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Article 12 (Royalties)
a.) The meaning of “industrial, commercial and scientific equipment”
b.) Software payment-related issues

The character and purpose of Article 12 with reference to “industrial, commercial and scientific equipment” and software-payment related issues

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Outline

1. The current version of the United Nations *Model Double Taxation Convention between Developed and Developing Countries* was adopted in its present form most recently in 2011 (the “Model”).

2. The Model and the Commentaries on its Articles reflect the parallel Articles and Commentaries of the Organisation for Economic Cooperation and Development’s (the “OECD”) *Model Tax Convention on Income and Capital* which most recently was updated in July 2014 (the “OECD Model”). The Articles and Commentaries are not identical, reflecting different influences on their development commonly attributed to the balance between the interests of “developing” and “developed” countries. For present purposes, it is convenient, though not meant to be restrictive or judgmental, to refer to salient OECD Model experience as the adopted experience of the UN unless there are clear reasons to qualify that apparent adoption. *It should be said at the outset that references to the OECD Model and its Commentaries, and its historical development in the relevant regard, are meant only to provide an objective framework for the present discussion, and are specifically not meant to suggest that the course of the Model should follow that of the OECD Model or that the influences that bear on the Model are the same as those that have animated the development of the OECD Model.*

3. In 2011, the Committee of Experts on International Cooperation in Tax Matters (the "Committee") discussed the 2011 update of the Model. They noted questions concerning the meaning of "industrial, commercial or scientific equipment" and the treatment of "software" payments which had not been addressed by them or their predecessors in detail but in their mind merit further inquiry. The Committee reiterated the desirability of this inquiry at its tenth session in October 2014.[1]

4. The questions posed by the Committee can be approached in two complementary ways.

5. One way is to examine broadly the role of Article 12 in the Model and, particularly concerning the taxation of business income. The other way, which is reflected in the Secretariat's own paper for which this Note is meant to be complementary, is to adopt what the Secretariat describes as "ad hoc 'fixes'" to address particular and immediate kinds of "equipment" and commercial experiences.[2] The meaning to be attributed to particular income producing objects, in point "industrial, commercial or scientific equipment" and "software", may have a profound effect, regardless of any specific examples of these terms, on the scope and consequential allocation of taxing rights by Article 12 so as to affect the balance in the Model concerning the taxation of business profits.

6. Article 12 in the Model contemplates the retention of source country taxing rights, assuming that relevant source country tax legislation contains suitable charges to tax, with an expansive and possibly bespoke notion of "royalties" regardless of prevailing private law connotations of this term. This approach effectively *expands* source country taxation, allowing Article 12 to function more effectively as a "source country rule". By more precisely or specifically defining terms such as "industrial, commercial or scientific equipment" and treating "software" on a unitary basis without necessary regard for its intrinsic technical or commercial elements in deference to its perceived primary character, the scope of Article 12 as a jurisdictional matter could become limited. This could, in turn, defeat the possible significance of Article 12 in the Model (notably in contrast with the OECD Model) for the allocation of international tax rights particularly for business income in the increasingly common situation where businesses may be considered to be carried on "in" source countries without by their nature requiring the kind of presence described in Article 5 even though they may be no less "present" for that reason than businesses conducted by similarly situated residents of the source country. Intrinsically, the Model has a strong residence country orientation[3]

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1 United Nations, Economic and Social Council (14 August 2014), Committee of Experts on International Cooperation in Tax Matters, tenth session, Geneva, 27-31 October 2014, Item 3(a)(vi) of the provisional agenda: Discussion of substantive issues relate to international cooperation in tax matters: article 12: general considerations including equipment-related issues, Differences between article 12 of the United Nations Model Double Taxation Convention between Developed and Developing Countries and article 12 of the Organization for Economic cooperation and Development Model Tax convention on Income and Capital, paras 7–9 , (E/C.18/2014/3); United Nations, Committee of Experts on International Cooperation in Tax Matters, Report on the tenth session (27-31 October 2014), Economic and Social Council Official Records, 2014 Supplement No. 25, paras 50 and 51.

2 E/C.18/2015/CRP.7.

3 Richard Vann has observed this, most recently in a presentation of which I am aware on September 7, 2015 at a "GTTC (Global Tax Treaty Commentaries) Duets Conference" hosted by the International Bureau of Fiscal Documentation in Amsterdam, The Netherlands.

even if this is not intuitive; that orientation becomes necessarily stronger the more refined and consequently limited the reach of Article 12 becomes.

7. This is why, in principle, it is useful to consider Article 12 in light more generally of its historical evolution to determine the meaning in principle to be ascribed to "industrial, commercial or scientific equipment" and the significance to be attached to software payments. This Note foresees the "general" as in fact a statement of the "specific". More specifically, it is concerned with the consequences of adopting detailed references to particular kinds of property without first determining the desirable scope of Article 12 as a means to permit source countries, in this paradigm assumed to be developing countries, to tax business income when the earner of that income has a more remote connection to the source country than typical interpretations of Article 5 require for exercising taxing rights.

8. This Note examines Article 12, and the particular dimensions of "industrial, commercial or scientific equipment" and software payments, from this perspective. In effect, it seeks definition and specificity with respect to these terms by considering, in historical context, whether they need to be or should be limited more precisely, and if so what would guide further refinement of Article 12 while preserving source country taxing rights considered by the Committee to be desirable.

9. The objective of this Note, accordingly, is to offer the Secretariat and the Committee the opportunity to consider whether to add additional detail to these terms or commercial arrangements for which they are relevant in Article 12 and its Commentary. It is not intended to be a definitive analysis in this regard, but merely to express salient issues in a way that would, if the Committee decides, be a starting point for further more involved scholarly and empirical research.

10. It is to be noted that the history of Article 12 is long, complex and in some ways, respectfully, both unclear and dense.[4] This Note takes deliberate liberties, in the interest

[4] Useful references, from which this Note draws and otherwise which have or may have affected its comments, are: Richard Vann, "The history of royalties in tax treaties 1921-61: Why?" in Comparative Perspectives On Revenue Law Essays in honour of John Tiley, Eds. John Avery Jones, Peter Harris and David Oliver (Cambridge: Cambridge University Press, 2008) Ch. 7, 166 – 196; Adolfo Martin Jiménez, "Article 12: Royalties – Global Tax Treaty Commentaries" in Global Tax Treaty Commentaries (The Netherlands: International Bureau of Fiscal Documentation, 2014, 2015); Kim Brooks, "Tax Treaty Treatment of Royalty payments from Low-Income Countries: A Comparison of Canada and Australia's Policies" (December 2007) 5:2 eJournal of Tax Research 168 – 197; Michael Lennard, "The UN Model Tax Convention as Compared with the OECD Model Tax Convention – Current Points of Difference and Recent Developments" Asia-Pacific Tax Bulletin (January/February 2009); K. Vogel et al., Klaus Vogel on Double Taxation Conventions 2nd and 3rd editions (Kluwer L. Intl. 1997); Veronika Daurer and Richard Krever, "Choosing Between the UN and OECD Tax Policy Models: An African Case Study" EUI Working Papers, RSCAS 2012/60 Robert Schuman Centre for Advanced Studies Global Governance Program-31 (2012); Catherine Bobbett and John Avery Jones, "The Treaty Definition of Royalties" (January 2006) Bulletin – Tax Treaty Monitor (The Netherlands: International Bureau of Fiscal Documentation, 2006). Concerning the origin of tax treaties and the orientation to and balance between "residence" and "source," see John F. Avery Jones, *The David R. Tillinghast Lecture: Are Tax Treaties Necessary?* (1999) 53:1 Tax Law Review 1 – 38; John F. Avery Jones, *Problems of Categorising Income and Gains for Tax Treaty Purposes* [2005] no. 5 British Tax Review 382 – 3999; and John F. Avery Jones, *The History of the United Kingdom's First Comprehensive Double Taxation Agreement* [2007] no. 3 British Tax Review 211 – 254, and see also Richard M. Bird and J. Scott Wilkie, *Source- v. residence-based taxation in the European Union: the wrong question?* In Taxing Capital Income in the European Union Issues and Options for Reform, Ed. Sijbren Cnossen (Oxford: Oxford University Press, 2000) Ch. 4, 78 – 109. In keeping with the nature of this Note, reference to these sources will not be made unless this Note draws specifically from comments of the authors.

of focusing on themes and to be efficient and practical in the spirit of this being a "scoping" Note, in referring to tax treaty history, drawing attention to pertinent threads of that history in an economical but it is hoped revealing fashion.[5] This note is in the nature of an interpretive critique of Article 12 conceptually for the above purpose. In that regard, the history of Article 12 has been distilled and inferred as much as expressed and chronicled, deliberately so that the threads of its significance are as readily apparent as possible to inform the Committee's review of Article 12.

