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**Article 12 (Royalties): possible amendments to the commentary
on article 12 in relation to software-related payments**

SOFTWARE PAYMENTS AS ROYALTIES UNDER ARTICLE 12¹

Summary

This paper aims to address issues related to software payments under Article 12 of the UN Model and suggest ways of applying the corresponding changes to the UN Model and Commentaries to the next membership of the Committee. With the expanding use of software in all spheres of commercial and personal life, the tax treaty treatment of software payments could benefit from higher level of clarification and certainty in the UN Model. It is recommended that a Subcommittee of experts should be created to consider and report on possible improvements to the UN Model and Commentaries for the benefit of all stakeholders in tax systems.

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Historical Background

OECD History

Historically, the work for development of guidance in respect of application of Article 12 on software payments originally appears in a report titled “Software: An Emerging Industry” that was published by the OECD in 1985. The recommendations made in Appendix 3 of the “Software: An Emerging Industry” for changes in Commentary on Article 12 led to the insertion of the paragraphs 12 to 19 of the OECD Commentary on Article 12. These changes were the first major guidance included in the Commentary on Article 12 in respect of software payments.

2. The second set of further guidance that was subsequently incorporated and continues to remain as existing guidance was adopted on the basis of another report titled “The 2000 Update to the Model Tax Convention” adopted by the OECD Committee on Fiscal Affairs on 29 April 2000, leading to modification of some of the paragraphs and insertion of paragraph 12, 12.1, 12.2, 13.1, 14, 14.1, 14.2, 14.3 and 14.4 in the OECD Commentary.

3. The third set of major changes in this guidance resulted from the recommendations made in the OECD report titled “Treaty characterization issues arising from E-Commerce” which was adopted by the OECD Committee on Fiscal Affairs on 7 November 2002, consequently leading to another report titled “The 2002 Update to the Model Tax Convention” adopted by OECD Council on 28 January 2003, which led to the paragraphs 11.1, 11.2 11.3, 11.5, 11.6, 17.1, 17.2, 17.3 and 17.4 of the OECD Commentary.

UN History

4. Article 12, paragraph 3, of the UN Model reproduces Article 12, paragraph 2, of the OECD Model but eliminates equipment rental from this Article. Moreover, paragraph 3 of Article 12 includes payments for tapes and royalties which are not included in the corresponding provision of the OECD Model. The relevant portions of the OECD Commentary and Committee comments are attached in **Annex I**.

5. At the 11th session of the Committee in 2015, a Subcommittee was formed to investigate the issue of software-related payments under Article 12 of the UN Model. The Subcommittee mandate was to consider and report on possible improvements to both the UN Model and Commentary.

6. The issue of taxation of royalties under Article 12 was initially scheduled for the 12th session of the committee, but was deferred until the 14th session, after the royalties Subcommittee had had a chance to meet to consider the issues. The relevant paper was [E/C.18/2017/CRP.5](#). The Subcommittee decided not to put forward any text regarding the characterization of royalty payments made for the acquisition of software, until other underlying issues are clarified. The Subcommittee proposed amendments to the commentaries of Article 12 of the UN Model at the 14th session. The proposal did not represent the Committee's unanimous recommendation, but reflected the view of the majority of the members of the Subcommittee.

7. The Subcommittee also noted, and the Committee agreed, that it would like to request the next membership of the committee to reconvene the Subcommittee on royalties, so that it could conclude the term of its mandate by addressing the nature of software-related payments and apply corresponding changes to the UN Model and Commentary, as appropriate.

Issue

8. Article 12 of the UN Model Convention largely replicates Article 12 of the OECD Model Convention, with substantive differences appear in paragraph 1 and 3. Paragraph 1 omits the word “only” found in the corresponding provision of the OECD Model Convention, which states that “Royalties arising in a Contracting State and paid to a resident of the other Contracting State may be taxed **only** in that other State”. By omitting the word “only”, the UN Model Convention aims to share taxing rights on royalties between the State of residence and the State of source. In effect, it preserves the source country taxing rights over royalties. It should be noted that several Member States of OECD have recorded reservations to the exclusive residence State taxation of royalties provided by Article 12 of the OECD Model Convention.² Several Non-OECD countries also reserve the right to tax royalties at source.³

² *Australia, Canada, Chile, Czech Republic, Greece, Italy, Korea, Mexico, New Zealand, Poland, Portugal, The Slovak Republic, Slovenia and Turkey* have reserved the right to tax royalties at source.

