to this issue are summarized in the following paragraphs.

**Lack of uniformity of views and positions**

4. The OECD has developed certain guidance on these issues in the form of paragraphs 12 to 17.4 of the Commentary on Article 12 of OECD Convention, which has also been included for reference in the Commentary on Article 12 of UN Convention, with the following disclaimer following it:

*"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."*

In the Commentary on Article 12 in OECD Convention, the differences in views of different member countries of OECD in respect of software payments are documented in paragraphs 39 to 47. Member countries that have documented a difference of opinion with the OECD commentary include Mexico, Portugal, Spain, Slovak Republic, Greece, Korea and Italy. Among non OECD countries, Argentina, Morocco, Serbia, Tunisia, Brazil, India, Colombia, Malaysia and Bulgaria are among the countries that have documented their differences with these views. However, the ambiguities in characterization of software related payment go beyond the differences of views that have been specifically documented by the countries, and also arise from the inclusion of "payments for the use or right to use software" within the definition of "royalty" in more than 500 bilateral treaties[7], as well as in the definition of royalty adopted by the European Union Council in its 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[8], which defines royalty as under:

*"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,*

[7] E/C.18/2015/CRP.7; paragraph 65 (page 22).
[8] Ibid; paragraph 64 (page 22).

*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."*

5. In addition to aforementioned differences of views, another significant source of ambiguity arises from the differences in the Copyright laws in different countries, particularly where software is treated as a scientific work having a copyright. As per paragraph 2 of Article 3 of both OECD and UN Model Conventions, as also most of the existing tax treaties, a term not defined in the treaty, such as "copyright" is to be understood in the following manner:

*"2. As regards the application of the Convention at any time by a Contracting State, any term not defined therein shall, unless the context otherwise requires, have the meaning that it has at that time under the law of that State for the purposes of the taxes to which the Convention applies, any meaning under the applicable tax laws of that State prevailing over a meaning given to the term under other laws of that State."*

6. The Commentary on Article 3 on both Conventions specifically clarifies that the domestic legislation at the time of application of the treaty, rather than the legislation at the time of the signing, will be applicable and that a specific legislation in respect of taxes will prevail. Thus, the definition of "royalty" in the domestic tax laws of the Contracting States as well as the definition and meaning of the term "copyright" under domestic laws of the Contracting State applying it become relevant in characterization of software payment.

7. The Commentary on Article 12 of OECD Convention also contains several references that provide significant insights on the conceptualization of "royalty". Paragraph 8 explains that it covers payments made under a license and compensation which a person would be obliged to pay for fraudulently copying or infringing the copyright, indicating that a payment for software that may arise from

the domestic copyright laws would be included within the definition of royalty.[9] Paragraph 8.2 explains the difference between the sale of rights in intellectual property and royalty from the grant of those rights.[10] Paragraphs 11 and 11.2 provide insights into the characterization of payments made for "know-how", which is generally considered as the information of an industrial, commercial or scientific nature restricted to public, and which may have practical application.[11] The conceptualization of software and payments for it is detailed in paragraph 12.1 and paragraph 12.2 as under:

*"12.1* ***Software may be described as a program, or series of programs, containing instructions for a computer*** *required either for the operational processes of the computer itself (operational software) or for the accomplishment of other tasks (application software). It can be transferred through a variety of media, for example in writing or electronically, on a magnetic tape or disk, or on a laser disk or CD-ROM. It may be standardized with a wide range of applications or be tailor-made for single users. It can be transferred as an integral part of computer hardware or in an independent form available for use on a variety of hardware.*

[9] "… The definition covers both payments made under a license and compensation which a person would be obliged to pay for fraudulently copying or infringing the right." *(paragraph 8 of OECD Commentary on Article 12)*

[10] "…As noted in paragraphs 15 and 16 below as regards software, difficulties can arise in the case of a transfer of rights that could be considered to form part of an element of property referred to in the definition where these rights are transferred in a way that is presented as an alienation. For example, this could involve the exclusive granting of all rights to an intellectual property for a limited period or all rights to the property in a limited geographical area in a transaction structured as a sale. Each case will depend on its particular facts and will need to be examined in the light of the national intellectual property law applicable to the relevant type of property and the national law rules as regards what constitutes an alienation but in general, if the payment is in consideration for the alienation of rights that constitute 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 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…". *(paragraph 8.2 of OECD Commentary on Article 12)*

[11] "In classifying as royalties payments received as consideration for information concerning industrial, commercial or scientific experience, paragraph 2 is referring to the concept of "know-how". Various specialist bodies and authors have formulated definitions of know-how. …. It generally corresponds to undivulged information of an industrial, commercial or scientific nature arising from previous experience, which has practical application in the operation of an enterprise and from the disclosure of which an economic benefit can be derived. … In the know-how contract, one of the parties agrees to impart to the other, so that he can use them for his own account, his special knowledge and experience which remain unrevealed to the public. It is recognized that the grantor is not required to play any part himself in the application of the formulas granted to the licensee and that he does not guarantee the result thereof. *(paragraphs 11 & 11.2 of OECD Commentary on Article 12)*

*12.2 The **character of payments received in transactions involving the transfer of computer software depends on the nature of the rights that the transferee acquires under the particular arrangement regarding the use and exploitation of the program. The rights in computer programs are a form of intellectual property. Research into the practices of OECD member countries has established that all but one protects rights in computer programs either explicitly or implicitly under copyright law.** Although the term "computer software" is commonly used to describe both the program — in which the intellectual property rights (copyright) subsist — and the medium on which it is embodied, the copyright law of most OECD member countries recognizes a distinction between the copyright in the program and software which incorporates a copy of the copyrighted program. Transfers of rights in relation to software occur in many different ways ranging from the alienation of the entire rights in the copyright in a program to the sale of a product which is subject to restrictions on the use to which it is put. The consideration paid can also take numerous forms. **These factors may make it difficult to determine where the boundary lies between software payments that are properly to be regarded as royalties and other types of payment. The difficulty of determination is compounded by the ease of reproduction of computer software, and by the fact that acquisition of software frequently entails the making of a copy by the acquirer in order to make possible the operation of the software.**"*

8. In addition, paragraph 13 also admits that "***… in unusual cases, the transaction may represent a transfer of "know-how" or secret formula***" thereby highlighting the possibility of characterizing software under different items specifically included in the definition of "royalty" in respect of which the consideration for use, or right of use will constitute royalty. Paragraphs 17.1 and 17.2 extend the approach to digital products while highlighting the complexities of characterization of consideration for downloading them and their dependence on domestic laws. [12] Thus, the inherent variations possible in approaching the

[12] "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

characterization of payments made for use of software are recognized in the Commentary on Article 12 of OECD Convention.

## Historical Background

9. The need for reviewing historical background arises from the relevance of paragraph 2 of Article 3 in interpreting the terms relevant to the issue such as "copyright" in the context of tax treaties signed and entered into by Contracting States either prior to the development of the existing guidance in paragraphs 12 to 17.4 of Commentary on Article 12 of OECD Convention in 2001 as well as in respect of countries, as referred above, that have specifically documented their difference of view with this guidance. Understanding the historical background also provides an insight into considerations and objectives that may have been instrumental in the development of the guidance in these paragraphs.

10. The work for development of guidance in respect of application of Article 12 on software payments appears to have its origin in a report titled "*Software: An Emerging Industry*" that was published by the OECD in 1985 and in consequence of which further work was undertaken that resulted in the report titled "*The Tax Treatment of Software*", which was adopted by the OECD Council on 23 July 1992[13]. The recommendations made in in Appendix 3 of this report for changes in Commentary on Article 12 were incorporated in another report titled "*The Revision of the Model Convention*", which was also adopted by the Council of the OECD on 23 July 1992, and lead to the insertion of the paragraphs 12 to 19 of the Commentary on Article 12. These changes were the first major guidance included in the Commentary on Article 12 in respect of software payments. The second set of further guidance that was subsequently incorporated and continues to remain as existing guidance was adopted on the basis of another report titled "*The 2000 Update to the Model Tax Convention*" adopted by the OECD Committee on Fiscal

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"."

[13] OECD Model Convention Vol II R (10) 2: The Tax Treatment of Software, paragraph 1

Affairs on 29 April 2000, leading to modification of some of the paragraphs and insertion of paragraph 12, 12.1, 12.2, 13.1, 14, 14.1, 14.2, 14.3 and 14.4 in the existing Commentary. The third set of major changes in this guidance resulted from the recommendations made in the OECD report titled "*Treaty characterization Issues arising from E-Commerce*" which was adopted by the OECD Committee on Fiscal Affairs on 7 November 2002, consequently leading to another report titled "*The 2002 Update to the Model Tax Convention*" adopted by OECD Council on 28 January 2003, which led to the paragraphs 11.1, 11.2 11.3, 11.5, 11.6, 17.1, 17.2, 17.3 and 17.4 of the existing Commentary. Reference to the aforementioned reports that led to these changes also provides useful insights about their adoption.

