E/C.18/2021/CRP.9

Distr.: General
8 April 2021

Original: English

Committee of Experts on International Cooperation in Tax Matters
Twenty-second session
Online meeting of 19 to 28 April 2021
Item 3(b) of the provisional agenda
Update of the UN Model Double Taxation Convention between Developed and Developing Countries

Update of the UN Model Double Taxation Convention between Developed and Developing Countries – Inclusion of computer software payments in the definition of royalties

Note by the Subcommittee on the UN Model Tax Convention between Developed and Developing Countries

Summary

This note is presented FOR DISCUSSION AND DECISION at the twenty-second session of the Committee to be held online from 19 to 28 April 2021.

The note includes a revised version of the proposal for inclusion of computer software payments in the definition of royalties and a draft Commentary. However, a majority of the Subcommittee could not recommend that the proposal and Commentary be adopted in their current form. The note explains what led the Subcommittee to that conclusion so that the Committee can reach an informed decision with respect to the issue.

1. At the 21st session of the Committee of Experts on International Cooperation in Tax Matters, the Committee discussed note E/C.18/2020/CRP.38 (Inclusion of Software Payments in the Definition of Royalties). The draft report of the 21st session notes:

> The Secretariat noted that the great majority of interventions supported continuing the work on the proposal, with a view to reaching a decision on the proposed change to the definition of royalties and the consequential Commentary changes at the twenty-second session. It also proposed that such work be carried on by the Subcommittee on the basis of a paper to be prepared by the Secretariat. That paper would include proposed Commentary and could also include changes to the proposal intended to address technical issues, such as the treatment of software that forms part of tangible goods and the fact that the domestic law of some States differed on the question of whether the transfer of software to an end-user should be considered as the acquisition of property or as a license…The paper would be presented for first discussion by the Subcommittee at a meeting that would ideally take place in February 2021, which would allow further changes to be made before the proposal is presented to the Committee for decision. This proposal was accepted.

2. In order to develop this paper, the Secretariat first circulated a questionnaire to participants in the Subcommittee on the Update of the UN Model, using the responses from participants in the Subcommittee to prepare a first draft of a revised proposal and Commentary. After meeting on 3-5 February to discuss that draft, the Subcommittee decided that it would be useful to receive additional technical input before making a recommendation to the full Committee. It therefore released for public comment a discussion draft which included a proposed revision to the definition of "royalties" and a draft Commentary on the proposed definition. Comments on the discussion draft and revisions of the Commentary were reviewed at further meetings of the Subcommittee held 22-24 March and 6 April 2021, after which the Subcommittee produced this note for consideration by the full Committee of Experts.

3. During its meetings, the Subcommittee considered a number of technical issues relating to the proposal itself, as anticipated in the directive from the Committee, as well as with respect to the Commentary. These issues generally relate to the treatment of computer software that is embedded in physical goods or that is bundled with the acquisition of other goods and services, which requires line-drawing between Article 12 and Articles 7, 12A, 12B and 14. Although the Subcommittee had productive discussions around these issues, there was not sufficient time to draft a full Commentary on which the Subcommittee could agree; therefore a majority of the members of the Subcommittee believe that further technical work is necessary before the Committee can make an informed decision as to whether to adopt the proposal.

4. Accordingly, a majority of the Subcommittee found that they could not recommend that the proposal and its Commentary be adopted in its current form. However, because some countries already include computer software within the definition of royalties in their

bilateral treaties, it was believed that it would be useful for the technical work to continue. They also believe that the work that has been done, reflected in the draft Commentary, should not be discarded. At the same time, it must be noted that a minority of the participants in the Subcommittee disagree with the proposal to include computer software in the definition of royalties as a matter of principle. On the other hand, a minority of the participants in the Subcommittee would adopt the modified proposal and Commentary in its current form; if the Committee does not adopt the proposal, those members of the Committee would want to include a minority view in the Commentary on Article 12, as described in Section 3 of the note, in the 2021 version of the UN Model.

