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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 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 at the twenty-first session of the Committee.

It includes the substantive parts of the discussion draft released on 1 September which included a proposal for the inclusion of software payments in the definition of royalties found in Art. 12(3) of the UN Model. The comments from non-governmental entities received on the discussion draft are included in the Annex.

At its twenty-first session, the Committee is invited to discuss this note and to decide whether and how how to pursue the work on the proposal included therein.

1. Note E/C.18/2020/CRP.13 on the "Application of Article 12 of the UN Model to software payments", which was prepared by the Subcommittee on the United Nations Model Tax Convention between Developed and Developing Countries, was discussed during the 20th session of the UN Tax Committee held online from 22 to 26 June 2020.

2. All Members speaking proposed to continue work on this topic. Different views were expressed, however, on what the focus of that further work should be. Many Members recommended that the Committee focus its attention on amending the existing definition of royalties so as to include a reference to software payments in that definition. For some of these, such a change could even be approved at the twenty-first session. Without prejudice to a final decision on the substantive issues, it was agreed to use a written comment process to produce quickly a note on the specific issue of the inclusion of software payments in the definition of royalties for written comments from stakeholders. That note was released as a discussion draft on 1 September 2020 and comments were requested by 2 October.

3. This note includes the substantive part of the discussion draft. The Annex includes the comments received from non-governmental entities. These comments, as well as comments from member States, were discussed by the Subcommittee during an online meeting held on 7 October 2020. It was then agreed to invite the Committee to decide whether and how to pursue the work on this proposal.

4. At its twenty-first session, the Committee is invited to discuss this note and to decide whether and how to pursue the work on the proposal included therein.

Inclusion of software payments in the definition of royalties

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1. Proposal for change to the definition of royalties

1. The definition of the term "royalties" in paragraph 3 of Article 12 of UN Model would be amended as follows (the proposed addition appears in ***bold italics***):

> 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.

2. Appropriate changes to the Commentary on Article 12 of the UN Model would accompany that change.

2. Reasons for the proposal

3. The members of the Committee who support the proposed change have first referred to paragraph 12.1 of OECD Commentary, which is quoted in paragraph 12 of the Commentary on Article 12 of the UN Model and which reads as follows:

> 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.

4. These members have argued that with the advancements in means of communication and information technology, computer programs or other software constitute a key tool in the conduct of most businesses. Computer programs and other software allow enterprises that use them to reduce the time needed to perform their tasks, improve efficiency and cut costs. In consequence, it cannot be denied that there is an increasing level of engagement of computer programs and other software in the economic life of States where they are used. That increasing engagement with the State where the software is used justifies the allocation of taxing rights to that State. Without prejudice, these members are of the view that it is a matter of allocation of taxing rights to source countries more than anything else for an item, payments in respect of which are already mostly within ambit of source State taxation as far as it involves use of copyright protecting the software. The proposed change would remove the blurred distinction between payments towards use of copyright in software or copyrighted software and would thus promote tax certainty and reduction of disputes.

5. According to these members, commercial exploitation by the owner or creator of software is heavily dependent on the laws on the protection of intellectual property rights in the territory of exploitation, i.e. where the user is. Non-residents nevertheless benefit from the

source country's legal system inasmuch as they rely upon it to protect and uphold intellectual property rights and enforce payment for transactions. Indeed, the protection of intellectual property rights in the case of computer software is critical to vendors and the need for protection of these rights arises. In addition, suitable telecommunication infrastructure in the source country may have a role in promoting the use of software. Also, population's competence in computers will be a relevant factor. Given that reproduction is so cheap and easy for computer software, there is greater dependence on source state protection. Imposition of withholding tax on source state on payment as consideration for use or right to use computer software itself is all the more justified when reproduction is easy and downloading inexpensive. The definition of royalties should thus be broadened to apply to payments for the use or right to use software itself to adapt to the realities of the digital age.

6. These members have also noted that the definition of royalties included in the UN Model applies to payments for the use of, or the entitlement to use, elements of intellectual property, on the one hand, and payments for the use or the right to use industrial, commercial or scientific equipment, on the other hand. In this latter case, as stated in paragraph 13.1 of UN Model Commentary on Article 12:

> …the owner of the equipment earns profits from letting another person use that equipment, 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. For this kind of business, the equipment itself, when used by another person, is treated in the United Nations Model Convention as having significance similar to that of a permanent establishment.

7. For these members, software payments are "payments for use or right to use" software (e.g. the acquisition of "shrink-wrap" software involves a license for the use of the software itself) and are not payments for the sale of property. One must distinguish payments for the acquisition of the intangible itself from payments for the acquisition of a single copy or for the acquisition of the right to download the software, the latter two cases being payments for the use of the software and not the acquisition of property.The comparison with transactions for the sale or import of goods, including natural resources, is therefore inappropriate. Also, in the case of industrial, commercial or scientific equipment affected by the lessee to its own activities, there is enough engagement of the State where such equipment is used, justifying taxation, in that State, of the income derived by the lessor from such lease. A similar logic applies with respect to the use of computer software.

8. These members have also observed that many countries already treat payments to non-residents in consideration for the use or right to use computer software as royalties under their domestic law. A number of existing bilateral tax treaties also cover payments for use or right to use software itself under the definition of "royalties" in Article 12. The treaties being referred to here are not the ones where explicit reference to "software" has been made in the definition of "royalties" to clarify that "software" is a literary work thus protected by copyright.

9. For these members, while it may be argued that source taxation on gross payments for software would not take account of the costs of developing and distributing the software and would carry the risk that the tax levied by the State of source would be passed on to the residents of that State who acquire software, the same applies to all payments for intangible property referred to in the definition of royalties and there are no reasons to treat software differently from such other property. The same also applies to interest payments, which may be subjected to source taxation under Article 11 of the UN Model.

10. According to these members, the existing Commentary on Article 12 already addresses a number of technical issues that could arise from the proposal, including how to address mixed contracts which cover the acquisition of software together with the acquisition of goods and services. Also, additional guidance could be developed to address issues such as the collection of tax where payments for software are made by individuals.

11. Finally, given the current uncertainty surrounding ongoing work related to taxation and the digitalisation of economy, these members consider that it is important to address the taxation of software payments, which has been on the agenda of the UN Tax Committee for many years. They also note that in the event of proposed changes in definition of royalty in Article 12 being accepted, the overlap between the Article 12B recently released for public comments and Article 12 can be addressed by suitably clarifying inter-se operation of the two and the interaction of the two proposals would not create problems.

3. Arguments against the proposal

12. The members who oppose the proposal have raised a number of arguments, including the following:

- It is not clear why payments for software should be treated differently from payments for other goods. For example, shrink-wrap software that is not customized for a particular customer, but are the same standardized products sold to all potential customers alike, are essentially a sale of a good that would give rise to business profits that fall under Article 7.
- The Committee should be mindful of the challenges of coordinating work on the taxation of software payments and other work related to taxation and the digitalisation of the economy.
- It is unclear on which on policy principle the proposal is based. The argument that source taxing rights on payments can be based on the fact that services or goods delivered by the payee create “an increasing level of engagement in the economic life of States where they are used” is problematic. What would this mean for countries exporting (rare) natural resources, like the rare metals used in cell phones, or oil, on which the world’s economy relies? Do these goods not have a “significant level of engagement in other State’s economy” and does that justify taxation in consumer States?

- An appropriate allocation of taxing rights is something countries must always consider. However, the allocation of taxing rights to the country of source is in of itself not justification for such a change. The underlying principles, and consistency with approaches taken elsewhere, must underpin such a change.
- Neither the prevalence of the use of a product software in a given country, the fact that producers of software rely upon the legal infrastructure in that country for the protection of intellectual property rights, the reliance on the telecommunication network of the country for the delivery of software, the ease of reproduction and cost of downloading software in that country nor the education or computer proficiency of the population of that country justify a taxing right for that country with respect to payments for the acquisition of software.
- The use of software should not be compared to the use of industrial, commercial or scientific equipment ("the leasing provision"), as included in Article 12(3) of the UN Model. Paragraph 13.2 of the commentary to Article 12 of the UN Model is explicit that intellectual property cannot be "equipment", confirming the underlying principle that the leasing provision is based on physical presence. Software by its nature means there is no physical presence in the source state and as such the considerations that underpin the leasing provision do not apply to computer software. Also, the business of selling software is fundamentally different from the business of leasing industrial, commercial or scientific equipment.
- While it is correct that some existing treaties allow the source taxation of software payments, it is important to note that other treaties (not referred to in paragraph 11 above) include a reference to software payments that does do not grant source taxation rights to the state of source on payments for acquiring copies of software for business or personal use but simply clarify that payments for the use of copyright in software is covered by the definition of royalties or clarify that copyright in software is included in the definition's reference to copyright of literary work.
- Payments for the acquisition of copies of software to be used for the personal or business use of the acquiror are not payments "for the use or right to use" the software but, rather, are payments for the acquisition of these copies. The definition of royalties should exclude such payments to the same extent that the part of the definition of royalty that refers to payments "for the use or right to use of industrial, commercial or scientific equipment" does not apply to payments for the acquisition of such equipment.
- Gross taxation of payments for software will likely mean the additional (tax) cost is passed on to end users. This increases the cost of software in the state where the software is used, potentially in a way that makes it too expensive for end users.
- The development of software is often expensive and may result in tax losses in the country where it is developed in the early years of development and where other unsuccessful software projects may be undertaken. This makes it particularly important

that income from the licensing of software is taxed on a net basis in the state where it is developed, as it is currently. As taxation on a gross basis ignores expenses incurred by the payee in earning the payments for use of that software, it may not be possible to get full credit for that suffered in the state of residence (which taxes on a net basis). This increases the likelihood that the software provider will either cease to sell its software into that other state, or that it increases the price for end users.

- The source taxation of software payments raises a number of practical difficulties, such as:
    - How would such a rule work when individuals purchase software?
    - How would the rule deal with software embedded in other products (e.g. the purchase of a computer or mobile phone with pre-installed software)?
    - How would the rule deal with software licenses that are centrally procured but where the software is used in a number of states?

13. Some of these members have also stressed that it would be important to review the Commentary changes that would be required to interpret the proposed changes (e.g. to understand the interaction between the proposed change and the other provisions of the UN Model and to address issues such as the definition of software and whether software embedded in a product will be covered by the change). It would also be important to seek public comments on any such Commentary changes.

ANNEX

COMMENTS RECEIVED FROM NON-GOVERNMENTAL ENTITIES

A. COMMITTEE FOR FISCAL STUDIES OF THE UNIVERSITY OF NAIROBI

1. The Committee for Fiscal Studies of the University of Nairobi appreciates the opportunity to contribute to the UN's discussion draft captioned *"Possible Changes to the United Nations Model Double Taxation Convention Between Developed and Developing Countries Concerning Inclusion of software payments in the definition of Royalties."*

2. The technical issues raised by this discussion form a core research priority of our committee under the "Raising Voice of Developing Countries" initiative.