11. The first report of software payments, "*The Tax Treatment of Software*" included the results of a survey that was undertaken as part of the preparation of that report regarding the practices followed by countries in respect of characterization of software payment during that period, i.e. between 1985 to 1992. As detailed in Appendix 1 of this report, the extensive survey sought information followed by the member countries, the responses to which are tabulated in Appendix 2 of this report, from where it can be observed that at that point of time, i.e. prior to the insertion of paragraphs 12 to 17.4 in the existing Commentary on Article 12, all member countries of OECD, except Switzerland, responded by saying that intellectual property in software is protected by copyright under domestic laws. Regarding the question whether a payment for software that is not of a capital nature would constitute "royalty" or a "payment for goods and services" under their laws, 16 of 21 affirmed that it would or could constitute "royalty" while others responded by saying that under their laws, such a distinction did not exist. 17 of them affirmed that tax would be deductible from such a payment, whereas 4 affirmed that no withholding tax would be deductible in their countries from such payments.[14] Regarding the differences between the bundled and unbundled software, most countries were of the view that it did not matter, whereas for some countries it mattered. In respect of payments made for joint contracts for software and services, almost all countries affirmed that they would tax only part of the payment relating to software as royalty. These details provide

[14] As the tabulated responses in Appendix 3 of this report, Netherlands, Ireland and Switzerland did not impose tax on royalties, whereas in Norway no tax was deductible as royalty was defined in its laws.

the insights into practices of the member countries of OECD that were being followed prior to the insertion of paragraphs 12 to 17.4 of existing commentary on Article 12 of OECD Convention, which in turn are significant indicators of the "context" that would be relevant for those tax treaties that have been signed prior to the development of such guidance. It may also be a significant indicator of "context" for the tax treaties that adopted the text of Article 12 as recommended by the UN Convention prior to the inclusion of reference to this guidance on software payments in the Commentary on Article 12 of UN Convention.

12. Since the existing guidance on characterization of payments for software have their genesis in this report, the review of its contents can help in understanding the underlying rationale and justification for the existing guidance in OECD Commentary. Paragraphs 38 to 47 of this report provide the relevant insights in this regard, and hence are worth referring here:

*"38. **Many bilateral treaties between Member countries maintain a limited rate of tax at source on royalties generally or on particular types of royalties. Twelve countries have indeed entered a reservation against the zero rate provided in Article 12.** As bilateral treaties which provide for tax at source on royalties usually adopt the full definition of royalties in paragraph 2 of Article 12, a number of countries exercise taxing rights at source on many types of software payments on the grounds that they represent royalties.*

*39. Source taxation of software payments raises questions of principles and of practical application. As regards the latter, it is necessary to determine — which of the various types of payments relating to software represent royalties; — how payments effected under mixed contracts are to be dealt with.*

***Analysis***

*40. The Committee examined whether it was in principle appropriate to regard software payments as within Article 12. It took into account the following:*

*a) Article 12 recommends a zero rate of tax on royalties with the* ***intention of protecting royalties from taxation in the State of source except to the limited extent provided by paragraph 3*** *of Article 12.*

*b)* ***Taxation of royalties at source may lead to taxation on a gross basis which disregards the expenses incurred by the payee in earning the royalties****.* ***In some cases this may result in unrelieved double taxation*** *when the State of residence is unable to credit fully the tax withheld at source because it taxes the royalties on a net basis.*

*c) Taxation on a gross basis occurs only in the absence of a permanent establishment; if a royalty is effectively connected with a permanent establishment, the effect of Article 7 together with paragraph 3 of Article 12 is to ensure taxation on a net basis. Paradoxically the less the connection of the payee with the State of source, the greater his tax burden there.*
*The Committee noted that* ***nevertheless within OECD there was near unanimity in affording protection to software rights under copyright law. It concluded from this that software payments made for the right to exploit intellectual property in software could not be separated from copyright royalties generally. It was not able to recommend that software payments should be regarded as entirely outside the scope of Article 12.*** *There are, however, difficulties in applying the copyright provisions of Article 12 to software royalties since paragraph 2 of the Article requires that software should be classified as a literary, artistic or scientific work. None of these categories seems entirely apt, but* ***treatment as a scientific work might be the most realistic approach****. Countries for which it is not possible to attach software to any of those categories might be justified in adopting in their bilateral treaties an amended version of paragraph 2 of Article 12 which either omits all references to the nature of copyrights or refers specifically to software.*

*41. The Committee also examined the question of the boundary between software payments in the nature of royalties and software payments of other kinds — a problem which gives rise to considerable difficulties.*

***First hypothesis: partial transfer of rights***

*42. The first hypothesis is that of payments made in circumstances where less than the full rights to software are transferred. Some countries argued that payments made in consideration of a partial transfer of intangible rights attached to software were within the broad scope of the definition in Article 12 even when the leasing of equipment is excluded. They considered that it was not appropriate to distinguish according to whether:*

*— a single payment or payments spread over a period of time are involved;*

*— the rights of use are transferred for a limited period or otherwise;*

*— the transferor of the rights is the author of the software or another person downstream in the commercial exploitation of the software.*

*They accordingly expressed the view that in all of the above circumstances the payments are taxable in the State of source (State S) if the convention between State S and the State of residence (State R) of the recipient provides for the taxation of royalties at source. The royalties received in State R are also taxable there in accordance with its laws. State R must eliminate double taxation in accordance with the convention for example by giving a tax credit.*

*43. The* ***contrary view of other countries was that the intention of Article 12 was to eliminate source taxation and that the definition of royalties had to be interpreted more narrowly so as to limit its scope. They considered that an important distinction had to be drawn between:***

***— the acquisition of software for the personal or business use of the purchaser;***

***— the acquisition of software for commercial development or exploitation.***

***In the first situation, they considered that the purchaser had done no more than purchase a product and that the payment fell to be dealt with in***

***accordance with Article 7 or Article 13 as appropriate. They did not consider it to be relevant that the product was protected by copyright and that there were restrictions on the use to which the purchaser could put it. In the second situation, they agreed that the payments were made for rights to exploit intellectual property and accordingly were likely to be royalties.*** *Examples of such exploitation included the reproduction or adaptation of software for onward distribution. In such situations, payments to the owner of the copyright were likely to be royalties especially if they were related to the number of products distributed.*

*44. The solution to these crucial differences of view must lie in the definition of royalties in paragraph 2 of Article 12:* ***"The 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 [...] any patent [...]". On the broad interpretation, the mere purchase of a product protected by copyright or a patent is likely to result in the payment of a royalty as consideration for use of the product. The narrower interpretation is that "use" as referred to in the Model Convention is limited to use by an acquirer who seeks to exploit commercially the intellectual property of another.*** *A substantial majority of the Committee took the firm view that the narrower interpretation was correct. They felt that* ***paragraph 1 of the Commentary on Article 12 which describes royalties in principle as "income to the recipient from a letting"*** *made the position clear. As the outright acquisition of a product (e.g. a computer programme) for simple use by the purchaser could not represent any form of letting it clearly could not give rise to a royalty within the meaning of Article 12.*

***Second hypothesis: transfer of all rights***

*45. In the second hypothesis, the payments are effected as consideration for the final transfer of all the rights attached to the software. In this case there was general agreement that the payments were in consideration for the acquisition of the software without involving questions on rights to use it. The provisions of Article 12 were not applicable.*

*46. A further question is whether it is appropriate to classify certain other transactions as a transfer of software such as:*

*— those whose purpose is to transfer the exclusive right to use software during a specific period or in a limited geographical area;*
*— those involving additional consideration related to the usage of the software;*
*— those which comprise substantial lump-sum payments.*
*47. Countries have differing practices in their treatment of such transactions and it is impossible to draw a clear borderline between payments which are properly to be treated as a capital gains matter and those that are royalties within Article 12 in every situation. Nevertheless there are clear principles to be followed in determining the nature of the transaction. Firstly, regard must be had to the precise terms of the contract under which the software rights were transferred. Secondly, where a transfer of ownership of rights has occurred, payments cannot be for the use of the rights. Finally, the form that the consideration takes, whether payment by instalments or, in the view of most countries, payment related to a contingency, is irrelevant in determining the character of a transaction."*

13. These observations of the Committee provide detailed insights about the guidance that it recommended for inclusion in the Commentary on Article 12 in OECD Convention. **The report documents that the argument supporting the need for drawing a distinction between software payment for personal or business use of the purchaser and the software payment for commercial development or exploitation was based on the intention of Article 12 in the OECD Convention, of eliminating source taxation and that the definition of royalties had to be interpreted more narrowly so as to limit its scope. It is also clear from the paragraph 38 that the OECD Committee took note of the fact that in spite of its recommendation that royalty should not be taxed at source, several of its members have not agreed to adopt that recommendation and several treaties provided taxation of royalty in source state.**

14. The report also documents that if the definition of the term "royalties" in the paragraph 2 of Article 12 was interpreted "*broadly*", then mere purchase of a product protected by copyright or a patent will result in the payment of a royalty as

consideration for use of the product, whereas if a *"narrower"* definition is adopted, only a payment made for commercial exploitation of such a product would be considered as royalty. The Committee adopted the narrower definition keeping in view the intention of Article 12 in OECD Convention of eliminating source based taxation. **This is an important insight, since it is obvious that those who do not intend to eliminate source taxation of royalty would not be expected to adopt this "narrower" interpretation of royalty.**

15. Since all subsequent reports of OECD that led to further expansion of this guidance went by the recommendations of this report, these insights become significant to this discussion. They also necessitate a review and comparison of the "intent" of Article 12 in the two Conventions.