³ *Albania, Argentina, Armenia, Azerbaijan, Belarus, Brazil, Bulgaria, Colombia, Croatia, the Democratic Republic of the Congo, Gabon, Hong Kong, Indonesia, Ivory Coast, Kazakhstan, Lithuania, Malaysia, Morocco, the People's Republic of China, the Philippines, Romania, Russia, Serbia, Singapore, South Africa, Thailand, Tunisia, Ukraine, and Vietnam* have reserved the right to tax royalties at source.

9. The issues related to the characterization of software payments arise mainly from paragraph 3 of Article 12, which does not specifically refer to software. Under paragraph 3 of Article 12

“The term “royalties” as used in this Article means payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work including cinematograph films, or films or tapes used for radio or television broadcasting, any patent, trademark, design or model, plan, secret formula or process, or for the use of, or the right to use, industrial, commercial or scientific equipment or for information concerning industrial, commercial or scientific experience”

Analysis

Classification of Software

10. At its 12th session, the Committee reviewed whether it was appropriate in principle to regard Article 12 as covering software payments. The character of payments received in transactions involving the transfer of computer software depends on the nature of the rights that the transferee acquires under the particular arrangement regarding the use and exploitation of the software. The rights in computer software are a form of intellectual property. The Committee noted that all but one of OECD member countries protect rights in computer software either explicitly or implicitly under copyright law. From this, the Committee concluded that software payments made for the right to exploit intellectual property in software could not be separated from general copyrights royalties. It was not able to conclude that software payments should be regarded as entirely outside the scope of Article 12. However, when software payments are regarded as royalties, paragraph 2 requires that software be classified as a literary, artistic or scientific work.

11. Regarding the classification of software as a literary, artistic or scientific work, there are two approaches. Firstly, a common practice is to specifically add ‘software’ as included in the ‘literary, artistic or scientific work’ in paragraph 3 of Article 12.⁴ This approach clarifies that

⁴ One of the clearest illustrations of this approach can be observed in paragraph 2 of Article 12 of the Japan-France treaty, which states:

software is included in the category of ‘literary, artistic or scientific work’. Another approach is to specifically include payments for use of software within the definition of ‘royalties’.⁵

Issues related to software payments

12. The Committee also examined the boundary between software payments in the nature of royalties and software payments of other kinds. In case of partial transfer of rights, the question lies in the definition of royalties in paragraph 3 of Article 12. The term “royalties” as used in Article 12 means payments of any kind received as a consideration for the **use of**, or the right to **use**, any copyright [...] any patent [...].

13. On a broad interpretation, the mere purchase of a software (e.g. a computer program) protected by copyright or a patent is likely to result in the payment of royalty as a consideration for use of the software. The narrower interpretation is that “use” in Article 12 is limited to the use by an acquirer who seeks to commercially exploit the intellectual property of another. A substantial majority of the Committee took a view that the narrower interpretation was correct. The reason was that paragraph 1 of the Commentary on Article 12 which describes royalties in principle as "income to the recipient from a letting" made the position clear. As the acquisition of software for simple use by the purchaser could not represent any form of letting, it clearly could not give rise to a royalty within the meaning of Article 12.

2. The term "royalties" as used in this Article means payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work (including computer software, cinematograph films, and films or tapes used for radio or television broadcasting), any patent, trade mark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience.

⁵ This approach can be seen in Paragraph 3 of Article 12 of Canada France treaty provides as under:

3. Notwithstanding the provisions of paragraph 2:

(a) royalties arising in a Contracting State and paid to a resident of the other Contracting State who is the beneficial owner of the royalties, shall be taxable only in that other State if they are:

(i) copyright royalties and other like payments in respect of the production or reproduction of any literary, dramatic, musical or artistic work (but not including royalties in respect of motion picture films nor royalties in respect of works on film or videotape or other means of reproduction for use in connection with television broadcasting), or

(ii) royalties for the use of, or the right to use, computer software, or

(iii) royalties for the use of, or the right to use, any patent or for information concerning industrial, commercial or scientific experience (but not including any such information provided in connection with a rental or franchise agreement);

14. Concerning the transfer of all rights, there was a consensus that consideration received for transfer of full ownership of all rights is in nature of capital gains. Therefore, the provisions of Article 12 were not applicable.

Recommendations

15. The issue on software-related payments is a matter of considerable importance in view of the development of often very high value computer technology in recent years. The issue is whether, bearing in mind the intent and purpose of Article 12 in UN Convention, which aims to tax royalties in the source state on a gross basis at a lower rate while also considering expenses incurred in the development of the property, payments for use or right to use software should be taxed as royalties under Article 12 and not under Article 7. A related issue is whether or not, in interpreting Article 12, ‘use’ of software should be considered the same as transfer of ‘right to use’ of software and a payment for either should constitute royalty.