5. The Committee is invited to consider these various views in deciding how to proceed on this issue.

Table of Contents

1. Background

1. The detailed background of work describing the work on this issue from the ninth Session of the Committee in October 2011 up to now is contained in E/C.18/2020/CRP.13 (i.e. the paper presented for the Committee's 20th Session in June 2020). At the 21st session of the Committee of Experts on International Cooperation in Tax Matters, the Committee discussed note E/C.18/2020/CRP.38 (Inclusion of Software Payments in the Definition of Royalties). The draft report of the 21st session notes:

> 40. Ms. Peters introduced note E/C.18/2020/CRP.38 on the application of Article 12 of the UN Model to software payments. The Secretariat recalled the discussion of the topic at the twentieth session, when it was decided that work should focus on a proposal for changing the definition of royalties in order to include a reference to payments for the use of, or the right to use, software payments. A note including the proposed change and the arguments for and against it was subsequently drafted by the Subcommittee and released as a discussion draft on 1 September 2020. The comments received by 4 October were presented at the virtual meeting of the Subcommittee held on 7 October, when it was decided to ask for a Committee decision at this session on whether and how to pursue the work on this topic.
>
> 41. A number of Members and observers intervened on this issue. While a large majority of Members supported continuing the work on the proposal, there were differing views on the proposal.
>
> 42. While some Members considered that it was time to reach a decision on the proposal, a number of Members indicated that they needed more time to consider the issues raised by the comments in particular and the impact of the proposal on the Commentary to the Model.
>
> 43. One observer who supported the proposal argued that the Commentary should specify that the proposed change was merely a clarification, which would ameliorate issues arising from the wording of existing treaties. He also suggested adopting a broad interpretation of the phrase "in consideration of" so that Article 12 could apply to situations where software is provided free of charge.
>
> 44. The Secretariat noted that the great majority of interventions supported continuing the work on the proposal, with a view to reaching a decision on the proposed change to the definition of royalties and the consequential Commentary changes at the twenty-second session. It also proposed that such work be carried on by the Subcommittee on the basis of a paper to be prepared by the Secretariat.
>
> 45. That paper would include proposed Commentary and could also include changes to the proposal intended to address technical issues, such as the treatment of software that forms part of tangible goods and the fact that the domestic law of some States differed on the question of whether the transfer of software to an end-user should be considered as the acquisition of property or as a license.

2. This note has been produced in accordance with that decision. Section 2 includes a revised version of the proposal for changes to the definition of royalties found in Art. 12(3) of the UN

Model and the proposed paragraphs of the UN Commentary on Article 12 relating to software and to digital content, marked to show changes (in ***bold italics*** or ~~strikethrough~~). Section 3 contains an alternative for the consideration of the Committee – a proposed version of a minority view with slightly different drafting and shorter Commentary.

2. Proposal for Inclusion of Computer Software in the Definition of Royalties

a. Proposed Change to the Treaty Text

3. The discussion draft of 1 September 2020 suggested simply adding the words "computer software" to the existing definition of the term "royalties" in paragraph 3 of Article 12 of the UN Model, so that paragraph 3 would have read as follows:

> 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, trade mark, design or model, plan, secret formula or process, ***computer software*** or for the use of, or the right to use, industrial, commercial or scientific equipment or for information concerning industrial, commercial or scientific experience.

4. Some comments suggested that the paragraph as a whole had become difficult to parse and that it would benefit from breaking out the separate types of property referred to in the definition of "royalties" for purposes of the UN Model. Separating out payments with respect to different types of property would also facilitate the common practice of providing different withholding rates for different categories of royalties. The Subcommittee therefore developed a revised proposal, which reads as follows:

> The term "royalties" as used in this Article means payments of any kind received as a consideration for***:***
>
> (a) the use of, or the right to use,
>
> ***i)*** any copyright of literary, artistic or scientific work including cinematograph films, or films or tapes used for radio or television broadcasting***;***
>
> ***ii)*** any patent, trademark, design or model, plan, or secret formula or process***;*** or
>
> ***iii)*** industrial, commercial or scientific equipment; or
>
> ~~iv) computer software~~;
>
> (b) information concerning industrial, commercial or scientific experience, ***or***
>
> (c) ***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.

