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March 16, 2021

**VIA EMAIL**

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

**Re: 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**

The Silicon Valley Tax Directors Group ("SVTDG")[1] is pleased to submit our comments in response to the United Nations Committee of Experts on International Cooperation in Tax Matters (the "**Committee**") discussion draft (the "**Discussion Draft**") on the inclusion of software payments in the definition of royalties in Article 12 of the United Nations Model Tax Convention between Developed and Developing Countries (the "**UN Model**"), published on February 16, 2021. We thank the Subcommittee on the Update of the UN Model for the opportunity to comment on the Discussion Draft.

We understand that the proposal included in the Discussion Draft has not been considered by the full Committee and the release of the proposal therefore does not indicate agreement by the Committee, nor does it bind the Committee in any way.

Commensurate with our letter of October 2, 2020, relating to the September 1, 2020, discussion draft on the same topic, the SVTDG continues to strongly recommend that the Committee should not adopt the proposal in the Discussion Draft. We set forth below our comments to the Discussion Draft, including our responses to certain of the Committee's specific requests for comments.

[1] The SVTDG represents U.S. high technology companies with a significant presence in Silicon Valley that are dependent on R&D and worldwide sales to remain competitive. The SVTDG promotes sound, long-term tax policies that allow the U.S. high tech technology industry to continue to be innovative and successful in the global marketplace. SVTDG members are listed in Appendix 1 to this letter.

We look forward to an opportunity to discuss our comments with you at your convenience.

Sincerely,

/s/ Robert F. Johnson

Robert F. Johnson
Co-Chair, Silicon Valley Tax Directors Group

**Written Submission in Response to Invitation for Comments 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**

**Silicon Valley Tax Directors Group**

**March 16, 2021**

**PART I: Introduction**

On February 16, 2021, the United Nations Committee of Experts on International Cooperation in Tax Matters (the "**Committee**") published a discussion draft (the "**Discussion Draft**") on the possible changes to the United Nations Model Double Taxation Convention Between Developed and Developing Countries (the **"UN Model"**) concerning the inclusion of software payments in the definition of royalties in Article 12 of the UN Model. The Committee has invited public comments on the Discussion Draft.

We understand that the proposal included in the Discussion Draft has not been considered by the full Committee and the release of the proposal therefore does not indicate agreement by the Committee, nor does it bind the Committee in any way. The current Discussion Draft does not respond in any meaningful way to the specific concerns raised in our (and other) letters relating to the justifications set forth in the prior discussion draft for adopting the proposed changes. Nonetheless, we continue to believe that the Committee should not adopt the changes proposed in the Discussion Draft for reasons similar to those explained in our letter of October 2, 2020, relating to the prior discussion draft. We have included our prior letter as Appendix 2 to this letter for your ease of reference.

As a preliminary matter, our fundamental concern with the Discussion Draft is that the proposed changes are contrary to prevailing principles of intellectual property law and well-established norms of international taxation that grant taxing rights in respect of payments for copies of computer software to the residence state. The gross basis taxation suggested by the proposal fails to take into account that payments for software products give rise to normal business income fully loaded with entrepreneurial costs (*i.e.*, expenses related to development, marketing, sales and support). Moreover, there is a long-standing general consensus among developed and developing countries which incorporates the distinction between the acquisition and use of copyrighted articles and the acquisition of the right to exploit copyright rights.[2] Accordingly, income from payments for software products should continue to be classified as business profits within the meaning of Article 7 of the UN Model.

If, notwithstanding the above, the Committee decides to adopt the proposed changes in the Discussion Draft, then we have set forth below some more specific comments to the Discussion Draft. In this regard, the Discussion Draft notes that one observer who supported the proposed changes argues that the Commentary should specify that the proposed changes are "merely a clarification, which would ameliorate issues arising from the working of existing treaties." We acknowledge that the proposed changes to the Commentary do not adopt this particular observer's recommendation. We firmly believe that any such language in the Commentary should not be adopted, as it would be disingenuous at best to suggest that the radical changes proposed in the Discussion Draft constitute "merely a clarification" to existing bilateral tax treaties. For example, the Supreme Court of India recently had an opportunity to address the proper characterization of payments in respect of copyrighted articles.[3] The court held that such payments by the Indian distributors and end users for purposes of various of India's income tax treaties did not constitute royalties, but rather constituted payments for copyrighted articles/sale of goods covered by the business profits article of the applicable Indian income tax treaties.