3. We are available at your convenience to discuss any issue in this submission.

1. Background

4. Deployment and use of technology is a ubiquitous aspect of global landscape and Kenya is no exception. With regard to software, business is increasingly subscribing for these remotely, including a wide range of office and organisational software. Software now also enables direct access to generate revenue from consumers for many activities: sectors covered are many and varied and include lending, gambling and gaming. In this way, non-resident providers of software and related services can have an extensive involvement in the society and economy of a country, even with little or no physical presence. They frequently derive substantial revenues from these activities, which in view of this involvement should, in our view, be taxable by the country where these activities take place.

5. Particularly in the case of business services, it should be noted that payments are usually deductible from the business income of the customer. Hence, if the payments are made to a non-resident there would be a net loss to the local tax base. Furthermore, multinational enterprises are able to route such income through conduits in countries where they are subject to low or no taxes. This gives them an unfair competitive advantage against local entrepreneurs or software developers, who would be taxed on their income or profit in the country. Yet, as non-residents with little or no local presence, they do not create local employment.

6. With regard to software payments, a key issue under tax treaties is whether they should be treated as royalties under article 12 or business income under article 7. If they qualify as royalties, countries can impose withholding taxes on the gross amount of the payment. If they qualify as business income, countries may impose corporation tax on the net profits.

7. It is preferable for tax administrations to have the payments characterized as royalties, as a withholding tax is easier to collect, while it is difficult to define an appropriate level of net profit for a non-resident entity.

8. When characterized as business income, the taxing rights of a source country such as Kenya are limited by tax treaties, which only allow this if a non-resident software company has a permanent establishment (PE) in the country. Essentially, if the software company does not have a PE in the country, it is highly likely that the software receipts will be subject to low or no taxation, as they can be routed through conduits in jurisdictions to ensure that such payments are exempt from tax.

9. Under Kenya's Income Tax Act, section 10c, any payment of a royalty by a resident person, or by the permanent establishment of a non-resident, is "income which accrued or was derived from Kenya", and hence taxable in Kenya. Kenya's tax treaties[1] and Income Tax Act[2] have adopted the definition of royalties found in art. 12(2) of the OECD's Model Convention. Art. 12(3) of the UN model has also adopted this definition.

10. Article 12(3) of the UN model and art. 12(2) of the OECD's Model Convention have an expansive definition of payments falling under the rubric of royalty. Although there is no specific reference to "software", the definition of a royalty includes a payment made as "consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work". Computer programs are protected as literary works under Kenya's Copyright Act, as in most countries around the world. Hence, the "right to use" a computer program is considered to be a royalty under Kenyan law.

11. However, Kenya Revenue Authority and some taxpayers have on some occasions had different interpretation and scope of the term "royalty." Nevertheless, the Kenya Court of Appeal has upheld application of a withholding tax on payments for the use of business software as constituting a royalty.[3] In other cases, application of withholding taxes on payments for access to electronic networks was disallowed, on the grounds that it was not clear whether the payments should qualify as "royalties", "technical services" or "professional fees." [4]

12. Further confusion results from the adoption by the OECD in 1992 of paragraphs in the commentary to its model convention, introducing a new interpretation of article 12. This adopted the view that granting the rights to use a computer program or software should not be treated as a "right to use" the copyright in the program. Although these paragraphs were subsequently quoted in the commentary of the UN model convention, it also stated that some members did not agree with this interpretation.

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1 See, for example, Art 12(3) Kenya-Canada DTA; Art 12(3) Kenya-Denmark DTA; Art 12(3) Kenya-Seychelles DTA

2 Sec 2(1), Income Tax Act (cap 470), Laws of Kenya.

3 Kenya Commercial Bank Limited v Kenya Revenue Authority [2016] eKLR, available at http://kenyalaw.org/caselaw/cases/view/126924

4 R vs. The Commissioner of Domestic Taxes ex-parte Barclays Bank of Kenya Ltd [2012] eKLR, available at http://kenyalaw.org/caselaw/cases/view/82982 ; R vs. The Commissioner of Domestic Taxes ex-parte Barclays Bank of Kenya Ltd [2015 eKLR], available at http://kenyalaw.org/caselaw/cases/view/109414/

13. Kenya of course is not an OECD member, and the Kenya Revenue Authority has not accepted the OECD interpretation in its application of Kenya's tax treaties.

2. CFS' Comments

14. The Committee supports the proposal to clarify the definition of royalties in Art. 12(3) of the UN Model so as to include a specific reference to software payments.

15. Doing so would confirm that source jurisdictions, such as Kenya, can continue to impose a withholding tax on software payments and avoid interpretive controversies between taxpayers and tax authorities.

16. The rapid digitalization of the economy and rapid technological development poses challenges for countries' tax systems, so the amendment will preserve their taxing rights. To be specific, some businesses have in many cases been able to advantage of the lack of clarity with regard to the definition of royalties to avoid source taxation.

17. In our view also, it should be made clear that this change is made for the purposes of clarification. Countries such as Kenya, which have always interpreted article 12 in their treaties to apply to payments for the use of computer programs or software, should be allowed to continue to do so, without the need to renegotiate these treaties. It should be for the OECD countries, which adopted the narrower interpretation of article 12, to justify this change in the scope of the provision.

B. CONFEDERATION OF BRITISH INDUSTRY (CBI)

Background

18. As the UK's leading business organisation, the CBI speaks for some 190,000 businesses that together employ around a third of the private sector workforce, covering the full spectrum of business interests both by sector and by size.

19. The UN Committee has indicated a number of members recommended that the UN Committee consider amending the definition of royalties within paragraph 3 of Article 12 of the UN Model to the following:

> *"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." (Emphasis added)*

20. Prior to the matter being discussed at the 21st session UN Committee meeting (3+ October – 6 November), a discussion draft has been issued, seeking comments. The deadline for comments is 2 October 2020 and the CBI now submits the following response accordingly.

Summary position

21. We oppose the proposed inclusion and consider that the above proposal does not justify the broadening of the scope of art. 12 and the re-allocation of taxing rights, given that in our view, the proposal has not sufficiently taken into consideration the economic impacts on countries or companies, nor the interaction of the existing legal framework taxing such transactions or the fact that such a proposal will increase tax uncertainty – which is contrary to one of the intended outcomes of the proposal.

22. While broadly endorsing the arguments raised by the members who oppose the proposal, below we highlight some of the additional risks we foresee in pursuing this proposal, including:

a. *The proposed change to art. 12 broadens the scope of the royalty article beyond commercial exploitation of copyrights and creates taxing rights without, in our view, sufficient factors to justify a reallocation of taxing rights from residence to source taxation.*

b. *Potential overlap with Pillar I leading to increased risk of computer software being taxed twice in the source/market jurisdiction.*

c. *Definition of computer software payments is not adequately defined within this discussion draft*

d. *Taxation of payments on a gross basis can lead to double taxation and lead to misallocation of taxation rights.*

e. *Depending on the precise design and rate, the concepts within the discussion draft may put a foreign* ***provider at a competitive disadvantage if they came to fruition.***

23. We discuss these five issues in more detail below.

a. The proposed change to art. 12 broadens the scope of the royalty article beyond commercial exploitation of copyrights and creates taxing rights without, in our view, sufficient factors to justify a reallocation of taxing rights from residence to source taxation

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

25. The OECD Commentary on art. 12, for instance, refers to the right to use a copyright on computer software for commercial exploitation. The commercial exploitation of the copyright rights can be considered a key factor in determining when a licence leads to royalties.

Copyright rights include, for example, the right to reproduce the program for distribution to the public and to the rights to modify the original program in a substantial and significant way.[5]

26. If the modification is just ancillary and unimportant, the licence does not involve a right for tax purposes, i.e. a tax right. In other words, if there is no commercial exploitation, there are no copyright rights for tax purposes, and the licence cannot give rise to royalties. Payments in these types of transactions, where there is not an exploitation of the protected right, would be dealt with as business profits in accordance with, we understand, art. 7.

27. The UN commentary mirrors this approach in paras 13.1 ("exploit the rights that would otherwise be the sole prerogative of the copyright holder"[6]) and 14.4 ("exploit any right in the software copyrights").[7] Also here, we understand payments in these types of transactions would be dealt with as business profits in accordance with art. 7.

28. Section 2 of the current UN Discussion Draft lists the reasons put forward by the members of the Committee who support the proposed change, and who would like to include this type of payments within the remit of art. 12, even in the absence of commercial exploitation.

29. Para 8 clarifies that:

> *"The commercial exploitation by the owner or creator of software is heavily dependent on the laws on the protection of intellectual property rights in the territory of exploitation, i.e. where the user is. Non-residents nevertheless benefit from the source*

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5 The protected rights are exclusive rights of the copyright owner which typically includes the rights such as those to copy (excluding for own use, back-ups or necessary functioning of the computer software for its ordinary intended purpose), modify the original source code of the program or reproduce the program in a substantial and significant way, and exclusive distribution rights. The existing guidance, for instance, makes it clear that the distribution of standard computer software is not the exploitation of the underlying protected right, but is a regular commercial activity.

6 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 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).

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.

country's legal system inasmuch as they rely upon it to protect and uphold intellectual property rights and enforce payment for transactions."

30. In response it can be noted that the proposal is to include payments within the remit of art. 12, even in the absence of commercial exploitation. The proposed change would therefore not only remove the distinction between payments towards use of copyright in software or copyrighted software (as noted by the members in Section 2), but also the important distinction between payments towards use of copyright in computer software with commercial exploitation (currently taxed under art. 12) and without commercial exploitation (currently taxed under art. 7).

31. The latter regards, inter alia, situations where there are no rights to reproduce the program for distribution to the public or rights to modify the original program in a substantial and significant way. On this basis, it is difficult to understand why, without commercial exploitation, non-residents would nevertheless benefit from the source country's legal system, since there is no need to protect and uphold intellectual property rights– apart from the (less likely) situation where there's a breach of the license agreement.

32. Furthermore, without commercial exploitation, it is also unlikely that there is any value being generated in the market into which computer software is being remotely sold.

33. Especially in the absence of an active and/or sustained participation of a business in the economy of a market jurisdiction, it appears difficult to argue that the presence of a suitable telecommunication infrastructure in the source country[8] and the population's competence in computers (alone) can be seen as sufficient factors to justify a reallocation of taxing rights from residence to source taxation.

34. The proposed change to art. 12 therefore broadens the scope of the royalty article beyond commercial exploitation of copyrights and creates taxing rights without, in our view, sufficient factors to justify such a reallocation of taxing rights from residence to source taxation.

b. Potential overlap with Pillar I leading to increased risk of computer software being taxed twice in the source/market jurisdiction

35. The sale (licensing) of computer software will, on current drafts, fall within the ambit of the reforms to international taxation (Pillar I and Pillar II) that are currently being contemplated by the more than 135 members OECD/G20 Inclusive Framework on BEPS, with a view to these reforms being implemented in the near future.