For the reasons described in paragraph 17 of the proposed Commentary on Article 12 of the UN Model found in Section 2, subparagraph (c) refers not only to the use of, or the right to use, computer software, but also to the acquisition of computer software for the acquiror's own use in order to provide for consistent treatment of economically equivalent transactions that take different legal forms. It does not,

however, apply to other acquisitions of computer software, such as the acquisition of computer software for the purpose of distribution in the absence of a right to reproduce the computer software. This result is similar to the result in paragraph 14.4 of the Commentary on Article 12 of the 2017 OECD Model Convention and is discussed in paragraph 20 of the proposed Commentary in Section 2.

b. Proposed Changes to the Commentary on Article 12

5. The portions of the Commentary on Article 12 that are relevant to the treatment of computer software would be modified as follows:

Paragraph 3

12. This paragraph ~~reproduces~~ ***corresponds to*** Article 12, paragraph 2, of the OECD Model Convention~~,~~ ***but, as explained below, includes specific references to industrial, commercial or scientific equipment and to computer software,[1] which are not referred to in the OECD definition. It therefore*** does not incorporate the 1992 amendment ***to the OECD definition that*** ~~which~~ eliminate***d***~~s~~ equipment rental from ***the definition*** ~~this Article~~. ~~Also, paragraph 3 of Article 12 includes payments for tapes and royalties which are not included in the corresponding provision of the OECD Model Convention.~~ ***It expands the coverage of the definition with respect to computer software beyond payments for the use of, or the right to use, a copyright in computer software to include payments for which the copyright is not exploited. Paragraph 3 of the UN Model also breaks out separate types of property referred to in the definition of "royalties" for purposes of this Model. This structure was viewed as making the definition easier to read and apply as well as accommodating the common practice of providing different withholding rates for different categories of royalties.*** ~~The following portions of the OECD Commentary are relevant (the bracketed paragraphs being portions of the Commentary that highlight differences between the United Nations Model Convention and the OECD Model Convention.~~ ***The Committee considers that the following part of the Commentary on Article 12 of the 2017 OECD Model Convention is applicable to Article 12 of this Model (the modifications that appear in square brackets, which are not part of the Commentary on the OECD Model Convention, have been inserted in order to provide additional explanations or to reflect the differences between the provisions of the OECD Model Convention and those of this Model):***

> 8. Paragraph 2 contains a definition of the term "royalties". These relate, in general, to rights or property constituting the different forms of literary and artistic property, the elements of intellectual property specified in the text***[, industrial, commercial or scientific equipment]*** and information concerning industrial, commercial or scientific experience. The definition applies ***[for instance]*** to payments for the use of, or the entitlement to use, rights ***[and property]*** of the kind mentioned, whether or not they have been, or are required to be, registered in a public register. ***[Subdivisions (a)(i) and (ii) of the]*** ~~The~~ definition cover~~s~~ both payments made under a licence and compensation which a person would be obliged to pay for fraudulently copying or infringing the right.
>
> …

[1] The Committee has not reached an agreement on the proposal to amend the definition of "royalties" in this manner. In order to provide a draft Commentary, however, it is necessary to assume that such a decision has been made.

8.4 As a guide, certain explanations are given below in order to define the scope of Article 12 in relation to that of other Articles of the Convention, as regards, in particular, [equipment renting and] the provision of information.

…

10. Rents in respect of cinematograph films are also treated as royalties, whether such films are exhibited in cinemas or on the television. It may, however, be agreed through bilateral negotiations that rents in respect of cinematograph films shall be treated as business profits and, in consequence, subjected to the provisions of Articles 7 and 9***[or 12B]***.

…

11.5 In the particular case of a contract involving the provision, by the supplier, of information concerning computer programming, as a general rule the payment will only be considered to be made in consideration for the provision of such information so as to constitute know how where it is made to acquire information constituting ideas and principles underlying the program, such as logic, algorithms or programming languages or techniques, where this information is provided under the condition that the customer not disclose it without authorisation and where it is subject to any available trade secret protection.

11.6 In business practice, contracts are encountered which cover both know-how and the provision of technical assistance. One example, amongst others, of contracts of this kind is that of franchising, where the franchisor imparts his knowledge and experience to the franchisee and, in addition, provides him with varied technical assistance, which, in certain cases, is backed up with financial assistance and the supply of goods. The appropriate course to take with a mixed contract is, in principle, to break down, on the basis of the information contained in the contract or by means of a reasonable apportionment, the whole amount of the stipulated consideration according to the various parts of what is being provided under the contract, and then to apply to each part of it so determined the taxation treatment proper thereto. If, however, one part of what is being provided constitutes by far the principal purpose of the contract and the other parts stipulated therein are only of an ancillary and largely unimportant character, then the treatment applicable to the principal part should generally be applied to the whole amount of the consideration.