**Difference in the intent & purpose of Article 12 of UN and OECD Conventions**

16. Article 12 of the UN Convention deviates significantly in the intent and purpose from the Article 12 of the OECD Convention, as evident from the exclusion of the word "*only*" from paragraph 1 and the insertion of source taxation rule in the form of paragraph 2. Thus, while the objective of Article 12 of OECD Convention is to confirm exclusive taxation rights for the residence country in respect of income covered by Article 12, the objective of this Article in UN Convention is exactly the opposite, i.e. to confer source based taxation of income covered by it. This difference also manifests in other areas, such as in the treatment of income derived from leasing of industrial, commercial and scientific equipment as royalty as well as in the inclusion of films or tapes in UN Convention. **The rationale for this distinctive approach is already explained in paragraphs 2 to 9 of the existing Commentary on Article 12 of UN Convention and continues to guide and govern the application of this Article. Unless it is intended to change the approach already detailed in paragraph 2 to 9 of the Commentary on Article 12 and harmonize it with the approach adopted in Article 12 of the OECD Convention, the guidance on interpretation on this issue would need to be in accordance with that approach. Thus, it would appear, that adopting the 'broader' interpretation of the term 'royalties' would be more in accordance with the intent and purpose of Article 12 in the UN Convention, wherein**

**consideration of a product protected by copyright or a patent is treated as royalty.**

## Other Considerations noted by the OECD Committee

17. It would be important to take into account any principles or considerations other than the intent of the Article of eliminating taxation of such payments in the source state, which may have influenced the guidance developed by the OECD Committee.

## Protection to software under copyright laws

18. The primary reason OECD Committee, in spite of the intention to eliminate source taxation of royalty, was unable to keep software payments completely outside the definition of 'royalties' was because all member states afforded protection to intellectual properties related to software under their respective copyright laws. This is an important consideration. Since, software can be copied at zero marginal cost, unless such protection is afforded by the Copyright laws of a State, any software would have virtually no market value.[15] Thus, existence of Copyright laws in a State should be an essential consideration for the taxation of royalty arising in that State, a principle that supports the source based taxation of royalty, including that for software.

19. Here it would be useful to examine whether the absence of Copyright protection would affect payments for use of software (for business or personal purposes). While this can be considered a matter fit for greater analysis, it can be safely concluded that it will result in significant adverse impact on such payments, and that the absence of Copyright protection significantly erode the quantum of

[15] In a market, the so called 'value' which is reflected by the 'willingness of consumer to pay" for a good, is determined by its scarcity. In the absence of Copyright protection, it would be legal to indulge in unauthorized trade of software, which will severely erode the value of such software.

such payments.[16] Thus, it cannot be said that the payment for use of software, is unrelated to the copyright protection or has nothing to do with it. While the payment for use of software (for business or personal purposes) may not involve making further copies, these payments depend on the critical presence and application of Copyright protection of the software and are derived from the protection to Copyrights in the source state. From this perspective, there is very little difference between payments made for making copies of software that is protected by Copyright laws, and the payments made for business or personal use of that software.

## Classification of 'software' as "literary, artistic or scientific work"

20. The OECD Committee expressed a view that it may be difficult to classify software as a literary, artistic or scientific work, and concluded among these categories 'scientific work' would be the most appropriate category. Unless someone comes up with an argument that software has nothing to do with science, the approach advocated by OECD Committee seems very reasonable, as is its recommendation for considering further clarification in the text of the definition of 'royalties' in the Article itself.

21. It would not be out of place to refer to the practices being followed by different countries that have included a specific reference to 'software' in their treaties. A common practice is to specifically add 'software' as included in the 'literary, artistic or scientific work' [17] This approach essentially does little more than clarifying that software is indeed included in the category of 'literary, artistic or scientific work'. Since, the OECD guidance for taxing payments for rights to copy and distribute software are based on their recognition as payment for

[16] This end result could result in two possible ways or both. First, unauthorized distribution of software by parties not having rights in software would erode the market price; second, the Copyright holders may, for fear of its unauthorized distribution, be more selective in making the software available for use to persons in such a State. Either ways, the quantum of payments received for software use would be adversely affected.

[17] One of the clearest illustrations of this approach can be observed in paragraph 2 of Article 12 of Japan France treaty, which states as under:

*2. The 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 computer software, cinematograph films, and films or tapes used for radio or television broadcasting), any patent, trade mark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience.*

In most other cases following such an approach, there is no use of parenthesis, but the intention appears to be the same, i.e. specifically include software in the category of 'literary, artistic or scientific work'.

copyright, and an implicit recognition of software as scientific work, this approach leads to the same outcome that would be derived without this modification. Thus, this approach can appropriately be considered a '**clarificatory approach**".

22. Another approach commonly followed is to specifically include payments for use of software within the definition of 'royalty' or within the definition of such payments as may be taxed in the same way in the source state, as followed in the Canada France treaty[18]. This approach provides for taxation of payments made for the use or right to use software, and which is thus, in essence, not in accordance with the OECD guidance of not taxing such payments, and hence could be considered as an '**alternative approach**' for taxing software payments as royalty.

**Distinction between "payment of ownership of rights" and "payment for use of rights"**

23. A somewhat intriguing statement has been made by the Committee in paragraph 47 of the report, which states, "*Secondly, where a transfer of ownership of rights has occurred, payments cannot be for the use of the rights",* apparently differentiating payments made for ownership or rights from payments made for use of rights. However, in respect of software that is protected by copyrights, the "right to use" the software is a significant right and actually includes all rights in it other than its distribution and modification. A payment made for acquiring this right is same as the payment for use of this right, and at least in case of software, where a person makes the payment for acquiring the right to use it so as to use, the two cannot be differentiated. Indeed, unless the payment is directly linked with the

[18] Paragraph 3 of Article 12 of Canada France treaty provides as under:
*3.Notwithstanding the provisions of paragraph 2:*
*(a) royalties arising in a Contracting State and paid to a resident of the other Contracting State who is the beneficial owner of the royalties, shall be taxable only in that other State if they are:*
*(i) copyright royalties and other like payments in respect of the production or reproduction of any literary, dramatic, musical or artistic work (but not including royalties in respect of motion picture films nor royalties in respect of works on film or videotape or other means of reproduction for use in connection with television broadcasting), or*
*(ii) royalties for the use of, or the right to use, computer software, or*
(iii) royalties for the use of, or the right to use, any patent or for information concerning industrial, commercial or scientific experience (but not including any such information provided in connection with a rental or franchise agreement);

amount of use (as may happen when access to a centralized software in a server under the control of software owner is provided over a network), the payment for software for business or personal use, without any limits or restrictions of use, should be considered as a payment for the 'right to use' that software rather than a payment for use of software. Since this payment is made for using this right, i.e. 'right to use' the payment for acquiring this right cannot be differentiated from the payment to use the software.

24. The question that may need further consideration is whether "right to use" is a right that comes within the purview of Copyright laws. The report also acknowledges the possible differences in the Copyright laws from country to country and the fact that making copies of the software for the purpose of own use may amount to a violation of Copyright laws in some countries and thereby require a transfer of "right to use" from the owner of copyright in the software. In such a case at least, the payment is clearly for acquiring the right to use.

**Conceptualization of Royalty as income from "letting out" of intellectual property**

25. The first sentence of the Commentary on Royalty in the Commentary on Article 12 of OECD Convention provides insights conceptualization of royalty, as under:

*"**In principle, royalties in respect of licences to use patents and similar property and similar payments are income to the recipient from a letting.**"*

This sentence clearly indicates conceptualization of 'royalties' as a sort of rent paid by the person not owning that property to its owner. The concept of rent is not dissimilar to the conceptualization of interest and dividend as rent paid by the lessee in respect of financial property, i.e. capital, to the owner of such property for using it. The conceptualization of royalty appears to have been adopted by the Committee in respect of film rentals in paragraph 10 of the Commentary as under:

*"10. Income from film rentals should not be treated as industrial and commercial profits but should be dealt with in the context of royalties. The tax would thus be levied on a gross basis but expenses would be taken into account in fixing the withholding rate. …"*

26. The payment made by a pharmaceutical enterprise for use of a drug patent can also be considered as the rent paid for the "right to use" the patent. If compared with the lease rentals of "industrial, commercial and scientific equipment", it can be observed that the only difference lies in the fact that in case of equipment, the rent will invariably be in respect of an exclusive right to use for the duration of its letting, whereas in respect of a patent, the right to use may or may not be exclusive. However, even this difference may be more a difference of form than substance, since an exclusive right to use a patent would be similar to leasing of equipment, whereas if the equipment is considered to derive its value from the intellectual property embedded in it, instead of its physical form, then the leasing of several similar equipments to different users would make it a case that would not be very different from non-exclusive right to use an intellectual property such as the pharmaceutical patent.

27. If software payments are compared with aforementioned examples, it can be seen that payment for use of software may not be very different from the payment made by the drug manufacturer for using patent, with perhaps the only difference being that most drug patents are unlikely to be of any personal use, unlike the software and its widespread personal use in the digital economy. That would justify extending same treatment of payments made for use of software as is the treatment of payments made for use of patents or letting out cinematographic films.

**Issues resulting from taxation on gross basis**

28. An important consideration noted by the OECD Committee related to taxation of gross payment. It noted that gross basis taxation disregards the expenses incurred by the payee in earning the royalties and in some cases, if the State of residence is unable to credit fully the tax withheld at source because it taxes royalties on net basis. Significantly, it also noted that such gross taxation happens only in the absence of a permanent establishment in the source country and is alleviated if royalty is effectively connected with a permanent establishment, since that makes paragraph 3 of Article 12 providing for net basis taxation into play.

29. Irrespective of whether one agrees or not with these observations, the concerns raised need further analysis that must include the relationship between Article 7 and Article 12. It may also necessitate the observations made in respect of payments related to the digital economy and taxation of its income, in the Final Report on Action 1 of BEPS. While doing so, it may be appropriate to look at Article 12 (along with Articles 10 and 11) as alternative provisions for taxing business income[19].