36. Indeed, the taxation of the digital economy, which is built upon intangibles such as software, is a key consideration within these reforms. Clearly, whilst the UN is a separate body to the OECD or the OECD/G20 Inclusive Framework, it remains in the interest of all parties (business, developed and developing countries alike) to ensure that the international tax system

8 In case software is delivered over the Internet, it is likely to also involve telecommunication infrastructure in third jurisdictions - outside the residence and source country.

is reformed in a coherent and multilateral manner, and with as few related but uncoordinated changes being implemented in close succession as possible.

37. Therefore there is potentially a significant overlap of this proposal with the OECD/G20 Inclusive Framework proposals, thus leading to an increased risk of computer software being taxed twice in the source/market jurisdiction.

38. Given the potential impact and advanced stage of the Inclusive Framework Pillar I and II discussions, we would strongly recommend postponing UN discussions on revisions to the royalty definition until the conclusion of the Inclusive Framework discussions.

c. Definition of computer software payments is not adequately defined within this discussion draft

39. The term "computer software" as used in the Article is not in our view adequately defined and rather refers to the interpretation at the level of parties' domestic legislation. As a consequence, there is a concern that the application of art. 12 will result in increased uncertainty, inconsistent treatment, and lengthy disputes between taxpayers and tax authorities. Indeed, such an outcome would be contrary to the coherent and multilateral agreement referred to at b. above.

40. The UN proposal also refer to the OECD commentary section 12.1 description of Software as:

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

41. The UN discussion draft currently considers that "increasing engagement with the State where the software is used justifies the allocation of taxing rights to that State." and "Proposed change would remove the blurred distinction between payments towards use of copyright in software or copyrighted software and would thus promote tax certainty and reduction of disputes."

42. Separate to the issues arising from amending the taxing rights, as noted within this paper, the concern around the definition is that the proposal does not take into consideration the range of items that include computer software, nor the ways in which computer software is consumed by businesses and end-users. Each of these points needs fully considering, as including all the transactions that contain 'computer software' may create distortive taxation results in different countries and potentially capture a significant numbers of transactions which are not intended to be caught by this change.

43. There has been substantive work undertaken by other bodies and countries over many years, which generally arrive at a consistent principle that a transaction of standard computer software is not a royalty. There are also countries where 'computer software' is included within their Double Tax Treaties who also make it clear that standard software is not a royalty. This discussion draft risks increasing confusion over how computer software transactions should be taxed, rather than relieving the problem. Such uncertainty will lead to additional compliance costs and disputes for companies and tax administrations as they seek to understand and apply the rules consistently.

44. There are already appropriate rules and legal structures in place to deal with the delineation between cross border transactions which should and should not be contained within the definition of a royalty.

d. Taxation of payments on a gross basis can lead to double taxation and lead to misallocation of taxation rights

45. The imposition of a tax on a gross basis denies the taxpayer the ability to take into account expenses that were incurred in connection with the development and provision of computer software, which would be deductible if tax were imposed on a net basis.

46. Thus, as noted also by the members in Section 2, it is possible that the Residence State's remedies for relieving double taxation may not be adequate to fully relieve the gross-basis taxation imposed by the other State. Consequently, taxation of computer software payments on a gross basis can lead to situations of double taxation.

47. In addition, there is a risk of over-taxation since revenue bears no necessary relationship to profit. For instance, selling shrink-wrap software can be considered a low-margin business so that even a Withholding Tax set a modest level could represent a significant percentage of taxable income of the seller.

48. Furthermore, WHT on computer software payments potentially imposes a higher tax burden (i.e. tax on gross receipts) on a company with no activities in-country (and hence no PE) than on a company that furnished those services through a local PE with significant substance in-country (and hence would be taxed only on net profits).

49. This again highlights the inconsistency of the proposed art. 12 with the established 'source' concept. Depending on the provisions for relief from double taxation agreed in a particular treaty, it also means that a potentially significant difference in the scope of double tax relief could emerge between treaty and non-treaty situations.

e. Depending on the precise design and rate, the concepts within the discussion draft may put a foreign provider at a competitive disadvantage if they came to fruition

50. A business' net economic returns for the activities in a country should not, in our view, be linked solely to the relative popularity of an industry or to the ease of reproduction of computer software. If computer software is sold within a country, there are already alternative,

appropriate mechanisms in place to ensure that these activities are appropriately captured within the tax system.

51. There is no direct correlation between the amount of investment a company makes in developing computer software and the economic viability of the product. Just because this is intellectual property, it would be flawed to assume that the taxing right and process should be similar to, say, interest.

52. The blanket approach of imposition of a WHT for all foreign computer software vendors on a gross basis may increase the costs of doing business in a given territory and put the vendor at a competitive disadvantage, effectively limiting access to the market and restricting choice of suppliers.

53. It is foreseeable that a computer software provider may seek to include a 'gross-up' clause within the customer contracts, so passing the impact of WHT back on to the customer, in return increasing the net computer software cost in that territory – which may therefore be higher than in other countries. The net impact of this could be an inhibition in trade.

54. Further, with some countries imposing WHT and others not on comparable transactions, this could lead to distortions in local markets, as well as provide an incentive for countries to compete on their WHT rates in this regard.

Conclusion

55. Overall, the proposals within this United Nations paper potentially lead to fundamental uncertainty in the way such transactions are taxed in different countries and additional compliance burdens for tax payers and tax authorities, as well as potentially incentivising uncompetitive practices between nations. For the above mentioned reasons, we consider that the proposals made in this discussion draft should not be adopted.

C. CONFEDERATION OF INDIAN INDUSTRY (CII)

1. Current situation

56. It is not possible to think of any business without using computer software and every company has to incur expenditure on computer software. Payments for software may be made to non-resident group companies or other unrelated non-residents. The domestic law requires deduction of tax at source from payments made to non-residents which are chargeable to tax.

57. The definition of "royalties" under the existing tax treaties does not make a specific reference to software payments and non-residents rely on treaty provision to claim that software payments do not qualify as royalty in terms of the tax treaty. This is backed by a very sound technical argument based on the distinction between "use of copy right" and "use of copy righted article".

58. The tax authorities however do not accept this argument and this results in tax disputes. Currently, hundreds of cases are pending before various judicial forums. Taxability of software has dragged number of MNCs in protracted litigation and the uncertainty prevails for decades.

2. The proposal and its implications

2.1 Proposal

59. The definition of the term "royalties" in paragraph 3 of Article 12 of UN Model would be amended as follows (the proposed addition appears in *bold italics*):

> *"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."*

2.2 Implications

60. The implications of the proposal would be as follows:

- Once the above provision is adopted in the UN Model, it would be gradually included in the actual bilateral tax treaties (also see comments in *para 5* below).
- Once this forms part of the actual tax treaties, the source country would get a clear taxing right over software payments.
- Once this forms part of the actual tax treaties, the country of residence, of the recipient of such software payments, will have a clear obligation to relieve double taxation.
- The taxes paid in India would thus off set the tax liability on such income in the country of residence. The double taxation can be relieved on the basis of Credit Method or Exemption Method as per the tax treaty.

3. Tax Certainty

61. Inclusion of specific taxing right in the tax treaty over software payment would ensure that the there is no dispute between the tax payer and the tax administration of the source country. This will relieve the tax payer from years of litigation and will give much desired tax certainty. Given that the country of residence will give credit for the taxes paid in the source country, this will also not have the impact of increasing the tax burden for the tax payers.

4. Need for cautious approach

62. The proposed changes will be a welcome move on the parameters of tax certainty and avoidance of disputes. However, there are also other aspects which need to be evaluated and a cautious approach is required.

4.1 Interaction between taxation of software payments under Article 12 and taxation of digital economy

63. Significant amount of work is currently happening under the OECD Pillar One and it needs to be ensured that there is no overlap. Even the UN Tax Committee has proposed Article 12B in the UN Model. A situation where the software payment is subjected tax under the new taxing right (Pillar One / UN Article 12B) as well as under Article 12 as royalties should be avoided.

4.2 Interaction between taxation of software payments under Article 12 and unilateral tax measures

64. In absence of the solution to the problem of taxation of digital economy by OECD Inclusive Framework, number of countries have taken unilateral measures under their domestic laws (e.g. digital services tax, equalization levy etc.). A situation where the software payment is subjected tax under such unilateral tax measures as well as under Article 12 as royalties should be avoided.

4.3 Unrelieved double taxation

65. Amendment to Article 12 will meet the desired objective only if there is no double taxation i.e. the tax paid in the source country is relieved by the country of residence under credit or exemption method. Accordingly, various business models need to be examined to ensure that the taxes paid in the source country is relieved in the country of residence.

4.4 Option for net basis of taxation

66. To ensure that there is no unrelieved double taxation, the tax payer should have an option of offering income to tax on "net basis". The proposed Article 12B contains such an option.

4.5 Withholding obligations on individuals

67. Individuals purchasing software for their personal use (as against business use) may not have to necessary infrastructure to comply with withholding obligations. It would not be reasonable to put an obligation of withholding taxes on individuals.

4.6 Commentary on "computer software"

68. It is understood that the UN Tax Committee would further develop this proposal by making appropriate changes in the Commentary to explain various nuances related to coverage of "computer software". Commentary should categorically give guidance on different types of software including shrink-wrap software and taxability of such software. Appropriate industry consultation would be desired once such commentary is drafted.

4.7 Implications for existing litigation

69. Currently, the tax payers have taken an argument that payment of software is not a payment for use of copyright but a payment for use of copyrighted article. This is technically

correct interpretation of the existing definition of "royalty" in the tax treaties. It needs to be ensured that existing litigation is not influenced by the amended Article 12 i.e. no retrospective applications.

5. Implementation mechanism - MLI

70. The amendment to Article 12(3) would be operational only after it forms part of the bilateral tax treaties. Modification of tax treaties is a long process and amendment of all existing tax treaties could take several years and hence the work done by the UN Tax Committee may end up to be a theoretical exercise.

71. Accordingly, the UN Tax Committee should consider using an MLI type mechanism to ensure that the treaties are amended in a short time.

6. Conclusion

72. The proposal to amend definition of royalty to include "software payment" is a welcome move and can give much desired certainty to the industry plus relief from future litigation. As against the existing litigation between the tax payer and tax administration of the source country, the proposed amendment ensures that the issue is addressed upfront by the treaty partner countries by agreeing on allocation of taxing rights. Nonetheless a cautious approach is desirable and the issues highlighted in *para 4* above are properly addressed.

73. Giving taxing right to the source country on software payments is consistent with the approach adopted by 138 countries in the OECD Inclusive Framework which recognizes new taxing right to the market jurisdictions.

