

## Trade and Investment

### Commission on Taxation

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**ICC Comments on UN Tax Committee Discussion Draft:  
Revised Proposal for a change to the definition of royalties in Article 12 of the United Nations Model Double Taxation Convention Between Developed and Developing Countries**

The International Chamber of Commerce (ICC), as the institutional representative of over 45 million businesses in more than 100 countries and in its capacity as Permanent Observer to the United Nations (UN) General Assembly, appreciates the opportunity to provide comments on the UN Model Convention Double Taxation Between Developed and Developing Countries (UN Model Convention) concerning the revised proposal regarding the inclusion of software payments in the definition of royalties.

ICC provided a [submission to the initial consultation](#) on this topic in October 2020, which is provided for ease of reference. Further contributions with respect to the additional request for input are provided below for kind consideration by the UN Tax Committee.

ICC advocates for a consistent global tax system, founded on the premise that stability, certainty and consistency in global tax principles are essential for business and will foster cross-border trade and investment; which is important for the economic development of all UN member countries.

#### **GENERAL COMMENTS**

As noted in our previous submission, ICC does not support the proposed inclusion of software payments in the definition of royalties and considers that the proposal does not justify the broadening of the scope of Article 12 and the re-allocation of taxing rights given that the proposal has not sufficiently taken into consideration the proliferation of research and tax policy review undertaken over the last few decades on this topic, the economic impacts on countries or companies, the interaction of the existing legal framework taxing such transactions or the fact that such a proposal will increase tax uncertainty and the potential for double taxation.

ICC believes that there are no principled grounds for altering the division of taxing rights for computer software payments and holds that the existing Article 7 treatment is sufficient in applying a principled division of taxing rights between source and residence states. ICC considers that the proposals within the UN discussion draft are not justified by the facts and would fundamentally lead to uncertainty in the way that such transactions are taxed in different countries, and lead to additional compliance burdens for taxpayers and tax authorities, as well as increasing uncompetitive practices between countries.

Introducing such uncertainty within the UN proposal also increases the risks of unilateral approaches by tax authorities as they seek to reach a national position, which itself may be contrary to that of treaty partners. Unilateral measures in cross-border transactions usually leads to an increase in tax litigation and the likelihood of double taxation.

Furthermore, ICC reiterates that the work of the Organisation for Economic Co-operation and Development (OECD) Inclusive Framework on the taxation of the digitalising economy will be integral regarding the impact on the current tax treatment of digital transactions and intangibles of all types, and therefore believes that this work should be completed and the results considered before any separate decisions are made with respect to proposed changes to the definition and the taxation of royalties in the UN Model Convention. ICC remains concerned that the proposed changes to Article 12 present an alternative solution which could undermine and distract from the

ongoing efforts within the OECD Inclusive Framework, particularly at this critical juncture when it is ever more prevalent for countries to further extend their collaborative efforts and converge towards a consensus-based solution by mid-2021. In this respect, ICC would respectfully suggest that it would be preferable to await the outcome of the OECD Inclusive Framework process in an effort to maintain the consistency and integrity of the international tax system.

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## **SPECIFIC COMMENTS**

### *Proposed changes to definition of royalties vis-à-vis broader changes to Article 12*

ICC respectfully suggests that it would be of benefit for the UN Tax Committee to conduct a comprehensive review of the implications related to the broader proposed changes to Article 12 (Article 12A on Fees for Technical Services and Article 12B for Taxation of Automated Digital Services), to ensure that the policy objectives and rationale are congruent across the existing and proposed changes, and in particular with consideration to the interaction or overlap with the proposed changes to the definition of royalties.

ICC is of the view that the proposals in their current form do not sufficiently address the interaction or overlap in this respect. For example, paragraph 22 of the proposed Commentary notes that Article 12A applies “to the provision of services, such as software consulting, that involve human input, while Article 12 relates to the use of property” and implies that it would be unlikely to have an overlap with the amended Article 12 (covering all software payments). ICC holds, however, that it would appear that the implications are not as limited as indicated in the proposed Commentary.