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[2] *See, e.g.,* Commentary to Article 12 of the OECD Model Tax Convention on Income and on Capital (2017), at ¶¶ 12 to 12.2 and U.S. Treasury Regulations § 1.861-18.

[3] *Engineering Analysis Centre of Excellence Private Limited et al. v. The Commissioner of Income Tax & ANR,* Civil Appeals Nos. 8733-8734 of 2018 *et al.* (Supreme Court of India, March 2, 2021); see ¶¶ 52, 144, and 169.

**PART II: Specific Concerns with the Discussion Draft**

## 1. Lack of sufficient guidance coordinating Articles 12, 12A, and 12B[4]

The Discussion Draft proposes to amend Article 12(3) by including separate subparagraphs for different categories of payments, including Article 12(3)(a)(i) for certain copyright rights, Article 12(3)(a)(iv) for computer software, and Article 12(3)(c) for the "acquisition of any copy of computer software for the purposes of using it." It appears that the general intention of separating the various categories of payments into different subparagraphs is to "facilitate the common practice of providing different withholding rates for different categories of royalties." Moreover, based on the proposed revisions to the Commentary we understand that broadly speaking Article 12(3)(a)(i) is intended to cover payments for the license of copyright rights (including in computer software), whereas Article 12(3)(a)(iv) and (3)(c) are intended to cover payments for the use of computer software or a copy thereof. However, if countries were to decide to adopt different withholding tax rates for payments covered by Articles 12(3)(a)(iv) and 12(3)(c), it is far from clear to us which would apply to a particular payment. Paragraph 16 to the proposed Commentary explains that Article 12(3)(a)(iv) is "intended to apply to direct payments for computer software," whereas Article 12(3)(c) was added "because the domestic law [of different countries] can vary in how it treats these economically equivalent transactions," referring to the different forms and mediums for delivering computer software. The explanation provided in paragraph 16 would need to be further clarified to delineate the respective scope of each subparagraph. Paragraph 20 of the proposed Commentary similarly acknowledges the "possibility of overlap" between the various subparagraphs, but then fails to provide any guidance for how to address such overlaps.

Along similar lines, paragraphs 21 and 24 of the proposed Commentary are deficient in distinguishing which payments are subject to Article 12, 12A, or 12B. While draft Article 12B generally defers to Articles 12 and 12A in the case of "income from automated digital services" that "include payments qualifying as 'royalties' or 'fees for technical services'", it would be equally important to provide very clear guidance as to which provision applies. For instance, the examples set forth in the proposed Commentary deal with potentially less controversial situations, such as where a user downloads free software to access online intermediation platform services (which would be subject to Article 12B) and assumes that a user may make a "separate payment" to download the software (which would be subject to Article 12). However, in many cases, the user will make a single payment for "bundled" software and services.

In addition, draft Articles 12 and 12B may deal with "economically equivalent" transactions (*e.g.*, individual tax preparation software, which may be sold to a user as a download of a copy or as an online cloud-based version that is functionally equivalent to the downloaded copy of the software). Applying different withholding tax rates to payments for such transactions or trying to delineate between them reinforces the position that such payments should continue to be treated as business profits within the meaning of Article 7 of the UN Model and that the proposed changes in the Discussion Draft are merely designed to raise revenue on companies that sell software regardless of the form of the transaction.

[4] We note that the Discussion Draft assumes, without an explanation similar to that provided in footnote 1 of the Discussion Draft, that Article 12B, relating to automated digital services, has been "introduce[d]" by the Committee of Experts in 2021. We understand that the Committee has not yet taken a formal decision to adopt Article 12B and that such decision may be made in 2021.