12. Whether payments received as consideration for computer software may be classified as royalties poses difficult problems but is a matter of considerable importance in view of the rapid development of computer technology in recent years and the extent of transfers of such technology across national borders**…** ~~In 1992, the Commentary was amended to describe the principles by which such classification should be made. Paragraphs 12 to 17 were further amended in 2000 to refine the analysis by which business profits are distinguished from royalties in computer software transactions. In most cases, the revised analysis will not result in a different outcome.~~

12.1 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.

The Committee notes that, since the original adoption of paragraph 12.1 by the OECD, it has become increasingly common for copies of software to be delivered via digital download or to be accessed remotely.

13. In 2021, the Committee of Experts[2] agreed to amend paragraph 3 to include specific references to computer software in new subparagraph (c), which does not require the copyright in such computer software to be exploited, for the reasons described in paragraph 14. However, payments in consideration for the use of, or the right to use, a copyright of computer software may also be covered by subdivision (a)(i). Accordingly, the Committee considers that the following part of the Commentary on Article 12 of the 2017 OECD Model is applicable for purposes of interpreting subdivision (a)(i) of paragraph 3 of Article 12 of this Model with respect to computer software (the modifications that appear in square brackets, which are not part of the Commentary on the OECD Model Convention, have been inserted in order to provide additional explanations or to reflect the differences between the provisions of the OECD Model Convention and those of this Model):

12.2 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 program. The rights in computer programs are a form of intellectual property. Research into the practices of OECD member countries has established that all but one protects rights in computer programs either explicitly or implicitly under copyright law. Although the term "computer software" is commonly used to describe both the program—in which the intellectual property rights (copyright) subsist—and the medium on which it is embodied, the copyright law of most OECD member countries recognises a distinction between the copyright in the program and software which incorporates a copy of the copyrighted program. Transfers of rights in relation to software occur in many different ways ranging from the alienation of the entire rights in the copyright in a program to the sale of a product which is subject to restrictions on the use to which it is put. The consideration paid can also take numerous forms. These factors may make it difficult to determine where the boundary lies between software payments that are properly to be regarded as royalties and other types of payment. The difficulty of determination is compounded by the ease of reproduction of computer software, and by the fact that acquisition of software frequently entails the making of a copy by the acquirer in order to make possible the operation of the software.

13. The transferee's rights will in most cases consist of partial rights or complete rights in the underlying copyright (see paragraphs 13.1 and 15 below), or they may be (or be

[2] The references to "the Committee of Experts", "majority" and "minority" in paragraphs 13, 14, 15 and 19 will be adjusted after the 22nd Session of the Committee in April 2021.

equivalent to) partial or complete rights in a copy of the program (the "program copy"), whether or not such copy is embodied in a material medium or provided electronically (see paragraphs 14 to 14.2 below). In unusual cases, the transaction may represent a transfer of "know-how" or secret formula (paragraph 14.3).

13.1 Payments made for the acquisition of partial rights in the copyright (without the transferor fully alienating the copyright rights) will represent a royalty ***[in accordance with subdivision (a)(i) of paragraph 3 of Article 12 of this Model]*** where the consideration is for granting of rights to use the program in a manner that would, without such license, constitute an infringement of copyright. Examples of such arrangements include licenses to reproduce and distribute to the public software incorporating the copyrighted program, or to modify and publicly display the program. In these circumstances, the payments are for the right to use the copyright in the program (i.e. to exploit the rights that would otherwise be the sole prerogative of the copyright holder). It should be noted that where a software payment is properly to be regarded as a royalty there may be difficulties in applying the copyright provisions of the Article to software payments since paragraph 2 requires that software be classified as a literary, artistic or scientific work. None of these categories seems entirely apt. The copyright laws of many countries deal with this problem by specifically classifying software as a literary or scientific work. For other countries treatment as a scientific work might be the most realistic approach. Countries for which it is not possible to attach software to any of those categories might be justified in adopting in their bilateral treaties an amended version of paragraph 2 which either omits all references to the nature of the copyrights or refers specifically to software.