[Annex]

74. The Confederation of Indian Industry (CII) works to create and sustain an environment conducive to the development of India, partnering industry, Government and civil society, through advisory and consultative processes.

75. For 125 years, CII has been working on shaping India's development journey and, this year, more than ever before, it will continue to proactively transform Indian industry's engagement in national development.

76. CII is a non-government, not-for-profit, industry-led and industry-managed organization, with about 9100 members from the private as well as public sectors, including SMEs and MNCs, and an indirect membership of over 300,000 enterprises from 288 national and regional sectoral industry bodies.

77. CII charts change by working closely with Government on policy issues, interfacing with thought leaders, and enhancing efficiency, competitiveness and business opportunities for industry through a range of specialized services and strategic global linkages. It also provides a platform for consensus-building and networking on key issues.

78. Extending its agenda beyond business, CII assists industry to identify and execute corporate citizenship programmes. Partnerships with civil society organizations carry forward corporate initiatives for integrated and inclusive development across diverse domains including affirmative action, livelihoods, diversity management, skill development, empowerment of women, and sustainable development, to name a few.

79. With the Theme for 2020-21 as *Building India for a New World: Lives, Livelihood, Growth*, CII will work with Government and industry to bring back growth to the economy and mitigate the enormous human cost of the pandemic by protecting jobs and livelihoods.

80. With 68 offices, including 9 Centres of Excellence, in India, and 9 overseas offices in Australia, China, Egypt, Germany, Indonesia, Singapore, UAE, UK, and USA, as well as institutional partnerships with 394 counterpart organizations in 133 countries, CII serves as a reference point for Indian industry and the international business community.

D. DHRUVA ADVISORS LLP

81. We, Dhruva Advisors LLP, are a Tier 1 boutique tax and regulatory firm based in India. We have bagged the India Tax Firm of the year for the last 4 years by International Tax Review. Our service portfolio includes several areas of domestic and international / cross-border taxation both on direct and indirect tax.

82. United Nations has performed a significant role in development of international taxation policy. The United Nations Committee of Experts on International Cooperation in Tax Matters (UN Tax Committee) has provided an effective platform to table and resolve concerns of developing nations on taxation matters. Tax initiatives of United Nations deserve credit of bringing harmony between the tax policy of developing nations and developed nations.

83. Amid the economic uncertainty prevailing in the global market, the tax committee has published discussion draft on inclusion of software payments in the definition of royalties. The efforts of the UN Tax Committee in this regard are indeed noteworthy. We acknowledge the proposal as a step to bring certainty to one of most contentious issue of software taxation. The UN tax committee has invited public comments on the proposal. In this reference, we humbly submit our recommendations herewith in the enclosed file.

Introduction

84. Information technology plays a key role in business strategies. Faster and seamless communication, vast storage capacity, strong surveillance capabilities, protection of records are just some of the key advantages of information technology. While some modern business models are evolved around information technology, for other businesses, use of information technology does provide a competitive advantage. Computer software significantly contributes to the economic and social activities of the business enterprise.

85. Taxation of computer software has been a vexed issue with judicial precedents all over the place. Traditional taxation rules which were made for bricks and mortar business at times

do not provide comprehensive guidance on taxation of payments with respect to use of computer software. This has been one of most debated issues amongst legislative authorities of countries, taxmen, businesses and judicial authorities. While many countries treat payment for computer software as royalty income under domestic tax law, lack of international guidance causes significant challenges in case of cross border transactions.

86. In order to meet with the challenges of taxation of computer software, we are very pleased to witness the work done by the United Nations in this regard. The proposals framed by the sub-committee will certainly bring in tax certainty for businesses and will help in avoiding long drawn litigation.

87. Whilst we welcome the proposal of inclusion of "computer software" in the definition of "Royalty" in the UN Model Tax Convention, in our view, there are few aspects which merit consideration. The same have been discussed below.

A. Shrink-wrapped computer software – whether royalty?

88. Characterization of income as royalty or otherwise should be determined based on the nature and extent of rights granted to the end user. The software industry operates on different models. A computer software can be made available to the end user by a variety of methods. Software products are developed in various forms such as custom-designed software, proprietary operating systems or standardized modular software programs bundled with hardware and low-priced shrink-wrapped diskettes designed for personal computers. Methods of delivery with respect to software transactions include single copy packages of standardized product, enterprise licenses, electronic distribution without tangible media like downloads from authorized website, reproduction by a distribution intermediary, bundling with hardware, limited duration licenses, custom programming and others.

89. In case of a shrink-wrapped computer software, the end user typically receives limited or restricted rights and hence consideration for supply of such software should generally be regarded to be in the nature of sale of a 'copyrighted article' and not in the nature of 'royalty'. The buyer / customer neither gets any commercial rights for exploitation nor gets the right to use a copyright in the software. Right to use a copyrighted article or product with the owner retaining his copyright should be understood differently from transferring or assigning rights in relation to the copyright. The enjoyment of some or all the rights which the copyright owner has should be the touchstone to invoke the royalty definition. A non-exclusive and non-transferable license enabling use of a copyrighted product should not be taxed as royalty income.

90. Shrink-wrapped computer software is traditionally considered as copyrighted article and hence, it is treated as 'Goods' under various legislations including the Goods and Services Act / Value Added Tax. Any income arising on sale of goods is treated as business income taxable under Article 7 of the Model Convention. As per Article 7 of UN Model Convention, business income can be taxed in a source country, only if such income is attributable to Permanent Establishment of enterprise in source country.

91. The proposed amendment to the definition of royalty is wide enough to capture any sale of shrink-wrapped computer software as royalty. Where the software is sold as a product, it would amount to sale of goods. Recharacterization of income from computer software as royalty would impose further challenges. In such a scenario, income from trading and distribution of computer software would also be taxable as 'Royalty' income, which seems unintended.

92. Further, royalty income is taxable on gross basis, without deduction of expenses. As a result of this proposed amendment, businesses engaged in purchase and sale of the computer software would be subject to taxation at gross level without deduction of purchase price. Such businesses would be subject to exorbitant tax burden and the supply chain could be adversely affected.

93. Thus, in our humble view, it would be inappropriate to classify such payments as 'royalty' where the payment is for obtaining rights limited to enabling effective operation of the software and not for the end user to commercially exploit the underlying rights or use the copyright in the software. Suitable clarifications in this regard either in Article 12 of the UN Model or in the accompanying commentary may be given so as to avoid any uncertainty in this regard.

B. Scope of 'computer software'

94. The proposed amendment in definition of 'royalty' intends to tax use or right to use 'computer software' as royalty income. While the draft proposal does not intend to provide definition of "computer software" as a part of Article 12 of UN Model Convention, the Discussion Draft refers to Commentary on Article 12 of UN Model Convention and OECD Model Convention for the definition. Considering multifaceted nature of 'computer software', it is highly recommended to provide for a definition of "computer software" under Article 12 itself.

95. The definition of 'computer software' under UN and OECD commentary provides that the computer software can be transferred as an integral part of computer hardware or in an independent form available for use on variety of hardware. While modern state-of-art equipment are equipped with artificial intelligence and automation, such equipment operates on software controlled or operated by computer and communication channels. Software is embedded in such hardware offers flexibility in operation.

96. While the present definition of computer software under the UN and OECD commentary seems to cover for only 'computer' related software, it mentions that the computer software can be transferred as an integral part of computer hardware or in an independent form available for use on a variety of hardware. Hence, it is recommended to provide specific exclusions to carve out software embedded in various machineries, devices, articles, tools and equipment from the scope of 'computer software' and 'royalty'.

C. E-commerce transactions – Potential overlap?

97. While OECD along with several countries is working towards a consensus-based approach for taxation of digital economy, there are several countries which have adopted unilateral and interim measures in this regard. The recent UN proposal in form of Article 12B also provides guidance on taxation of automated digital services. In light of these developments, the proposal to cover 'computer software' within ambit of royalty may appear to be an overlapping exercise in some situations.

98. Given the same, in our view, Article 12 should provide a carve out to exclude e-commerce / digital economy related transactions from the ambit of 'royalty'.

D. Comparison with equipment royalty is not justified

99. The UN Model Convention treats payments for the use or the right to use industrial, commercial or scientific equipment as 'royalty' income. While right to use the equipment and sale of equipment are different transactions, the former is taxable as royalty income and the latter is taxable as business income.

100. While the proposal intends to remove the distinction between use or right to use of copyright and copyrighted article, the proposed amendment appears to cover sale of computer software within the ambit of royalty. Sale of computer software is akin to sale of goods and not payment for use or right to use computer software. Hence sale of computer software should be excluded within the ambit of royalty

101. Sale of computer software should be taxable as profits of business under Article 7 similar to sale of equipment. Suitable clarifications in this regard would be welcome.

E. Taxation of computer software on gross basis results into additional tax cost

102. The tax treaties provide for a foreign tax credit on doubly taxed income. While income from development and sale of computer software is taxable in the home country on a net basis (i.e. after deduction of expenses), as a result of proposed amendment, the same would be taxable on a gross basis in the source country.

103. Accordingly, several businesses may not be entitled to claim credit of taxes in paid in source country owing to the difference between the gross income taxable in source country and the net income taxable in the country of residence. A major or full portion of the foreign taxes paid in the source country could lapse and become a sunk cost. This would increase the tax cost of the software industry manifold. Whilst this is something which is not completely avoidable, suitable clarifications on the aforementioned aspects can help in minimizing the tax burden and the potential passing of the tax cost to the ultimate consumers.

E. EDUARDO ANTONIO CABALLERO BARRETO (sent in Spanish)

***1) Definición de** Regalías **del Modelo de Convenio de las Naciones Unidas, los** "pagos por el uso o el derecho al uso de programas de computación"**.*

104. Con su inclusión el pago por el uso o el derecho al uso de programas de computación no estaría alcanzado por lo dispuesto en el artículo 7 Beneficios empresariales y a su vez llena el vacío sobre la situación cuando no existe establecimiento permanente ni el artículo de Ganancias de capital (por no existir una transferencia definitiva), Se evitaría, asimismo, consultas sobre el alcance de la definición del párrafo 3 (definicion) propuesto, o interpretaciones extensivas que con la finalidad de incluirlo (abarcar dicha situación), se excedan en la interpretación de la letra del convenio. Ahora bien, la propuesta ni sus comentarios resuelven el tratamiento cuando se enajenen equipos con software incluido. En principio, interpreto que la consecuencia sería la de aplicación a cada software incluida de cada equipo.

F. GANESH RAJGOPALAN

105. I commend the UN Committee of Experts for their path-breaking work on allocating taxing rights on software payments and coming up with the current Discussion Draft. In this regard, I wish to offer my comments on two aspects: (a) the proposed change to the definition of royalties and (b) the changes to the Commentary on Article 12 which do not find mention in the Discussion Draft.