11. This Note should accordingly be received as an initial response to the Committee's questions. It is intended to provide a basis for discussion and further inquiry resulting, possibly, in a comprehensive inquiry. The Note is prepared to seek reaction and direction with a view to preparing such a brief. For the time being the most primary pertinent sources consulted in preparing this Note are listed only in footnote 5; given this Note's purpose and limited scope. These sources are available to be consulted more specifically and comprehensively should the Committee wish to consider Article 12 further.[6]

12. This Note addresses:
   a. The relevant history of Article 12 of the Model and the OECD Model;
   b. The meaning of "industrial, commercial and scientific equipment" and "software" in and / or in relation to Article 12 of the Model compared to the OECD Model, relying on primary sources underlying the OECD Model that illuminate Article 12's scope and the difference in scope of the Model's and the OECD Model's versions;
   c. The role of Article 12 to specifically allocate taxing rights over income that qualitatively is or may be "business profits" contemplated by Articles 5 and 7 but

[5] This Note has been prepared based on a thorough canvass of primary materials compiled by or under the auspices of the League of Nations, notably the 1927 and 1928 Model Tax Conventions and related commentary and resulting drafts of Conventions in 1931 and 1933: League of Nations Fiscal Committee Report to the Council on the Work of the Third Session of the Committee (May 29th to June 6th, 1931, Geneva) including "Draft Plurilateral Conventions for the Prevention of the Double Taxation of Certain Categories of Income" and League of Nations Fiscal Committee Report to the Council of the Fourth Session of the Committee (June 15th to June 26th, 1933, Geneva) including a "Draft Convention Adopted for the Allocation of Business Income Between States for the Purposes of Taxation"; Mitchell B. Carroll, Prevention of International Double Taxation and Fiscal Evasion Two Decades of Progress under The League of Nations (Geneva: League of Nations, 1939); various and many reports and commentaries under the auspices of the League of Nations from 1928 to 1943; the Mexico and London Model Tax Conventions and commentary prepared by the Fiscal Committee of the United Nations (Fiscal Committee, London and Mexico Model Tax Conventions Commentary and Text (Geneva: League of Nations, 1946)); primary source documents (committee minutes and reports, delegates reports and comments) of the OEEC and OECD until the adoption of the 1963 OECD Model Tax Convention; primary source documents (committee minutes and reports, delegates reports and comments) of or directed by the Fiscal Committee of the OECD and relevant Working Parties from 1963 to 1992 (including reports addressed to Article 12 in connection with "equipment" and "containers": "The taxation of income derived from the leasing of industrial, commercial or scientific equipment," OECD 1983; and "The taxation of income derived from the leasing of containers," OECD 1983); the 1963, 1977, 1992 and subsequent restatements of the OECD Model Tax Convention and commentaries; the 1980 and 2011 UN Model Tax Convention and commentaries; salient commentaries by Vogel, Vann, Jiménez and Brooks, supra note 4; E.B. Nortcliffe (Canadian Tax Foundation International Tax Conference, 1964) concerning work of the OECD Fiscal Committee and royalties particularly; UN Committee of Experts on International Cooperation in Tax Matters, E./c.18/2014/CRP.8 Note from the Coordinator of the Subcommittee on Tax Treatment of Services: Draft Article and Commentary on Technical Services. Specific references to salient observations in the primary materials are made only exceptionally in keeping with the nature and purpose of this Note, but a full bibliography of primary sources considered exists to be considered if work on the Committee's questions proceeds and can, in due course, be provided.

[6] See supra note 5, and also note 4.

only covered by those Articles if a “typical” source country “permanent establishment” exists; and

d. A recommendation for further study of the issues presented in this Draft Note with a view:
   i. either to removing “industrial, commercial and scientific equipment” from the definition of “royalties” in Article 12(3) while retaining source taxation of royalties, or to resolving to tax payments for the use of such equipment as a unique subset of “business profits” for which the mere presence in the source country of the equipment or the residence in the source country of the person with a legally enforceable right to use the equipment would be sufficient to constitute a “permanent establishment” of the non-resident equipment owner / rights owner of the equipment in the source country to which payments for the use of the equipment would be attributed and commensurate income determined in accordance with Article 7; and
   ii. to determine whether payments for “software” alone or as part of a “mixed” or “bundled” contract should be treated wholly or partly as “royalties” in Article 12 or, as contemplated immediately above, should be treated as “business profits” taxable only in accordance with Articles 5 and 7, possibly reinforced by deeming a “permanent establishment” to exist where the software is used in a source country or by a resident of the source country.

The Model and the OECD Model[7]

13. There are well known differences between the Model and the OECD Model that arise from the relative interests, taxation capacity and resources of “developed” versus “developing countries”. Notable among them is the scope of Article 12, particularly the allocation of taxing rights to both “source” and “residence” countries and the application of the Article to payments for the use of property other than intellectual and cultural property.[8]

14. The extended scope of Article 12 of the Model, contrasted with its cousin in the OECD Model, is deliberate. In material part the reason would appear to be to permit “source” countries to retain taxing rights over income arising from business 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. Consequently, the source county would retain taxing rights over payments made to non-residents for “letting” business property, payments that intrinsically may be and accordingly are considered to be “business profits” of the recipient but possibly not otherwise taxable by the “source” country because the non-resident is not sufficiently “present” there commercially as that would be translated in tax jurisdiction terms to have a “permanent establishment” to which such payments would in accordance with the principles underlying Articles 5 and 7 be attributed. In this connection, it is observed that a tax treaty might, and the Model and the OECD Model seemingly do, ascribe to the term “royalties” payment streams and the reasons for them that might not

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7 This discussion draws on the references in supra notes 4 and 5.

8 The evolution and practical effect of Article 12, in terms of the development of tax treaties and of the OECD Model in particular, may be said effectively to reflect a “residence” country orientation even though it may not commonly be seen that way and for many this would be counterintuitive. See supra note 3, and John F. Avery Jones supra note 4.

bear a royalty characterization under private law. Ultimately it is for a taxing jurisdiction to determine whether and how its charges to tax are configured, including whether they follow and build on, or alternatively overcome limitations of, the private law to which tax law and tax treaties are accessory. It may be important for this discussion about the significance of Article 12 that the Model would treat as "royalties" payments which intrinsically, as a legal matter, do not have or bear that character.

15. The design of Article 12 in relation to "industrial, commercial and scientific equipment" was sensitive to the avoidance of double taxation as a general objective of a tax treaty. In that regard, defining "royalties" to include payments for the use of such property can be seen as not solely to allow for the assertion of (withholding) taxation rights, but also to set limits on the taxation of "business profits" consistent with those found in Articles 5 and 7. At the same time Article 12 defers to those other Articles where a recipient of "royalties" overtly is earning business income in the source country in a typical manner, that is by maintaining a "permanent establishment" there to which the relevant arrangements were specifically connected and therefore to which payments are considered to be attributable.

16. It is also clear that the mere "presence" of a non-resident's property in a "source" country - through its use by a resident of the "source" country - was not considered in itself to be a taxable business presence in the nature of a "permanent establishment"; to invoke source country taxation in the absence of Article 12's extended scope in the Model, it was considered necessary that the non-resident recipient of the "royalties" conduct activity in the "source" country through a business presence that separately satisfied the definition of "permanent establishment".

17. There is evident tension in deliberations by the Fiscal Committees of the Organisation for European Economic Co-operation (the "OEEC") and OECD traceable to their awareness that a non-resident could be considered to be commercially active in a "source" country to the fullest extent necessary without actually being itself "present there" in conventional terms, by carrying on its business vicariously and even effectively collaboratively through a "source" country user of its property. This was the case even if the payments were invariant with respect to the degree or outcome of use of the property measured financially or with respect to production by the "source" country user.

18. Additionally, discernibly underlying the architecture and evolution of Article 12 of the OECD Model specifically with respect to the letting of property has been an explicit concern about base erosion, that is the reduction of a "source" country's tax base by the payment to non-residents of deductible charges for the use of property, coupled with the non-taxability of the recipients' income in the absence of a "source" country permanent establishment. Well before its time, this foreshadows concerns that that are equivalent to those which are a principal subjects of the OECD's continuing study with the G-20 of "base erosion and profit shifting" as well as a remedy that employs withholding tax to deal with imbalances in the taxation of business profits and opportunities presented to

carry on business in a source country without establishing a presence considered to satisfy the typical characteristics of a "permanent establishment".[9]

19. Article 12 also concerns payments that may not be "business profits", which have a closer connection either to a return on an investment akin to dividends or interest, or lacking any such origin or nexus and are in the nature of "other income" or "capital payments". Indeed, in the case of equipment leasing and the provision of software, transactions that appear to be and are formulated as user arrangements may, predominantly despite legal nomenclature, be transactions of another kind, such as financings in the case of financing leases or sales on credit in the case of "hire purchase" or "lease option" transactions.

20. As in the case of services, which is a subject of separate study by the Committee but which involves like uses, characterization and resulting taxing right allocation issues arise from "mixed" or "bundled" contracts.