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 ***[in accordance with subdivision (a)(i) of paragraph 3 of Article 12 of this Model]…*** ~~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~~ ***[outside the scope of subdivision (a)(i) but could be covered by subparagraph (c) of the definition of royalties.]***

14.3 Another type of transaction involving the transfer of computer software is the more unusual case where a software house or computer programmer agrees to supply information about the ideas and principles underlying the program, such as logic, algorithms or programming languages or techniques. In these cases, the payments may be characterised as royalties to the extent that they represent consideration for the use of, or the right to use, secret formulas or for information concerning industrial, commercial or scientific experience which cannot be separately copyrighted. This contrasts with the ordinary case in which a program copy is acquired for operation by the end user.

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.

A [XX minority] of the Committee of Experts are of the view that the payments referred to in paragraphs 14, 14.1, 14.2 and 14.4 of the OECD Commentary extracted above may constitute royalties under subdivision (a)(i) of paragraph 3. Their view in respect of paragraphs 14, 14.2 and 14.4 is that there is a use or right to use copyright in those situations, even though it may be to enable the user to operate the program or download the digital product. In their view, it cannot be said that payment is a consideration only for the use of software or copyrighted article and not for using the copyright, when without use of copyright there cannot be any use of the copyrighted article. It is not practicable to

disaggregate the payment towards consideration for various uses in such situations. They view the purpose for which the software is copied as irrelevant for characterizing the payment. Further, they believe that commercial exploitation of a copyright by the user is not a requirement for characterizing the payment for the copyright as royalties. In respect of paragraph 14.4, the payments in question are viewed by them to be in the nature of royalties as the right to distribute is a use of a copyright, which is a valuable economic right of the copyright owner which exists independent of other rights in the copyright, including the copying right and the exhibition right.

14. In the view of a [majority] of the Members of the Committee, the addition of subparagraph (c) is necessary to allow for source State taxing rights 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 subdivision (a)(i) but would be covered by subparagraph (c) of paragraph 3. Accordingly, subparagraph (c) addresses 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. Subparagraph (c) therefore serves the same function with respect to computer software as subdivision (a)(iii) serves with respect to industrial, commercial or scientific equipment. In the view of those Members, a person that is making payments for the use of, or the right to use, computer software described in subparagraph (c) is making a payment in consideration for the letting of that intangible property just as a person that is making payments covered by subdivision (a)(iii) is making a payment in consideration for the letting of tangible property. For the reasons described in paragraph 17 below, subparagraph (c) also refers to the acquisition of computer software for the acquiror's own use to provide for consistent treatment of economically equivalent transactions that take different legal forms.

15. A [XX minority] of the Committee opposed including an explicit reference to software in paragraph 3. In general, they believe that it is appropriate to focus on the business of the entity allowing the use of the software or selling a copy of the software, and that entity should not be taxable in the source State unless it has a permanent establishment in that State; in that case net taxation would be allowed under Article 7 rather than the gross basis taxation that usually applies under Article 12. They point to the arguments against the imposition of a gross basis withholding tax on royalties generally that are described in paragraphs 6 to 9 and 11 of the UN Commentary on Article 12 and conclude that they apply equally with respect to payments for computer software. Therefore, they agree with the distinction made by Paragraphs 13.1 and 14 of the OECD Commentary between the use of a copyright right and the use of a copyrighted article, comparing the acquisition of standardized computer software to the purchase of a product such as a book and arguing that both should give rise to business profits, not royalties. They also do not agree that it is appropriate to compare computer software with industrial, commercial or scientific equipment.

16. Another set of concerns is that the proposed definition may not provide adequate clarity, making it challenging to administer and resulting in more, rather than fewer, disputes and that there is more risk of overlap with other Articles of the convention than with respect to other types of payments covered in Article 12. In addition, some were concerned about 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 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 that are generally of low value. Those who share this last concern may want to redraft subparagraph (c) to exclude the personal use of computer software by individuals, as in the following:

> ***(c) 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, unless the consideration is paid by an individual for computer software for the personal use of an individual.***