## Relationship between Article 12 and Article 7

30. The relationship of these articles is clarified in paragraph 6 of Article 7 of UN Convention as under:

*"6. Where profits include items of income which are dealt with separately in other Articles of this Convention, then the provisions of those Articles shall not be affected by the provisions of this Article."*

As also clarified in the paragraphs 59 to 62 of Commentary on paragraph 7 of Article 7 of the 2008 OECD Model Convention (which are also referred to in paragraph 21 of the Commentary on paragraph 6 of Article 7 of the 2011 UN Model Convention), income that constitute royalties may often be taxable as business profits but by application of the priority rule provided in paragraph 7 of OECD Model Convention and paragraph 6 of UN Model Convention, royalties are taxable only under Article 12 and not under Article 7.[20]

31. Thus, the rules provide special treatment to these special categories of income, i.e. interest, dividend and royalty, even if they constitute business profits, by exempting them from the threshold for taxation provided by Article 5

[19] This approach has also been strongly recommended in note was prepared by Mr. Scott Wilkie (E/C.18/2015/CRP.6) for the benefit of this Committee.

[20] Paragraph 62 of Commentary on paragraph 7 of Article 7 of 2008 OECD Model Convention states:

*62. It has seemed desirable, however, to lay down a rule of interpretation in order to clarify the field of application of this Article in relation to the other Articles dealing with a specific category of income. In conformity with the practice generally adhered to in existing bilateral conventions, paragraph 7 gives first preference to the special Articles on dividends, interest etc. It follows from the rule that this Article will be applicable to business profits which do not belong to categories of income covered by the special Articles, and, in addition, to dividends, interest etc. which under paragraph 4 of Articles 10 and 11, paragraph [4] of Article 12 and paragraph 2 of Article 21, fall within this Article [...]. It is understood that the items of income covered by the special Articles may, subject to the provisions of the Convention, be taxed either separately, or as business profits, in conformity with the tax laws of the Contracting States.*

(permanent establishment), by imposing tax on the gross amount instead on net basis as provided in Article 7, and limiting the maximum rate of tax that can be levied on such income (compared to the absence of such limit on income taxable under Article 7. This "exception rule" approach of taxing income that may very well be in the nature of business profits, under Article 12, has also been referred to by Mr. Scott Wilkie in his paper[21].

32. The concerns related to gross taxation and ignoring of expenses while taxing royalty income under Article 12 are not new. Paragraphs 2 and 3 of the Commentary on Article 12 of UN Convention recognizes them as under:

> *2. When the user of a patent or similar property is resident in one country and pays royalties to the owner of the property who is resident in another country, the amount paid by the user is generally subject to withholding tax in his country, the source country. The source country tax is imposed on the gross payments, with no allowance for any related expenses incurred by the owner. Without recognition of expenses, the owner's after-tax profit may in some cases be only a small percentage of gross royalties. Consequently, the owner may take the withholding tax in the source country into account in fixing the amount of the royalty, so that the user and the source country will pay more for the use of the patent or similar property than they would if the withholding tax levied by the source country were lower and took into account the expenses incurred by the owner. A manufacturing enterprise or an inventor may have spent substantial sums on the development of the property generating the royalties, because the work of research and testing involves considerable capital outlays and does not always yield successful results. The problem of determining the appropriate tax rate to be applied by the source country to gross royalty payments is therefore complex, especially since the user may make a lump sum payment for the use of*

[21] E/C.18/2015/CRP.6

*the patent or similar property, in addition to regular royalty payments.*
*3. The Commentary on Article 12 of the OECD Model Convention includes the following preliminary remarks:*

*1. In principle, royalties in respect of licences to use patents and similar property and similar payments are income to the recipient from a letting. The letting may be granted in connection with an enterprise (e.g. the use of literary copyright granted by a publisher or the use of a patent granted by the inventor) or quite independently of any activity of the grantor (e.g. use of a patent granted by the inventor's heirs).*

*2. Certain countries do not allow royalties paid to be deducted for the purposes of the payer's tax unless the recipient also resides in the same State or is taxable in that State. Otherwise they forbid the deduction. The question whether the deduction should also be allowed in cases where the royalties are paid by a resident of a Contracting State to a resident of the other State is dealt with in paragraph 4 of Article 24.*

33. **The reference to paragraph 4 of Article 24[22] is related to the obligation of the source state to provide deduction to a payment covered under Article 12 to a resident of the other Contracting State in the same manner as it would provide to a payment of this nature to a resident of that State. This obligation, unless accompanied with the right to tax such payments at source will actually amount to erosion of its tax base, and thus there would be a strong argument in favor of combining it with a right to collect tax on that income, while taking**

[22] Paragraph 4 of Article 24 (Non Discrimination) provides as under:
*4. Except where the provisions of paragraph 1 of Article 9, paragraph 6 of Article 11, or paragraph 6 of Article 12 apply, interest, royalties and other disbursements paid by an enterprise of a Contracting State to a resident of the other Contracting State shall, for the purpose of determining the taxable profits of such enterprise, be deductible under the same conditions as if they had been paid to a resident of the first-mentioned State. Similarly, any debts of an enterprise of a Contracting State to a resident of the other Contracting State shall, for the purpose of determining the taxable capital of such enterprise, be deductible under the same conditions as if they had been contracted to a resident of the first-mentioned State.*

**care of the possible concerns related to taxation of software royalties on gross basis.**

34. The possible ways of approaching concerns related to taxation of royalties under Article 12 on gross basis and its consequences are already documented in paragraphs 6 and 7 of the Commentary on Article 12. The conclusions arrived at by the Committee are documented in paragraphs 8 and 9 as under:

*8. Since the former Group of Experts reached no consensus on a particular rate for the withholding tax to be charged on royalties on a gross basis, the rate should be established through bilateral negotiations. The following considerations might be taken into account in negotiations:*

*—— First, the country of source should recognize both current expenses allocable to the royalty and expenditure incurred in the development of the property whose use gave rise to the royalty. It should be considered that the costs of developing the property are also allocable to profits derived from other royalties or activities, past or future, associated with these expenditures and that expenditure not directly incurred in the development of that property might nevertheless have contributed significantly to that development;*

*—— Second, if an expense ratio is agreed upon in fixing a gross rate in the source country, the country of the recipient, if following a credit method, should also use that expense ratio in applying its credit, whenever feasible. Therefore, that matter should be considered under Article 23 A or 23 B.*

*9. Other factors might influence the determination of the withholding tax on gross royalties, including the developing countries' need to earn revenue and conserve foreign exchange; the fact that royalty payments flow almost entirely from developing countries to developed countries; the extent of assistance that developed countries should, for a variety of reasons, extend to developing countries; and the special importance of providing such assistance in the context of royalty payments; the desirability of preventing a shift of the tax burden to the licensees in the licensing arrangement; the ability that taxation at source confers on a developing country to make selective judgements by which, through reduced taxation or exemption, it*

*could encourage those licensing arrangements if they were considered desirable for its development; the lessening of the risks of tax evasion resulting from taxation at the source; the fact that the country of the licensor supplies the facilities and activities necessary for the development of the patent and thus undertakes the risks associated with the patent; the desirability of obtaining and encouraging a flow of technology to developing countries; the desirability of expanding the field of activity of the licensor in the utilization of the research; the benefits that developed countries obtain from world development in general; the relative importance of revenue sacrifice; the relation of the royalty decision to other decisions in the negotiations.*

35. Unless it can be shown that the concerns related to taxation on gross payments in case of software payments (including payments for use or right to use software) are substantially different, there would be little reason for deviating with these conclusions already arrived and accepted by the Committee.

## Issues related to E-Commerce and new business models in digital economy[23]

36. Software payments have become common in both B2B as well as B2C transactions in modern digital economy. These challenges have already been recognized and accepted globally in the Final Report on Action 1 of BEPS project, which includes a detailed analysis that would be outside the scope and mandate of work mandated to this sub-committee. However, it may not be out of place to refer to certain relevant observations of that Report.

37. With the global reach of internet-of-things (IOT), it is possible for software developers to distribute it directly to the users, without requiring an intermediate entity, thereby allowing enterprise of a State to derive substantial income from

[23] As per the Final Report on Action of BEPS Project, "*The digital economy is the result of a transformative process brought by information and communication technology (ICT), which has made technologies cheaper, more powerful, and widely standardized, improving business processes and bolstering innovation across all sectors of the economy.*" As per the Report, "*The digital economy and its business models present however some key features which are potentially relevant from a tax perspective. These features include mobility, reliance on data, network effects, the spread of multi-sided business models, a tendency toward monopoly or oligopoly and volatility. The types of business models include several varieties of e-commerce, app stores, online advertising, cloud computing, participative networked platforms, high speed trading, and online payment services. The digital economy has also accelerated and changed the spread of global value chains in which MNEs integrate their worldwide operations.*"

other States without requiring a physical presence. The Report on Action 1 refers to this redundancy of physical presence PE in the digital economy as a proxy threshold test for determining the significant presence of an enterprise of another State in the economic life of that State.[24]

38. Paragraph 184 of the Final Report on Action 1 of BEPS Project[25] details how evolution of modern digital economy has made the physical presence redundant for digital enterprises, which can interact with customers directly without need for either a physical presence or an agent in the country from it is deriving its profits. Paragraph 256 of this report[26] highlights the challenges that

