ITI Promoting Innovation Worldwide

ITI Comment on Possible Changes to the United Nations Model Double Taxation Convention Between Developed and Developing Countries Concerning Inclusion of Software Payments in the Definition of Royalties

15 March 2021

Subcommittee on the United Nations Model Tax Convention between Developed and Developing Countries:

Thank you for the opportunity to comment on the United Nations (UN) Committee of Experts' (COE) updated discussion draft for possible changes to the UN Model Double Taxation Convention Between Developed and Developing Countries (UN Model) to include software payments in the definition of Article 12 royalties subject to gross-basis withholding taxes.

The Information Technology Industry Council (ITI) is the premier global advocate for technology, representing the world's most innovative companies. Founded in 1916, ITI is an international trade association with a team of professionals on four continents. We promote public policies and industry standards that advance competition and innovation worldwide. Our diverse membership and expert staff provide policymakers the broadest perspective and thought leadership from technology, hardware, software, services, and related industries.

Up front, we would like to state that a payment for the use of, or the right to use, a software copyright is a royalty. A payment for the use of a software program copy – which is standardized across all potential customers – is not a royalty, just as a payment for a physical or electronic book is not a royalty.

The February 2021 discussion draft – a follow-up to the September 2020 discussion draft – would expand the definition of Article 12 royalties to include payments of any kind received as a consideration for the "the use of, or the right to use, computer software" or "the acquisition of any copy of computer software for the purposes of using it." A change of this nature would not be a clarification, but a fundamental reclassification of revenue derived from computer software payments. It would also create significant ambiguity regarding the interaction of proposed Article 12, Article 12A, and proposed Article 12B. These changes would result in additional disputes between taxpayers and tax authorities. As such, ITI recommends that the COE should not adopt the proposed amendment to the definition of "royalties" under Article 12 to include software payments.

In addition to principled objections, ITI members have practical concerns about the impact of such a change on their ability to globally market their software products to the benefit of individuals, businesses, governments, and non-governmental organizations. However, if the COE decides to

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continue its discussions on this proposal, ITI reiterates our previous suggestion that it be taken up by the next COE given the limited remaining time for the current COE to consider such a significant proposal. Delay would also provide time for full consideration of the results of the Organisation for Economic Co-operation and Development (OECD)/G20 Inclusive Framework's efforts to realize a multilateral, consensus-based solution to the tax challenges arising from the digitalization of the global economy, which may have implications for the tax treatment of digital transactions and intangibles.

While the solicitation for comments in response to the February 2021 discussion draft focuses on technical aspects of how amending the definition of "royalties" to include software payments would work in practice, ITI believes the COE should take a step back and give greater consideration to such a change. ITI's response to the September 2020 discussion draft raised several concerns that have not been acknowledged or addressed in the current discussion draft. We have included this communication for your reference and will highlight a few of our principled concerns about the underlying rationales cited to justify the reclassification of revenue derived from software payments.

There is no doubt there have been significant advances in productivity-enhancing goods and services. However, the supporters of the discussion draft have not demonstrated that advances in software technology would necessitate a change in tax treatment: the development of more streamlined and cost-effective mechanisms for delivery of software does not merit a change to the underlying classification of the payment.

Article 12 of the OECD Model Tax Convention on Income and on Capital, of which the Commentary maintains that "payments in these types of transactions would be dealt with as business profits in accordance with Article 7," draws on a reasoned approach of usage versus the exploitation of software copyright rights. As the minority notes, this approach to classifying transactions involving software accounts for the difference between a copyright right and a copyrighted article. To reiterate, a payment for the use of, or the right to use, a software copyright is a royalty. A payment for the use of a software program copy – which is standardized across all potential customers – is not a royalty, just as a payment for a physical or electronic book is not a royalty. Paragraph 14.4 of the Commentary of the 2017 OECD Model applies this logic as it acknowledges that "distributors are paying only for the acquisition of the software copies not to exploit any right in the software copyrights," and therefore relevant transactions should be treated as business profits under Article 7. Rather than distinguishing between a software copyright holder and a distribution intermediary, the classification of such software payments should reflect that software copies sold without the use of, or the right to use, a software copyright right should be subject to net basis taxation in accordance with Article 7.

By making minor edits to the existing Article 12 Commentary relating to software, the proposed changes would effectively render irrelevant all distinctions based on differences between use of a copyright and use of a copyrighted article, at least where payments are taxable under proposed Article 12(3)(a)(i), 12(3)(a)(iv), and 12(3)(c) are subject to the same rate.