17. The user may access computer software through a physical medium or by downloading it through the internet or an intranet. As noted in paragraph 14.1 of the Commentary on Article 12 of the 2017 OECD Model set out above, the method by which the computer software is transferred to the transferee is not relevant to the categorization for purposes of Article 12. Therefore, it should not matter whether a user downloads computer software under what is legally a "license" to use that software under domestic law, or "purchases" a copy of computer software which that user is entitled to use as its legal owner. In the latter case, any computer file, CD-ROM or other medium containing the copy of the computer software that is purchased is the means by which the owner of that copy can access the computer software, which is the object of the transaction. Because the domestic law can vary in how it treats these economically equivalent transactions, and in some countries it may not be clear whether computer software is transferred by sale or by license, subparagraph (c) refers to an acquisition of computer software for the acquiror's own use as well as the use of computer software in order to provide for consistent and reciprocal treatment.

18. Under subparagraph (c) of paragraph 3 of Article 12, payments made for computer software by the user of that software will always represent a royalty, without regard to whether the consideration is for the granting of rights to use the software in a manner that would, without such license, constitute an infringement of copyright. Thus, as under the OECD Model, the term "royalties" will include payments under arrangements that include licenses to reproduce and distribute to the public software incorporating a copyrighted program, or to modify and publicly display the program. In these circumstances, the payments are for the right to use the copyright in the program (i.e. to exploit the rights that would otherwise be the sole prerogative of the copyright holder). However, the addition of subparagraph (c) to paragraph 3 of the UN Model eliminates the distinction, with respect to computer software, between the use of the copyright and the acquisition or use of the copyrighted article. Under paragraph 3 of the 2017 OECD Model and its Commentary, if a resident of State S makes a payment to a resident of State R that allows the State S resident to use standardized computer software owned by the State R resident, those payments generally would be treated as business profits, not as royalties, that would not be taxable in State S under Article 7 unless the State R resident has a permanent establishment therein. The addition of subparagraph (c) would allow taxation by State S in those circumstances.

19. Moreover, as a result of the addition of subparagraph (c), the definition of "royalties" in paragraph 3 includes payments with respect to software that is transferred through a "program copy", a result different from that in paragraph 14 of the OECD Commentary on Article 12. Similarly, the definition would encompass payments for "site licenses", "enterprise licenses", or "network licenses", which, according to paragraph 14.2 of the OECD Commentary, are not treated as royalties for purposes of paragraph 2 of Article 12 of the OECD Model.

20. The words "for the purposes of using it" at the end of subparagraph (c) are 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. A [XX minority] of the members of the Committee disagree with the analysis in paragraph 14.4 of the Commentary on Article 12 of the 2017 OECD Model Convention. In their view, 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. Those taking this position therefore would delete the words "for the purposes of using it."

21. As described in the preceding paragraphs, the most common transactions to which subparagraph (c) will apply are payments for the use or acquisition of operating or application software ("apps") to perform functions on traditional computers – mainframes, desktops and the various forms of personal computers, such as laptops, tablets, smartphones and video game consoles. However, it is increasingly common for software to be embedded in physical goods or for rights to use software to be granted in conjunction with other transactions. In those cases, the right to tax payments for computer software provided in subparagraph (c) could result in very different taxation of the various components of the transaction. Various principles already laid out in the Commentary on Article 12 of this Model can be used to analyze such transactions.

22. In some cases, it will be possible to resolve the issue by identifying the consideration "for which the payment is essentially made", as described in paragraph 17.1 of the Commentary on Article 12 of the 2017 OECD Model (extracted in paragraph 30 below). For example, many consumer goods contain embedded computers and related software that improve the performance of the good or provide additional functionality (such as advanced electronics in an automobile or an automatic timer on a coffeemaker). Because this transaction is for the purchase of the good and, as such, not for the purchase of the embedded software, the purchase price of such goods should be treated as business profits taxable under Article 7 rather than disaggregated and taxed partially under Article 12. (See paragraph 17 of the OECD Commentary on Article 12, extracted in paragraph 23 below, for guidance with respect to software bundled with the sale of computer hardware.) However, the separate or subsequent payment for the use of a copy of computer software, for example a program that helps to boost horsepower that can be downloaded to an automobile's on-board computer, would be covered by the definition in paragraph 3.