Furthermore, paragraph 39 of the proposed Commentary on Article 12B, suggests that the use of software through cloud computing arrangements, requiring minimal human involvement, could potentially fall within Article 12A and 12B. It is unclear whether, by expanding Article 12 to cover non-copyright-related software payments, exclusions such as fees paid by an individual for services for personal use (Article 12A(3)) would no longer exempt such payments from source base taxation. Paragraph 24 of the proposed Commentary on Article 12 lacks clarity on the distinction on payments covered by Article 12 and Article 12B in addressing the determination of payments that fall within Article 12(3)(a)(iv) (i.e. payment for the use of computer software) rather than Article 12B (payment for automated digital services).

ICC believes that the current proposals to revise the Commentary on Article 12 with respect to software, do not adequately take into account the broader proposed changes to the Article, particularly concerning distinctions between the use of a copyright and copyright article, which would essentially be deemed irrelevant, more specifically where the same rate applies to payments subject to tax under proposed Article 12(3)(a)(i), 12(3)(a)(iv), and 12(3)(c).

Under the current rules, payments for the use of computer software do not generally qualify as royalties per se, only some of these payments can be classified as royalties if they are made primarily for the use or the right to use and economically exploit the copyright embedded in the computer software.

The proposal to include payments within the remit of Article 12 would not only remove the distinction between payments for the use of copyright in software versus payments for the right to use the copyrighted article, but also the important distinction between payments towards use of copyright in computer software with commercial exploitation (currently taxed under Art. 12) and towards use of the copyrighted article (without commercial exploitation - currently taxed under Art. 7).

Alternatively, ICC is in accordance with the minority view expressed in paragraph 15 of the Commentary related to “the effect on individuals who, while theoretically required to withhold on payments under Article 12, in practice were seldom required to do so before the addition of subdivision (a)(iv) and subparagraph (c) of paragraph 3 because only enterprises are likely to

engage in activities that constitute the “use” of a copyright (such as reproduction and distribution). They are concerned that individuals are ill-equipped to comply with withholding obligations that may apply with respect to a quite wide variety of transactions. Also, in their view, the proposed definition may not provide adequate clarity, making it challenging to administer and resulting in more, rather than fewer, disputes.” ICC believes that the rationale for the change is not justified bearing in mind that the proposed taxing right would go beyond the taxing authority exercised by many jurisdictions within their domestic law.

### **Specific questions:**

***Is the description of “software” in paragraph 12.1 of the Commentary on Article 12 of the OECD Model (extracted in paragraph 12 of the proposed UN Commentary) (a) consistent with current business practice and (b) appropriate for use as a definition in this context, perhaps by adding the definition to Article 3?***

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

ICC wishes to reiterate some points for consideration in this context. The term “computer software” as used in the Article is not adequately defined, and basically refers to the interpretation at the level of parties’ domestic legislation. As a consequence, there is a concern that the application of Article 12 will result in increased uncertainty, inconsistent treatment, and lengthy disputes between taxpayers and tax authorities.

The concern around the definition is that the proposal fails to take into consideration the range of items that include computer software, nor the ways in which computer software is procured and used by businesses and end-users. Each of these points needs to be fully considered, as simply treating all the transactions that contain ‘computer software’ as royalties will create perverse and distortive taxation results in different countries which also likely capture significant amounts of unintended transactions.

There are already appropriate rules and legal structures in place to deal with the delineation between cross border transactions which should and should not be contained within the definition of a royalty. Many jurisdictions have been able to establish and administer distinctions between payments for the use of copyrights and payments for copyrighted articles.

There are double-tax treaties (DTTs) around the world which do contain the word ‘computer software’ or ‘computer programs’ within the definition of ‘royalties’ and also a majority of countries where such definitions are excluded. Where the terms are included (e.g., in several of the US DTTs), there is also guidance (e.g. Technical Interpretation notes / Protocol’s) which set out that the distribution of standard commercial off the shelf (COTS) software would not be within the definition of a royalty. Consequentially, simply including the word ‘computer software’ within the definition of a royalty will not eliminate uncertainty but will add to the potential amount of variable approaches taken by different countries.