106. I give my comments on the second aspect first since I believe that the same would have a bearing on the first aspect.

1. Existing Commentary - Need for change

1.1 Classification of computer software as literary or scientific work

107. The proposal to clarify in the Commentary on whether computer software is a literary or scientific work has been rightly omitted. The matter is largely settled by the TRIPS Agreement mandating computer programmes to be protected as literary work which is generally followed in the national copyright laws. The Committee is to be commended for deciding to drop the proposal.

1.2 The relevance of national copyright laws for taxation

108. In para 8.2 of the OECD Model Commentary on Article 12, the OECD rightly endorses the dependence on the national intellectual property laws for determining what constitutes an alienation of intellectual property rights for allocating taxing rights between States through the possible application of Article 7 or Article 13 on the one hand and Article 12 on the other. Though this paragraph is not quoted in the UN Model Commentary, there should be no disagreement with this proposition to depend on the domestic copyright laws to determine when there is an alienation of copyright, or for that matter, when there is a use of copyright.

109. The 2017 Update of the UN Commentary on Article 12 reproduces some of the paragraphs 12 to 17 from the OECD Commentary relating to software payments. These paragraphs were introduced originally in the OECD Model Commentary to describe the characteristics of payments for the use of copyright with respect to computer software. However, the UN Commentary also notes that some members of the Committee of Experts were of the view that certain of these paragraphs quoted in the UN Commentary may constitute royalties. This concern is well-founded and needs to be redressed. There are some instances in the quoted paragraphs of the OECD Commentary which deviate from the position under national copyright laws which are discussed below.

1.3 Description of copyright royalties in Commentary unnecessary

110. Before we go into these inconsistencies in the quoted paragraphs, it is important to examine the question whether the explanations attempted in these paragraphs are at all necessary. The copyright laws of countries provide protection to the copyright owner of works including computer software. Where the copyright owner chooses to permit others to use these rights which he owns exclusively through the operation of copyright laws, the consideration that he receives for the same is for the use of copyright and is to be characterised as royalties under Article 12(3) of the UN Model. The copyright laws of countries have a significant degree of harmonization due to the operation of copyright conventions as well as the reciprocal nature of protection offered in each jurisdiction. Nevertheless, there are differences as well. The national copyright law that apply in case of a particular transaction naturally determines whether a payment is for the use of copyright that is to be characterised as royalties. The Commentary does not. Also, the differences in these laws in different countries cannot be normalised by the Commentary to give a standard result.

111. However, the UN Commentary quotes several paragraphs of the OECD Commentary which describe copyright and what is the ‘use of copyright’ in respect of software payments. These descriptions deviate in certain significant respects from the positions found generally under national copyright laws and are dealt with below.

1.4 Paragraph 12.2 of the OECD Commentary quoted in the UN Commentary

112. The OECD Commentary in Para 12.2 states that:

> *“the rights in computer programs are a form of intellectual property. ……. 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.”*

113. Though the above paragraph correctly concludes that a computer program is different from the copyright in that program, its use of the term ‘software’ as distinct from ‘computer program’ is confusing when these terms refer to the same thing.

Recommendation:

114. The Committee may consider redrafting of the contents of the paragraph to clarify that the terms 'software' and 'computer program' both refer to the same expression. It may be useful to add text describing the difference between the creative element (content), the medium (the work) and the statutory protection (copyright) under national copyright laws and the copyright conventions which will facilitate proper characterisation of software payments for Article 12 of the Model.

1.5 Paragraphs 14, 17.2 and 17.3 of the OECD Commentary quoted in the UN Commentary

115. The OECD Commentary states in paragraph 14:

> *"... the rights acquired <u>in relation to the copyright</u> 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. <u>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</u>. 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. ...." [underlining supplied for emphasis].*

116. Paragraphs 17.2 and 17.3 are reproduced below:

> *"17.2 Under the relevant legislation of some countries, transactions which permit the customer to electronically download digital products may give rise to <u>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</u>. 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), <u>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</u> 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 <u>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</u>, such copying is merely the means by which the digital signal is captured and stored. <u>This use of</u>*

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." [underlining supplied for emphasis].

117. The above paragraphs deal with "just enough copyright"[9] to run a computer program and regard a licence to copy granted to the user under a license agreement (EULA) as a licence to copyright. The Commentary confuses the 'fair use' by a lawful owner of a copy of a computer program as use of copyright.

118. Certain acts have been statutorily prescribed to be non-infringing acts which are variously termed in different countries' copyright law as 'permitted acts'' 'fair dealing' and 'fair use' provisions. The purpose of these provisions is as a defence against alleged infringement as well as to balance the legitimate rights of the copyright owner and public interest as well as to facilitate intended and lawful use of the works. The Berne Convention[10] provides for a 'three-step test' for legislating such permitted acts for certain special cases where reproduction does not conflict with author's normal exploitation of the work and does not unreasonably prejudice the legitimate interests of the author.[11]

119. Paragraph 14 mistakes the user rights (which are permitted acts) with the copyright owner's rights. These permitted acts are non-infringing. These acts are not only a defence available to a user (against any allegation of infringement of the owner's copyright) but also his (user's) affirmative rights. They are not copyright but a limitation on copyright. Where a particular act is a permitted act, the copyright owner has no exclusive right to the same. The contours of these permitted acts aid in understanding the extent of copyrights available to a copyright owner which he can permit others to use for a consideration which can properly be characterised as royalty under Article 12(3) of the UN Model.

120. Paragraph 17.2 and 17.3 extracted above are other examples where user rights available through the operation of copyright laws are confused with copyrights which are the exclusive rights of the owner. The interpretation in these paragraphs is contrary to the position found generally under national copyright laws.

Recommendation:

121. Para 14, 17.2 and 17.3 may be redrafted to bring out the import of permitted acts or fair use or fair dealing provisions contained generally in national copyright laws as user rights and not copyrights. Alternatively, both these paragraphs as they exist currently may be omitted

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9 This term is used in Document No. E/C.18/2018/CRP.9 dated 4 October 2018, paragraph 8.2.

10 Berne Convention for the Protection of Literary and Artistic Works, 1886 (as amended on September 28 1979) <https://wipolex.wipo.int/en/text/283693> accessed 2 February 2019; ("Berne Convention").

11 Berne Convention, Article 9(2).

since these paragraphs, even if redrafted, do not add any further clarity to the position under copyright laws.

1.6 Para 14.4 of the OECD Commentary quoted in the UN Commentary

122. Paragraph 14.4 of the OECD Commentary which deals with distribution intermediaries declares that:

> *"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." [Underlining supplied].*

123. Notably, the OECD considered technical changes on the above subject for the first time in the Draft 2008 Update of the Commentary. Concerning the taxation of software distribution, this is what the OECD Draft 2008 Update had to say:[12]

> *"Since the copyright law of some countries covers to some extent the right to distribute copies, arrangements between a software copyright holder and a distribution intermediary sometimes grant to the distribution intermediary the right to distribute copies of the program without the right to produce the copies. Representatives from the software industry have asked the OECD to clarify that where the rights acquired in relation to the copyright are limited to those necessary for the commercial intermediary to distribute copies of the software program, the payment made by the distributor does not correspond to a royalty. The following is the clarification to the Commentary that the Working Party has adopted to deal with that issue." [underlining supplied].*

124. The declaration by the above paragraph that distributors do not exploit any right in the software copyrights is contrary to national copyright laws. The OECD Draft 2008 Update in paragraph 15 itself states the contrary - that the copyright laws of some countries cover the right to distribute copies to some extent. The right to issue copies to the public not being copies already in circulation is the distribution right and belongs exclusively to the copyright owner.[13]

125. Paragraph 14.4 makes a distinction between the distribution of copies of software by a commercial intermediary without the right to reproduce the program, on the one hand, and with

12 Draft Contents of the 2008 Update to the Model Tax Convention OECD Model Commentary 2008 Update dated 21st April 2008, para 15.

13 A preliminary survey by the author of copyright laws of around 28 countries (of which many are OECD members) reveal that the distribution right is one of the copyrights. These countries are (in alphabetical order): Argentina, Australia, Austria, Belgium, Brazil, Canada, China, Denmark, Finland, France, Germany, Ghana, India, Ireland, Italy, Japan, Luxembourg, Mexico, Netherlands, New Zealand, Norway, Slovakia, Spain, Sweden, Swiss Confederation, United Kingdom, United States and Zambia. Source: the website of World Intellectual Property Organisation (WIPO) website : https://wipolex.wipo.int

the right to copy, on the other. The Commentary finds the former more akin to a commercial transaction of distributing products the profits of which would be covered under Article 7, and not exploitation of copyright which will fall under Article 12. However, copyright laws do not make that distinction. Copyright is a bundle of rights and each right in the copyright can be dealt with independent of the others. The distribution right does not depend on the reproduction right and operates independently of the other rights as do the other rights in copyright.[14] According to the OECD Commentary, distribution right gets triggered only when accompanied by the use of reproduction right, which is contrary to the provisions of copyright law. The OECD Commentary does not give any basis for adopting such a conclusion to allocate taxing rights.

126. From all the rights in copyright available to works, the OECD Commentary recommends, again without revealing the basis, only the consideration towards the use of distribution right (not accompanied with a right to copy) to be treated as commercial profits rather than as royalties.

Recommendation:

127. Para 14.4 of the OECD Commentary fails to recognise that the distribution rights of the copyright owner are commercial rights having economic value. Copyright holders of software world over have moved the courts to counter unauthorised distribution and to establish their copyrights in various territories. The copyright owners take these actions not to pursue some abstract copyright principles but to ensure pecuniary compensation and to prevent others from freeloading upon their economic and statutory right. This paragraph may be suitably redrafted to describe the above. Alternatively, the paragraph may be omitted altogether as it does not add anything further to the position under copyright laws.

1.7 Concluding remarks

128. National copyright laws have sound economic rationale and legal basis which are relevant for allocating taxing rights between States. If a work enjoys protection under the copyright law of a country, any copying of that work will amount to an infringement of the copyright in that work. In the absence of copyright protection, there can be no exploitation of the copyright in a work and consequently, no income is earned from the use of copyright. Thus, it is intuitive that the protection is an essential prerequisite for commanding a consideration for the use of the rights which exclusively belong to the copyright owner. The above paragraphs of OECD Commentary quoted in the UN Model Commentary deviate from these principles while allocating taxing rights under treaties. It is submitted that there exists a strong basis for the UN Model Commentary to depart from the OECD understanding in this respect. The Committee of Experts may consider the same.

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14 Paul Goldstein, Goldstein on Copyright (3rd edn, Aspen Publishers, 2006) 7:122.2, while describing Title 17 of the United States Code.

129. The above comments continue to be relevant and necessary notwithstanding the proposed change in the definition of royalties contained in Article 12(3) of the UN Model as consideration for 'use of copyright' continues in that definition.