We agree with the views described in paragraph 15 of the draft Commentary concerning the disadvantages of expanding Article 12(3) to cover payments for the use or acquisition of copyrighted computer software (i.e., as distinct from the use of the copyright itself), including the

particular challenges of trying to exercise such taxing rights over payments by individuals. There are significant practical and administrative implications for imposing a withholding obligation on individuals. The proposed taxing right would be much broader than domestic taxing authority in most jurisdictions, which calls into question the rationale for the proposed change.

In addition, significant additional thought and analysis is required to clarify how proposed Article 12 (covering all computer software program and copyright payments) would interact with Article 12A (provision of technical services including software consulting) and the proposed Article 12B. The proposed Commentary on Article 12 is ambiguous and fails to explain how to distinguish between Article 12 payments and Article 12B payments, since it does not address the question of how to determine whether a payment falls within Article 12(3)(a)(iv) (i.e., payment for the use of computer software) rather than Article 12B (payment for automated digital services). Failing to address these critical issues will lead to more, rather than less, disputes between taxpayers and tax authorities based on these substantial ambiguities and overlapping definitions.

Thank you again for the opportunity to provide comments on the COE's updated discussion draft concerning the possible inclusion of software payments in the definition of royalties. For the reasons outlined above and in our previous submission, ITI recommends that the COE should not adopt the proposal described in the discussion draft, which will result in more disputes between taxpayers and tax authorities. We appreciate the COE's attention to our concerns and stand ready to answer any questions that may arise.

Sincerely,

Megan Funkhouser
Director of Policy, Tax and Trade

Attachment: ITI's October 2020 Comment on the United Nations Model Double Taxation Convention Between Developed and Developing Countries Concerning Inclusion of Software Payments in the Definition of Royalties

Attachment:

ITI Comment on Possible Changes to the United Nations Model Double Taxation Convention Between Developed and Developing Countries Concerning Inclusion of Software Payments in the Definition of Royalties

1 October 2020

Subcommittee on the United Nations Model Tax Convention between Developed and Developing Countries:

Thank you for the opportunity to comment on the United Nations (UN) Committee of Experts' (COE) discussion draft for possible changes to the UN Model Double Taxation Convention Between Developed and Developing Countries (UN Model) concerning inclusion of software payments in the definition of royalties.

The Information Technology Industry Council (ITI) is the leading global association for technology companies. Our members are headquartered around the world, operate globally, and include all major verticals of the tech sector, including companies that specialize in hardware, software, internet services, cybersecurity, and beyond. We take a global perspective with our comments, drawing on the deep international experience of our members.

ITI understands this proposal has been raised for consideration by members of the COE before (and no action was taken on the previous proposal), although the current discussion draft under consideration incorporates new rationales in support of amending the UN Model Convention. As active participants in the innovation economy, ITI members have practical concerns about the impact of such a change on their ability to engage with global markets, as well as principled concerns about the underlying rationales cited to justify the reclassification of revenue derived from software payments. ITI does not believe that the newly raised arguments for amending the definition of "royalties" to include software payments are persuasive. ITI therefore recommends that the COE should not adopt the proposal described in the discussion draft. However, if the COE decides to continue its discussions on this proposal, ITI suggests that it be taken up by the next COE, given the limited remaining time for the current COE to consider such a significant proposal. ITI welcomes the opportunity to further participate in an exchange of views with our many members that are active in the software industry.

A change to include computer software payments in the definition of royalties in the UN Model would be a concerning departure from Article 12 of the Organisation for Economic Co-operation and Development's (OECD) Model Tax Convention on Income and on Capital, of which the Commentary maintains that "payments in these types of transactions would be dealt with as business profits in accordance with Article 7," based on a reasoned approach of usage versus the

exploitation of software. In addition, such a change should only be made to the UN Model if such change enjoys widespread support. Based in part on the arguments put forth by opponents to the proposal as outlined in the discussion draft, it is our belief that this proposal does not represent a widely held view. The fact that some jurisdictions have unilaterally opted to treat payments to non-residents for software copies as royalties should not be considered relevant in the context of amending the definition of royalties in the UN Model Convention for the purposes of bilateral treaty negotiations. The proposed comprehensive expansion of the definition of royalties to include computer software payments would not only increase compliance costs and raise the likelihood of disputes, it would effectively institutionalize greater fragmentation across jurisdictions (many jurisdictions, notably, do not treat as royalties payments for software without the right to exploit the copyright).

