E/C.18/2022/CRP.24

Distr.: General
03 October 2022

Original: English

Committee of Experts on International Cooperation in Tax Matters
Twenty-fifth session

Geneva, 18-21 October 2022
Item 3(c) of the provisional agenda
Issues related to the United Nations Model Double Taxation Convention between Developed and Developing Countries

The inclusion of computer software in the definition of royalties

Summary

At its 23rd Session, the Committee of Experts established the Subcommittee on the Update of the United Nations Model Double Taxation Convention between Developed and Developing Countries and agreed on certain priorities for the Subcommittee's work during this Membership of the Committee of Experts. Those priorities included continuing the work on a proposal to include computer software within the definition of royalties in paragraph 3 of Article 12.

At its 24th Session, the Committee approved the Subcommittee's work program, which included the proposal that the work on this issue proceed by having participants in the Subcommittee consider a series of examples to determine what would or would not be within the scope of a revised definition.

However, during the course of those discussions, it became clear that it would be necessary to take a step back to determine where there currently is agreement and disagreement regarding the application of the current definition in Article 12 with respect to computer software. Accordingly, the Subcommittee prepared this document to ask for further guidance from the Committee before continuing this work.

The Committee is therefore asked to ***decide*** whether:

a) the Subcommittee should work on developing an expanded definition of royalties that refers to computer software, such as that included in paragraph 16 of the Commentary on Article 12 of the UN Model, including relevant commentary on what would or would not be covered by such an expanded definition (without prejudging whether that expanded definition would be added to the text of Article 12 or be included as a minority position in the Commentary); or

b) the Subcommittee should instead consider making changes to the existing Commentary on Article 12 with a view towards modifying the results in the example found in paragraph 2 of this note to the effect that the payment constitutes a royalty.

I. Introduction

1. This note provides background regarding a long-standing proposal to include a specific reference to payments for the use of computer software in the definition of royalties in paragraph 3 of Article 12 of the United Nations Model Double Taxation Convention between Developed and Developing Countries (UN Model). The Subcommittee on the Update of the UN Model is seeking guidance from the Committee regarding how to proceed with the proposal. There was agreement within the Subcommittee that the goal of any work in this area should be to provide certainty to governments and taxpayers regarding when payments for the use of computer software will be treated as royalties within the meaning of Article 12. However, there are a number of different views regarding how to achieve such certainty, given that there is not agreement on when payments for computer software currently are covered by Article 12.

2. To illustrate, participants in the Subcommittee were asked to consider the following example:

> Company R is a software company that is a resident of State R. Its main product consists of a standardized suite of software encompassing basic office functions – e-mail, spreadsheets, word processing, etc. Most customers download the software from Company R's website. As a result, Company R has closed its distributors in many countries and has consolidated its activities in State R. Company S, a resident of State S, acquires the right to use Company R's software by paying to download the software onto its computers.[1]

3. Their different approaches to this example are described in Section II of this note. Section III sets out different options for taking the work forward. Section IV requests the views of the Committee on several questions.

II. Current Interpretations of Article 12 relating to Computer Software

4. The current definition of "royalties" in paragraph 3 of Article 12 does not refer to computer software. It reads:

> 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.

5. The Commentary on Article 12 of the UN Model quotes a large amount of text from the Commentary on Article 12 of the OECD Model. This text was adopted in the 2001 version of the UN Model and modified in 2011 to take into account changes that had been made to the OECD Commentary in the intervening years. This Commentary has always recognized that payments for computer software do not fit easily within the definition of royalties. Because the definition depends on the copyright law of the source State, it is likely that there will be disparate treatment in different countries. Accordingly, in a sense, the quoted Commentary can only identify issues that countries should address in order to achieve their goals,

[1] There is also some disagreement regarding the distribution of computer software, described in paragraph 13 of the Commentary on Article 12 of the UN Model, quoting paragraph 14.4 of the Commentary on Article 12 of the OECD Model, but the Subcommittee is not asking for guidance from the Committee on those issues at this time.

whether their goals are to ensure that tax can be imposed by the source State or to prevent the imposition of such tax. [2]

6. To aid in this analysis, the Commentary describes several requirements that would have to be met before payments for computer software would be covered by the definition of "royalties". First, before a payment could be made for the "use of…copyright", the computer software would have to be subject to copyright protection in the State in which it is used. The Commentary notes that most countries provide copyright protection for computer software.

7. The second requirement is that the computer software would have to constitute "literary, artistic or scientific work". The Commentary states that none of those categories seems "entirely apt" but notes that the copyright laws of many countries treat computer software as either a literary or scientific work. The Subcommittee has not been made aware of any issues that have been raised with respect to this requirement. Accordingly, there appears to be general agreement that at least some payments relating to computer software fall within the scope of Article 12.