2. Proposed Change to the Definition of Royalties

2.1 Background

130. The practice of inclusion of the words "computer software" in the definition of royalties in double tax treaties is prevalent since 1997. However, the effect of such insertion is varied. Around 535 treaties were found containing the word "software" in the definition of royalties.

131. In several treaties, countries have agreed to the inclusion of the use of computer software in the definition of royalties without their domestic law taxing such payments as royalties or otherwise without being attributed to the existence of a permanent establishment. In such cases, the inclusion of these terms appears to be of no relevance.

2.2 Cascading effect

132. The proposed change in the Discussion Draft intends to cover under the definition of 'royalties' in Article 12(3) of the UN Model payments for 'use of computer software' independent of payments for the 'use of copyright'. This could result in a cascading effect on the costs of computer software to end-users where such software is supplied via intermediaries rather than directly by the copyright owner or copyrights are acquired to deliver the end software.

133. To elaborate, if an intermediary in Country B obtains from the copyright owner in Country A the right to provide software for use by an end-user in Country C, the payment made by such intermediary to obtain that right is for the use of copyright and is royalties under Article 12(3) of A – B Treaty based on the UN Model. At the same time, the payment an end-user makes to the intermediary for the use of software would now be covered under the expanded definition of royalties and be subject to taxation under that Article on a gross basis under B-C Treaty. The allocation of taxing rights under the B-C Treaty would not consider the payment made by the intermediary to the copyright owner to obtain the copyright. Both payments being on gross basis would result in double taxation which does not get eliminated or relieved.

134. In the above example, the copyright owner, the intermediary and the end-user are in three different jurisdictions. Since the tax on both legs of the transaction are paid by different taxpayers and the taxing right for the two legs belong to different contracting states, it is unlikely that such an effect would get mitigated.

Recommendation:

135. The cascading effect described above can be avoided by excluding payments for the use of copyright in respect of computer software from the definition of royalties while, at the same

time, including payments for use of computer software in that definition. For example, Article 12(3) of Ireland – Serbia Treaty (2009) defines royalties as follows:[15]

> "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:
>
> 1) any copyright of literary, artistic or scientific work (including cinematographic films and recordings on tape or other media used for radio or television broadcasting or other means of reproduction or transmission *and excluding computer software*);
>
> 2) 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 (other than ships or aircraft operated in international traffic) or for information concerning industrial, commercial or scientific experience." [emphasis supplied]

136. However, the above would result in the country of intermediary giving up its taxing right over the income of the copyright owner though its tax base is reduced by a deduction for such payment from the intermediary's profits. On the other hand, the country of the end-user benefits from taxing the intermediary on the payments made by the end-user.

137. Alternatively, the taxing rights to the Source State for payments for the use of computer software may be on a net basis. The net basis taxation would recognise the active nature of the income from payment for the use of computer software (the end-user usually requires along with the software supplied regular support and updates) in contrast to other royalty income which is generally passive income.

138. Another option would be to prescribe a lower rate for payment for the use of computer software to mitigate the cascading effect described above.

2.3 Arguments for the proposed change

139. The various arguments given in the Discussion Draft for the inclusion of the term are now discussed in this section.

> *The proposed change would remove the blurred distinction between payments towards the use of copyright in software or copyrighted software, and thus, promote tax certainty and reduction of disputes [Discussion Draft, paragraph 7].*

140. It is submitted that redrafting the paragraphs of the OECD Commentary quoted in the UN Model Commentary that contain statements that deviate from the legal position under national copyright laws described above would reduce disputes in the characterisation of software payments to a large extent. Also, tax disputes on whether software payments fall under the definition of royalties are caused primarily due to the interpretation of national copyright laws which can best be resolved by judicial courts on a legal basis.

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15 Source: <<https://www.revenue.ie/en/tax-professionals/tax-agreements/double-taxation-treaties/s/serbia.pdf>> accessed on 5 February 2019.

141. The proposed expanding of the scope in the definition of royalties also come with their interpretational issues that could still lead to newer disputes. For instance, whether payment for software is for the 'use of software' or for the purchase of a copy would depend on the contractual terms of the transaction. Existence of an End User Licence Agreement (EULA) may not necessarily be determinative.

> *Many countries already treat payments to non-residents in consideration for the use or right to use computer software as royalties under their domestic law. Several treaties already cover payments for the use or right to use software itself under the definition of "royalties" in Art. 12. (other than the ones where explicit reference to "software" to clarify that "software" is a literary work thus protected by copyright) [Discussion Draft, paragraph 11].*

142. On a survey of around 3000+ double tax treaties, around 535 treaties were found to contain a reference to computer software in the definition of royalties. Of these, 267 treaties include payments for the use of computer software as a separate category in the definition of royalties, similar to the proposed change.

143. In other treaties, the inclusion in the definition of royalties is of a nature and effect that is different from what is being proposed in the Discussion Draft. For instance, in some treaties, payments for the use of or right to use software is included in the definition of royalties -

- only where source code is transferred, or the software is tailor-made, or the use is subject to productivity payments;[16]
- where less than the full rights to software are transferred either if the payments are in consideration for the right to use copyright on software for commercial exploitation or if they related to software acquired for the business use of the purchaser;[17]
- only if the payments are made for the right to use and exploit the copyright in the program;[18] and
- only where the use software in a manner which, in the absence of a license, would constitute a violation of copyright laws are deemed to be royalties, whereas consideration for the right to distribute software are not deemed to be royalties as long as they do not include the right to reproduce this software. Such payments shall be treated as business profits in accordance with Article 7.[19]

144. It may be noted that the above examples of inclusion of payment for the use of computer software in the definition of royalties is dissimilar to the change proposed by the Discussion Draft.

145. To summarise, treaty practice on the inclusion of computer software payments in the definition of royalties is varied depending on the requirements of the countries concerned. It

16 E.g., Korea - Germany (2000), Canada (2006), Panama (2010), Ethiopia (2016).

17 E.g., Mexico with Russia (2004), and Panama (2010).

18 E.g., Singapore - Sri Lanka (2014).

19 E.g., France with Hong Kong, Panama, St. Martin and Taiwan (2010).

can be argued that there is no one solution followed by countries for allocating taxing rights on software payments to the source state and probably, it is not required.

146. Many countries do not tax payments for the use of computer software as royalties in their domestic law.[20] These countries would need to introduce the new source rule in their tax laws to effectively enforce this new taxing right under treaties.

147. Further, payments for the use of computer software provided online is sought to be covered under automated digital services in Article 12B (proposed). With computer software now increasingly being supplied online through digital download or in the cloud through subscription-based models, the amendment in Article 12(3) may not even be necessary.

G. INTERNATIONAL CHAMBER OF COMMERCE (ICC)

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

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

General comments

150. ICC notes that the work of the Organisation for Economic Co-operation and Development (OECD) Inclusive Framework on the taxation of the digitalising economy (which includes many of the members of the UN Tax Committee of Experts) will have an impact on the current tax treatment of digital transactions and intangibles of all types, and therefore believes that this work should be completed and the results considered before any separate decisions are made with respect to proposed changes to the definition and the taxation of royalties in the UN Model Convention.

151. Software distribution and usage has changed dramatically in the last 10 years minimising the need for most software users to make a copy to use the software. ICC holds that these changes should be carefully considered in deciding the appropriate tax treatment of payments for software particularly when the proposal represents such a fundamental change from the existing law and practice in many countries. ICC suggests that input from industry to

20 On a preliminary survey of tax laws of a few countries where there are references to 'software'/'computer programme' in the definition of royalties in their treaties, the author could find only India, Spain and the Slovak Republic which include payments for the use of computer software under royalties. Needless to add, this finding was primarily to see how these countries taxed software and not based on a detailed study of these laws.

understand current and evolving software business and distribution models should be sought and considered in this respect. For example, digital services do not involve the transfer of technology; they are simply technology-enabled services and, as such, fall under Article 7 (Business Profits) of the UN Model Convention.

152. ICC notes that the current proposal does not reflect the consensus views of the UN Sub-committee members, which is especially important when considering such a relevant change to the UN Model Convention. A more thorough analysis and consideration of all the issues by the full committee, to attempt to achieve consensus, is required.

153. ICC believes that there are no principled grounds for altering the division of taxing rights for computer software payments and holds that the existing Article 7 treatment is sufficient in applying a principled division of taxing rights between source and residence states.

154. ICC considers that the proposal will likely result in a higher tax burden due to the generally higher withholding tax rate in source jurisdictions compared to the average corporate income tax rate in developed countries. ICC suggests that it is not timely for tax increases which could hamper economic growth, which is essential to rebuilding economies ensuing post-COVID recession.

155. ICC notes that gross withholding taxes do not take account of the costs of developing, distributing and updating the software, which are significant and often result in losses which must be recouped before a taxpayer can turn any profit. The imposition of withholding taxes in this context will require taxpayers to pass these costs on to customers, often local SMEs in their growth phase, through price increases which could adversely impact source country economic growth and disincentivise investment.

156. ICC fully supports a harmonised approach to ensure that international tax rules remain relevant and applicable in an increasingly digitalised global economy. In this respect, ICC believes that a departure from the existing UN, OECD or EU approach could lead to confusion, the likelihood of double taxation, tax disputes and increased compliance costs.

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

158. ICC highlights below some of the additional risks in pursuing this proposal as follows:

a. *The proposed change to Article 12 broadens the scope of the royalty article beyond commercial exploitation of copyrights and creates taxing rights without sufficient factors to justify a reallocation of taxing rights from residence to source taxation.*

b. *Potential overlap with the OECD Pillar I work could lead to increased risk of payments for computer software being taxed twice in the source/ market jurisdiction.*

c. *Definition of computer software payments is not adequately defined within this discussion draft.*

d. *Taxation of payments on a gross basis can lead to double taxation / over-taxation and lead to misallocation of taxation rights.*

e. *Depending on the precise design and rate, taxation on a gross basis can put a foreign provider at a competitive disadvantage and increase costs for customers.*

f. *Additional confusion, double taxation, compliance costs and disputes will likely result in trying to address how these changes will apply to new business models.*

159. These points are elaborated on in further detail below.

Specific comments on the proposal

a. *The proposed change to Article 12 broadens the scope of the royalty article beyond commercial exploitation of copyrights and creates taxing rights without sufficient factors to justify a reallocation of taxing rights from residence to source taxation.*

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

161. The OECD Commentary on Art. 12, for instance, refers to the right to use a copyright on computer software for commercial exploitation. The commercial exploitation of the copyright rights can be considered a key factor in determining when a license leads to royalties. Copyright rights include, for example, the right to reproduce the program for distribution to the public and the rights to modify the original program in a substantial and significant way.[21]

162. If the modification is just ancillary and unimportant, the license does not involve a right for tax purposes, i.e. a tax right. In other words, if there is no commercial exploitation, there is no transaction in copyright rights for tax purposes, and the license cannot give rise to royalties. Payments in these types of transactions, where there is not an exploitation of the protected right, are business profits in accordance with Article 7.