[24] Paragraph 35 of the Final Report on Action 1 of BEPS Project states:
*35. The PE concept effectively acts as a threshold which, by measuring the level of economic presence of a foreign enterprise in a given State through objective criteria, determines the circumstances in which the foreign enterprise can be considered sufficiently integrated into the economy of a state to justify taxation in that state (Holmes, 2007; Rohatgi, 2005). A link can thus reasonably be made between the requirement of a sufficient level of economic presence under the existing PE threshold and the economic allegiance factors developed by the group of economists more than 80 years ago. This legacy is regularly emphasized in literature (Skaar, 1991), as well as reflected in the existing OECD Commentaries when it is stated that the PE threshold "has a long history and reflects the international consensus that, as a general rule, until an enterprise of one State has a permanent establishment in another State, it should not properly be regarded as participating in the economic life of that other State to such an extent that the other State should have taxing rights on its profits".5 By requiring a sufficient level of economic presence, this threshold is also intended to ensure that a source country imposing tax has enforcement jurisdiction, the administrative capability to enforce its substantive jurisdiction rights over the non-resident enterprise.*

[25] Paragraph 184 of the Final Report on Action 1 of BEPS Project states as under:
*184. In many digital economy business models, a non-resident company may interact with customers in a country remotely through a website or other digital means (e.g. an application on a mobile device) without maintaining a physical presence in the country. Increasing reliance on automated processes may further decrease reliance on local physical presence. The domestic laws of most countries require some degree of physical presence before business profits are subject to taxation. In addition, under Articles 5 and 7 of the OECD Model Tax Convention, a company is subject to tax on its business profits in a country of which it is a non-resident only if it has a permanent establishment (PE) in that country. Accordingly, such non-resident company may not be subject to tax in the country in which it has customers.*

[26] Paragraph 256 of the Final Report on Action 1 of BEPS Project states as under:
*256. These questions relate in particular to the definition of permanent establishment (PE) for treaty purposes, and the related profit attribution rules. It had already been recognized in the past that the concept of PE referred not only to a substantial physical presence in the country concerned, but also to situations where the non-resident carried on business in the country concerned via a dependent agent (hence the rules contained in paragraphs 5 and 6 of Article 5 of the OECD Model). As nowadays it is possible to be heavily involved in the economic life of another country without having a fixed place of business or a dependent agent therein, concerns are raised regarding whether the existing definition of PE remains consistent with the underlying principles on which it was based. For example, the ability to conclude contracts remotely through technological means, with no involvement of individual employees or dependent agents, raises questions about whether the focus of the existing rules on conclusion of contracts by persons other than agents of an independent status remains appropriate in all cases.*

have arisen in application of PE rules that were not conceptualized for the digital economy, and which tend to make the 'nexus' rule inherent in existing definition of PE irrelevant in the digital economy.

39. **From the perspective of the issue of taxation of software payments as royalty, it would be relevant to note from these observations, that the increased ability of enterprises to directly interact with their customers and commercially interact with them, virtually obviates the need for them to transfer 'rights to copy and distribute' to another person, making the payments from such rights largely redundant. Even if it some enterprises may still derive income under this category, it can be safely concluded that such payments in respect of software has already receded significantly. With most software developers providing software for use to their customers through the internet, it can be safely concluded that this category of income is not relevant anymore in the manner it may have been once. Thus, unless the intent and purpose of the Article 12 (as in the OECD Convention) is to eliminate source based taxation of royalty income, excluding software payments from the scope of definition of 'royalties' would neither be logical, nor be feasible.**

**CONCLUSION & RECOMMENDATION**

40. **In view of the above, for the intent and purpose of Article 12 in UN Convention, which aims to tax royalties in source state on gross basis at a lower rate, keeping in view the expenses incurred in the development of the property, payments for use or right to use software should be taxed as royalties under Article 12 and not under Article 7, by adopting the 'broader' interpretation of the definition of 'royalties' that was considered but not adopted by the OECD Committee that prepared that 1992 Report titled "*The Tax Treatment of Software*". For the purpose of interpreting Article 12, use of software should be considered same as transfer of 'right to use' of software and a payment for either should constitute royalty. Accordingly, the *ad verbatim* references in paragraph 12 of the commentary on Article 12 of UN Convention to the text of paragraphs 12 to 17.4 of the Commentary on Article 12 of OECD Convention need to be replaced by appropriate text of Commentary reflecting the aforementioned conclusions. However, while doing**

**so, additional options to take care of different concerns and possible deviations in approach would need to be provided.**

41. **Even though an alteration in the Article 12 does not appear to be necessary, the Commentary should, include possible options for countries that would like to explicitly provide for source based taxation of software payments as royalty, either by including 'software' within the scope of 'scientific work' (i.e. clarificatory approach) or by explicitly providing within the article that payment for use of software will be taxable as royalty in the state from where it arises.**

42. **Other possible options for inclusion in the Commentary could be for those countries that may wish to restrict taxation of software payments as royalty only to business-to-business payments that are claimed as deduction and which lead of erosion of their tax base. Another option could for those countries who may wish to subject the taxation of royalty to a minimum revenue threshold, so as to facilitate compliance and administration.**

43. **For countries that wish to look at Article 12 as an alternative to Article 7, a possible option in the Commentary could be to enable taxation on a net basis, either by allowing deduction of a notional 'deduction' from the gross amount or by a 'deeming profit' rule, the specifics of which could be agreed bilaterally by the Contracting States.**

44. **For this purpose, draft amendments replacing ad verbatim references to paragraphs 12 to 17.4 of the Commentary on Article 12 of OECD Convention are suggested in the next part of this note.**

**Suggested Amendments in Paragraph 12 of Commentary on Article 12**
*Paragraph* 3

12. This paragraph reproduces Article 12, paragraph 2, of the OECD Model Convention, but does not incorporate the 1992 amendment thereto which

eliminates equipment rental from this Article. Also, paragraph 3 of Article 12 includes payments for tapes and royalties which are not included in the corresponding provision of the OECD Model Convention. The following portions of the OECD Commentary are relevant (the bracketed paragraphs being portions of the Commentary that highlight differences between the United Nations Model Convention and the OECD Model Convention):

8. Paragraph 2 contains a definition of the term "royalties". These relate, in general, to rights or property constituting the different forms of literary and artistic property, the elements of intellectual property specified in the text and information concerning industrial, commercial or scientific experience. The definition applies to payments for the use of, or the entitlement to use, rights of the kind mentioned, whether or not they have been, or are required to be, registered in a public register. The definition covers both payments made under a licence and compensation which a person would be obliged to pay for fraudulently copying or infringing the right.

8.4 As a guide, certain explanations are given below in order to define the scope of Article 12 in relation to that of other Articles of the Convention, as regards, in particular, [equipment renting and] the provision of information.

10. Rents in respect of cinematograph films are also treated as royalties, whether such films are exhibited in cinemas or on the television. It may, however, be agreed through bilateral negotiations that rents in respect of cinematograph films shall be treated as business profits and, in consequence, subjected to the provisions of Articles 7 and 9.

11. In classifying as royalties payments received as consideration for information concerning industrial, commercial or scientific experience, paragraph 2 is referring to the concept of "knowhow". Various specialist bodies and authors have formulated definitions of know-how. The words "payments … for information concerning industrial, commercial or scientific experience" are used in the context of the transfer of certain information that has not been patented and does not generally fall within other categories of intellectual property rights. It generally corresponds to undivulged information of an industrial, commercial or scientific nature arising from previous experience, which has practical application in the

operation of an enterprise and from the disclosure of which an economic benefit can be derived. Since the definition relates to information concerning previous experience, the Article does not apply to payments for new information obtained as a result of performing services at the request of the payer.

Some members of the Committee of Experts are of the view that there is no ground to limit the scope of information of an industrial, commercial or scientific nature to that arising from previous experience. The OECD Commentary then continues:

11.1 In the know-how contract, one of the parties agrees to impart to the other, so that he can use them for his own account, his special knowledge and experience which remain unrevealed to the public. It is recognized that the grantor is not required to play any part himself in the application of the formulae granted to the licensee and that he does not guarantee the result thereof.

11.2 This type of contract thus differs from contracts for the provision of services, in which one of the parties undertakes to use the customary skills of his calling to execute work himself for the other party. Payments made under the latter contracts generally fall under Article 7 or in the case of the United Nations Model Convention

Article 14.

11.3 The need to distinguish these two types of payments, *i.e.* payments for the supply of know-how and payments for the provision of services, sometimes gives rise to practical difficulties. The following criteria are relevant for the purpose of making that distinction:

- Contracts for the supply of know-how concern information of the kind described in paragraph 11 that already exists or concern the supply of that type of information after its development or creation and include specific provisions concerning the confidentiality of that information.
- In the case of contracts for the provision of services, the supplier undertakes to perform services which may require the use, by that

supplier, of special knowledge, skill and expertise but not the transfer of such special knowledge, skill or expertise to the other party.

— In most cases involving the supply of know-how, there would generally be very little more which needs to be done by the supplier under the contract other than to supply existing information or reproduce existing material. On the other majority of cases, involve a very much greater level of expenditure by the supplier in order to perform his contractual obligations. For instance, the supplier, depending on the nature of the services to be rendered, may have to incur salaries and wages for employees engaged in researching, designing, testing, drawing and other associated activities or payments to sub-contractors for the performance of similar services.