8. The crux of the issue therefore relates to the third requirement, which is that the payment must be received "as a consideration for the use of, or the right to use, any copyright…" Even though this requirement is the most controversial in practice, there is substantial agreement on certain points. For example, there is broad agreement within the Subcommittee that, if Company S in the example above were granted a license to "reproduce and distribute to the public software incorporating the copyrighted program, or to modify and publicly display the program",[3] payments made by Company S in consideration of that right would constitute royalties.[4]

9. Thus, the primary difference of opinion regarding the scope of the current Commentary relates to situations, such as that described in paragraph 2 above, that do **not** involve commercial exploitation or the right to modify computer software. In some countries, the acquisition of rights to use computer software is denominated as a license, not a sale, even in the case of "shrink-wrapped software" (standardized computer software frequently used by retail customers, including individuals). Use of the software without acquiring such a license would constitute copyright infringement, so that some countries take the view that payments made to obtain rights to use the software, such as those in the example in paragraph 2, constitute "payments

[2] A number of bilateral tax treaties include a reference to computer software. However, some of those were entered into by countries that wanted to ensure that payments for computer software were not subject to tax at source (in treaties where the source State did not have a right to tax royalties) while others were entered into by countries seeking to impose such source State tax. The mere fact that "computer software" is included in a bilateral treaty does not, therefore, suggest anything about the motivations of the parties to the relevant treaty, or to the effect of such inclusion, without considering the parties' treaty policy and the other provisions of Article 12. For example, the 1996 U.S. Model Income Tax Convention included a reference to computer software in the definition of royalties while the 2006 U.S. Model Income Tax Convention did not, even though there was no change in policy regarding the United States' desire to ensure that payments for the use of computer software (and, in particular, shrink-wrapped software) would not be subject to taxation in the country of source in the absence of a permanent establishment.

[3] Paragraph 13 of the Commentary on Article 12 of the UN Model, quoting paragraph 14 of the Commentary on Article 12 of the OECD Model.

[4] Many of those who believe that this is the outer limit of what constitutes "use of copyright" use the shorthand "rights for commercial exploitation" or "rights to modify" to describe the test in the Commentary.

… for the right to use, any copyright of literary, artistic or scientific work" and therefore fall within the definition of royalties in paragraph 3 of Article 12.[5]

10. Those arguing against treatment of such payments as a royalty had to deal with the fact that, at the time the Commentary on software was being drafted, it was necessary in most cases for the user of computer software to copy the software onto his or her computer in order to use the software. Under the copyright law of many countries, the act of making that copy would be a violation of copyright in the absence of a license from the owner of the intangible. The Commentary argues that the making of that copy should be ignored. It states:

> 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.[6]

This theory is stated more clearly a few paragraphs later, with respect to digital products, where the Commentary states that "the main question to be addressed is the identification of that for which the payment is essentially made."[7] Those adopting this approach frequently compare the use of computer software to reading a book. Both the software and the book are subject to copyright, but neither the use of the software nor the reading of the book involves the "use…of copyright." In this view, the copyright in computer software is "used" only if the person making the payment is given the right to modify the software or to exploit it commercially. Under this view, in the example set out in paragraph 2, the payments would not be treated as royalties.

11. However, this approach is not universally accepted. The 2011 version of the Commentary on Article 12 of the UN Model included a short statement indicating that not all of the then-members of the Committee agreed with those interpretations. In the 2021 version, that short statement was elaborated. In particular, paragraph 15 of the Commentary on Article 12 of the UN Model now states the view of these members that:

> the situations described in paragraphs 14 and 14.2 [setting out the position described in paragraph 7 above] of the quoted OECD Commentary should give rise to royalties because, contrary to the conclusions in those paragraphs, the fact that the copying of the computer software or other digital product would constitute a violation of copyright if done without a license means that the user is using copyright when that user operates the program or downloads the digital product.[8]

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[5] In practice, however, few countries seem to impose tax on payments relating to shrink-wrapped software, perhaps because their domestic law provides an exemption, making the scope of the treaty provision irrelevant.

[6] Paragraph 13 of the Commentary on Article 12 of the UN Model, quoting paragraph 14 of the Commentary on Article 12 of the OECD Model.

[7] Paragraph 13 of the Commentary on Article 12 of the UN Model, quoting paragraph 17.1 of the Commentary on Article 12 of the OECD Model.

[8] It might also be noted that Greece, Mexico, Portugal, the Slovak Republic, and Spain have all registered observations on the OECD Commentary that call into question various aspects of the analysis set out in paragraph 10 of this note. Similarly, Argentina, Brazil, Colombia, India, Morocco, Serbia and Tunisia, which have set out their positions on the OECD Model, have indicated that they share some of the same views as those OECD members.

Under this view, in the example set out in paragraph 2, the payments would be treated as royalties. During the last membership of the Committee, this interpretation continued to be a minority position.

12. Finally, because the analysis set out in paragraph 11 depends on the act of copying the computer software to find that there has been a "use of copyright", technological advances may narrow considerably the circumstances in which payments may be found to be a royalty under that theory. In many cases, it no longer is necessary for the users of computer software to copy the software to their own computers. Instead, users now frequently can access software through an internet connection. A payment for the use of computer software in that case generally would constitute income from automated digital services that would be covered by Article 12B (if that provision is included in the relevant treaty) or Article 7. However, the argument set out in paragraph 9 does not depend on whether the software has been copied to the user's computer, and therefore would not be affected by this technological change.