163. The UN commentary mirrors this approach in paras 13.1 ("exploit the rights that would otherwise be the sole prerogative of the copyright holder"[22]) and 14.4 ("exploit any right in the

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21 The protected rights are exclusive rights of the copyright owner which typically includes the rights such as those to copy (excluding for own use, back-ups or necessary functioning of the computer software for its ordinary intended purpose), modify the original source code of the program or reproduce the program in a substantial and significant way, and exclusive distribution rights. The existing guidance, for instance, makes it clear that the distribution of standard computer software is not the exploitation of the underlying protected right, but is a regular commercial activity.

22 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 where the consideration is for granting of rights to

software copyrights").[23] Also here, payments in these types of transactions are business profits in accordance with Article 7.

164. Section 2 of the current UN Discussion Draft lists the reasons put forward by the members of the Committee who support the proposed change, and would like to include this type of payment within the remit of Art. 12, even in the absence of commercial exploitation. Para 8 clarifies that:

> "*The commercial exploitation by the owner or creator of software is heavily dependent on the laws on the protection of intellectual property rights in the territory of exploitation, i.e. where the user is. Non-residents nevertheless benefit from the source country's legal system inasmuch as they rely upon it to protect and uphold intellectual property rights and enforce payment for transactions*."

165. In response it can be noted that the proposal is to include payments within the remit of Art. 12,even in the absence of commercial exploitation. The proposed change would therefore not only remove the distinction between payments for the use of copyright in software versus payments for the right to use the copyrighted article (a copy of the software program) (as noted by the members in Section 2), but also the important distinction between payments towards use of copyright in computer software with commercial exploitation (currently taxed under Art. 12) and towards use of the copyrighted article (without commercial exploitation-currently taxed under Art. 7).

166. The latter regards (i.a.) situations where there are no rights to reproduce the program for distribution to the public or rights to modify the original program in a substantial and significant way. On this basis, it is difficult to understand why-without commercial exploitation-non-residents would nevertheless benefit from the source country's legal system protecting copyright rights, since the license agreement clearly restricts the user's rights even beyond the restrictions under copyright law, there is no transaction in copyright rights to protect and uphold–apart from the (less likely) situation where thereisa breach of the license agreement(protected bymore general contract law).

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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).

23 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.

167. Furthermore, without commercial exploitation, it is also unlikely that there is any specific value being generated by the payor in the market into which computer software is being remotely sold.

168. Particularly in the absence of an active and/or sustained participation of a business in the economy of a market jurisdiction, it seems difficult to understand that the presence of a suitable telecommunication infrastructure in the source country[24] and population's competence in computers (alone) can be seen as sufficient factors to justify a reallocation of taxing rights from residence to source taxation.

169. Many of the arguments set out in section 2 of the document, are equally applicable to tools, machines, appliances, and devices, particularly in the age of the Internet of Things (IoT), automated features, smart devices, etc. Accordingly, ICC believes that they do not represent valid distinguishing characteristics to justify different tax treatment for software payments. In many of these examples, performance features are heavily dependent on software code, internet connectivity, data collection and transmission (e.g. cars, phones, jet engines, generators, locomotives, medical devices, robotic manufacturing, appliances, etc).

170. Paragraph 7 argues that with the advancements in means of communication and information technology, computer programs or other software constitute a key tool in the conduct of most businesses. As noted in para 7, "*Computer programs and other software allow enterprises that use them to reduce the time needed to perform their tasks, improve efficiency and cut costs*". Therefore, according to the text there is increased engagement in the economic life of states which justifies increased allocation of taxing rights to the state. In addition to the arguments outlined under section 3 of the document, it should be noted that source country tax revenues will benefit from the use of software. Such economic efficiencies and cost reductions allow local businesses to increase profitability, competitiveness, job creation leading to increases in business taxes on profits and wage taxes from employees. More generally, businesses purchase all products and services to increase their productivity, increase customer revenue, and reduce costs. Software products and services are tools purchased for the same reasons; therefore, the payment for standard computer software for personal or operational business use should not be treated, or taxed, differently than any other business input.

171. Paragraph 8 argues that commercial exploitation of the software is heavily dependent on the IP protection laws in the source state. In addition, the telecom infrastructure in the source state may also have a role in promoting the use of the software. This in itself does not justify a reallocation of taxing rights. This is particularly true where the infrastructure in question has been created and funded by significant investment by private businesses. Software developers (and/or the IP owner) rely significantly primarily on end user license agreements to limit customer use and protect their rights. These licenses can be more restrictive than copyright laws. IP protection laws and telecom infrastructure benefit a broad array of companies selling

24 In case software is delivered over the Internet, it is likely to also involve telecommunication infrastructure in third jurisdictions - outside the residence and source country.

protected products and services into the source country, so this rationale does not justify different source country taxation for computer software payments.

172. Paragraph 8 also states *"Given that reproduction is so cheap and easy for computer software, there is greater dependence on source state protection."* ICC considers that this proposal within the UN discussion draft fundamentally misunderstands the use of software in any context other than software licensed for copy and distribution to the public. In the context of software services, the user has access to the functional output of the software but is unlikely to have access to any of the protected rights over the software, such as the ability to copy the service provider's software. As the transaction is not for copyright rights, there is minimal, or no value provided by the copyright laws of the source state in this context. This is also the case with respect to e-commerce app stores, online advertising, participative networked platforms and online payment services. These platforms do not rely on the copyright laws of the source state and, thus, again there is minimal or no value that is added by the copyright laws of the source state. Due to significant improvements in network bandwidth (funded by software developers) software users increasingly download their computer software program directly from the software developer, or rent software directly from the 'cloud', giving the software developer greater control, based on license keys, to prevent unauthorised copying. As such, ICC states that there is no justification for royalty characterisation of any payment when there is minimal, or no value added by the source state.

173. Paragraph 10 states that software payments are *"payments for use or right to use" software (e.g. the acquisition of "shrink-wrap" software involves a license for the use of the software itself) and are not payments for the sale of property".* It is a well-settled matter of law and/or rule in many jurisdictions that the payment for a standard copy of a computer program is a transaction for a copyrighted article and treated equivalent to the purchase of a product.

174. However, in today's digitalised economy, payments for many software services do not involve any transfer of a copy of the computer software from one party to the other (nor the provision of services by a technical expert). Albeit there is a transaction involving software, these are technology-enabled services rather than the transfer of technology. Therefore, ICC holds that such payments should be covered solely by Article 7 (business profits article) of the UN model convention. As copies of standardised software (i.e., shrink-wrap software) do not differ from other goods, they too are covered by Article 7, and the delivery format for the standard software should not delineate the tax treatment thereof.

175. Paragraph 11 states that "*that many countries already treat payments to non-residents in consideration for the use or right to use computer software as royalties under their domestic law".* Whilst it is a sovereign right for jurisdictions to determine the treatment of software payments under their domestic law, ICC believes that this does not justify any changes to the UN Model Convention. Many countries do not treat these payments as royalties under their domestic law.

176. ICC maintains that the proposed change to Article 12 therefore broadens the scope of the royalty article beyond commercial exploitation of copyrights and creates taxing rights without

sufficient factors to justify such a reallocation of taxing rights from residence to source taxation.

b. Potential overlap with the OECD Pillar I work could lead to increased risk of payments for computer software being taxed twice in the source/ market jurisdiction.

177. The sale of computer software was enumerated as a consumer-facing business (CFB) in the January OECD Inclusive Framework Outline on addressing the tax challenges of digitalisation. The draft Pillar I Blueprint clarifies that certain computer software that may be delivered online will be in-scope as Automated Digital Services ('ADS') and the same material delivered by a multinational enterprise (MNE) on a physical medium will be in scope as CFBs.

178. On this basis there is potential overlap of the proposal with Pillar I work leading to increased risk of computer software being taxed twice in the source/ market jurisdiction.

179. Given the potential impact and advanced stage of the Pillar I and II discussions, ICC recommends postponing discussions on revisions to the royalty definition until the conclusion of the Inclusive Framework Pillar I and II discussions in order to avoid duplicities and inconsistencies.

c. Definition of computer software payments is not adequately defined within this discussion draft

180. The term "computer software" as used in the Article is not adequately defined, and basically refers to the interpretation at the level of parties' domestic legislation. As a consequence, there is a concern that the application of Article 12 will result in increased uncertainty, inconsistent treatment, and lengthy disputes between taxpayers and tax authorities.

181. The UN discussion draft also refers to the OECD commentary section 12.1 description of Software as: *"Software may be described as a program, or series of programs, containing instructions for a computer required either for the operational processes of the computer itself (operational software) or for the accomplishment of other tasks (application software). It can be transferred through a variety of media, for example in writing or electronically, on a magnetic tape or disk, or on a laser disk or CD-ROM. It may be standardised with a wide range of applications or be tailor-made for single users. It can be transferred as an integral part of computer hardware or in an independent form available for use on a variety of hardware."*

182. The UN discussion draft reaches the assertion that "*increasing engagement with the State where the software is used justifies the allocation of taxing rights to that State*" and "*proposed change would remove the blurred distinction between payments towards use of copyright in software or copyrighted software and would thus promote tax certainty and reduction of disputes.*"

183. Separate to the issues arising from amending the taxing rights, as noted within this paper, the concern around the definition is that the proposal also fails to take into consideration the

range of items that include computer software, nor the ways in which computer software is procured and used by businesses and end-users. Each of these points needs to be fully considered, as simply treating all the transactions that contain 'computer software' as royalties will create a perverse and distortive taxation result in different countries which also likely capture significant amounts of unintended transactions.

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

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

186. The topic has been considered by multiple working parties previously within the United Nations, as well as detailed considerations by the OECD (for example, their report to the working party No.1 on the OECD Committee of Fiscal Affairs in February 2001 where they considered the tax treaty characterisation of 28 different categories of typical e-commerce transactions ('2001 report')). It is worth noting that the 2001 report identified different computer software related transactions which fell within the definition of royalties, as well as those which did not. The Technical Advisory Group for the 2001 report whose conclusions included the identification of multiple computer software transactions which should not be royalties included Ministries of Finance from Australia, Chile, China, Germany, India, Israel, Japan, Norway, United Kingdom and United States, as well as business representatives. Many of these countries (also being UN members) have detailed tax certainty positions (via law, practice and case law) which would be at opposition to the discussion draft from the United Nations and consequentially at fundamental risk of increasing tax uncertainty for countries as well as taxpayers.

d. Taxation of payments on a gross basis can lead to double taxation / over-taxation and lead to misallocation of taxation rights.

187. The imposition of a tax on a gross basis denies the taxpayer the ability to take into account expenses that were incurred in connection with the development and provision of computer software, which would be deductible if taxes were imposed on a net basis.

