

29 March 2017

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**Committee of Experts on International  
Cooperation in Tax Matters  
Fourteenth Session**

New York, 03-06 April 2017

Agenda item 3 (a) (iii)

Article 12 (Royalties): possible amendments to  
the commentary on Article 12 in relation to industrial,  
commercial or scientific equipment and software-related payments

**Possible Amendments to the Commentary on Article 12 (Royalties)**

**Background**

Upon conclusion 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.

On the 9<sup>th</sup> 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 10<sup>th</sup> session of the Committee. 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 of Experts on International Cooperation in Tax Matters held in Geneva, the secretariat's note, as well as a paper commended

from Mr. Scott Wilkie were taken up by the Committee and the Subcommittee on Royalties (Subcommittee) was formed to further investigate those issues. The issue of taxation of royalties was put forward for consideration at the agenda of the twelfth Session of the Committee, but was deferred until the Fourteenth Session, after the relevant Subcommittee has had an opportunity to meet.

### **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 11<sup>th</sup> Session of the Committee of Experts. The Subcommittee is comprised of Members from tax administrations with wide and varied experience in dealing with matters relating to international taxation as well as Members from academia, international organizations and the private sector, including from multinational enterprises and advisers. Membership is assumed on a personal capacity:

### **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 Nii Yarboi Mensah (Ghana)

Ms. Ingela Willfors (Sweden)  
Ms. Noor Azian Abdul Hamid (Malaysia)

Ms. Liselott Kana (Chile)  
Mr. Jorge Rachid (Brazil)  
Mr. Al Khalifa (Qatar)  
Mr. El Hadji Ibrahima Diop (Senegal)  
Mr. Johan Cornelius de la Rey (South Africa)  
Ms. Xiaoyue Wang (China)  
Mr. Ignatius Kawaza Mvula (Zambia)  
Mr. Mohammed Amine Baina (Morocco)

**Other Members:**

Ms. Anna Binder (WU)  
Mr. Scott Wilkie (Osgoode Hall Law School)  
Mr. Claudio Souza (Brazil)  
Mr. Enrique Bolado (Mexico)  
Lili Wang (China)  
Radha Kishan Rawal (India)

**Current Activities of the Subcommittee**

The Subcommittee met on the 16<sup>th</sup> and 17<sup>th</sup> of February 2017 in Brussels, hosted by the European Commission. The Subcommittee would like to thank the European Commission for hosting the meeting and for its support. The group discussed (i) issues in relation with the characterization of consideration derived from leasing of "industrial, commercial and scientific equipment;" and (ii) issues related to software payment. CRP 8/2016 containing various issues relating to equipment royalties and software related payments was presented by the Coordinator to the Members of the Subcommittee.

On occasion of the meeting, the Subcommittee received a presentation from Bill Sample, from Microsoft, on the nature of the payments made for the use of software. Mr. Sample provided

important insight into the difference between payments made for the acquisition of a copyright, a patent, or a software, highlighting from his perspective under what circumstances those payments would be regarded to be royalty payments. The Subcommittee thanked Mr. Sample for his important contribution to the work of the Subcommittee, and decided not to put forward any text regarding the characterization of royalty payments made for the acquisition of software, until other underlying issues of a more technical nature are clarified. The Subcommittee asked Mr. Sample to continue assisting the Subcommittee by providing further oral and written inputs into the commercial nature of license and software agreements.

### **The Subcommittee Proposal for the current membership of the Committee**

The Subcommittee wishes to seek approval from the Committee, of the proposed amendments to the commentaries of Article 12 of the UN Model. The Subcommittee would like to request for the Committee to consider those modifications when approving the next update of the UN Model (Annex I).

The proposal reflects the view of the majority of the members of the Subcommittee.

### **Issue to be considered by the next membership of the Committee**

The Subcommittee would like to request the next membership of the Committee to reconvene the Subcommittee on royalties, so that it can conclude the terms of its mandate by addressing the nature of software related payments and apply the corresponding changes to the UN Model and Commentaries, as appropriate.

## **Annex I**

13.1 The reference in Article 12(3) to "industrial, commercial or scientific equipment" addresses circumstances in which the owner of the equipment earns profits from letting another person use that equipment, without having the owner establish any presence in the state where it is used, or where the user resides, which would satisfy the requirements of Article 5 for the existence of a permanent establishment. For this kind of business the equipment itself, when used by another person, is treated in the United Nations Model Convention as having significance similar to that of a permanent establishment.

13.2 The term "equipment" is not defined in this Model. Accordingly, the provisions of paragraph 2 of Article 3 apply, which means that the term may have different meanings in different States. However, a feature that is always present is that the equipment will be used in the performance of a task. It is a tool used by a business in the sense that it is not enjoyed for its own sake. Thus, for example, a car rented by a tourist will not be considered to be "equipment." Neither can equipment include intellectual property, immovable property covered by Article 6, or property covered by Article 8. Industrial, commercial or scientific equipment is clearly a subset of equipment and may, outside of a consumer context, include (not an exhaustive list) ships, aircraft, cars and other vehicles, cranes, containers, satellites, pipelines and cables etc.

13.3 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, some or all of which may, depending on the case, fall under Articles 7, 11, 13, 14 or 21. Some contracts combine the lease element and the sale element, so that it sometimes proves difficult to determine their nature and 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 paramount, 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 an 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 up to the date the lessee 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 likely user of the equipment, or it is not feasible for the equipment to be leased to another lessee;
- the lessee of the equipment behaves as owner;
- the lessee carries positive and / or negative residual value risk or utility in respect of the equipment;
- the lease payments to use the equipment are high particularly at the beginning such that they constitute an inordinately large proportion of the amount needed to secure the acquisition;
- the lease payments materially exceed the current fair rental value and thus compensate for more than just the use of property; and\*
- some portion of the lease payments is specifically designated as interest or is otherwise readily recognizable as the equivalent of interest.

\*[One member of the Subcommittee was of the view that in place of the word "and", the word "or" should be used.]

13.4 With regard to satellite operators and their customers, the characterization of a payment by the customer to the satellite operator as a royalty will depend to a large extent on the specific contractual arrangements. If the owner of the satellite leases it to another person and that person operates it, the payment for the lease would be a royalty payment for the use of industrial, commercial or scientific equipment. However, in many cases the customer does not acquire the possession or control of the satellite, but makes use of part or all of its transmission capacity. The satellite would continue to be operated by the lessor. In such cases, [some] members are of the opinion that the payments made would be in the nature of transmission services to which Article 7 or Article 12 A applies. [Some] other members are of the opinion that a payment for the use

of the transmission capacity (or transport or transmission capacity in the case of pipelines or cables) could be regarded as payments made for the leasing of industrial, commercial or scientific equipment.