21. To the extent that transactions are, wholly or partly, financing transactions involving payments that are or are in the nature of interest, Article 12 supplies a consistent outcome with Articles 10 and 11. To the extent the payments and relevant arrangements would not be encompassed by any of Articles 7, 10, 11 and 12 and they are "income" or "capital", then the "other income" and "capital" Articles of the Model and the OECD Model would, consistent with those other Articles, apply to allow amounts possibly to be by taxable by a "source" country if considered to "arise" there, in the case of "other income," or to be used there, in the case of "capital". This is consistent with the principles underlying the other specific Articles, including particularly Article 12. Otherwise, equally consistent with those Articles, exclusive "residence" country taxation does, in the case of income amounts, and may, in the case of "capital", result.

22. The possibility of what now are described as "double non-taxation" and "treaty shopping" were subjects of explicit consideration by the Fiscal Committee of the OECD and its predecessor the OEEC concerning the design of Article 12. Of particular concern, as primary OECD source documents and Commentary to Article 12 of the

9 Inevitably, and usefully, this Note reflects an awareness of the OECD's work on "base erosion" ("BEPS") the final reports concerning which were released on October 5, 2015 and will be presented to the G20 Finance Ministers on October 8, 2015. This Note is not about BEPS, as such. However, it is noticeable that the streams of the BEPS project responding to Actions on various specific subjects seem to converge on devising what amount to "source of income" rules that focus on taxpayers' nexus / connection to observable productive activities to which, even in the case of "intangibles" and "risk" they meaningfully contribute and have the functional and financial means to contribute as well as on the political jurisdictions and geographic territories in which they are "present" or are connected. This convergence is expressed not only in "economic substance" terms but with heightened regard for "legal substance," i.e., the correspondence (or not) between how taxpayers have organized their arrangements including by adopting business forms and through contract, on the one hand, and evidence, i.e., empirical observations, about whether their arrangements actually conform to those forms and contracts to reflect genuine and possible reliance on them. Directionally, this is consistent with the analysis in this Note, which focuses on why source countries may be justified in preserving opportunities to tax business income of non-residents even if, and even taking account of OECD BEPS project advances, they would not have an established typical business presence in the source country. This, too, raises difficult questions about whether there is what amounts to equality between the notion of "carrying on business (in a place)" and "permanent establishment," which is difficult and complicated question when the influences of digital means of conducting business and digital products are considered. However, a tax treaty merely defines the limits of consensual allocations of tax rights, leaving to countries whether to assert those rights to serve justifiable interest. Accordingly the discussion in this note is not to say that countries should adopt a "shadow business profits" approach through Article 12, but merely that they may wish to be aware of this effect and possibility in deciding how to refine or limit the Article including by specific reference to particular forms of "equipment".

1963 and 1977 OECD Models addresses, are payments for the use of property, i.e., equipment, to recipients resident in what would now be considered to be intermediate or conduit jurisdictions (with favorable treaties with "source" countries), the capital of which was owned by residents of third countries; in short, there has been a persistent "treaty shopping" awareness and concern inchoate in Article 12 and its development, and in the difference in Model and OECD Model versions.

23. With these concerns in mind, which evidently were in the view of the Fiscal Committees of both the OEEC and the OECD, to achieve identifiable objectives that arise naturally from those concerns, the Model still, and the OECD Model formerly did define "royalties," a term that may or may not depending on applicable private law of treaty partners have this connotation, to encompass payments for the use of business property other than intellectual and cultural property, and to include payments for the use of "industrial, commercial and scientific property". That is, as does any deeming or like rule, the Model declares payments and underlying property interests to be something that otherwise they otherwise are not or, to hedge, may not be. This Note, for the time being, does not explore the notion of "royalties" further, although depending on the course of any further inquiry on this subject, such a study may be warranted, even necessary.

24. The Model affirms and preserves the interests of developing countries as "source" countries in a number of respects, allowing those countries the entitlement to tax income earned by non-residents of those countries by making substantial use of those countries' infrastructure, resources and labour supply – in short, by being commercially active in the "source" country in ways that are equivalent to a similarly situated resident of the "source" country.

25. In the absence of suitable provisions tailored to the interests of developing countries, non-residents would be able to earn "business profits" that in business and economic terms arise in, i.e., have a "source" in, those countries but in accordance with international taxation "norms" may not be taxed by those countries. Accordingly, for example, the 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 comprise payments for the use of various manifestations of "intangible" property but also other business property described as "industrial, commercial or scientific equipment" in the definition of royalties in Article 12 of the Model.

Discussion

Interpreting the Question

26. The essence of the question posed by the Committee is, it is submitted, not merely definitional.[10]

27. The history of Article 12 of the Model and the OECD Model bears heavily on any change of course that the Committee would consider with a view to limiting or more precisely delimiting the scope of Article 12.

28. The nominal subject of this inquiry being the meanings of “industrial, commercial or scientific equipment” and software in Article 12, masks, or perhaps frames, a more fundamental question, which can be understood and addressed in two ways.

A Proxy for Taxing Business Profits.

29. First, are business profits or a proxy for them, earned by a non-resident by letting property to a “source” country user taxable *regardless* of whether the non-resident carries on that business at a “permanent establishment” (as that term would typically be understood) in the source country, to which those profits, additionally, are attributable? As Article 12 reflects, if the “royalties,” which as noted earlier include amounts in relation to arrangements that are not royalties under the general law but are constituted as such for Article 12’s purpose, are “business profits” attributable to, i.e., “effectively connected to”, a “permanent establishment” and / or other business activities in the source country, then Article 12 defers to Articles 5 and 7. If no such “effective connection” exists, Articles 5 and 7 do not preclude the preservation of source country tax rights by Article 12 which allows those profits to be taxed on a gross basis, i.e., without reduction by and deduction of applicable expenses incurred to earn the gross revenue.

30. This outcome is curious when seen this way except to the extent that the tax, most likely a withholding tax, might and could be at a rate under the source country law that took into account the gross basis of the levy, i.e., implicitly assumed the existence of deductions equal to a proportion of the revenue so as to cause the application of the withholding tax rate to approximate result in a net income taxation.[11]

31. The OECD was concerned about this asymmetry, among other concerns, when it reviewed Article 12 after adopting the 1977 OECD Model; eventually this concern was addressed in 1992 by deleting the reference to “industrial, commercial or scientific equipment” from the definition of “royalties” in Article 12.

32. Payments for software seemingly have never been defined or deemed to be “royalties”; accordingly general principles, taking into account the complexity of “mixed” or “bundles” transfers apply and to the extent that cognizable, i.e., according to the Model and OECD Model Commentaries, predominant, transfers of intellectual or cultural

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10 The question is not restated here; see supra para 3, 4 and 5.

11 See Vann and Jiménez, supra note 4.

property take place that do satisfy the definition of “royalties” that Article 12 applies. Put another way, to solve this concern, if it is to be solved, it was necessary to reverse a deeming convention in Article 12 for “equipment”; for software that would not be considered to be equipment, no such reversal is required.

A Proxy for a Permanent Establishment – A Constructive Permanent Establishment

33. The second way to interpret the effect of Article 12 when a non-resident does not have a source country permanent establishment is that it effectively deems the subject property or use rights to be or constructively treats it to be in the nature of a permanent establishment. Apart from the gross basis of taxation, which could be addressed through modifications of Article 12 or recommendations and guidance in Commentary to it, the effect is to treat the non-resident as having a virtual or representative – a constructive – permanent establishment in the source country, even if the affected property is used by a source country resident in a third country.

34. This outcome is curious possibly for other reasons.

35. The Model addresses circumstances in which a non-resident’s connection to a source country, if measured by the standards of the OECD Model may be insufficient to constitute a permanent establishment. Consequently, the Model already provides for building sites of short duration and the provision of services in a particular manner to be permanent establishments. In other words, Article 5 of the Model includes, within the present frame of reference, deemed permanent establishment rules. Presumably, Article 5 could, similarly, provide that property transferred for the limited use by a source country resident constitutes a permanent establishment of the non-resident transferor; countries concerned about whether a non-resident would comply with applicable reporting requirements and more generally the assertion of tax jurisdiction could apply “back-up withholding” to the use payments which, if at all, would only be relieved (including the rate of tax) under a tax treaty if the non-resident complied with source country tax reporting.

36. Additionally, the more obscure Article 22 provides that capital that is not immoveable or comprising part of a permanent establishment of a non-resident in a source country is not taxable by the source country. It is at least questionable whether charges for the use of property, particularly if they recover the cost of the property as would be the case for even operating leases, are “capital” within the contemplation of Article 22 and whether, in that connection, there is a conflict with Article 12 that may need to be explained or rationalized.

37. One way or another, as long as source country taxation is preserved, i.e., the source country has the continuing right to tax the income from letting property; in jurisdictional terms there is no case in which an affected non-resident engaged in commercial enterprise in or with source country residents is not a business taxpayer in the source country. The rest of the exercise is refinement, i.e., on what base and at what rate. But the jurisdictional division of taxing rights, which is and it seems from the history of the Model and more clearly the OECD Model, is what is intended.