**2. Identification of transactions involving “computer software” versus transactions involving tangible goods with embedded software**

Paragraph 17 of the Discussion Draft notes that the proposed changes to Article 12(3) are intended to apply to a limited category of transactions involving “computer software.” Specifically, Article 12(3) is not intended to apply to computer software “when the fundamental purpose of the transaction is the purchase of [a] good and such software cannot be purchased independently of the good.” After explaining that “many consumer goods contain software that improves the performance of the good or provides additional functionality (such as advanced electronics in an automobile . . .),” and that such software is not within the scope of the proposed changes to Article 12(3), paragraph 7 then goes on to confusingly provide that “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 [of a royalty] in [Article 12(3)].”

The standards set forth in paragraph 17 are not practical or administrable. For example, users would be required to determine upfront whether software included in the purchase of a good may be “purchased independently of the good.” If so, users would then apparently be required to allocate a portion of the purchase price for the good to the value of such software to collect and remit the appropriate level of withholding tax. Regardless of whether the user could purchase the software independently of the good, the user would also be required to determine whether the “fundamental purpose of the transaction is the purchase of the good.” We respectfully submit that a better approach would be to agree that a transaction involving a software embedded device is classified as involving the acquisition of software (rather than the purchase of a non-software good) if the taxpayer concludes a separate commercial contract, with a separate stated price, for the software. In all other cases of bundled products, the payment should be characterized as a payment for the good which contains the software.

The impracticalities of the proposed Commentary provide yet another reason why the transfer of a copy of computer software, in whatever form, should continue to be classified as business profits within the meaning of Article 7 of the UN Model.

**3. The treatment of software payments as payments for the “letting” of intangible property**

Paragraph 14 of the proposed Commentary expresses the view of certain Members of the Committee that draft Article 12(3)(a)(iv) is justified because “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 covered by [Article 12(3)(a)(iii), relating to industrial, commercial, or scientific equipment (“ICSE”)] is making a payment in consideration for the “letting” of tangible property.” Paragraph 14 draws a false analogy between ICSE and computer software. As we explained in our letter of October 2, 2020:

> ‘Equipment’ in the ICSE context cannot refer to software because the underlying principle of the ICSE provision is based on physical presence of a tangible item owned by the taxpayer. Software does not involve physical presence in any jurisdiction, including in market countries. Indeed, the US Treasury and IRS recently proposed to replace the definition of “computer program” in US Treasury regulations section 1.861-18 with the term “digital content,” which highlights the extent to which software is digital and lacks any physical aspect. Moreover, to the extent that software is sold on a physical medium, the predominant object of the transaction is the digital content contained on the physical medium and not the rights to use the tangible medium.

Thus, treating payments for software like payments for ICSE is not justified.

## 4. The treatment of distribution intermediaries

We agree with the draft Commentary's retention of paragraph 14.4 of the Commentary on Article 12 of the 2017 OECD Model Tax Convention on Income and on Capital (the **"OECD Model"**), relating to distribution intermediaries. Thus, we strongly disagree with the minority views expressed in the Annex to the Discussion Draft and in paragraph 19 of the draft Commentary that "payments with respect to [distribution] rights should be covered by Article 12 even in the absence of reproduction rights." Therefore, if the Committee decides to adopt the changes in Discussion Draft, we agree that the words "for the purpose of using it" should be retained in draft Article 12(3)(c).[5]

Paragraph 14.4 of the OECD Model correctly sets forth the international consensus view that in cases where a distribution intermediary makes payments to acquire and distribute copies of computer software without the right to reproduce such software, any rights in relation to those acts of distribution would be ignored for purposes of analyzing the transaction for tax purposes.[6] Accordingly, payments received by the software copyright holder in connection with the distributor's purchase and resale of the software are properly treated as business profits covered by Article 7 of the UN Model.