III. Alternative Views regarding the Way Forward

13. Although there essentially are two different views regarding the correct interpretation of the current wording of paragraph 3 of Article 12, there are (roughly) five views regarding the issue of whether the text of Article 12 of the UN Model or its Commentaries should be changed in some way.

14. The first view is that paragraph 13 of the Commentary on Article 12 of the UN Model, quoting the OECD Commentary, is incorrect as a technical matter and as a matter of policy. Those holding this view would argue for deleting certain portions of that Commentary, starting with the last three sentences of paragraph 14 of the Commentary on Article 12 of the OECD Model (quoted in paragraph 13 of the Commentary on Article 12 of the UN Model). Adopting this view would also mean deleting the alternative provision developed by the last membership of the Committee which is described in paragraph 16 of the Commentary on Article 12 of the UN Model.

15. A second view is that paragraph 13 of the Commentary on Article 12 of the UN Model provides a result in the example set out in paragraph 2 that is incorrect as a matter of policy, but that the solution lies in changing the result for the future. Those holding this view support a change to the definition of royalties that includes payments for the "use of computer software" which no longer depends on the "use of copyright" in computer software. They may or may not be convinced by the argument that copying software to one's own computer does not constitute a "use" of copyright, but they generally believe that changing Commentary that has been in the UN Model for many years would lead to further disruption or confusion, not certainty. There was sufficient support for this position during the last membership of the Committee to add an alternative provision to the Commentary for use by countries holding this view. Paragraph 16 of the Commentary on Article 12 of the UN Model states:

> In the view of a large minority of the members of the Committee, Article 12 should allow for source State taxing rights even in cases where the user of computer software is not exploiting the copyright in the software. In their view, Article 12 is intended to cover payments for the letting of property, which is broader than use of the copyright. For example, if a company that is a resident of State S uses in its business human resources software that is owned by a company that is a resident of State R, payments made for that use would not be covered by the current definition of royalties in paragraph 3 of Article 12. In their view, Article 12 should address circumstances in which the owner of the computer software earns profits from letting another person use that computer software, without having the owner establish any presence in the State where it is used, or where the

> user resides, which would satisfy the requirements of Article 5 for the existence of a permanent establishment. In the view of those Members, a person that is making payments for the use of, or the right to use, computer software is making a payment in consideration for the letting of that intangible property just as a person that is making payments for the use of industrial, commercial or scientific equipment (already included in paragraph 3) is making a payment in consideration for the letting of tangible property. States sharing this view may want to include at the end of paragraph 3 the following sentence:
>
> > The term also includes payments of any kind received as consideration for the use of, or the right to use, any computer software, or the acquisition of any copy of computer software for the purposes of using it.

Those holding this position would support continuing technical work on defining what is included within the scope of this alternative provision and possibly revising the text of Article 12 itself if there is sufficient support to do so.

16. A third view is that the current Commentary is correct as a technical matter and as a matter of policy. Those holding this view do not see a need to make any changes to the Model, including its Commentary. However, they do not object to continuing discussions in the Subcommittee on the technical issue of what is covered by the alternative provision set out in paragraph 16 of the Commentary on Article 12 of the UN Model.

17. The fourth and fifth views agree that the current Commentary is correct as a technical matter, but differ from the third view in that they are more open to the possibility that there are policy justifications for expanding the scope of Article 12 to cover the example in paragraph 2 of this note. Those holding this view would like to continue the technical discussions in the Subcommittee, on which substantial progress was made during the Subcommittee's June meeting. Some of those falling into this category (the fourth view) might be open to making a change to the text of paragraph 3 of Article 12 to refer to computer software if it is possible to provide sufficient certainty regarding the scope of such a provision. However, others (the fifth view) would add some additional guidance after paragraph 16 of the Commentary regarding the scope of that provision, but would not support a change to the text of the UN Model.

18. To summarize, those holding views two to five set out in paragraphs 15 to 17 above support continuing technical work limited to defining the scope of payments that would be covered by a definition of royalties that has been expanded to cover payments for computer software, while leaving open the question of whether such an expanded definition would be included as an alternative provision in the Commentary or would appear in the text of Article 12 of the UN Model. The majority of those who spoke during the Subcommittee's meeting on 16 September 2022 held one of those four views.

19. However, there was also a small but vocal minority who supported the first view set out in paragraph 14 of this note. Accordingly, the Subcommittee agreed to ask the Committee for guidance regarding the Subcommittee's next steps in taking this work forward.

IV. Questions for the Committee

20. The Committee is therefore asked to decide whether:

> a) the Subcommittee should work on developing an expanded definition of royalties that refers to computer software, such as that included in paragraph 16 of the Commentary on Article 12 of the UN Model, including relevant commentary on what would or would not be covered by such an

expanded definition (without prejudging whether that expanded definition would be added to the text of Article 12 or be included as a minority position in the Commentary); or

b) the Subcommittee should instead consider making changes to the existing Commentary on Article 12 with a view towards modifying the results in the example found in paragraph 2 of this note to the effect that the payment constitutes a royalty.