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Committee of Experts on International Cooperation in Tax Matters
Twenty-second session
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Item 3(b) of the provisional agenda
Update of the UN Model Double Taxation Convention between Developed and Developing Countries

Changes to the Commentary on Article 12 of the United Nations Model Double Taxation Convention between Developed and Developing Countries to reflect decisions made at the 22nd Session with respect to the inclusion of Article 12B and the treatment of computer software

Note by the Secretariat

Summary

At the Committee's twenty-second session, it considered E/C.18/2021/CRP.15, which addressed changes consequential to the decision to include Article 12B in the United Nations Model Double Taxation Convention between Developed and Developing Countries. That document did not include proposed drafting changes relating to Article 12 because such changes would depend on the Committee's decision with respect to whether to amend the definition of royalties to include payments for computer software as described in E/C.18/2021/CRP.9. Later, the Committee decided not to so amend the definition of royalties, but to include in the Commentary to Article 12 a minority view drafted along the lines of Section 3 of E/C.18/2021/CRP.9, with several modifications requested during the session.

This note includes proposed changes to the Commentary on Article 12 to reflect the decisions of the Committee.

The Committee is invited to discuss and approve the proposed changes included in this note when it will resume its discussion of item 3(b) of its agenda (Update of the UN Model Double Taxation Convention between Developed and Developing Countries).

1. Modification of the Commentary on Article 12 to take into account the addition of Article 12B to the UN Model (marked to show changes against the existing Commentary)

1. The following change to paragraph 10 of the Commentary on Article 12 of the 2017 OECD Model, extracted in paragraph 12 of the Commentary on Article 12 of the UN Model appears necessary:

> 10. Rents in respect of cinematograph films are also treated as royalties, whether such films are exhibited in cinemas or on the television. It may, however, be agreed through bilateral negotiations that rents in respect of cinematograph films shall be treated as business profits and, in consequence, subjected to the provisions of Articles 7 and 9***[or 12B]***.

2. The following addition after paragraph 17 of the Commentary on Article 12 of the 2017 OECD Model, extracted in paragraph 12 of the Commentary on Article 12 of the UN Model, appears to be necessary:

13. In 2021, the Committee of Experts agreed to introduce Article 12B, addressing automated digital services. As a result, the downloading of software and some other digital content may be covered in Article 12B. However, because Article 12B(7) provides that "income from automated digital services" does not include payments qualifying as "royalties", it is still necessary to determine the extent to which the download of software and other digital material constitutes the use of a copyright, in which case a payment for such download would be covered by paragraph 3 of Article 12. In other cases, payments in consideration for the download of software and other digital content would constitute "income from automated digital services" or "business profits", taxable under Article 12B or Article 7, respectively. To aid in making those distinctions, the Committee considers that the Commentary on Article 12 of the 2017 OECD Model Convention in paragraphs 12 to 16, as reproduced in paragraph 12 above in respect of software and the following part of the Commentary on Article 12 of the 2017 OECD Model Convention in respect of digital content other than software is applicable to Article 12 of this Model (the modifications that appear in square brackets, which are not part of the Commentary on the OECD Model Convention, have been inserted in order to provide additional explanations or to reflect the differences between the provisions of the OECD Model Convention and those of this Model):

> 17.1 The principles expressed above as regards software payments are also applicable as regards transactions concerning other types of digital products such as images, sounds or text. The development of electronic commerce has multiplied the number of such transactions. In deciding whether or not payments arising in these transactions constitute royalties, the main question to be addressed is the identification of that for which the payment is essentially made.
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> 17.2 Under the relevant legislation of some countries, transactions which permit the customer to electronically download digital products may give rise to use of copyright by the customer, e.g. because a right to make one or more copies of the digital content is granted under the contract. Where the consideration is essentially for something other than for the use of, or right to use, rights in the copyright (such as to acquire other types of contractual rights, data or services), and the use of copyright is limited to such rights as are required to enable downloading, storage and operation on the customer's computer, network or other storage, performance or display device, such use of copyright should not affect the analysis of the character of the payment for purposes of applying the definition of "royalties".