The Annex to the Discussion Draft asserts that under the copyright laws of some countries, the right of distribution is "one of the exclusive rights of the copyright owner" included in the bundle of copyright rights. Moreover, the Annex asserts that in those countries where the distribution right is not exhausted on the first sale of a copy anywhere in the world ("international exhaustion"), a distributor who purchases and resells copies of the software exercises a distribution right that constitutes a copyright right and that such payment is therefore properly characterized as a royalty rather than the purchase price for a copyrighted article. The discussion in the Annex, however, fails to take into account that the distribution right is incidental to and supportive of the reproduction right. The copyright law is intended to protect the right of the copyright owner to reproduce copies of the work and to place those copies into the stream of commerce. This is why Paragraph 13.1 of the OECD Article 12 Commentary, as referenced in paragraph 13 of the proposed UN Commentary, expressly refers to both the right "to reproduce and distribute to the public" copies of the software program as the essential description of a software license that gives rise to royalties.

The vagaries of any particular country's copyright laws with respect to the application of the first sale/exhaustion doctrine should not control the outcome for tax purposes, particularly in the context of a model tax convention such as the UN Model. Because model tax conventions are intended to guide states that are negotiating bilateral conventions, we believe that model tax conventions should represent a clear, if not overwhelming, consensus. For the avoidance of doubt, we acknowledge that any two contracting states may negotiate their own bilateral convention in a way that deviates from the model convention. However, the guiding model convention must exhibit clear principles built upon consensus support. Because we do not believe that the proposal in the Discussion Draft reflects the predominant view among all UN Member States, we do not believe that this proposal should be included in the UN Model.

In addition, although the discussion in the Annex cites India as an example of one country that apparently does not apply the international exhaustion principle as a copyright law matter, we note that

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[5] For the avoidance of doubt, as noted at the beginning of this letter, we strongly disagree with adopting any of the changes to Article 12 of the UN Model or the Commentary thereunder.

[6] *See, e.g.*, US IRS Treasury regulations section 1.861-18(c)(2)(i), which includes among the list of copyright rights for which royalties may be paid the right "to *make copies* of the computer program *for purposes of distribution* to the public by sale or other transfer of ownership, or by rental, lease or lending." Emphasis added.

the Indian Supreme Court very recently held that, for purposes of various Indian income tax treaties, payments by Indian distributors (and end users) with respect to the purchase and resale of copyrighted articles do not constitute royalties, but rather constitute payments for copyrighted articles/sale of goods covered by the business profits article of the applicable Indian income tax treaties. Indeed, the court specifically cites to paragraph 14.4 of the Commentary under Article 12 of the OECD Model as support for its conclusion.[7] Notably, in its analysis the court does not address whether the Indian distribution intermediaries exercise any copyright rights as a matter of Indian copyright law. Therefore, the court explains that it is "clear that the OECD Commentary on Article 12 of the OECD Model Tax Convention, incorporated in the DTAAs in the cases before us, will continue to have persuasive value as to the interpretation of the term 'royalties' contained therein."[8]

The minority views expressed in paragraph 19 of the draft Commentary and in the Annex of the Discussion Draft would also result in unwarranted disparate treatment of "economically equivalent" transactions (*i.e.*, transactions for the purchase and resale of tangible goods and transactions for the purchase and resale of copyrighted articles).[9]

## Part III: Conclusion

Adopting the proposal put forth in the Discussion Draft would result in a fundamental and unjustified change to the existing law on the characterization and taxation of payments for the right to use software copies. The potential difficulties that the proposal in the Discussion Draft would create do not appear to have been properly or carefully considered enough, especially given the amount of the time this Committee has had to analyze the issue and the long-term impacts that the proposed amendment to Article 12(3) would undoubtedly have. For this reason, we would recommend that Article 12(3) remain as currently drafted and that the Committee should cease its efforts to revise the definition of royalties to include software payments because the existing UN Model already properly classifies these payments in their various forms for the reasons stated in this letter.