11.4 Examples of payments which should therefore not be considered to be received as consideration for the provision of know-how but, rather, for the provision of services, include:

— payments obtained as consideration for after-sales service,
— payments for services rendered by a seller to the purchaser under a warranty,
— payments for pure technical assistance,
— payments for a list of potential customers, when such a list is developed specifically for the payer out of generally available information (a payment for the confidential list of customers to which the payee has provided a particular product or service would, however, constitute a payment for know-how as it would relate to the commercial experience of the payee in dealing with these customers),
— payments for an opinion given by an engineer, an advocate or an accountant, and
— payments for advice provided electronically, for electronic communications with technicians or for accessing, through computer networks, a trouble-shooting database such as a database that provides users of software with non-confidential information in response to frequently asked questions or common problems that arise frequently.

11.5 In the particular case of a contract involving the provision, by the supplier, of information concerning computer programming, as a general rule the payment will

only be considered to be made in consideration for the provision of such information so as to constitute knowhow where it is made to acquire information constituting ideas and principles underlying the program, such as logic, algorithms or programming languages or techniques, where this information is provided under the condition that the customer not disclose it without authorization and where it is subject to any available trade secret protection.

11.6 In business practice, contracts are encountered which cover both know-how and the provision of technical assistance. One example, amongst others, of contracts of this kind is that of franchising, where the franchisor imparts his knowledge and experience to the franchisee and, in addition, provides him with varied technical assistance, which, in certain cases, is backed up with financial assistance and the supply of goods. The appropriate course to take with a mixed contract is, in principle, to break down, on the basis of the information contained in the contract or by means of a reasonable apportionment, the whole amount of the stipulated consideration according to the various parts of what is being provided under the contract, and then to apply to each part of it so determined the taxation treatment proper thereto. If, however, one part of what is being provided constitutes by far the principal purpose of the contract and the other parts stipulated therein are only of an ancillary and largely unimportant character, then the treatment applicable to the principal part should generally be applied to the whole amount of the consideration.

*[ up to this point the Commentary can remain unchanged. Thereafter new paragraphs in the UN Commentary beginning with paragraph 12.1 may be inserted by modifying the existing OECD Commentary as under:]*

12.1 ~~***12.***~~ Whether payments received as consideration for computer software may be classified as royalties poses difficult problems but is a matter of considerable importance in view of the rapid development of computer technology in recent years and the extent of transfers of such technology across national borders. ~~***In 1992, the Commentary was amended to describe the principles by which such***~~

***~~classification should be made. Paragraphs 12 to 17 were further amended in 2000 to refine the analysis by which business profits are distinguished from royalties in computer software transactions. In most cases, the revised analysis will not result in a different outcome~~. In particular, with the increasing use of software in all aspects of business and personal life, these payments often constitute an increasing proportion of overall economy, including for developing countries, requiring that a clear view may be taken by countries in respect of their taxation.***

12.2 ***~~12.1~~*** Software, ***also known as Computer Program,*** may be described as a program, or series of programs, containing instructions for a computer required either for the operational processes of the computer itself (operational software) or for the accomplishment of other tasks (application software). It can be transferred through a variety of media, for example in writing or electronically, on a magnetic tape or disk, or on a laser disk or CD-Rom. It may be standardized with a wide range of applications or be tailor-made for single users. It can be transferred as an integral part of computer hardware or in an independent form available for use on a variety of hardware.

12.3 ***~~12.2~~*** The character of payments received in transactions involving the transfer of computer software depends on the nature of the rights that the transferee acquires under the particular arrangement regarding the use and exploitation of the program. The rights in computer programs are a form of intellectual property. ***~~Research into the practices of OECD member countries has established that all but one~~ Most countries*** protect***~~s~~*** rights in computer programs either explicitly or implicitly under copyright law ***and their reproduction, copying, modification, sale or rental by a person other than the owner of the copyright or a person authorized by him is usually prohibited by such laws***. ***~~Although the term "computer software" is commonly used to describe both the program – in which the intellectual property rights (copyright) subsist – and the medium on which it is embodied, the copyright law of most OECD member countries recognizes a distinction between the copyright in the program and software which incorporates a copy of the copyrighted program.~~*** Transfers of rights in relation to software occur in many different ways ranging from the alienation of the entire rights in the copyright in a program, ***which would amount to sale of the copyright,*** to ***~~the sale~~ limited transfer of right to use that software ~~of a product which is~~***

***~~subject to~~ usually with*** restrictions ***made under a licensing agreement*** on the use to which it is put***, which would make such transfer of rights equivalent to renting of the software for use***. The consideration paid can also take numerous forms. ***~~These factors may make it difficult to determine where the boundary lies between software payments that are properly to be regarded as royalties and other types of payment. The difficulty of determination is compounded by the ease of reproduction of computer software, and by the fact that acquisition of software frequently entails the making of a copy by the acquirer in order to make possible the operation of the software.~~***

***~~13. The transferee's rights will in most cases consist of partial rights or complete rights in the underlying copyright (see paragraphs 13.1 and 15 below), or they may be (or be equivalent to) partial or complete rights in a copy of the program (the "program copy"), whether or not such copy is embodied in a material medium or provided electronically (see paragraphs 14 to 14.2 below). In unusual cases, the transaction may represent a transfer of "know-how" or secret formula (paragraph 14.3).~~***

12.4 ***~~13.1~~*** Payments 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. Examples of such arrangements include ***grant of*** license***~~s~~*** to reproduce***, ~~and~~*** distribute***, modify or for the right to use ~~to the public~~*** software ***~~incorporating the copyrighted program~~***, ***~~or to modify and publicly display the program~~***. ***~~In these circumstances, the payments are for the right to use the copyright in the program (i.e. to exploit the rights that would otherwise be the sole prerogative of the copyright holder). It should be noted that where a software payment is properly to be regarded as a royalty there may be difficulties in applying the copyright provisions of the Article to software payments since p~~P***aragraph ***~~2~~ 3*** requires that software be classified as a literary, artistic or scientific work. ***~~None of these categories seems entirely apt.~~*** The copyright laws of many countries deal with this problem by specifically classifying software as a literary or scientific work. For

other countries treatment as a scientific work might be the most ~~***realistic***~~ ***appropriate*** approach. ***Countries that may wish to provide greater clarity in this regard may explicitly include software in the category of literary or scientific work in this paragraph.*** Countries for which it is not possible to attach software to any of those categories might be justified in adopting in their bilateral treaties an amended version of paragraph 2 which ~~***either omits all references to the nature of the copyrights or refers specifically to***~~ ***explicitly includes payment for*** software ***as royalty***.

12.5 ***Paragraph 14 of the OECD Commentary (2014 update) differentiates between the payment received for grant of rights to reproduce, distribute or modify the software from the payment received for the right to use. The rationale for adoption of this position by the OECD is provided in paragraphs 38 to 47 of the Report titled, "The Tax Treatment of Software", which documents that the Committee tasked with preparing that Report was faced with two opposing views. One view preferred a broad interpretation of paragraph 2, wherein payments received for transfer of right to use software protected by copyright would be considered royalty. This view was opposed by other countries on the ground that the purpose and intent of Article 12 in the OECD Convention was to eliminate source taxation and that the definition of royalty has to be interpreted more narrowly so as to limit its scope. They considered that an important distinction had to be drawn between the acquisition of software for the personal or business use of the purchaser; and the acquisition of software for commercial development or exploitation. In the first situation, they considered that the purchaser had done no more than purchase a product and that the payment fell to be dealt with in accordance with Article 7 or Article 13 as appropriate. They did not consider it to be relevant that the product was protected by copyright and that there were restrictions on the use to which the purchaser could put it. In the second situation, they agreed that the payments were made for rights to exploit intellectual property and accordingly were likely to be royalties. Examples of such exploitation included the reproduction or adaptation of software for onward distribution. In such situations, payments to the owner of the copyright were likely to be royalties especially if they were related to the number of products distributed.***

***12.6 With respect to the position adopted by the OECD in paragraph 14 of its Commentary on Article 12, the Committee of Experts noted that inherent differences exist in the purpose and intent of the Article 12 in the two Conventions. Whereas the purpose and intent of Article 12 in OECD Convection is to eliminate source taxation of royalty, the purpose and intent of Article 12 in the UN Convection is to grant partial rights of taxing royalty to the source state. The Committee also noted that its view on payments for granting right to use intellectual property that is protected by Copyright laws or similar protections, such as in case of patent is to provide source state partial taxation rights on such payments under paragraph 2 of Article 12. A similar view has also been taken by it in respect of payments received for rental payments for use of Cinematographic films, as explained in paragraph 9 above. It also noted that in view of the widespread digital networks today enable copyright owners of software to directly grant license for use to the public, without necessitating grant of copying or distribution to intermediaries, treating grant of license to use software differently from other transactions involving transfer of partial rights in a software will practically eliminate the source taxation of such payment. As this would not be in accordance with the purpose and intent of the UN Convention, the Committee decided not to accept the narrower interpretation adopted by the OECD in applying the definition of royalty in case of software payments, and instead opted for the broader interpretation according to which, any payments for grant of any rights in the software, irrespective of whether they are in respect of use of the software or to reproduce, distribute or modify it, would constitute royalty as defined in paragraph 3.***

~~***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 utilizing 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 analyzing 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.*~~

12.7 ~~*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 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.*~~

12.8 ~~*14.3*~~ Another type of transaction involving the transfer of computer software is the more unusual case where a software house or computer programmer agrees to supply information about the ideas and principles underlying the program, such as logic, algorithms or programming languages or techniques. In these cases, the payments may be characterized as royalties ~~*to the extent that*~~ ***since*** they represent consideration for the use of, or the right to use, secret formulas or for information

concerning industrial, commercial or scientific experience ~~***which cannot be separately copyrighted***~~. ~~***This contrasts with the ordinary case in which a program copy is acquired for operation by the end user.***~~