38. It is to be noted, incidentally, that in contemporary terms, this is directionally what the OECD seemingly is seeking to achieve with proposed refinements to the definition of permanent establishment to more comprehensively attribute permanent establishment status to representatives of non-residents (Action 7) and in making proposals to mitigate treaty abuse (Action 5 and 6). It has the same effect, again directionally, as the United Kingdom's recently enacted "diverted profits tax" and Australia's proposed refinements to its "general anti-avoidance rule" to capture income thought to have an objectively verifiable nexus to the region, i.e., the country in terms of political jurisdiction and geography, in which it is considered to arise.[12]

39. Fundamentally though this is not much different than what was conceived, first, in the 1943 Mexico Draft of the League of Nations Model and that might be seen as being carried forward in the Model and until 1992 carried forward in the OECD Model. It is worth noting, too, that the jurisdictional principle – the treatment of business profits in this way – is consistent whether the Model's preservation of source taxation or the OECD Model's exclusive residence taxation applies. Either way, the "royalties" are being assimilated to business profits but taxed on a more "rough justice" basis, it may be said, given the precision but also the limitations and possible rigidity of Articles 5 and 7 and their Commentaries: if the Model applies, the business profits tax metaphor described above would seemingly preserve source taxation of the business profits; if the OECD Model metaphor applies, then the business profits are not taxable by a source country unless the non-resident carries on business in the source country in a way that involves more than simply letting property to a source country resident.

The Restated Question

40. The related questions embedded in the inquiry about the meaning and significance for Article 12 of "industrial, commercial or scientific equipment" and software, then, might be said to be whether and to what extent business profits earned by a non-resident by making its property, other than financial property, available for use by another should result in the property owner being considered to earn business profits, taxable by the jurisdiction in which they arise, by carrying on business actually or constructively in the country where the user of the property resides and / or the property is or may be used at the discretion of the user and as the user directs despite the limitations of Articles 5 and 7 that otherwise would foreclose taxation by the user's country, i.e., the source country.[13]

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12 These references to BEPS actions take account of reports published on October 5, 2015 concerning, respectively, "Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance" (Action 5), "Preventing the Granting of Treaty Benefits in Inappropriate Circumstances" (Article 6), and "Preventing the Artificial Avoidance of Permanent Establishment Status" (Action 7), as well, more generally and directionally in this Note the underlying themes and perceptions of commercial activities in "Aligning Transfer Pricing outcomes with Value Creation" (Actions 8 – 10).

13 In this context, additional questions arise to be considered if the user resides in a country that is different than where the property is actually used by the user or at its direction. While this sort of triangular situation should be investigated, if the non-resident letting the use of the property to the user is considered to carry on its business via the user's use of the non-resident owner's property, the user's country would, in this example, be treated as the source country the taxing rights of which is preserved, which is not to deny that the third country too might seek to exercise taxing rights also. This Note does not seek to resolve this question, but simply to pose it in a way that is consistent with the implications of Article 12 discussed in this Note and to set a basic framework for exploring the question further.

41. The broader scope of Article 12 to apply to returns that are other than business profits is acknowledged above; passive or investment aspects of Article 12 which co-exists with the business aspect may be readily aligned with the species of intellectual and cultural property that, separately, the use of which may generate “royalties”.

42. This commentary proceeds on the assumption that generally, if property fitting the descriptions “industrial, commercial or scientific equipment” or software is involved, more likely than not the owner and purveyor of use rights respecting that property is engaged in business with respect to that property. As noted earlier, if this is not the case, then apart from the taxation of returns on certain intellectual and cultural property, Article 12 would still co-exist harmoniously with other relevant Articles of the Model and the OECD Model. Accordingly, the non-business aspect is not further addressed in this Note.

Analysis

43. There is a wealth of primary resources that may assist to shed light on the meaning or significance of “industrial, commercial or scientific equipment” and software in the context of Article 12 of the Model or the OECD Model.[14]

44. In order to answer questions about the meaning or scope of these terms in the context of Article 12, it is necessary to consider the role and significance, more generally, of Article 12 in the Model, and in that connection in relation, too, to the OECD Model. The dictionary definitions of these terms, while offering a point of reference or departure, do not determine their significance in Article 12.

45. Legal dictionaries, capturing particular statutory definitions and judicial interpretations, generally define “equipment” as a physical or tangible implement, tool or other instrumentality that is used to perform a task and is capable of being transferred, absolutely and outright, i.e., by way of sale, or for a limited time and according to conditions, i.e., by way of a license or other use arrangement for which a fee in the nature of a “royalty” would be paid. This is the likely meaning of “equipment” in Article 12, taking account of its juxtaposition with various particular legal forms and, additionally manifestations of “intangible property” and also of the charge to tax that is permitted and preserved by Article 12 based on the “use” of equipment – equipment therefore being a species of property, a “thing”, that is capable of being used to accomplish a task but itself, when not in use, is not intrinsically useful or used in a matter that produces some sort of return or reward.

46. The meaning of these terms, it is submitted, must however extend beyond a general base level definition that would be insensitive to a possibly more elastic usage in Article 12. Their meaning, it is suggested, must and only can be determined with reference to the significance of Article 12, notably in relation to Articles 5 and 7, and in that connection the implicit significance, evaluated in terms of tax jurisdiction, of the terms that give Article 12 life but also may or could confine its jurisdictional scope.

[14] See, in particular, historical materials described or noted supra in note 5, and summarized by Jiménez and discussed also by Vogel, Vann and Brooks supra note 4.

47. In that connection, regardless of any historical implications, it must also be considered whether the present reach of Article 12 in relation to "equipment" and software offers a potential solution, if one is desired, to how to tax "business profits" of non-residents who present themselves in a source country in ways that are not captured by the usual definitions of "permanent establishment." This might be the case where, given the nature of the business and in that regard the circumstances any person would carry it on including the actual need for a conventional presence, a non-resident just as much present commercially in the source country as a similarly situated resident of that country. In other words the taxation of the non-resident by the source country would only be limited because of a requirement to have a business presence in the source country that is unnecessary to carry on the business and without which like businesses of residents of the source country could or would be carried on in any event.

48. The history of Article 12 in relation to "industrial, commercial or scientific equipment" and more recently to software is consistent with these terms being, effectively, "code" for a more profound tax jurisdiction question, whatever may be the definitional scope of these terms (and allowing for the complexity created by "mixed" or "bundled" transfers). In other words, the salient question is the significance of these terms in light of the allocation of taxing rights provided in Article 12 and, accordingly, the intended scope and nature of those taxing rights, rather than what "equipment" or "software" may mean more generally.

49. The League of Nations 1927 and 1928 Model Tax Conventions did not distinguish payments in the nature of royalties from "other income" including business income that was taxable by the country of a taxpayer's residence unless the taxpayer earned the income by carrying on activities in the source country in a fashion that would justify taxation by the source country for this reasons. This is the seed of exclusive residence taxation of royalties.[15]

50. This feature of developing tax treaties remained virtually intact throughout the work undertaken by the League of Nations from 1928 until 1946 during which period the 1943 League of Nations Mexico Model Convention was conceived.[16] During that period consideration was given to breaking out and treating separately certain limited intellectual property royalties for copyrights and patents, but also it is evident in draft Conventions considered by the Fiscal Committee of the League of Nations in 1931 and 1933 (in particular concerning the nature and attribution of business income) that payments and income arising from them relating to the letting of tangible property were reserved to the residence country of their recipients.[17] The focus, in the development of the treatment of royalties during this period was evidently on various kind of what casually would be described as intellectual property and distinctions that would be made between "creative" and other rights. This is an indication, among other things, that in Article 12's pedigree there is a primary concern with manifestations of intangible property and "know-how", and not "bundles" of property and services or "equipment".

15 See Jiménez, supra note 4, at paras 1.2.1.2.2 and 1.2.1.3.2 in particular.

16 See supra note 5, the Mexico and London Model Tax Conventions and commentary prepared by the Fiscal Committee of the United Nations (Fiscal Committee, London and Mexico Model Tax Conventions Commentary and Text (Geneva: League of Nations, 1946).

17 Id. And see Vann and Vogel, supra note 4.

51. The 1943 Mexico Model Convention and the 1946 London Model Convention of the League of Nations established what might be seen as the present jurisdictional alternatives for taxing royalties, in a manner of speaking reflecting the “source” / “residence” tension (and interests) addressed in this Note. Each Convention contained a dedicated Article for this purpose.[18]

52. Possibly reflecting concerns of the sort that animate the Model in so far as less developed countries, or to put it more generally the interests of source countries, may be concerned, the Mexico Model contemplated the allocation of rights to tax royalties (other than generally for immovable and cultural royalties) to the source country. The London Model assigned these taxing rights exclusively to the residence country.

53. Interestingly, and this possibly is revealing, neither Model Convention incorporated payments for the use of “equipment” despite earlier draft Conventions sensitive to this, notably in relation to what would be considered to be “business income”.[19] Ignoring the separate attention paid in the royalties Articles of both Conventions to returns from immovable property and certain natural resources, each Convention addressed only a limited but inclusionary subset of the specific kinds of intellectual property still covered separately in Article 12 of the Model and the OECD Model: “… [r]oyalties and amounts received as a consideration for the right to use a patent, a secret process or formula, a trade-mark or other analogous right …” in the case of the 1943 Mexico Model, and “… [r]oyalties derived … in consideration for the right to use a patent, a secret process or formula, a trade-mark or other analogous right …” in the case of the 1946 London Model. Evidently, implied by the use of the “analogous” and the reference to particular forms of legally protectable intellectual property, it is reasonable to see these royalties articles as being limited to species of business property that were intangible, and decidedly were not “equipment,” expressly or by implication. This may also be inferred from the first allusions to addressing royalties in a tax treaty, broached in the 1930s during the evolution of the League of Nations’ model tax treaties with reference to copyrights and patents.[20] While it might be possible to infer a more elastic connotation of business property, it seems unlikely that such an expansive scope was conceived for “royalties” in these Models.