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[7] *Engineering Analysis Centre of Excellence Private Limited et al.,* at ¶ 152.

[8] *Id*. at ¶ 158.

[9] Paragraph B of the Annex sets forth a disingenuous argument by asserting that excluding distribution intermediaries from royalty treatment would result in possible abuse cases, where a direct sale to end users would result in royalty payments under proposed Article 12(3)(c). Such an argument lays bare the inappropriateness of treating sales of copyrighted articles as giving rise to royalty income. Neither sales to end users nor sales to distributors of copyrighted articles should give rise to royalty income.

## 1. List of SVTDG Members

10x Genomics, Inc.
Accenture
Activision Blizzard
Adobe
Advanced Micro Devices, Inc
Agilent Technologies, Inc.
Aimmune Therapuetics
Airbnb, Inc.
Align Technology, Inc.
Alphabet Inc.
Amazon
Analog Devices
Ancestry
Apple
Applied Materials
Aptiv
Arista Networks Inc.
Atlassian
Auth0, Inc.
Autodesk
Bio-Rad Laboratories
BMC
Broadcom Inc.
Cadence Design Systems, Inc.
Chegg
Cirrus Logic
Cisco Systems, Inc.
Confluent
CrowdStrike Holdings, Inc.
Cypress Semiconductor
Dell
Dolby Laboratories, Inc.
Dropbox, Inc.
eBay
Electronic Arts
Expedia Group, Inc.
Facebook
FireEye
Fitbit, Inc.
Flex
Fortinet
Genentech
Genesys
Getaround
Gigamon Inc.
Gilead Sciences, Inc.
GLOBALFOUNDRIES U.S. Inc.
GlobalLogic
GoPro Inc.
Hewlett-Packard Enterprise
HP Inc.
Indeed.com
Informatica
Ingram Micro
Intel
Intuit Inc.
Intuitive Surgical
Jazz Pharmaceuticals
Keysight Technologies, Inc.
KLA
Kraken
Lam Research
LiveRamp
Marvell
Maxim Integrated
Mentor Graphics
Microsoft
NetApp, Inc
Netflix
NVIDIA Corporation
Oracle
Palo Alto Networks, Inc.
PayPal
Pure Storage Inc
Qualcomm
RingCentral
Ripple Labs, Inc.
Robinhood
Rubrik
Salesforce
Seagate Technology
ServiceNow
Snap Inc.
Snowflake
Splunk
Stripe
SurveyMonkey
Synopsys, Inc.
The Cooper Companies
The Walt Disney Company
TiVo
Twilio Inc.
Twitter
Uber
Unity Technologies
Velodyne Lidar Inc.
Verifone
Veritas Technologies
Visa
VMware
Western Digital
Workday, Inc.
Xilinx, Inc.
Yelp
Zoom Video Communications, Inc.

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October 2, 2020

**VIA EMAIL**

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

**Re: Comment on Possible Inclusion of Software Payments in the Definition of Royalties in Article 12 of the United Nations Model Double Taxation Convention Between Developed and Developing Countries**

The Silicon Valley Tax Directors Group ("SVTDG")[10] is pleased to submit our comments in response to the United Nations Committee of Experts on International Cooperation in Tax Matters (the "**Committee**") discussion draft (the "**Discussion Draft**") on the inclusion of "computer software" in the definition of royalties in Article 12 of the United Nations Model Tax Convention between Developed and Developing Countries (the "**UN Model**") published on September 1, 2020.

The Discussion Draft does not represent a consensus view of the Committee. There is a section that details the arguments of the proponents (the "**Proponents**") of including "computer software" in the definition of royalties in Paragraph 3 of Article 12. There is also a section that details, albeit in much less detail, the arguments and responses to the Proponents' arguments made by those members that oppose the inclusion of "computer software" in Article 12(3) (the "**Opponents**"). The SVTDG believes that the Proponents have not provided a sufficient justification to change the current text of Article 12, and accordingly we recommend that the Committee should not adopt the proposal.