As noted in the discussion draft by COE members who oppose the proposal, the sale of a software copy (e.g., shrink-wrap software) represents "a sale of a good that would give rise to business profits that fall under Article 7" of the UN Model Convention because the product is standardized across all potential customers, as is the case with a tangible good or product. This approach to classifying transactions involving software acknowledges the difference between a copyright right and a copyrighted article. A payment for the use of, or the right to use, a software copyright is a royalty. A payment for the use of a software program copy is not a royalty, just as a payment for a physical or electronic book is not a royalty. ITI believes that there have been no developments that would warrant a change to this classification. While the software industry has developed more streamlined and cost-effective mechanisms for delivery of software, this in itself does not merit a change to the underlying classification of the payment.

Furthermore, the implication that a company's access to copyright protection – and by extension, recourse – through a State's legal system should have any impact on a State's justification for the allocation of taxing rights disregards the valuable but disparate roles that intellectual property (IP) protection and tax law play in facilitating a stable and thriving business environment. There are several fundamental issues with this implication. First, on principle, a State's reallocation of taxing rights should not be evaluated or dependent on a State's activities to protect a copyright. Both tax administration and the effective and balanced protection of IP are incredibly important legal systems for the operation of global businesses that drive innovation, create jobs, and enable growth. However, the administration of IP law should not be considered as a viable justification for a departure from existing, long-standing international tax principles in the development or administration of taxation law. Second, for the specific case of software, businesses selling software into a market are more likely to make use of end user license agreements (EULAs), which serve as a legal contract between the specific customer and the developer, than source state copyright laws in order to provide additional legal protections for the seller/developer. In fact, modern software delivery models (such as online platforms and "app" stores) provide greater control for businesses to prevent unauthorized activities with respect to their software. For example, EULAs impose restrictions on customers *in addition to* the restrictions that copyright law already imposes on such activities (i.e., reselling the program copy or reverse engineering the software source code) that either do not, or may not, rise to the level of copyright infringement. Third, software's "level of engagement" with the economy has no relevance for the technical question of whether a payment should be characterized as business profits or royalties. The discussion draft's example of natural

resources further reinforces that even if this was the case, software is not unique in its "level of engagement" with the state where it is used. The fact that software products are prevalent does not distinguish them from a variety of products sold today and does not justify a change to the classification of a payment for the use of a software program copy as business profits. A software product does not "engage" in a market any more than does a commodity such as oil or copper.

Software is a business input that benefits businesses of all sizes as well as governments and non-governmental organizations, and its use can amplify the efficient and seamless execution of everyday activities. Within this context, the imposition of gross withholding taxes on all software payments (assuming the proposal is adopted and a tax treaty does not eliminate the royalty withholding tax) not only disregards the costs associated with creating, updating, and delivering the software, but may also contribute to a higher tax burden and reduced profitability as well as the potential for passing the tax onto end users through higher prices. Companies may have to divert their business activities away from jurisdictions that treat all computer software payments as royalties subject to withholding tax, which would effectively reduce domestic access to productivity-enhancing goods and services that drive economic growth in the market jurisdictions.

Providing a stable tax environment enables companies to devote resources to sustaining and growing the business, all the more important as governments continue to mount the strongest possible economic and public health responses to the outbreak of COVID-19. The March 26 statement released by G20 Leaders underscores this sentiment: "*We reiterate our goal to realize a free, fair, non-discriminatory, transparent, predictable and stable trade and investment environment, and to keep our markets open.*" During these exceptionally challenging times, we applaud the G20 leaders for their commitment to realizing a stable and open environment and encourage the COE to adopt a similar approach.

Finally, ongoing work under the auspices of the Inclusive Framework – which features participation from nearly 140 governments – to address tax challenges of the digitalizing global economy will likely have implications for the tax treatment of digital transactions and intangibles. Nevertheless, ITI does not believe that such work affects the classification of computer software payments, which enjoys a general consensus among countries to distinguish between payments for acquiring copyrighted articles (i.e., business profits) and payments for exploiting copyright rights (i.e., royalties). In the interest of ensuring a predictable and stable tax landscape, ITI recommends that the proposal described in the discussion draft not be adopted. If the COE decides to pursue further discussions on the proposal, it may be appropriate to hold consideration of this topic until the next COE is convened and after the Inclusive Framework has completed the designs for its project, and tax administrations and companies alike can work through the implementation of what are expected to be significant changes to the global tax system.