17.3 This is the case for transactions that permit the customer (which may be an enterprise) to electronically download digital products (such as software, images, sounds or text) for that customer's own use or enjoyment. In these transactions, the payment is essentially for the acquisition of data transmitted in the form of a digital signal and therefore does not constitute royalties but falls within Article 7***[, 12B]*** or Article 13, as the case may be. To the extent that the act of copying the digital signal onto the customer's hard disk or other non-temporary media involves the use of a copyright by the customer under the relevant law and contractual arrangements, such copying is merely the means by which the digital signal is captured and stored. This use of copyright is not important for classification purposes because it does not correspond to what the payment is essentially in consideration for (i.e. to acquire data transmitted in the form of a digital signal), which is the determining factor for the purposes of the definition of royalties. There also would be no basis to classify such transactions as "royalties" if, under the relevant law and contractual arrangements, the creation of a copy is regarded as a use of copyright by the provider rather than by the customer.

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

2. Addition to the Commentary to reflect the Committee decision regarding the proposal to include computer software payments in the definition of royalties

3. The following addition to the Commentary on Article 12 of the UN Model reflects the decisions made with respect to E/C.18/2021/CRP.9 at the 22nd Session of the Committee of Experts (marked to show changes from Section 3 of E/C.18/2021/CRP.9):

14. Some members of the Committee of Experts are of the view that the payments referred to in paragraphs 14, 14.1, 14.2, 14.4, 15, 16, 17.2 and 17.3 of the OECD Commentary extracted above may constitute royalties. ***This view, recorded in the [9th] Session of the Committee of Experts was elaborated upon by members of the Committee in conjunction with the 2021 Update of the UN Model. The view of these members is that the situations described in paragraphs 14 and 14.2 should give rise to royalties because, contrary to the conclusions in those paragraphs, the fact that the copying of computer software or other digital product would constitute a violation of copyright if done without a license means that the user is using copyright when he operates the program or downloads the digital product. For these purposes, they view the reliance placed in paragraphs 14 and 14.2 of the Commentary on the purpose for which the software is copied to be incorrect; they do not believe that commercial exploitation of a copyright by the user is necessary in order to characterize the payment as a royalty. As a result, they do not agree with the common distinction made between the use of a copyright and the use of a copyrighted article, as they conclude that, without the use of the copyright there can be no use of the copyrighted article. With respect to*** ~~Their view in respect of paragraphs 14, 14.2 and 14.4 is that there is a use or right to use copyright in those situations, even though it may be to enable the user to operate the program or download the digital product. In their view, it cannot be said that payment is a consideration only for the use of software or copyrighted article and not for using the copyright, when without use of copyright there~~

~~cannot be any use of the copyrighted article. It is not practicable to disaggregate the payment towards consideration for various uses in such situations. They view the purpose for which the software is copied as irrelevant for characterizing the payment. Further, they believe that commercial exploitation of a copyright by the user is not a requirement for characterizing the payment for the copyright as royalties.~~ ~~In respect of~~ paragraph 14.4, the payments in question are viewed by them to be in the nature of royalties as the right to distribute is a use of a copyright, which is a valuable economic right of the copyright owner which exists independently of other rights in the copyright, including the copying right and the exhibition right. In all of these cases, they view it as impracticable to disaggregate the payment towards consideration for various uses.

15. ~~In addition,~~ In the view of a large minority of the Members of the Committee, Article 12 should allow for source State taxing rights ***even*** in cases where the user of computer software is not exploiting the copyright in the software. In their view, Article 12 is intended to cover payments for the letting of property, which is broader than use of the copyright. For example, if a company that is a resident of State S uses in its business human resources software that is owned by a company that is a resident of State R, payments made for that use would not be covered by the current definition of royalties in paragraph 3 of Article 12. In their view, Article 12 should address circumstances in which the owner of the computer software earns profits from letting another person use that computer software, without having the owner establish any presence in the state where it is used, or where the user resides, which would satisfy the requirements of Article 5 for the existence of a permanent establishment. In the view of those Members, a person that is making payments for the use of, or the right to use, computer software is making a payment in consideration for the letting of that intangible property just as a person that is making payments for the use of industrial, commercial or scientific equipment (already included in paragraph 3) is making a payment in consideration for the letting of tangible property.

~~Those holding~~ ***States sharing*** this view may want to include at the end of paragraph 3 the following sentence:

> The term also includes any consideration for the use of, or the right to use, any computer software, or the acquisition of any copy of computer software for the purposes of using it.