In this letter we have addressed the various rationales raised by the Proponents, as well as the responses from the Opponents, to explain the basis for our conclusion and recommendation.

[10] The SVTDG represents U.S. high technology companies with a significant presence in Silicon Valley that are dependent on R&D and worldwide sales to remain competitive. The SVTDG promotes sound, long-term tax policies that allow the U.S. high tech technology industry to continue to be innovative and successful in the global marketplace. SVTDG members are listed in Appendix 1 to this letter.

We look forward to an opportunity to discuss our comments with you at your convenience.

Sincerely,

/s/ Robert F. Johnson

Robert F. Johnson
Co-Chair, Silicon Valley Tax Directors Group

**Written Submission in Response to Invitation for Comments on Possible Inclusion of Software Payments in the Definition of Royalties in Article 12 of the United Nations Model Double Taxation Convention Between Developed and Developing Countries**

**Silicon Valley Tax Directors Group**

**October 2, 2020**

## PART I: Introduction

On September 1, 2020, the United Nations Committee of Experts on International Cooperation in Tax Matters (the "**Committee**") published a discussion draft (the "**Discussion Draft**") on the inclusion of "computer software" in the definition of royalties in Article 12 of the United Nations Model Tax Convention between Developed and Developing Countries (the "**UN Model**"). The Committee has invited public comments on the Discussion Draft.

The Discussion Draft does not represent a consensus view of the Committee. There is a section that details the arguments of the proponents (the "**Proponents**") of including "computer software" in the definition of royalties in Paragraph 3 of Article 12. There is also a section that details, albeit in much less detail, the arguments and responses to the Proponents' arguments made by those members that oppose the inclusion of "computer software" in Article 12(3) (the "**Opponents**").

Generally, the Proponents justify including "computer software" in the definition of royalties and cite to the allocation of taxing rights to market countries. Although the justifications and arguments underlying the proposal in the Discussion Draft are new for the most part, none of the Proponents' arguments in favor of the change withstand scrutiny.

Our main concern with the Discussion Draft is that the Proponents' newly articulated justifications for the proposal, which would purport to override long-standing and clearly established principles regarding the proper tax treatment of software payments, do not provide a sound and principled basis for taxing software product payments as royalties. For the reasons that we discuss below, software product payments should continue to be treated as business profits, as such payments represent the normal business income of software providers, burdened by development, selling and marketing, distribution, and support costs commensurate with any other similar businesses.

It appears that the Discussion Draft is designed as a blunt tool to raise revenue on companies that sell software by characterizing all payments for computer software as royalties. For example, the Discussion Draft cites, as part of the rationale for the proposal, "the current uncertainty surrounding ongoing work related to taxation and the digitalisation of economy," suggesting that the fact that the extensive OECD / Inclusive Framework work is still in progress justifies the proposal. However, the Discussion Draft fails to realize the cascading practical impacts that including "computer software" in the definition of royalties would likely have.

Most, if not all, of the other justifications for the proposal advanced by the Proponents are merely recitations of facts (such as the increased efficiencies that inure to businesses deploying computer software) that do not constitute a principled rationale for the proposal.

We have addressed the various rationales raised by the Proponents, as well as the responses from the Opponents, below.

## PART II: Specific Concerns with the Discussion Draft

### 5. Engagement in the economic life of market countries

Paragraph 7 contains the argument that due to advances in the means of communication and information technology, software constitutes a key tool the conduct of most businesses. The argument continues that software increases productivity and efficiency and reduces costs, which means that there is an "increasing level of engagement of computer programs and other software in the economic life of States where they are used." This "increasing level of engagement . . . justifies the allocation of taxing rights to source countries."

We agree with the Opponents that this justification is "problematic."[11] A "significant level of engagement in other State's economy" is not unique to software, yet the Discussion Draft would seek to use a justification that applies to any sector to single out companies that sell software. Even if this rationale were unique to software, or if the Discussion Draft sought to impose its proposal on a more inclusive swath of industries and companies, it does not justify treating such payments as royalties. Suggestions that software or any other product has "engagement" with a market country is not relevant to whether a transaction involves a payment for the grant of rights to exploit a copyright or involves a payment for the use of a copyrighted article.