16. The Commentary could include possible options for countries that would like to explicitly provide for source based taxation of software payments as royalty, either by including ‘software’ within the scope of ‘scientific work’ or by explicitly providing within the article that payment for use of software will be taxable as a royalty in the state where it arises. Other possible options for inclusion in the Commentary could be for those countries that may wish to restrict taxation of software payments as royalty only to business-to-business payments that are claimed as deduction and which may lead to erosion of their tax base. Another option could be for those countries who may wish to subject the taxation of royalty to a minimum revenue threshold, so as to facilitate compliance and administration.⁶

17. For countries that wish to look at Article 12 as an alternative to Article 7, a possible option in the Commentary could be to enable taxation on a net basis, either by allowing deduction of a notional ‘deduction’ from the gross amount or by a ‘deeming profit’ rule, the specifics of which could be agreed bilaterally by the Contracting States.

⁶ For example, in France, the royalty tax rate is 33.3%. However, the rate increases to 75% for royalties paid to company in noncooperative countries. Qualifying payments to EU companies may be exempt under EU directives (As of March 2017).

18. In view of the importance of the issue, it is recommended that a broadly based subcommittee with industry, as well as governmental and other relevant expertise should be formed. It should be noted in this respect that the mandate given to the previous Subcommittee was as follows:

“The Subcommittee is to consider and report on possible improvement to the commentary on Article 12 (Royalties) of the Model, and if required, the text of the Article. It is mandated to initially report to the Committee at the October session of the Committee in 2016, addressing as its initial priority such improvements to the commentary discussion on industrial and scientific equipment and software related payments as are most likely to be accepted by the Committee for its inclusion in the next version of the Model.”

Annex: Relevant parts of the UN Art. 12 Commentary (with quotations from the OECD Commentary)

11. In classifying as royalty payments received as consideration for information concerning industrial, commercial or scientific experience, paragraph 2 is referring to the concept of “know-how”. Various specialist bodies and authors have formulated definitions of know-how. The words “payments ... for information concerning industrial, commercial or scientific experience” are used in the context of the transfer of certain information that has not been patented and does not generally fall within other categories of intellectual property rights. It generally corresponds to undivulged information of an industrial, commercial or scientific nature arising from previous experience, which has practical application in the operation of an enterprise and from the disclosure of which an economic benefit can be derived. Since the definition relates to information concerning previous experience, the Article does not apply to payments for new information obtained as a result of performing services at the request of the payer.

Some members of the Committee are of the view that there is no ground to limit the scope of information of an industrial, commercial or scientific nature to that arising from previous experience. The relevant portions of the OECD Commentary then continue:

11.1 In the know-how contract, one of the parties agrees to impart to the other, so that he can use them for his own account, his special knowledge and experience which remain unrevealed to the public. It is recognised that the grantor is not required to play any part himself in the application of the formulae granted to the licensee and that he does not guarantee the result thereof.

11.2 This type of contract thus differs from contracts for the provision of services, in which one of the parties undertakes to use the customary skills of his calling to execute work himself for the other party. Payments made under the latter contracts generally fall under Article 7 or in the case of the United Nations Model Convention Article 14.

11.3 The need to distinguish these two types of payments, i.e. payments for the supply of know-how and payments for the provision of services, sometimes gives rise to practical difficulties. The following criteria are relevant for the purpose of making that distinction:

- Contracts for the supply of know-how concern information of the kind described in paragraph 11 that already exists or concern the supply of that type of information after its development or creation and include specific provisions concerning the confidentiality of that information.
- In the case of contracts for the provision of services, the supplier undertakes to perform services which may require the use, by that supplier, of special knowledge, skill and expertise but not the transfer of such special knowledge, skill or expertise to the other party.
- In most cases involving the supply of know-how, there would generally be very little more which needs to be done by the supplier under the contract other than to supply existing information or reproduce existing material. On the other hand, a contract for the performance of services would, in the majority of cases, involve a very much greater level of expenditure by the supplier in order to perform his contractual obligations. For instance, the supplier, depending on the nature of the services to be rendered, may have to incur salaries and wages for employees engaged in researching, designing, testing, drawing and other associated activities or payments to sub-contractors for the performance of similar services.

11.4 Examples of payments which should therefore not be considered to be received as consideration for the provision of know-how but, rather, for the provision of services, include:

- payments obtained as consideration for after-sales service,
- payments for services rendered by a seller to the purchaser under a warranty, payments for pure technical assistance,
- payments for a list of potential customers, when such a list is developed specifically for the payer out of generally available information (a payment for the confidential list of customers to which the payee has provided a particular product or service would,

however, constitute a payment for know-how as it would relate to the commercial experience of the payee in dealing with these customers),

- payments for an opinion given by an engineer, an advocate or an accountant, and
- payments for advice provided electronically, for electronic communications with technicians or for accessing, through computer networks, a trouble-shooting database such as a database that provides users of software with non-confidential information in response to frequently asked questions or common problems that arise frequently.