12.9 ~~***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. ***Paragraph 14.4 of OECD Commentary takes a view that i***~~***I***~~n such transactions, distributors are paying only for the acquisition of the software copies and not to exploit any right in the software copyrights***, which would not constitute royalty***. ~~***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 analyzing 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 customization for the purposes of its installation.***~~ ***For reasons already detailed in paragraph 12.5 and 12.6 above, the Committee did not agree with this view. Thus, where a distributor is making payment to the owner of the copyright for distributing copies of software to the public, irrespective of whether it prepares these copies from a master copy provided to it by the copyright owner or whether it downloads each copy separately from its website, such payment being a payment in respect of partial rights in respect of the software would constitute royalty under paragraph 3. This will not be the case with a distributor, who without obtaining any rights in the software or making payments in respect of the same, is only facilitating its distribution to the public as a distribution service provider. The income of such distributor would usually be taxed under Article 7.***

12.10 ~~***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),*** ***S***~~***s***~~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. ***Paragraph 16 of OECD Commentary provides that certain cases of transfer of less than full ownership, as in case of exclusive right of use of the copyright during a specific period or in a limited geographical area, additional consideration related to usage or consideration in the form of a substantial lump sum payment would also not constitute royalty. However, since accepting this distinction would open a world of opportunities for artificial structuring of transfer of rights in software with the objective of disguising royalty payments for the purpose of avoiding source taxation, the Committee did not accept this view, and preferred not to accept such artificial distinction. Payments made for less than full ownership should thus be considered as royalty within the definition of royalty in paragraph 3, unless countries bilaterally agree to take a different view.*** ~~***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.

12.11 ~~***17.***~~ Software payments may be made under mixed contracts. Examples of such contracts include sales of computer hardware with built-in software and concessions of the right to use software combined with the provision of services. The methods set out in paragraph 11 above for dealing with similar problems in

relation to patent royalties and know-how are equally applicable to computer software. Where necessary the total amount of the consideration payable under a contract should be broken down on the basis of the information contained in the contract or by means of a reasonable apportionment with the appropriate tax treatment being applied to each apportioned part.

12.12 ***~~17.1~~*** The principles expressed above as regards software payments are also applicable as regards transactions concerning other types of digital products such as images, sounds or text. The development of electronic commerce has multiplied the number of such transactions. ***The changing business models adopted by enterprises have also given rise to new challenges, which are being examined and may lead to evolution or adoption of additional options. However, greater analysis of such options and detailed guidance for their application may be required before they can be recommended by the Committee of Experts.*** ***~~In deciding whether or not payments arising in these transactions constitute royalties, the main question to be addressed is the identification of that for which the payment is essentially made.~~***

***~~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".~~***
***~~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.***

***17.4 By contrast, transactions where the essential consideration for the payment is the granting of the right to use a copyright in a digital product that is electronically downloaded for that purpose will give rise to royalties. This would be the case, for example, of a book publisher who would pay to acquire the right to reproduce a copyrighted picture that it would electronically download for the purposes of including it on the cover of a book that it is producing. In this transaction, the essential consideration for the payment is the acquisition of rights to use the copyright in the digital product, i.e. the right to reproduce and distribute the picture, and not merely for the acquisition of the digital content.***

***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. The OECD Commentary then continues:***

12.13 Paragraph 2 of Article 12 provides for taxation of the gross payment made for grant of rights in respect of software. This could give rise to concerns similar to those examined and discussed in paragraph 8 and 9. In such cases, Contracting States can either agree to a maximum rate of tax in the source state taking into account these concerns. Alternatively, Contracting States that so desire may also opt to amend the paragraph 2 by providing a specified deduction for the expenses. In order to prevent escalation of compliance burden and keeping in view the

constraints often faced by the developing countries, one possible option could to provide fixed deduction on a pro rata basis, on account of depreciation of the software, the specifics of which can be bilaterally agreed by the Contracting States.
12.14 For Contracting States that may wish not to tax software payments made for personal use, and instead may want to limit it to those payments that are claimed as business expenditure leading to erosion of tax base, an option could be to amend paragraph 2 of Article 12 by limiting payments therein to those that are claimed as deduction by an enterprise for the purpose of computing its income. Another possible option for those Contracting State that may not wish to extend the application of Article 12 to smaller payments, with the purpose to limit compliance burden, could be to provide a minimum revenue threshold in respect of payments covered under paragraph 2.

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**Clean version of suggested paragraph 12 of Commentary on Article 12**

*Paragraph* 3

12. This paragraph reproduces Article 12, paragraph 2, of the OECD Model Convention, but does not incorporate the 1992 amendment thereto which eliminates equipment rental from this Article. Also, paragraph 3 of Article 12 includes payments for tapes and royalties which are not included in the corresponding provision of the OECD Model Convention. The following portions of the OECD Commentary are relevant (the bracketed paragraphs being portions of the Commentary that highlight differences between the United Nations Model Convention and the OECD Model Convention):

8. Paragraph 2 contains a definition of the term “royalties”. These relate, in general, to rights or property constituting the different forms of literary and artistic property, the elements of intellectual property specified in the text and information concerning industrial, commercial or scientific experience. The definition applies to payments for the use of, or the entitlement to use, rights of the kind mentioned, whether or not they have been, or are required to be, registered in a public register. The definition covers both payments made under a licence and compensation which a person would be obliged to pay for fraudulently copying or infringing the right.

8.4 As a guide, certain explanations are given below in order to define the scope of Article 12 in relation to that of other Articles of the Convention, as regards, in particular, [equipment renting and] the provision of information.

10. Rents in respect of cinematograph films are also treated as royalties, whether such films are exhibited in cinemas or on the television. It may, however, be agreed through bilateral negotiations that rents in respect of cinematograph films shall be treated as business profits and, in consequence, subjected to the provisions of Articles 7 and 9.

11. In classifying as royalties payments received as consideration for information concerning industrial, commercial or scientific experience, paragraph 2 is referring to the concept of “knowhow”. Various specialist bodies and authors have formulated definitions of know-how. The words “payments … for information concerning industrial, commercial or scientific experience” are used in the context of the transfer of certain information that has not been patented and does not generally fall within other categories of intellectual property rights. It generally corresponds to undivulged information of an industrial, commercial or scientific nature arising from previous experience, which has practical application in the operation of an enterprise and from the disclosure of which an economic benefit can be derived. Since the definition relates to information concerning previous experience, the Article does not apply to payments for new information obtained as a result of performing services at the request of the payer.

Some members of the Committee of Experts are of the view that there is no ground to limit the scope of information of an industrial, commercial or scientific nature to that arising from previous experience. The OECD Commentary then continues:

11.1 In the know-how contract, one of the parties agrees to impart to the other, so that he can use them for his own account, his special knowledge and experience which remain unrevealed to the public. It is recognized that the grantor is not required to play any part himself in the application of the formulae granted to the licensee and that he does not guarantee the result thereof.

11.2 This type of contract thus differs from contracts for the provision of services, in which one of the parties undertakes to use the customary skills of his calling to execute work himself for the other party. Payments made under the latter contracts generally fall under Article 7 or in the case of the United Nations Model Convention

Article 14.

11.3 The need to distinguish these two types of payments, *i.e.* payments for the supply of know-how and payments for the provision of services, sometimes gives rise to practical difficulties. The following criteria are relevant for the purpose of making that distinction:

- Contracts for the supply of know-how concern information of the kind described in paragraph 11 that already exists or concern the supply of that type of information after its development or creation and include specific provisions concerning the confidentiality of that information.
- In the case of contracts for the provision of services, the supplier undertakes to perform services which may require the use, by that supplier, of special knowledge, skill and expertise but not the transfer of such special knowledge, skill or expertise to the other party.
- In most cases involving the supply of know-how, there would generally be very little more which needs to be done by the supplier under the contract other than to supply existing information or

reproduce existing material. On the other majority of cases, involve a very much greater level of expenditure by the supplier in order to perform his contractual obligations. For instance, the supplier, depending on the nature of the services to be rendered, may have to incur salaries and wages for employees engaged in researching, designing, testing, drawing and other associated activities or payments to sub-contractors for the performance of similar services.

11.4 Examples of payments which should therefore not be considered to be received as consideration for the provision of know-how but, rather, for the provision of services, include:

- payments obtained as consideration for after-sales service,
- payments for services rendered by a seller to the purchaser under a warranty,
- payments for pure technical assistance,
- payments for a list of potential customers, when such a list is developed specifically for the payer out of generally available information (a payment for the confidential list of customers to which the payee has provided a particular product or service would, however, constitute a payment for know-how as it would relate to the commercial experience of the payee in dealing with these customers),
- payments for an opinion given by an engineer, an advocate or an accountant, and
- payments for advice provided electronically, for electronic communications with technicians or for accessing, through computer networks, a trouble-shooting database such as a database that provides users of software with non-confidential information in response to frequently asked questions or common problems that arise frequently.

11.5 In the particular case of a contract involving the provision, by the supplier, of information concerning computer programming, as a general rule the payment will only be considered to be made in consideration for the provision of such information so as to constitute knowhow where it is made to acquire information constituting ideas and principles underlying the program, such as logic, algorithms or programming languages or techniques, where this information is provided under

the condition that the customer not disclose it without authorization and where it is subject to any available trade secret protection.