Although the increased use of software by businesses does increase efficiency, which in turn increases profitability, that is the primary goal of a business purchaser of any product or service. We agree with the Opponents' point that it is not clear in Paragraph 7 why payments for software should be treated differently from payments for other goods. There is no principled justification for treating software differently than payments for any other tool or service.[12]

We assume that the underlying purpose of the proposal in the Discussion Draft is to increase the amount of taxes paid by non-resident companies in market countries. However, increasing efficiency and reducing costs leads to increased profitability and competitiveness for businesses in market countries, which in turn leads to job creation. All of these lead to increased market state tax collections through business taxes on resident companies and increased wage taxes on employees.

Finally, Paragraph 7 states that the distinction between payments for the acquisition of a copyrighted article and the rights to exploit a copyright have "blurred" and that the proposal would therefore "promote tax certainty and reduction of disputes." We respectfully disagree. It is true that copyright law is not monolithic and may vary from country to country, but there is a long-standing general consensus among developed and developing countries which incorporates the distinction between the acquisition and use of copyrighted articles and the acquisition of the right to exploit copyright rights.[13]

**6. Reliance on the protection of market country intellectual property laws**

Paragraph 8 combines a number of effects of the "realities of the digital age" along with the argument that commercial exploitation by the owner or creator of software is heavily dependent on the laws relating to the protection of intellectual property rights in the territory of exploitation to conclude that the definition of royalties should be expanded to apply to computer software.

Again, companies that sell software to customers in market jurisdictions are not unique in relying upon the legal systems of (i) their own country of residence and (ii) market countries to ensure that their contracts are honored. We agree with the Opponents that neither the prevalence of the use of software in a given country, the fact that producers of software rely on the legal system in that country for the protection of intellectual property rights, the reliance on telecommunication networks for the delivery of software, the ease of reproduction and the relatively low cost of downloading software, nor the level of education or proficiency with computers in the market countries justify reallocating taxing rights to the market country.[14] More specifically, none of these factors justify treating the non-residents' normal

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[11] *See* Discussion Draft, Paragraph 15 (third bullet).

[12] *See* Discussion Draft, Paragraph 15 (first bullet).

[13] *See, e.g.,* Commentary to Article 12 of the OECD Model Tax Convention on Income and on Capital (2017), at ¶¶ 12 to 12.2 and U.S. Treasury Regulations § 1.861-18.

[14] *See* Discussion Draft, Paragraph 15 (fifth bullet).

business income from the sale of software as royalty income instead of business profits. Like other companies, software companies deploy personnel and assets, and their sales of products are burdened with the same development, sales and marketing, and distribution costs, as any other industry. Accordingly, there is nothing in the nature of the software business which justifies that their business income should be taxed any differently.

**7. Comparison to industrial, commercial or scientific equipment ("ICSE")**

Paragraphs 9 and 10 set forth the argument that payments for software are "payments for the use or right to use" software and are not payments for the purchase of property. We agree with the Opponents that the use of software should not be compared to the use of ICSE.[15]

"Equipment" in the ICSE context cannot refer to software because the underlying principle of the ICSE provision is based on physical presence of a tangible item owned by the taxpayer. Software does not involve physical presence in any jurisdiction, including in market countries. Indeed, the US Treasury and IRS recently proposed to replace the definition of "computer program" in US Treasury regulations section 1.861-18 with the term "digital content," which highlights the extent to which software is digital and lacks any physical aspect. Moreover, to the extent that software is sold on a physical medium, the predominant object of the transaction is the digital content contained on the physical medium and not the rights to use the tangible medium.