23. The same principle can be applied to other cases in which no separate charge is made for computer software, such as an app that can be downloaded to a smartphone, which serves as a bridge that facilitates access to goods or services. For example, an individual downloads an app and inputs payment card information that allows seamless access to a hotel reservation system or an on-line intermediation platform for home rentals. In those cases, the payments made by the individual are essentially made as consideration for the stay in the hotel or in the home of the user subscribing to the intermediation platform offering his home for rent, which is evidenced by the fact that a similar price would be paid if the hotel reservation has been made in person or by phone. Subparagraph (c) would not apply in those situations.

24. A similar example in which there may be no separate charge for computer software, because its use benefits the owner of the software, is in connection with the performance of various services, for which there is a charge. For example, many types of equipment include sensors that track usage of the equipment in order to predict when maintenance will be required so as to avoid breakdowns that disrupt service. In many cases, the related software is provided to the owner of the equipment by a company that is under contract to provide maintenance services. In those cases, there may be no

charge to the owner of the equipment for the use of the software because the software primarily benefits the maintenance company, which effectively bears the risk of breakdowns. Similarly, a person who subscribes to, and pays for, remote exercise classes that can be accessed through software installed on separately-purchased exercise equipment is paying for a service, not for the use of the software.

25. As the transactions described in the preceding paragraphs demonstrate, in transactions between unrelated parties, the contracts between the parties will reflect the value that the parties place on the provision of computer software. That is, if a business is not charging an unrelated party for computer software that it is providing, it can be assumed that the owner of the software is benefiting in some other way from providing the software. For that reason, subparagraph (c) generally should apply to transactions between parties dealing at arm's length only when there is a contractually-required, separately-invoiced payment for the use of computer software. Governments should impute a payment for computer software only in cases where the contracts do not accurately reflect the economic relationships between the parties.

26. The addition of subparagraph (c) creates the possibility of overlap between different portions of the definition. For example, if the copyright laws of a Contracting State classify software as a literary or scientific work, then payments with respect to use of the copyright could be covered by both subdivision (a)(i) and subparagraph (c). Similarly, the supply of logic, algorithms or programming languages or techniques described in paragraph 14.3 of the OECD Commentary could be covered by both subparagraphs (b) and (c). If, is as often the case, different withholding rates apply to different categories of royalties, negotiators will want to consider how best to clarify which rate will apply to such payments, perhaps by excluding payments for computer software from subdivision (a)(i) or excluding payments covered by (a)(i) from subparagraph (c).

27. There also are possible overlaps between the provisions of Articles 12, 12A and 12B. Paragraph 7 of Article 12B provides that payments covered by Articles 12 and 12A are excluded from the scope of Article 12B. For example, a payment in consideration for the online acquisition of a copy of standardized accounting software for use in a business would be within the scope of Article 12 and therefore would be excluded from Article 12B. Because the purpose of the transaction was the acquisition of a copy of the software for the use of the payor, Article 12 would apply to the payment, which would therefore be excluded from the scope of Article 12B, by reason of Article 12B(5). However, Article 12 does not apply to the free downloading of software to facilitate what is fundamentally a different type of transaction, such as the acquisition of goods or the receipt of services. Thus, if a merchant provides free application software to facilitate the on-line purchase of goods, sales of such goods will give rise to business profits which are subject to Article 7 (see paragraph 60(iv) of the Commentary on Article 12B). Similarly, free downloads of application software to access online intermediation platform services or online gaming, which are intended to facilitate automated digital services would not implicate Article 12, so that the entire profit would fall within the scope of Article 12B. However, if the user makes a separate payment in order to download the application software, that payment would be subject to Article 12.

28. There is less risk of overlap between Article 12 and Article 12A or Article 14 as regards payments for computer software, because Articles 12A and 14 apply to the provision of services, such as software consulting, that involve human input, while Article 12 relates to the use of property. Thus, if a resident of a source State hires a resident of another State to develop or modify computer software owned by that source State resident, payments made under that contract for services will be covered by Article 12A (or Article 14, if the requirements of that article are met), not Article 12, as "one of the

parties undertakes to use the customary skills of his calling to execute work" for the other party (see paragraph 11.2 of the OECD Commentary on Article 12). However, if the resident of the other Contracting State owns computer software which it has already developed, and licenses that computer software to the source State resident for its own use, without further modification, payments made under that arrangement will be subject to Article 12. Finally, if, in the second case, the resident of the source State requests modifications to the computer software in order to meet the needs of its business, then any payments made with respect to those modifications would fall within Article 12A or Article 14.