54. Nonetheless, it seems clear enough that the attention paid to royalties was primarily because of a perception that they constituted business revenue, i.e., business profits. This implication is virtually continuous from the earliest modelling of tax treaties by the League of Nations. To treat income either as business or other income, in any event deferring to the exclusive right of a residence country to tax it in the absence of an observable and for tax purposes cognizable business presence in the country where otherwise the income might be considered to arise, implicitly reflects the continuing tax

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[18] See supra note 5, the Mexico and London Model Tax Conventions and commentary prepared by the Fiscal Committee of the United Nations (Fiscal Committee, London and Mexico Model Tax Conventions Commentary and Text (Geneva: League of Nations, 1946).

[19] See Jiménez, supra note 4.

[20] See Vogel, supra n. 4 (2nd Edition), II Explanatory Notes on the Model Conventions, 3. Historical background and problems involved.

treaty convention, shared by the Model and the OECD Model, to treat business profits and other income as the exclusive taxing domain of residence states.

55. However, in the case of the Mexico and London Model Conventions, this implication need not be left to surmise. Telling are key elements of the explanation of these Models published by the League of Nations' Fiscal Committee.[21] This explanation bears directly on the subsequent adoption, not without evident indecision, by 1960 of the reference to "industrial, commercial or scientific equipment" in the final OEEC Model Tax Convention that became the more or less enduring OECD Model Tax Convention in 1963.

56. Two things are particularly notable about the Committee's consideration (leaving aside generally immovable and cultural property). The Mexico Model, in the royalties' article, provides for exclusive source state taxation of the royalties that are specified, namely certain intellectual property royalties commonly associated with business operations. The London Mode adopts a different jurisdictional choice – comparing Articles X(2) and X(3) of the Mexico Model and the Articles X(2) and X(4) of the London Model, in the London Model more thorough exclusive taxation by the residence country notably in respect of what might commonly be seen as business property is stipulated, subject to a "transfer pricing" rule of sorts in Article X(3) of the London Model which allows for source country taxation on a net basis (which is interesting in light of Options for consideration discussed later in this Note). The depth of the significance of this difference in the allocation of taxing rights can only be fully understood by comparing, also, the business profits articles of those Models. In the Mexico Model it would be sufficient, seemingly, to preserve source country taxation that business be conducted in that country other than by way of "isolated or occasional transactions" in the absence of a source country permanent establishment.

57. While it might be construed or inferred that nevertheless a source country permanent establishment was foreseen as a necessary condition to source country taxation, the absolute first instruction of Article IV(1) of the Mexico Model seems to assert without this condition that "[i]ncome from any industrial, commercial or agricultural business and from any other gainful activity shall be taxable only in the State where the business or activity is carried out." That Article's first reference to a permanent establishment was, in Article IV(2), to what amounts to a *de minimis* test for occasional activity – "occasional" essentially was construed, if not defined, by a kind of force of attraction test: occasional was only not occasional in jurisdictional terms if a non-resident had established a pre-existing connection to the source country in the form of a permanent establishment. Somewhat confusingly, perhaps, Article IV(3), dealing with multiple permanent establishments, provides for an allocation of taxable income according to the territories where the income is produced, which might imply a competing construction that in the absence of permanent establishment a source country could not tax business income; but this allocation rule only applies if there are multiple permanent establishments.

21 See supra note 5, the Mexico and London Model Tax Conventions and commentary prepared by the Fiscal Committee of the United Nations (Fiscal Committee, London and Mexico Model Tax Conventions Commentary and Text (Geneva: League of Nations, 1946).

58. Are there further inferences to draw? Perhaps. Despite the somewhat awkward construction of Article IV in the Mexico Model, Articles IV(2) and (3) could be seen as reflecting the presumption that a taxpayer would, at least, have a permanent establishment where it resides, in its home country where it is what amounts to a tax citizen. But, even so, if the taxpayer was able to carry on business in the source country without establishing a permanent establishment there, Article IV(1) would confine taxation to the source country, without recourse to the multiple permanent establishment allocation rule in Article IV(3), if dealings "in" the source country, which might in the circumstances be or even only be dealings "with" source country residents, would be considered to be "carried out" in the source country. Alternatively, there may be an implied assumption that at least in the commercial circumstances of the day, it was more likely than not that carrying on activities would entail having a business presence where those activities are carried on, i.e., a permanent establishment for any meaningful business activities touching a source country. All of this reflects pressure on what "carried out" means, a persistent question that manifests itself in different guises in international tax matters, for example, in connection with determining corporate residence and where broadcasting and catalogue (the modern analogue is internet) sales businesses are conducted, and even at present, in connection with digital transfers and digital products as they are being studied by the OECD in the BEPS project. This is a question that has caused some countries to adopt extended statutory definitions of carrying on business for which commercial contacts alone with residents of a source country are sufficient to establish the existence of business dealings there.

59. All of that said, what is considered important for the present inquiry in this Note is that there is an evident sense in the Mexico Model, which is most closely identified with the Model in its attention to source country taxation, that a taxable connection to a source country may and even should exist merely because commercial activities occur there and, more generally, commercial opportunity arises and is enjoyed because of those contacts. In short, merely carrying out activities in a source country may be sufficient to sustain source country taxation. Possibly more pointed was the expressed concern that imposing a permanent establishment limitation on source country taxation might allow business profits that should be taxable by the source country based on other measures of connection and proximity to be excluded from taxation.

60. This interpretation of the Mexico Model is possibly made clearer by comparing the companion provision of the London Model adopted three years later. Articles IV(1) and (2) of the London Model make the existence of a permanent establishment in the source country a condition to the preservation of source country business taxation: "[i]ncome derived from any industrial, commercial or agricultural enterprise and from any other gainful occupation shall be taxable in the State where the taxpayer has a permanent establishment. If an enterprise in one State extends its activities to the other State without possessing a permanent establishment therein, the income derived from such activities shall be taxable only in the first State."

61. These examples of the Committee's analysis are particularly revealing:

a. *It was argued in favour of the criterion contained in the Mexico draft that, if an enterprise were to be taxable on its profits in a foreign country only if it had a permanent establishment in that country, some countries would lose revenue.*

Moreover, certain forms of fiscal evasion might be encouraged. Indeed, some enterprises might seek to avoid taxation in a country by carrying out their business in that country without maintaining a permanent establishment therein or by concealing the existence of such an establishment.[22]

b. *The second paragraph of Article X refers to royalties from scientific, industrial and commercial property* [it is noted in fact that the language of Article X is not that expansive, but refers only to particular kinds of property, though the impression created by this commentary is that a general letting for use of business property might have been in the awareness if not the contemplation of the Fiscal Committee], *such as patents, secret processes and formulae, trade-marks and trade-names. The Mexico Convention,* ***applying the principle of immediate economic origin****, placed them under a single rule according to which the royalties are taxable in the country where the patent or other similar right to which they correspond is exploited. As a result, the returns of patent and similar rights always remained taxable in the country where the rights were used, whether the proprietor exploited them himself or* ***through a lessee****.*[23] [Emphasis added]

62. Two further observations are apposite. The Mexico Model, like the Model which seems at least directionally to be its successor in some respects, is oriented to where income is considered to be earned in economic terms, that is where productive endeavors occur. Interestingly, this theme has been rejuvenated in the OECD's consideration of transfer pricing of intangibles, the meaning and alignment of risk in business operations and other aspects of international taxation which are objects of the BEPS Action Plan. Also, there is a clear indication that a lessor of property, more generally a person who provides the use of that property to another while retaining ownership of the property, is carrying on *its* business, i.e., "exploiting" vicariously through the user of the property. These are important connotations of the Mexico Model, and revealing of the mindset of those tackling the interests of source countries in retaining taxing rights. They reinforce the perception that Article 12 is, essentially, a bespoke manifestation of a treaty's treatment of business profits more generally, and in the Mexico Model's case, intended that business income be taxable by source countries if, in economic terms, it could be said that it was earned there. It would not be surprising if the subsequent development of tax treaties, by the League of Nations and the OEEC, continued to grapple with how comprehensively and according to what conditions business income would be taxable, possibly in spite of the absence of a permanent establishment in the source country.