11.6 In business practice, contracts are encountered which cover both know-how and the provision of technical assistance. One example, amongst others, of contracts of this kind is that of franchising, where the franchisor imparts his knowledge and experience to the franchisee and, in addition, provides him with varied technical assistance, which, in certain cases, is backed up with financial assistance and the supply of goods. The appropriate course to take with a mixed contract is, in principle, to break down, on the basis of the information contained in the contract or by means of a reasonable apportionment, the whole amount of the stipulated consideration according to the various parts of what is being provided under the contract, and then to apply to each part of it so determined the taxation treatment proper thereto. If, however, one part of what is being provided constitutes by far the principal purpose of the contract and the other parts stipulated therein are only of an ancillary and largely unimportant character, then the treatment applicable to the principal part should generally be applied to the whole amount of the consideration.

12.1 Whether payments received as consideration for computer software may be classified as royalties poses difficult problems but is a matter of considerable importance in view of the rapid development of computer technology in recent years and the extent of transfers of such technology across national borders. In particular, with the increasing use of software in all aspects of business and personal life, these payments often constitute an increasing proportion of overall economy, including for developing countries, requiring that a clear view may be taken by countries in respect of their taxation.

12.2 Software, also known as Computer Program, may be described as a program, or series of programs, containing instructions for a computer required either for the operational processes of the computer itself (operational software) or for the accomplishment of other tasks (application software). It can be transferred through a variety of media, for example in writing or electronically, on a magnetic

tape or disk, or on a laser disk or CD-ROM. It may be standardized with a wide range of applications or be tailor-made for single users. It can be transferred as an integral part of computer hardware or in an independent form available for use on a variety of hardware.

12.3 The character of payments received in transactions involving the transfer of computer software depends on the nature of the rights that the transferee acquires under the particular arrangement regarding the use and exploitation of the program. The rights in computer programs are a form of intellectual property. Most countries protect~~s~~ rights in computer programs either explicitly or implicitly under copyright law and their reproduction, copying, modification, sale or rental by a person other than the owner of the copyright or a person authorized by him is usually prohibited by such laws. Transfers of rights in relation to software occur in many different ways ranging from the alienation of the entire rights in the copyright in a program, *which would amount to sale of the copyright,* to limited transfer of right to use that software usually with restrictions made under a licensing agreement on the use to which it is put, which would make such transfer of rights equivalent to renting of the software for use. The consideration paid can also take numerous forms.

12.4 Payments made for the acquisition of partial rights 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. Examples of such arrangements include grant of license~~s~~ to reproduce, distribute, modify or for the right to use software Paragraph 3 requires that software be classified as a literary, artistic or scientific work. The copyright laws of many countries deal with this problem by specifically classifying software as a literary or scientific work. For other countries treatment as a scientific work might be the most appropriate approach. Countries that may wish to provide greater clarity in this regard may explicitly include software in the category of literary or scientific work in this paragraph. Countries for which it is not possible to attach software to any of those categories might be justified in adopting in their bilateral treaties an amended version of paragraph 2 which explicitly includes payment for software as royalty.

12.5 Paragraph 14 of the OECD Commentary (2014 update) differentiates between the payment received for grant of rights to reproduce, distribute or modify

the software from the payment received for the right to use. The rationale for adoption of this position by the OECD is provided in paragraphs 38 to 47 of the Report titled, "The Tax Treatment of Software", which documents that the Committee tasked with preparing that Report was faced with two opposing views. One view preferred a broad interpretation of paragraph 2, wherein payments received for transfer of right to use software protected by copyright would be considered royalty. This view was opposed by other countries on the ground that the purpose and intent of Article 12 in the OECD Convention was to eliminate source taxation and that the definition of royalty has to be interpreted more narrowly so as to limit its scope. They considered that an important distinction had to be drawn between the acquisition of software for the personal or business use of the purchaser; and the acquisition of software for commercial development or exploitation. In the first situation, they considered that the purchaser had done no more than purchase a product and that the payment fell to be dealt with in accordance with Article 7 or Article 13 as appropriate. They did not consider it to be relevant that the product was protected by copyright and that there were restrictions on the use to which the purchaser could put it. In the second situation, they agreed that the payments were made for rights to exploit intellectual property and accordingly were likely to be royalties. Examples of such exploitation included the reproduction or adaptation of software for onward distribution. In such situations, payments to the owner of the copyright were likely to be royalties especially if they were related to the number of products distributed.

12.6 With respect to the position adopted by the OECD in paragraph 14 of its Commentary on Article 12, the Committee of Experts noted that inherent differences exist in the purpose and intent of the Article 12 in the two Conventions. Whereas the purpose and intent of Article 12 in OECD Convection is to eliminate source taxation of royalty, the purpose and intent of Article 12 in the UN Convection is to grant partial rights of taxing royalty to the source state. The Committee also noted that its view on payments for granting right to use intellectual property that is protected by Copyright laws or similar protections, such as in case of patent is to provide source state partial taxation rights on such payments under paragraph 2 of Article 12. A similar view has also been taken by it

in respect of payments received for rental payments for use of Cinematographic films, as explained in paragraph 9 above. It also noted that in view of the widespread digital networks today enable copyright owners of software to directly grant license for use to the public, without necessitating grant of copying or distribution to intermediaries, treating grant of license to use software differently from other transactions involving transfer of partial rights in a software will practically eliminate the source taxation of such payment. As this would not be in accordance with the purpose and intent of the UN Convention, the Committee decided not to accept the narrower interpretation adopted by the OECD in applying the definition of royalty in case of software payments, and instead opted for the broader interpretation according to which, any payments for grant of any rights in the software, irrespective of whether they are in respect of use of the software or to reproduce, distribute or modify it, would constitute royalty as defined in paragraph 3.

12.7 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.

12.8 Another type of transaction involving the transfer of computer software is the more unusual case where a software house or computer programmer agrees to supply information about the ideas and principles underlying the program, such as logic, algorithms or programming languages or techniques. In these cases, the payments may be characterized as royalties since they represent consideration for the use of, or the right to use, secret formulas or for information concerning industrial, commercial or scientific experience.

12.9 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. Paragraph 14.4 of OECD Commentary takes a view that in such transactions, distributors are paying only for the acquisition of the software copies and not to exploit any right in the software copyrights, which would not constitute

royalty. For reasons already detailed in paragraph 12.5 and 12.6 above, the Committee did not agree with this view. Thus, where a distributor is making payment to the owner of the copyright for distributing copies of software to the public, irrespective of whether it prepares these copies from a master copy provided to it by the copyright owner or whether it downloads each copy separately from its website, such payment being a payment in respect of partial rights in respect of the software would constitute royalty under paragraph 3. This will not be the case with a distributor, who without obtaining any rights in the software or making payments in respect of the same, is only facilitating its distribution to the public as a distribution service provider. The income of such distributor would usually be taxed under Article 7.

12.10 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. Such payments are likely to be business profits within Article 7 or 14 or a capital gain within Article 13 rather than royalties within Article 12. Paragraph 16 of OECD Commentary provides that certain cases of transfer of less than full ownership, as in case of exclusive right of use of the copyright during a specific period or in a limited geographical area, additional consideration related to usage or consideration in the form of a substantial lump sum payment would also not constitute royalty. However, since accepting this distinction would open a world of opportunities for artificial structuring of transfer of rights in software with the objective of disguising royalty payments for the purpose of avoiding source taxation, the Committee did not accept this view, and preferred not to accept such artificial distinction. Payments made for less than full ownership should thus be considered as royalty within the definition of royalty in paragraph 3, unless countries bilaterally agree to take a different view. 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.

12.11 Software payments may be made under mixed contracts. Examples of such contracts include sales of computer hardware with built-in software and

concessions of the right to use software combined with the provision of services. The methods set out in paragraph 11 above for dealing with similar problems in relation to patent royalties and know-how are equally applicable to computer software. Where necessary the total amount of the consideration payable under a contract should be broken down on the basis of the information contained in the contract or by means of a reasonable apportionment with the appropriate tax treatment being applied to each apportioned part.

12.12 The principles expressed above as regards software payments are also applicable as regards transactions concerning other types of digital products such as images, sounds or text. The development of electronic commerce has multiplied the number of such transactions. The changing business models adopted by enterprises have also given rise to new challenges, which are being examined and may lead to evolution or adoption of additional options. However, greater analysis of such options and detailed guidance for their application may be required before they can be recommended by the Committee of Experts.

12.13 Paragraph 2 of Article 12 provides for taxation of the gross payment made for grant of rights in respect of software. This could give rise to concerns similar to those examined and discussed in paragraph 8 and 9. In such cases, Contracting States can either agree to a maximum rate of tax in the source state taking into account these concerns. Alternatively, Contracting States that so desire may also opt to amend the paragraph 2 by providing a specified deduction for the expenses. In order to prevent escalation of compliance burden and keeping in view the constraints often faced by the developing countries, one possible option could to provide fixed deduction on a pro rata basis, on account of depreciation of the software, the specifics of which can be bilaterally agreed by the Contracting States.
12.14 For Contracting States that may wish not to tax software payments made for personal use, and instead may want to limit it to those payments that are claimed as business expenditure leading to erosion of tax base, an option could be to amend paragraph 2 of Article 12 by limiting payments therein to those that are claimed as deduction by an enterprise for the purpose of computing its income. Another possible option for those Contracting State that may not wish to extend the application of Article 12 to smaller payments, with the purpose to limit compliance burden, could be to provide a minimum revenue threshold in respect of payments covered under paragraph 2.