**8. Reference to domestic law treatment of software payments to non-residents**

Paragraph 11 sets forth the argument that "many" countries already treat payments to non-residents in consideration for the use or right to use software as royalties under their domestic law. While it is true that some (a minority) of countries adopt such an approach, similar to the other facts cited to justify the proposal, this fact alone should have no bearing on the decision to include software in a Model Treaty definition of royalties. It is impossible to evaluate this justification because the Discussion Draft does not provide any of the principles underlying these countries' treatment of software payments as royalties that the Proponents rely upon or agree with. It is understandable that certain jurisdictions and governing bodies may influence each other, but the fact that some countries may treat software payments as royalties alone does not justify any change to the UN Model.

Because model tax conventions are intended to guide states that are negotiating bilateral conventions, we believe that model tax conventions should represent a clear, if not overwhelming, consensus. For the avoidance of doubt, we acknowledge that any two contracting states may negotiate their own bilateral convention in a way that deviates from the model convention. However, the guiding model convention must exhibit clear principles built upon consensus support. Because we do not believe that the proposal in the Discussion Draft reflects the predominant view among all UN Member States, we do not believe that this proposal should be included in the UN Model.

**9. Market country taxation on gross payments for software**

In Paragraph 12 the Proponents appear to be responding to points made by the Opponents. The Opponents observe that the high development costs of software may result in losses in the country of residence of the company engaged in development activities.[16] Gross basis taxation would not take into account the significant expenses for development, sales and marketing, distribution, and customer support to name a few. The Proponents assert that the risk that taxes levied in the market country may

[15] *See* Discussion Draft, Paragraph 15 (sixth bullet).

[16] *See* Discussion Draft, Paragraph 15 (tenth bullet).

be passed on to residents of the market country who acquire software is no different than payments for any other intangible property referred to in Article 12(3).

The Proponents engage with the points made by the Opponents by assuming that payments for software are royalties. Their assumption here creates a false comparison. Income associated with sales of software products are not equivalent to income from "interest" or any other type of passive or investment income. Instead, payments for software products give rise to normal business income fully-loaded with entrepreneurial costs (i.e., expenses related to development, marketing, sales and support). Accordingly, income from payments for software products should continue to be classified as business profits within the meaning of Article 7 of the UN Model. To counter and evaluate the Proponents argument in Paragraph 12, those in opposition would need to assume that payments for software are royalties. As we have discussed throughout this letter, we do not think that such an assumption is justified based on the arguments set forth in the Discussion Draft or prevailing principles of tax and intellectual property law.

### 10. Clarifying the treatment of software payments at a time of ongoing work on the taxation of the digital economy

Paragraph 14 sets forth the argument that it is important that the Committee clarify its position on the treatment of software payments "given the current uncertainty surrounding ongoing work related to the taxation of the digital economy." The OECD's current work addressing the tax challenges arising from the digitalisation of the economy, including the pace of that work as the Inclusive Framework works towards a consensus solution, has absolutely no bearing on whether software payments should be included in the definition of royalties.

## Part III: Conclusion

Adopting the proposal put forth in the Discussion Draft would result in a fundamental and unjustified change to the existing law on the characterization and taxation of royalties. We do not believe that the Proponents have set forth arguments that justify revising Article 12(3) to include "computer software" in the definition of royalties. The potential difficulties that the proposal in the Discussion Draft would create do not appear to have been properly or carefully considered enough, especially given the amount of the time this Committee has had to analyze the issue and the long-term impacts that the proposed amendment to Article 12(3) would undoubtedly have. For this reason, we would recommend that Article 12(3) remain as currently drafted and that the Committee should cease its efforts to revise the definition of royalties to include software payments because the existing UN Model already properly classifies these payments in their various forms for the reasons stated in this letter including the fact that there are Opponents with whom we agree and who have made arguments and observations that reflect the practical difficulties that would most likely result from revising Article 12(3). If the Committee does continue to discuss this proposal, we recommend that the work of the Subcommittee should continue under the next Committee because the current Committee does not have enough time remaining in its term to give this issue the attention and study that it requires. We would be happy to assist in any efforts to continue considering this issue.

* * *

## 1. List of SVTDG Members

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