63. In the period after 1946 and before the creation of the OECD and the adoption of the 1963 OECD Model, consideration was given by the Fiscal Committee of the OEEC, seemingly episodically during the 1950s, to including "equipment" in the definition of royalties and allowing for source country taxing rights. Proposals in both regards seemed to ebb and flow during this period until, in the late 1950s, the Fiscal Committee of the OEEC had firmly gravitated to including equipment "royalties" within the

22 See supra note 5, the Mexico and London Model Tax Conventions and commentary prepared by the Fiscal Committee of the United Nations (Fiscal Committee, London and Mexico Model Tax Conventions Commentary and Text (Geneva: League of Nations, 1946), pp 13 and 14.

23 Id., p 27.

compass of the "royalties" article and providing for exclusive residence country taxation.

64. The commentary to the Mexico Model Convention is recalled. Despite the specific and seemingly exclusive reference to particular intellectual property and cultural royalties, a broader compass of “scientific, industrial and commercial property” from a jurisdictional perspective in relation to business income earned vicariously through the use by others of an owner’s property (giving rise to business income for the owner in the only way in which it could be earned) still may have been in the institutional mind of the Fiscal Committee. In view of the commercial dealings of the day it is not hard to imagine this possibility notwithstanding that the most common manifestation of property for which royalties were paid may have been intangible. The point of this observation is to suggest that at least directionally the underlying perception and conception of royalties around the time of the Mexico and London Model Conventions may have been broader than the Conventions’ language suggest, regardless of the different and seemingly more limited approaches to allocating taxing rights.

65. The debate concerning this development of the royalties article, which presaged the formulation and adoption of 1963 OECD Model with these two features in Article 12 was conducted with an explicit awareness of source country interests in relation to the taxation of business income.[24] “Royalties” for the use of “industrial, commercial or scientific equipment” apparently were seen as business profits. Two concerns pervaded the discussion. The first was whether business profits from conducting commercial enterprise in a source country otherwise would go untaxed by the source country, or perhaps any other country, in the absence of a source country permanent establishment. The second was whether the delivery of user rights without the need for a taxable business presence in the source country allowed non-residents to organize their affairs so as to direct payments for those rights to low tax jurisdictions, particular where the recipients of those amounts would not be considered, possibly, to be what modern treaty practice describes as their beneficial owners.

66. Accordingly, animating the discussion about royalties for equipment during this formative period of Article 12’s development were concerns about permanent establishment avoidance, the taxation of what fundamentally and economically were business profits, treaty shopping and the abuse of tax treaties using conduit arrangements.

67. The answer to these concerns, captured in Article 12 of the OECD Model was effectively to treat user payments for equipment as business profits, taxable only in accordance with Articles 5 and 7. It may be telling, for the ongoing BEPS discussion, that this decision was taken with a considered awareness of how this preserved, or possibly even fostered, tax avoidance of the sort that is an important catalyst for the BEPS inquiry.

68. This architecture of Article 12 was preserved in the 1977 OECD Model. In the post 1963 period leading up to 1977, the Fiscal Affairs Committee of the OECD actively

[24] General reference is made to primary documents of the Fiscal Committee of the OEEC in the 1950s, particularly in the period 1959 to 1960, immediately before the transformation of the OEEC to the OECD in 1961. See supra note 5.

considered the same concerns that had been addressed during the original modern formulation of that Article, but left it fundamentally unchanged. It remained, in so far as user payments for "equipment" were concerned, an ulterior business profits distributive rule, mirroring and reinforcing the approach to the division of taxing rights for business income found in Articles 5 and 7. Despite concerns about possible tax avoidance through what in the BEPS and transfer pricing contexts would now be attributed to the artful use of contracts for "rights" in tax planning, the direction of Article 12 in the OECD Model seems to have been to reinforce the avoidance of double taxation. That is, the inclusion of "industrial, commercial or scientific equipment" in a treaty that assigns taxing rights exclusively to the residence country unless the non-resident earns royalties through a source country permanent establishment, and in that even defers to Articles 5 and 7, is tantamount to saying that equipment royalties are not royalties in the sense of the distributive rules in Articles 10, 11 and 12.

69. Seen this way the OECD Model provides almost as if for clarity, and has since inception provided, that regardless of whether payments for the use of property that is not intellectual or cultural property are royalties under private law, the fact that they could be is neutralized by deeming them to be so in a rule that denies source country taxation rights.

70. This approach also seems to reinforce the primary orientation of Article 12 to intellectual and cultural property rights, which was the genesis of separate tax treaty treatment originally in the 1930s. So, contrary perhaps to popular perception, regardless of the precise definition, Article 12 in the OECD Model actually denies, rather than allows, source country taxation of the use of property (by the residence country transferor in transferring its use in the course of its business, and by the transferee in effective collaboration with the transferor by using the property gainfully) to the same extent as Articles 5 and 7 essentially by incorporating their terms by reference. If the use of the property, i.e., its letting, was not in the course of conducting a business, returns on its use were and are also not taxable by the source country according to the OECD Model.

71. After 1977, the Fiscal Committee of the OECD continued to consider Article 12. The 1992 OECD Model removes any reference to "equipment" from the definition of "royalties" without altering the exclusive residence country taxation rights. This was done primarily out of a concern that fundamentally payments for the use of property are business profits to the recipient, which ought not to be taxable by the source country unless the non-resident carries on business in the source country at a permanent establishment connected to the letting of the property and earning the returns. Correspondingly, business profits should not be taxable on a gross revenue basis, in keeping with the approach to business income taxation in Articles 5 and 7. Reconsideration of Article 12 for "equipment" generally was accompanied by a study of how to tax income from leasing containers, in a manner of speaking a subset of the larger "equipment" question but with a competing characterization that the subject activity might comprise the performance of a service that involves organizing the deployment of containers through various facilities (depots) but the object of which, as such, was not leasing containers. Accordingly the focus of the container inquiry was on the hybrid or "mixed" or "bundles" nature of the affected transactions, not unlike

similar questions with which Article 12 contends and which persist concerning software. Broadly, within the residence orientation of Article 12, the container analysis was consistent with that for "equipment" more generally.

72. All of this may be seen as reinforcing a restatement or interpretation of the Committee's question according to the approach taken in this Note. This may help to illuminate and understand why the precise nature or kind of "equipment" or software may be less important than whether it is the object of a letting or use transfer,

73. In effect, the question raised by the two species of property addressed by this Note is whether a non-resident owner of this property who makes it available for use by a source country resident should be considered, vicariously or possibly collaboratively as if in partnership with the source country resident, to carry on business where the source country resident resides (and, possibly, if different where the property is actually used).

74. From this perspective, Article 12 may be seen as a surrogate or covert manifestation of Articles 5 and 7, with ulterior anti-tax avoidance elements.

75. This commentary has focused on "equipment" because that has been actively considered in the evolution of Article 12. Conceptually, however, equipment can be considered to comprise any implement, even possibly a virtual implement that is provided by one to another for use subject to reversion intact. In so far as "software" is concerned, either it includes intellectual property that is addressed by Article 12, in which case the allocation of taxing rights contemplated by Article 12 applies, or it is seen as a composite in the nature, perhaps, of equipment to which Article 12 applies (in the case of the Model) or not (under the OECD Model).

76. Similar issues concerning "mixed" or "bundled" contracts encountered in examining services are also present here. The Commentary to Article 12 of the Model and to Article 12 of the OECD Model, as well as the Committee's ongoing work to understand how services should be addressed by the Model including to consider a specific services Article, are sufficient to explain the issue of "mixed" or "bundled" contracts and how, if a particular aspect is primary and not incidental or ancillary, that aspect would be categorized among possibly competing Articles. This Draft Note, at least for the time being, will not address this issue.

The BEPS Inquiry – Directionally Consistent Perceptions

77. It is notable that the OECD, in furthering the inquiry initiated by the G-20 concerning "base erosion and profit shifting" has considered various tax treaty issues, among them whether the treaty definition of "permanent establishment" should be clarified or enhanced to include less proximate direct presence of a non-resident in a source country that nevertheless, in light of the purpose of treaties to allocate taxing rights in line with where commercial relations and economic connections are found, comports with a constructive permanent establishment. [25]

[25] OECD, Action Plan on Base Erosion and Profit Shifting, Action 7 (Paris: OECD, 2013): Public Discussion Draft BEPS Action 7: Preventing the Artificial Avoidance of PE Status, 31 October 2014 – 9 January 2015 (Paris: OECD, 2014); Revised Discussion Draft BEPS Action 7: Preventing the Artificial Avoidance of PE Status, 15 May 2015 – 12

78. The OECD's work in this regard has largely been confined to studying the role of representatives of various legal kinds who act on behalf of or "as", or who otherwise represent, non-residents in a source country so as to permit the non-resident to earn business profits with the same effective presence as would exist more directly in the absence of intermediation.

79. While final recommendations of the OECD are still pending, it seems that the OECD will recommend that countries wishing to address this issue may do so, among other ways, by treating source country intermediaries as permanent establishments of non-residents where none otherwise would exist regardless of the legal designation or role of the intermediary, and additionally to treaty non-residents as having a taxable representative presence if they actively involve themselves in the activities and undertaking of a source country resident serving their interests.