The recent Indian Supreme Court case opinion<sup>1</sup> provides some useful insight on the appropriate treaty treatment of payments for computer software: “...the amounts paid by resident Indian end-users/distributors to non-resident computer software manufacturers/suppliers, as consideration for the resale use of the computer software through EULAs/distribution agreements, is not the payment of royalty for the use of copyright in the computer software, and that the same does not give rise to any income taxable in India, as a result of which the persons referred to in section 195 of the Income Tax Act.”

The proposed change to Article 12 broadens the scope of the royalty article beyond commercial exploitation of copyrights and creates taxing rights without, in our view, sufficient factors to justify a reallocation of taxing rights from residence to source taxation. ICC also considers that the inclusion of the point “...the acquisition of any copy of computer software for the purposes of using it” is a fundamental departure from the existing taxing rights and as such could increase tax uncertainty.

ICC believes that the inclusion of the wording in paragraph 3 will not be an appropriate definition for the taxation of software, therefore any supporting statement cannot be an appropriate use of such wording.

In its own context, many of the points raised within paragraph 12.1 can support explanations of business practice, but when applied to the previous and current draft of Article 3 will be unsupported and distortive and as such ICC does not support such an application.

The proposed adjustments in Article 3 will increase tax uncertainty due to the level of conflicting interpretations and will not be easy to administer consistently by either tax administrations or taxpayers. This is due to a combination of reasons, including, *inter alia*, the challenges that would arise from applying the Article to various business scenarios, difficulties in the bifurcation of different software models, increased lack of clarity when certain transactions are caught, distortive economics whereby transactions between different countries can be treated differently, increased economic pressure to increase prices/change trade patterns with (developing countries) where this rule applies, conflicts at international level between OECD and non-OECD positions.

For the aforementioned reasons, Article 12.1 is not appropriately suited to support an explanation of Article 3 and we recommend that the proposals to change Article 3 are not adopted. On its own and used within an appropriate context, Article 12.1 can have its own merits, but when applied to this draft of Article 3, becomes unsupported.

***Do paragraphs 16 and 17 of the proposed UN Commentary adequately distinguish between goods that constitute “computers” and those that are not “computers” notwithstanding that they incorporate software to execute their functions or provide some degree of connectivity? What additional language or examples would help to clarify the distinction?***

ICC agrees with the statement in paragraph 16 that “...the method by which the computer software is transferred to the transferee is not relevant to the categorization for purposes of Article 12.” Alternatively, ICC members disagree with the subsequent conclusion that “...it should not matter whether a user downloads a copy of computer software pursuant to what is legally a “license” under domestic law, or “purchases” a copy of computer software...”. ICC believes that the statement does not factor the fundamentally different transaction models for license and purchase and holds that a “purchase” of a copy of computer software should not be within the remit of the definition of “royalties”, and additionally “licenses” to use software are not within the definition of royalties. From a legal perspective, it is essential to review the nature of the transaction to determine what is being

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<sup>1</sup> 2021 SCC OnLine SC 159. <https://www.natlawreview.com/article/impact-and-analysis-supreme-court-decision-characterization-and-taxation-software>

licensed to the customer and to ensure that the application of the law is based upon a solid and fair application to the actual facts of the case.

ICC acknowledges the intent to align international consistency on the treatment of software transactions, yet notes that interpretation and application of the following section of Article 16 is unclear: *“Because the domestic law can vary in how it treats these economically equivalent transactions, and to provide a consistent treatment of these transactions, subparagraph (c) was added to paragraph 3.”* ICC considers that paragraph 3 does not create consistency between countries’ approach to this topic, but instead creates a wider gap between the approaches taken due to the levels of uncertainty created on many areas of the drafting and potential applications.

ICC, therefore, does not consider that the aforementioned paragraph distinguishes between *“goods that constitute “computers” and those that are not “computers”*”.