14. In other types of transactions, the rights acquired in relation to the copyright are limited to those necessary to enable the user to operate the program, for example, where the transferee is granted limited rights to reproduce the program. This would be the common situation in transactions for the acquisition of a program copy. The rights transferred in these cases are specific to the nature of computer programs. They allow the user to copy the program, for example onto the user's computer hard drive or for archival purposes. In this context, it is important to note that the protection afforded in relation to computer programs under copyright law may differ from country to country. In some countries the act of copying the program onto the hard drive or random access memory of a computer would, without a license, constitute a breach of copyright. However, the copyright laws of many countries automatically grant this right to the owner of software which incorporates a computer program. Regardless of whether this right is granted under law or under a license agreement with the copyright holder, copying the program onto the computer's hard drive or random access memory or making an archival copy is an essential step in utilising the program. Therefore, rights in relation to these acts of copying, where they do no more than enable the effective operation of the program by the user, should be disregarded in analysing the character of the transaction for tax purposes. Payments in these types of transactions would be dealt with as commercial income in accordance with Article 7.

14.1 The method of transferring the computer program to the transferee is not relevant. For example, it does not matter whether the transferee acquires a computer disk containing a copy of the program or directly receives a copy on the hard disk of her computer via a modem connection. It is also of no relevance that there may be restrictions on the use to which the transferee can put the software.

14.2 The ease of reproducing computer programs has resulted in distribution arrangements in which the transferee obtains rights to make multiple copies of the program for operation only within its own business. Such arrangements are commonly referred to as “site licences”, “enterprise licenses”, or “network licences”. Although these arrangements permit the making of multiple copies of the program, such rights are generally limited to those necessary for the purpose of enabling the operation of the program on the licensee’s computers or network, and reproduction for any other purpose is not permitted under the license. Payments under such arrangements will in most cases be dealt with as business profits in accordance with Article 7

14.4 Arrangements between a software copyright holder and a distribution intermediary frequently will grant to the distribution intermediary the right to distribute copies of the program without the right to reproduce that program. In these transactions, the rights acquired in relation to the copyright are limited to those necessary for the commercial intermediary to distribute copies of the software program. In such transactions, distributors are paying only for the acquisition of the software copies and not to exploit any right in the software copyrights. Thus, in a transaction where a distributor makes payments to acquire and distribute software copies (without the right to reproduce the software), the rights in relation to these acts of distribution should be disregarded in analysing the character of the transaction for tax purposes. Payments in these types of transactions would be dealt with as business profits in accordance with Article 7. This would be the case regardless of whether the copies being distributed are delivered on tangible media or are distributed electronically (without the distributor having the right to reproduce the software), or whether the software is subject to minor customisation for the purposes of its installation.

15. Where consideration is paid for the transfer of the full ownership of the rights in the copyright, the payment cannot represent a royalty and the provisions of the Article are not applicable. Difficulties can arise where there is a transfer of rights involving:

- exclusive right of use of the copyright during a specific period or in a limited geographical area;
- additional consideration related to usage;
- consideration in the form of a substantial lump sum payment.

16. Each case will depend on its particular facts but in general if the payment is in consideration for the transfer of rights that constitute a distinct and specific property (which is more likely in the case of geographically-limited than time-limited rights), such payments are likely to be business profits within Article 7 (or 14 in the case of the United Nations Model Convention) or a capital gain within Article 13 rather than royalties within Article 12. That follows from the fact that where the ownership of rights has been alienated, the consideration cannot be for the use of the rights. The essential character of the transaction as an alienation cannot be altered by the form of the consideration, the payment of the consideration in instalments or, in the view of most countries, by the fact that the payments are related to a contingency.

17. Software payments may be made under mixed contracts. Examples of such contracts include sales of computer hardware with built-in software and concessions of the right to use software combined with the provision of services. The methods set out in paragraph 11 above for dealing with similar problems in relation to patent royalties and know-how are equally applicable to computer software. Where necessary the total amount of the consideration payable under a contract should be broken down on the basis of the information contained in the contract or by means of a reasonable apportionment with the appropriate tax treatment being applied to each apportioned part.

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.

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 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.

The view expressed by the OECD aims to limiting the scope of Article 12 regarding software. This view has not been shared unanimously by the Committee. Dissenting opinion was that the distinction between the use of copyright underlying software (royalties) and the use of minimum copyright to operate software (no royalties) is difficult to establish. Moreover, it might not be in every country's interest to limit the scope of Article 12. Due to the dissenting opinion, the Committee stated that "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."