80. In short, the OECD is studying whether and to what extent a non-resident should be considered or permitted to conduct business "in" a source country without being taxable by it because of the absence of a typical or conventional permanent establishment in that country. Said differently, the question being addressed by the OECD is whether a constructive business presence is sufficient even if such a typical or conventional presence does not exist and, in that regard noting the particular interests of developing countries served by the Model neither a "building site" nor a "services" permanent establishment would be considered to exist.

81. Seen this way, the BEPS inquiry being conducted by the OECD is a focus for the questions addressed in this Note. This may offer directional assistance. To the extent that this work would be seen as effectively entrenching the present limitations in Article 5 on when a permanent establishment would exist by expanding its scope only in relation to a non-resident acting "through" representatives or intermediaries, the Committee members may wish to consider questions of consistency where their countries adhere to both the Model and the OECD Model with or without reservations or observations and, also, are adherents to the BEPS project and will be identified with its outcomes.

82. "Software" is not better defined than already in the Commentaries to Article 12 of the Model and the OECD Model. In sum, it is generally seen to consist of the digital content that creates a digital tool. In this respect, it is a modern example of "equipment" in relation to how it would be used to accomplish a task. The possibility that software, at least to this extent, could be seen and treated as "equipment" in the absence of a limited definition of "equipment" in the Model or a specific use and definition of "software" as such in Article 12 cannot be ruled out, and may deserve further consideration in light of the role intended to be played by Article 12. On the other hand, taking account of those Commentaries on Article 12, other elements of the definition of "royalties" in Article 12(3) could describe elements of or commonly associated with "software" including rights subject to industrial or artistic copyright, patents, trademarks, designs or models, and secret formulae or processes.

June 2015 (Paris: OECD, 2015; BEPS Final Report, Preventing the Artificial Avoidance of PE Status (Paris: OECD, 2015)..

83. In both cases, but possibly more acutely with respect to “software” rights to use property or assets that are in the nature of “equipment” and “software” co-exist with rights to obtain or use other “things” through “mixed” or “bundled” contracts that in addition may entail the provision “services” incorporating, somehow, the use and benefits from property or assets used by a service provider, directly or through a process that does not involve the intervention of the service provider. Alternatively a services aspect could be ancillary, or the “equipment” or “software” aspect could be ancillary, as existing Model and OECD Model Commentary as well commentary prepared in connection with the Committee’s work on services reflect.[26] The need to disaggregate “mixed” or “bundled” transfers and then to value identifiable transferable rights as well as reliability and verifiably may affect the determination of how the Committee treats “software” other than as a “package” of rights that may entail physical and intangible elements as well as a service component, where the key consideration may be whether a limited or conditional transfer for use has taken place with reversion of the same property to its owner at the termination of its limited or conditional use by another person.

84. In the case of services, the Committee’s response has been to consider adopting a particular Article to deal with “technical services” on the basis that these would be the object of a transaction, and not involve transfers of rights to property but, at most, only use by the service provider of property to perform the service. In other words, the object of the transaction is not the letting of property belonging to one, to another for the other’s own use in the pursuit of its endeavors without active intervention or an interest of the property, apart from being paid and recovering the property more or less intact subject to normal wear and tear.

85. The critical question for this inquiry, it is submitted, is what these connotations of “equipment” and software are for the reasonable scope of Article 12 in relation, principally, to Articles 5 and 7. That is, what role did, does or could Article 12 serve, in particular in relation to the taxation of amounts that are components of “business profits” and that, more generally, are earned from carrying on business “in” a source country by letting for other’s use, i.e., transferring for the temporary use by others, “tools” – “equipment” and if it is different “software” – used by others to earn business income?

86. Affecting how this question may be answered is the possibility, as in the case of Articles 10 (dividends on shares) and 11 (interest) that the provision of property other than financial property, for use by another, can possibly be passive as well as active, the latter being identified with owners of property whose business it is to facilitate its use by others through “operating lease” arrangements, where temporary use is the object, or “finance lease” or “hire purchase” where the outright acquisition of the property is the essence of the transaction and, additionally, the provider of the property also finances, as a lender, the acquirer and in that connection may provide or in any event is providing a financial service.

[26] See E/C.18/2014/CRP.8, Committee of Experts on International Cooperation in Tax Matters, Tenth Session, Geneva, 27031 October 2014, Agenda Item 3(a)(x)(b), Taxation of Services – Article on technical services. This refers to relevant Commentary in the OECD Model.

87. This is another situation in which, apart from narrow or non-contextual definitions of "equipment" or software, contract characterization may be important to determine whether and to what extent Article 12 does or should apply, anticipating as in the case of other "mixed" or "bundled" whether comparing "operating" versus "financing" leases payments are exclusively or primarily for the "use" of property or whether they combine or aggregate payments of other kinds such as a purchase price or principal and interest notwithstanding that the property is used in the same manner as if acquired by way of a user arrangement such as a lease.

88. Article 12 is seen, with Articles 10 and 11, as one of a trio of distributive rules mostly concerned with withholding tax and closely identified with earning income passively rather than actively.

89. There is, however, a material distinction, subtle though it may be, between financial capital addressed by Articles 10 and 11, and property that is "let" to others for compensation. This is reflected in Article 12, which provides no protocol or rate limitations applicable to source taxation, but simply preserves the application of source country taxing rights where they otherwise exist.

90. Financial capital has an inchoate return potential that exists apart from what the capital is used for. The use of the capital by its owner, for example by lending money, is the trigger for that return even if the user of that capital does nothing with it. The lender is paid the time value of that capital, which could, presumably be realized to the same extent by providing it to others. In other words, there is no special connection or allegiance between an investor in shares or interest bearing debt, and the investee to whom the capital is transferred for limited or indefinite use. That is the case even if it is the business of the provider of the financial capital to make it available and it does that in a business-like way. It lies in the nature of money and its value set by external markets what the return is or should be for its use.

91. By contrast, "equipment" and software embed no inchoate return of this nature. Despite parallels, and acknowledging that there is some doubt, the capacity of let property that is not financial property lies in its specific utility to perform a function. The return only arises from the use of this property; an inherent return in the property is not being released in the same way as for financial property. Rather, it is the utility and use – the particular use and the manner of use – that creates a return that otherwise did not and would not exist. The possibility of generating such a return arises from the use of the property in particular circumstances, assuming credit worthiness of the use from the circumstances of use rather than from a mere release of value inherent in the property which could be captured in a host of alternative settings where money capital could be used.

92. This distinction makes it more plausible to perceive what amounts to a *functional* partnership or co-venture between the provider of "industrial, commercial or scientific equipment" and software, and the user, with the user being, in effect, the means by which the owner of the property uses the property in a business setting to create a return – a flow of revenue - that otherwise would not exist, through external use of the

property to accomplish other objectives. This reflects the close connection that compensation for the use of property has with "business profits", which the history of Article 12 explains.

93. This connection is more marked to the extent that the compensation paid for the use of property is in some manner indexed to measure of its successful use or production, financial or otherwise, from that use.

94. Indeed, to the extent that distinctions would need to be made from the passive versus active use of property in the context of Article 12, in addition to a distinction between transfers that inherently are financing or services transactions, a further distinction may be whether badges of "business participation" in the nature of an economic partnership are present such that Articles 5 and 7 are the primary treaty Articles to apply, not Article 12, or alternatively Article 12 should be applied, in that particular situation, on a "net" basis according to principles underlying Article 7 (without deferring to Article 7) on the basis that a deemed permanent establishment exists by virtue of the presence of "equipment" or software in the source country or, in any event, if the actual use is external to the source country the payer is a resident of the source country. This is a possible way of parsing and rationalizing contextually the operation of Article 12 with respect to "equipment" and software where, it is thought, the interests of a developing country require and deserve to have recognized a connection or proximity of a non-resident that in economic and commercial terms is akin to a more traditional business.

Observations

95. The following observations are made to summarize the comments in this Note and to suggest approaches to recrafting Article 12 and / or avenues for further inquiry, including in ways considered to be compatible with the complementary analysis prepared for the Committee concerning Article 12:

a. Article 12 is a companion to Articles 5 and 7, in relation to business profits, Article 21, other income, and Article 22, capital. It allocates taxing rights based on where income earning activity actually takes place or, in the context of a treaty, is presumed to take place. The latter is identified with Articles 5 and 7 which, essentially, presume that commercial activity does not take place where, otherwise, amounts would be considered to arise in commercial and economic terms unless the recipient has established via the permanent establishment notion that the activity does take place (in a fiscal sense) in the source country.

b. Article 12 applies to amounts, which are defined to be "royalties" regardless of private law limitations, which may have a "passive" or "active" association. Regardless, however, of this distinction, it is more likely than not that payments made to use "industrial, commercial or scientific" equipment and for "software" are made to a recipient engaged in business activity. This is not necessarily the case but is more predictable for "equipment" possibly than "software" although in principle the distinction, if there is one, is not beyond doubt. This is the controlling feature of Article 12; the reason for or means by which the user uses "equipment" or software is not relevant, although it may be likely, again more likely for "equipment," that the user is a business user.