ICC believes that there is a lack of clarity regarding the proposed limitation to computer software as opposed to software that “improves the performance of the good or provides additional functionality”. Paragraph 17 of the Commentary indicates that “the reference to “computer software” in paragraph 3 is not intended to encompass such software when the fundamental purpose of the transaction is the purchase of the good and such software cannot be purchased independently of the good...However, the separate purchase of a copy of computer software, for example, a navigation program that can be downloaded to an automobile’s on-board computer in the normal use of that computer, would be covered by the definition in paragraph 3.”

It is noted that the intent is not to capture computer software “when the fundamental purpose of the transaction is the purchase of the good and such software cannot be purchased independently of the good”. Existing guidance and rules are available regarding the necessity for a ‘reasonable apportionment’ where bundled transactions are required to be separated for tax purposes. In this respect, ICC does not consider this to be an appropriate basis to differentiate software transactions. There are many cases where comparable or competing products contain either software which can/cannot be purchased independently of the good. In this respect, ICC believes that the proposed approach of differentiation could result in unintended consequences around challenges for ‘unbundling’ parts of software as well as to further subject individual components to different taxation principles in an arbitrary manner, which would unnecessarily lead to complexity. Paragraph 17 also fails to provide a clear distinction between goods that constitute “computers” and those that are not “computers” notwithstanding that they incorporate software to execute their functions or provide some degree of connectivity.

Fundamentally, ICC does not consider this separation as the key factor that should determine the taxation consequences thereof. ICC supports the position that the principle of whether a transaction including software is subject to a royalty would be determined based upon where there is a transaction for the alienation and exploitation of the protected intellectual property rights, as opposed to the physical container containing the software. The physical container itself could also be subject to a royalty in certain circumstances – for instance in relation to payments for trademarks or protected design rights.

Both the OECD and UN commentaries have commented that the delivery mechanism of the software is not relevant in determining the taxation thereof. In paragraph 17, the downloaded “navigation program” draws the delivery mechanism back into question. Further clarity is sought on whether the royalty classification will be impacted if the software is downloaded, accessed via cloud, embedded on a product and activated by a ‘key’, has mixed purposes (e.g. navigation software updates may affect the core operating software of the vehicle as well as user maps). ICC considers that this method of splitting whether a transaction will be a royalty does not set a clear and consistent principle, but requires considerable amounts of specialist technical resources for basic compliance and audit purposes, yet presents significant risks of addressing the uncertainty it creates.

ICC remains concerned that the proposed limitation could also be expanded more broadly to other devices and does not believe that the purchase of software copies should be treated as royalties.

***The proposed Commentary continues to adopt paragraph 14.4 of the Commentary on Article 12 of the 2017 OECD Model on distribution intermediaries. Some participants in the Subcommittee do not agree with the analysis in that paragraph for the reasons set out in the Annex to this Discussion Draft. Do you agree with the position set out in paragraph 19 of the proposed Commentary or with the analysis in the annex? If the latter, do you agree that the appropriate approach is to delete the words ‘for the purposes of using it’ at the end of subparagraph (c)?***

The discussion draft contains the following proposed wording to Article 3 “The term “royalties” as used in this Article means payments of any kind received as a consideration for: (c) *the acquisition of any copy of computer software for the purposes of using it.*”

The purpose and application of paragraph 14.4 is much wider than the scope of the discussion draft where paragraph 19 is applying this commentary for a new and out-of-context approach whereby it appears to be seeking to apply it to cases with “...distribution rights in the absence of reproduction rights...”.

Whilst the Model itself may not be legislation in many countries, ICC believes that it may form the foundation of what becomes the basis of legislation.

There is nothing within subparagraph (c) that indicates that the intent of the wording is “...*intended to produce the same result as in paragraph 14.4 of the Commentary on Article 12 of the 2017 OECD Model with respect to distribution rights in the absence of reproduction rights...*” Instead, subparagraph (c) appears to be aimed at capturing payments made as consideration for “...*the acquisition of any copy of computer software for the purposes of using it*”. There does appear to be a significant misalignment between the reading of subparagraph (c) and the stated intent contained within paragraph 19, with the risk that more transactions are inadvertently captured than intended.