29. The Committee considers that the following part of the Commentary on Article 12 of the 2017 OECD Model Convention is applicable to Article 12 of this Model, including with respect to computer software (the modifications that appear in square brackets, which are not part of the Commentary on the OECD Model Convention, have been inserted in order to provide additional explanations or to reflect the differences between the provisions of the OECD Model Convention and those of this Model):

> 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***.6*** 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.

A [XX minority] of the Committee of Experts are of the view that the payments referred to in paragraphs 15 and 16 of the OECD Commentary extracted above may constitute royalties without regard to subparagraph (c).

30. In 2021, the Committee of Experts agreed to introduce Article 12B, addressing automated digital services. As a result, the downloading of some digital content is covered in Article 12B. However, because Article 12B(5) provides that "income from automated digital services" does not include payments qualifying as "royalties", it is still necessary to determine the extent to which the download of digital material constitutes the use of a copyright, in which case a payment for such download would be covered by subdivision (a)(i) of paragraph 3 of Article 12. Payments for digital downloads of computer software may also constitute royalties under subparagraph (c) of paragraph 3 of Article 12. (See paragraphs 17 to 21 above.) In other cases, payments in consideration for the download of digital content would constitute "income from automated digital services" or "business profits", taxable under Article 12B or Article 7, respectively. To aid in making those distinctions, the Committee considers that the following part of the Commentary on Article 12 of the 2017 OECD Model Convention is applicable to Article 12 of this Model (the modifications that appear in square brackets, which are not part of the Commentary on the OECD Model Convention, have been inserted in order to provide additional explanations or to reflect the differences between the provisions of the OECD Model Convention and those of this Model):

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 ***[subdivision (a)(i) of]*** 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 ***[under subdivision (a)(i) of paragraph 3 of Article 12 of this Model]*** but falls within ***[subparagraph (c) of that paragraph or, if that is not the case, within]*** Article 7***[, 12B]*** 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" ***[under subdivision (a)(i)]***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.

17.4 By contrast, transactions where the essential consideration for the payment is the granting of the right to use a copyright in a digital product that is electronically downloaded for that purpose will give rise to royalties. This would be the case, for example, of a book publisher who would pay to acquire the right to reproduce a copyrighted picture that it would electronically download for the purposes of including it on the cover of a book that it is producing. In this transaction, the essential consideration for the payment is the acquisition of rights to use the copyright in the digital product, i.e. the right to reproduce and distribute the picture, and not merely for the acquisition of the digital content.

Because Article 12B(5) provides that payments described in Article 12 are excluded from Article 12B, payments described in paragraph 17.4 continue to be subject to Article 12, notwithstanding that they may also be described in paragraphs 5 and 6 of Article 12B. A [XX minority] 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, without regard to subparagraph (c).

3. Alternative Minority View

6. If the Committee does not agree to adopt the proposal in Section 2, then those who support the inclusion of computer software suggest that the following minority view be included in paragraph 12 of the Commentary to Article 12 and a new paragraph 13, immediately following paragraph 17.4 of the Commentary on Article 12 of the 2017 OECD Model Convention extracted therein:

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. ***Their view in respect of paragraphs 14, 14.2 and 14.4 is that there is a use or right to use copyright in those situations, even though it may be to enable the user to operate the program or download the digital product. In their view, it cannot be said that payment is a consideration only for the use of software or copyrighted article and not for using the copyright, when without use of copyright there cannot be any use of the copyrighted article. It is not practicable to disaggregate the payment towards consideration for various uses in such situations. They view the purpose for which the software is copied as irrelevant for characterizing the payment. Further, they believe that commercial exploitation of a copyright by the user is not a requirement for characterizing the payment for the copyright as royalties. In respect of paragraph 14.4, the payments in question are viewed by them to be in the nature of royalties as the right to distribute is a use of a copyright, which is a valuable economic right of the copyright owner which exists independent of other rights in the copyright, including the copying right and the exhibition right.***

13. In addition, in the view of a [XX minority] of the Members of the Committee, Article 12 should allow for source State taxing rights 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.

Those holding this view may want to include at the end of paragraph 3 the following sentence:

> ***The term also includes any 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.***