c. Article 12, in so far as "equipment" is concerned, but also more generally, is closely identified with "business profits" and the basis on which rights to tax business profits are allocated. The genesis of Article 12 in the OECD Model, from its earliest implicit manifestations in the 1927 and 1928 Draft Model Conventions of the League of Nations through the most recent refinements captured in the 1992 restatement of that Model, consistently reflect this outlook. Though the OEEC (and seemingly very thoroughly in a directional way in one Model, before it the League of Nations) and OECD evidently took the view that returns in the nature of business profits should only be taxable by a residence country, equally (and presciently, taking account of BEPS and its progenitors), they were 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 agreed requirements for a permanent establishment to exist. Presumably, they were satisfied, however, that supervening principles of international law including customary international law, captured in the Commentary to Article 1 of the OECD Model, would be sufficient to deter unwarranted reliance on treaties to achieve appropriate relief from source country taxation and possibly what is referred to inelegantly but descriptively as "double non-taxation".

d. Article 12 of the Model is more cautious and circumspect about any justification for allowing or tolerating this potential loss of (or de facto as well as legal renunciation of) source country taxing rights. In this regard, the Model serves other interests, where retained source taxation is conceivably very important but might be easily avoided. The preservation via Article 12 of the right to tax business profits, by declaring them to be "royalties" and then preserving their taxation at source (likely though not necessarily by way of withholding tax) does more than reinforce a treaty's intended mitigation of "double taxation" through the consistent allocation of (in the case of the OECD Model, exclusive) rights to tax business income. It creates an ulterior business profits Article that applies where the main business profits Article does not, but for the same reasons – the commercial proximity of the return to the source country taking account of what, practically, is required to be present (or not) in the source country to earn the return. The different treatment of returns on other property, which may be portfolio in nature, does not detract or indeed affect this argument; to the extent that returns are portfolio in nature, retention of source state taxing rights is consistent with Articles 10 and 11 of both the Model and the OECD Model.

e. The *nature* of "industrial, commercial or scientific equipment" and software, i.e., including how *expansively or narrowly it is defined or could be construed*, is less important than including these items within the compass of Article 12 with the resulting effect. Assuming that the "equipment" or software (alone or an identifiable component of a "mixed" or "bundled" transfer) is transferred for conditional and limited use, entailing retained ownership by its provider and not outright alienation, Article 12 will be engaged. Taking account of Article 12's specific references to various manifestations of intangible property, it is reasonable to conclude, regardless of any particular other features, that "equipment" is any tangible property that is capable of being used without being depleted by another, as a device or tool, for a utilitarian purpose. The same is the case for software, except that it, or the valuable aspect of it, is not tangible and may already, to some extent, be captured by the specific kinds of intellectual property to which Article 12 in any case applies.

f. A source country could mitigate "slippage" in the taxation of business profits by adopting, possibly through bilateral negotiations, particular definitions of "industrial, commercial or scientific equipment" (and each component of that phrase, i.e., "industrial," "commercial," "scientific" and "equipment") and / or software, to preserve or expand taxation of business profits that otherwise might escape both Articles 5 and 7 and Article 12 and, otherwise, to identify particular elements of "mixed" or "bundled" contracts that do fall within Article 12's reach. However, it is not clear why that would be necessary. The connotations of "industrial," "commercial" and "scientific" seem clear enough when understood as devices to allocate taxing jurisdiction over business profits and otherwise there would be indifference, for Article 12, in their meaning, i.e., these are unlikely to be associated with portfolio returns, but even if they were it is not likely that Article 12 would not apply. "Equipment," in context seems readily able to sustain the definition suggested above, including particularly in terms of the jurisdictional aspect.

g. The principal difference between Article 12 of the Model and of the OECD Model is the Model's reservation of a source country's entitlement to tax business profits in all cases. On that basis, though acknowledging tax system administration and compliance considerations that could be difficult, the Committee might wish to consider ways to more perfectly reconcile Articles 5 and 7 and Article 12 as constituting a comprehensive regime – a "code" within the Model - to preserve source country taxation of non-residents' profits that are earned in and by virtue of a presence of some kind in, and reliance on, the resources of and opportunities available (only available) in the source country.[27] These would be motivated by the same considerations that caused the OECD to remove the reference to "industrial, commercial or scientific equipment" from the definition of "royalties" in Article 12 of the OECD Model, but to a different effect consistent with the Model.

   i. Option A: Payments for the use of "industrial, commercial or scientific equipment" or for elements of software (possibly, other than those elements that are intellectual property already comprised within the definition of "royalties" apart from "equipment") would only constitute payments to

[27] These suggest or are inspired by approaches in like or analogous circumstances that may be motivated, it is reasonable to think, by reasons of the sort considered in this Note, which can be found in some countries' domestic tax law and / or tax treaty royalties' articles. An interesting reference, in particular, for Option B is the "transfer pricing" rule found in Article X(3) of the League of Nations London Model, which essentially allowed for source taxation of certain royalties paid between members of a commonly controlled group but on a net basis; see supra note 5, the Mexico and London Model Tax Conventions and commentary prepared by the Fiscal Committee of the United Nations (Fiscal Committee, London and Mexico Model Tax Conventions Commentary and Text (Geneva: League of Nations, 1946), pp 65 and 66.

which Article 12 applied if Articles 5 and 7 did not, if they are computed with reference to measures of their successful and productive use by and / or for the explicit measurable benefit to the user. The gist of this suggestion is that if the return to a non-resident should be seen as business profits earned by the non-resident in the source country, then the conduct by the non-resident of its business vicariously by, with or through the source country resident user of the equipment or software would be a condition of Article 12's application. This connection would be consistent with treating the "equipment" or software, as the case may be, or the user as a constructive permanent establishment of the non-resident. The rate of tax, a source country prerogative, would still be a point for discussion and bilateral negotiation in so far as the gross revenue basis of taxation was retained.

ii. Option B: Article 12 would apply on a (modified) net basis, by election of the non-resident taxpayer. That is, in the first instance source taxation, likely by way of withholding tax, by a source country would apply on the same basis presently contemplated by Article 12. However, provided that a non-resident recipient of royalties filed a tax return according to the domestic law requirements of the source country for reporting business income, it would be permitted to pay tax at business income tax rates on the "income" associated with letting property to a source country user.

1. The source country tax permitted by Article 12 would in the first instance be treated as a "back up withholding tax," would be collected, and would be refundable on filing net basis returns to the extent that the tax collected with the permission of Article 12 exceeded the tax actually due when computed on a net basis.
2. As do other Articles of the Model and the OECD Model, the Competent Authorities of the treaty countries could agree on protocols for withholding according to Article 12 (including conditional waivers on assurances submitted in advance about the expected degree of taxation on a net basis).
3. To deal with administrative complexity, the computation of income could be on a "modified" net basis, recognizing only a specific menu of expenses of a "direct" nature (and possibly an allocation of certain "indirect" charges, but not general overhead), consistent in turn with transfer pricing principles applied as part of the "Accepted OECD Approach" to attribute income to a permanent establishment. The OECD association with the AOA should not, it is submitted, be controversial; even apart from the AOA as such, it is hard to imagine how, one way or another, analysis consistent with those principles would not have applied in any event (and likely was).

h. Each of these options, regardless of their differences and more or less consistency with the principles underlying Articles 5 and 7:

i. Is faithful to the consistent history and purpose of Article 12 as a jurisdictional rule in both the Model and the OECD Model, notwithstanding the different jurisdictional stances of the two;
ii. Is faithful to the relevant difference between and interests served by the Model, and in particular Article 12 of the Model, relative to its OECD Model analogue;
iii. Is internally consistent with the preservation of taxing rights for portfolio income contemplated by Articles 10 and 11 of both Models; and
iv. Is properly inelastic to any particular connotation or definition of "equipment" or software in relation to the jurisdictional role served by Article 12, in circumstances where the Commentary to Article 12 deals adequately with "mixed" or "bundled" transfers and the proposal in the Committee's deliberations on services for how to distinguish and channel elements of such transfers (indeed, it might be suggested that resolving the issue of services as a subset of business profits needing special treatment beyond the restrictions of Articles 5 and 7, without in parallel addressing to similar effect other business profits capable of being earned in the typical sense being in a source country invites confusion and risks inconsistent and internally (in a treaty) incoherent outcomes).

i. It is interesting to observe that germs of the preferred solution for contending with the avoidance of tax on "stateless" business income arising from the exploitation of business rights using contracts as the OECD might recommend (and as the U.K. and Australia have already adopted or recommended) have been long present in the Model.

Concluding Comment

96. This Note approached the key definitional and scope questions of interest to the Committee concerning Article 12 by using an analytical methodology to try to infer the meaning to be, or that could be (notably in the interest of "developing" countries) ascribed to "industrial, commercial and scientific equipment" and its application to payments for the use of software by testing the (potential) jurisdictional reach of Article 12 concerning business profits. As mentioned at the outset, the purpose of this Note, aligned with its companion paper, is to suggest useful avenues for further inquiry and in light of the historical development of Article 12 and the pertinent differences between the Model and OECD Model to suggest and highlight the importance of this further inquiry in light of more broadly based and ongoing studies of what should be limits on the allocation of taxing rights in contemporary business settings.

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