Therefore, consideration paid under subparagraph (c) must be (i) for the acquisition of any copy for computer software, and (ii) the purpose of the acquisition must be for the purpose of using it. These cannot be tangential impacts, but the reason for the transaction.

The drafting risks changing to some basic principles around the distribution of software and when it should be classified as a royalty in regard to the alienation and exploitation of protected property rights, which ICC considers to be a principled logic for the application of the rules.

ICC acknowledges that there may be a minority which has a restrictive view that “...*distribution is an integral part of copyright rights in many countries and payments with respect to such rights should be covered by Article 12 even in the absence of reproduction rights...*”

ICC considers it an important foundation that there is a separation of the rights over property and the property that is being distributed. The rights over software include economic rights which can be split and transacted separately. It is well established that economic rights are subject to separate intellectual property protection and each right capable of individual (or collective) exploitation or restriction. There is not a necessity to group a reproduction right and a distribution right as these are separately identifiable components. Each of these rights can be separately protected, restricted, exploited and defended. ICC members do not follow the logic of there being a need for these to be grouped together and propose that such wording is rejected from paragraph 19.

ICC does not agree with this minority view position and is unable to agree with the position in paragraph 19.

Existing case law, e.g., in the case of *Vernor v. Autodesk*, the judge provided a clear distinction between cases when the users' resale of a copy of the computer software would and would not be protected by the first sale doctrine.

Similarly in the case of *Bobbs-Merrill Co. v. Straus*, (210 U.S. 339, 350-51 (1908)) – the Supreme court ruled that restrictive pricing on a book was only enforceable against the first sale of copies of the work (now codified into US law at 17 U.S.C. s.41 (1909)). As per the Berne Convention, computer software is afforded protection akin to literary work.

Based upon existing case law and conflicting information available against several positions within the Annex, ICC is not able to reach the same conclusion as is indicated within the Annex.

With respect to possibly deleting the words “for the purposes of using it’ at the end of subparagraph (c), if the assumption is that ‘using’ is based upon the consideration being for the ordinary intended operational use of the software, ICC strongly opposes the inclusion of this wording in the revised proposed subsection (c).

This alone would place countries on completely opposed paths as to the approach on taxation on software. It has been commonly accepted practice in considerable numbers of OECD and United Nations countries to treat the payments for the standard use of software as outside the scope of royalties and treated as a ‘business profits’ transaction. As a result of this ‘accepted’ treatment, software transactions are able to be treated as a distribution of an item, whereas if the consideration is for the alienation and exploitation of the intellectual property, this would be a separately identifiable transaction and within the scope of royalties.

The market forces ultimately determine whether software is commercially viable. The price of software is built into the business models of companies, and not all companies developing and selling software remain commercially viable.

This potential interpretation of subsection (c) broadens the scope of the royalty article beyond commercial exploitation of copyrights and creates taxing rights without, in our view, sufficient factors to justify a reallocation of taxing rights from residence to source taxation. It is also foreseeable that such change could lead to increases in prices of software, and/or impact upon the viability of selling software into that jurisdiction.

Further, the source taxation of software payments raises a number of practical difficulties, such as dealing with purchases of software by individuals, as well as how to deal with centrally procured software licenses that are used in a number of countries.

To conclude, ICC is unable to agree with the position in the Annex, and does agree with the proposal to delete ‘for the purposes of using it’. However, ICC also believes that this question does not go far enough and further recommends the deletion of subsection (c) in totality. ICC does not support the revised draft paragraph 3, which is far more likely to increase uncertainty, negative economic impacts on country positions, increase tax controversy and conflicts between taxpayers and tax authorities, and will lead to complex bifurcation and valuation issues.

## **About The International Chamber of Commerce (ICC)**

The International Chamber of Commerce (ICC) is the world's largest business organization representing more than 45 million companies in over 100 countries. ICC's core mission is to make business work for everyone, every day, everywhere. Through a unique mix of advocacy, solutions and standard setting, we promote international trade, responsible business conduct and a global approach to regulation, in addition to providing market-leading dispute resolution services. Our members include many of the world's leading companies, SMEs, business associations and local chambers of commerce.

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