188. Thus, as noted also by the members in Section 2, it is possible that the Residence State's remedies for relieving double taxation may not be adequate to fully relieve the gross-basis

taxation imposed by the other State. Consequently, taxation of computer software payments on a gross basis can lead to situations of double taxation.

189. In addition, there is a risk of over-taxation since revenue bears no necessary relationship to profit. For instance, selling shrink-wrap software can be considered a low margin business so that even a withholding tax set at a modest level could represent a significant percentage of taxable income of the seller.

190. Furthermore, withholding tax on computer software payments potentially imposes a higher tax burden (i.e. tax on gross receipts) on a company with no activities in-country (and hence no permanent establishment (PE)) than on a company that furnished those services through a local PE with significant substance in-country (and hence would be taxed only on net profits).

191. This again highlights the inconsistency of the proposed Article 12 with the established 'source' concept. Depending on the provisions for relief from double taxation agreed in a particular treaty, it also means that a potentially significant difference in the scope of double tax relief could emerge between treaty and non-treaty situations.

e. Depending on the precise design and rate, taxation on a gross basis can put a foreign provider at a competitive disadvantage and increase costs for customers.

192. A business' net economic returns for the activities in a country should be linked to the value functions within that location, and not solely linked to the popularity of an industry or to the ease of reproduction of computer software. If computer software is sold within a country, there are already alternate appropriate mechanisms in place to ensure that the value creating activities are appropriately captured within the tax system.

193. Placing additional taxation obligations into low-value-add and low-risk areas of this value chain undermines the principles of a fair return attributable to the relevant jurisdictions. There is no direct correlation between the amount of risk and investment a company makes in developing computer software and the economic viability of the product. Solely because this is intellectual property, it would be flawed to assume that the taxing right and process should be similar to interest.

194. The blanket approach of imposition of a withholding tax for all foreign computer software vendors on a gross basis may increase the costs of doing business in that territory and put the business at a competitive disadvantage, effectively foreclosing access to the market and restricting a legitimate choice of suppliers.

195. It is foreseeable that a computer software provider may seek to include a 'gross-up' clause within the customer contracts, to pass on the impact of withholding tax to the customer, in return increasing the net computer software cost in that territory. Essentially the increased cost which would be higher than that in other countries, could have a negative impact on cross-border trade productivity, and economic growth.

196. Further, with some countries imposing withholding tax and others not on comparable transactions, this could lead to distortive market places and in addition could lead to the inadvertent use of tax rule differences to favour competitive growth in some countries over others.

f. Additional confusion, double taxation, compliance costs and disputes will likely result in trying to address how these changes will apply to new business models.

197. The proposal to include computer software within the definition of royalties fails to consider the continuing evolution of different business models, and risks arbitrarily and artificially creating a new class of taxing rights for transactions which were not intended within the remit of the withholding tax rules.

198. As computer software becomes more integrated into a wider array of business models, adding 'computer software' to the royalty definition makes it increasingly challenging for all parties to apply the correct tax treatment to 'royalties', 'services or other commercial transactions subject to business profits', etc..

199. This uncertainty could lead to taxing the same income twice, additional compliance costs and disputes for companies and tax administrations as they seek to understand and apply consistency. Currently, there are clear examples of where different services are provided which do not fall within the definition of know-how (royalties) or technical services or other similar categories under which tax is withheld. For such transactions, there is considerable research and support for such service transactions to be treated as a business profit and taxed within Article 7 (business profits).

200. The royalty clause can apply without explicitly mentioning computer software, such as the commercial exploitation of any copyright right (e.g. books, music, movies). However, there are many instances where payments for computer software are not royalties. Making it unclear if a transaction, which may have been typically the domain of a business profit (for example payment for services), is now a royalty risks fundamental negative change if services-based payments are captured within the definition of a royalty because they contain an element of computer software.

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

202. Overall, ICC considers that the proposals within the UN discussion draft are not justified by the facts and would fundamentally lead to uncertainty in the way that such transactions are taxed in different countries, and lead to additional compliance burdens for tax payers and tax authorities, as well as increasing uncompetitive practices between countries.

About The International Chamber of Commerce (ICC)

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

H. INFORMATION TECHNOLOGY INDUSTRY COUNCIL (ITI)

204. The Information Technology Industry Council (ITI) is the leading global association for technology companies. Our members are headquartered around the world, operate globally, and include all major verticals of the tech sector, including companies that specialize in hardware, software, internet services, cybersecurity, and beyond. We take a global perspective with our comments, drawing on the deep international experience of our members.

205. ITI understands this proposal has been raised for consideration by members of the COE before without any action having been taken, and the current discussion draft under consideration incorporates new rationales in support of amending the UN Model. As active participants in the innovation economy, ITI members have practical concerns about the impact of the proposal on their ability to engage with global markets, as well as principled concerns about the underlying rationales cited to justify the reclassification of revenue derived from software payments. ITI does not believe that the newly raised arguments for amending the definition of "royalties" to include software payments are persuasive. ITI therefore recommends that the COE not adopt the proposal described in the discussion draft. However, if the COE decides to continue its discussions on this proposal, ITI suggests that it be taken up by the next COE, given the limited remaining time for the current COE to consider such a significant proposal. ITI welcomes the opportunity to further participate in an exchange of views with our many members in the software industry.

206. The substance of our concerns stems from the fact that a change to include computer software payments in the definition of royalties in the UN Model would be a concerning departure from Article 12 of the Organisation for Economic Co-operation and Development's (OECD) Model Tax Convention on Income and on Capital, the Commentary of which maintains that "payments in these types of transactions would be dealt with as business profits in accordance with Article 7," based on a reasoned approach of usage versus the exploitation of software.

207. In addition, a departure of this nature should only be made to the UN Model if such change enjoys widespread support. Based in part on the arguments put forth by opponents to the proposal as outlined in the discussion draft, it is our belief that this proposal does not represent a widely held view. The fact that some jurisdictions have unilaterally opted to treat payments to non-residents for software copies as royalties should not be considered relevant in

the context of amending the definition of royalties in the UN Model for the purposes of bilateral treaty negotiations. The proposed comprehensive expansion of the definition of royalties to include computer software payments would not only increase compliance costs and raise the likelihood of disputes, it would effectively institutionalize greater fragmentation across jurisdictions (many jurisdictions, notably, do not treat as royalties payments for software without the right to exploit the copyright).

208. As noted in the discussion draft by COE members who oppose the proposal, the sale of a software copy (e.g., shrink-wrap software) represents "a sale of a good that would give rise to business profits that fall under Article 7" of the UN Model because the product is standardized across all potential customers, as is the case with a tangible good or product. This approach to classifying transactions involving software acknowledges the difference between a copyright right and a copyrighted article. A payment for the use of, or the right to use, a software copyright is a royalty. A payment for the use of a software program copy is not a royalty, just as a payment for a physical or electronic book is not a royalty. ITI believes that there have been no developments that would warrant a change to this classification. While the software industry has developed more streamlined and cost-effective mechanisms for delivery of software, this in itself does not merit a change to the underlying classification of the payment.

209. Furthermore, the implication that a company's access to copyright protection – and by extension, recourse – through a State's legal system should have any impact on a State's justification for the allocation of taxing rights disregards the valuable but disparate roles that intellectual property (IP) protection and tax law play in facilitating a stable and thriving business environment. There are several fundamental issues with this implication. First, on principle, a State's reallocation of taxing rights should not be evaluated or dependent on a State's activities to protect a copyright. The administration of IP law should not be considered as a viable justification for a departure from existing, long-standing international tax principles in the development or administration of taxation law. Second, businesses selling software into a market are more likely to make use of end user license agreements (EULAs), which serve as a legal contract between the individual customer and the developer, than source state copyright laws in order to provide additional legal protections for the seller/developer. In fact, modern software delivery models (such as online platforms and "app" stores) provide greater control for businesses to prevent unauthorized activities with respect to their software. For example, EULAs impose restrictions on customers in addition to the restrictions that copyright law already imposes on such activities (i.e., reselling the program copy or reverse engineering the software source code) that either do not, or may not, rise to the level of copyright infringement.

210. Finally, software's "level of engagement" with the economy has no relevance for the technical question of whether a payment should be characterized as business profits or royalties. The discussion draft's example of natural resources further reinforces that even if this was the case, software is not unique in its "level of engagement" with the state where it is used. A software product does not "engage" in a market any more than does a commodity such as oil or copper. The fact that software products are prevalent does not distinguish them from

a variety of products sold today and does not justify a change to the classification of a payment for the use of a software program copy as business profits.

211. Software is a business input that benefits businesses of all sizes as well as governments and non-governmental organizations, and its use can amplify the efficient and seamless execution of everyday activities. Within this context, the imposition of gross withholding taxes on all software payments (assuming the proposal is adopted and a tax treaty does not eliminate the royalty withholding tax) not only disregards the costs associated with creating, updating, and delivering the software, but may also contribute to a higher tax burden and reduced profitability as well as the potential for passing the tax onto end users through higher prices. Companies may have to divert their business activities away from jurisdictions that treat all computer software payments as royalties subject to withholding tax, which would effectively reduce domestic access to productivity-enhancing goods and services that drive economic growth in the market jurisdictions.

212. Providing a stable tax environment enables companies to devote resources to sustaining and growing their businesses, which is all the more important as governments continue to mount the strongest possible economic and public health responses to the outbreak of COVID-19. The March 26 statement released by G20 Leaders underscores this sentiment: "We reiterate our goal to realize a free, fair, non-discriminatory, transparent, predictable and stable trade and investment environment, and to keep our markets open." During these exceptionally challenging times, we applaud the G20 leaders for their commitment to realizing a stable and open environment and encourage the COE to adopt a similar approach.

213. Finally, ongoing work under the auspices of the Inclusive Framework – which features participation from nearly 140 governments – to address tax challenges of the digitalizing global economy will likely have implications for the tax treatment of digital transactions and intangibles. Nevertheless, ITI does not believe that such work affects the classification of computer software payments, which enjoys a general consensus among countries to distinguish between payments for acquiring copyrighted articles (i.e., business profits) and payments for exploiting copyright rights (i.e., royalties). In the interest of ensuring a predictable and stable tax landscape, ITI recommends that the proposal described in the discussion draft not be adopted. If the COE decides to pursue further discussions on the proposal, it would be more appropriate to hold consideration of this topic until the next COE is convened and after the Inclusive Framework has completed the designs for its project, at which point tax administrations and companies alike can work through the implementation of what are expected to be significant changes to the global tax system.

214. Thank you again for the opportunity to provide comments on the discussion draft. We remain at your disposal should you have questions.

I. LEGAL COMMITTEE OF ITALCAM

215. The Legal Committee (COJUR) is a technical organ of ITALCAM, whose purpose is to promote exchanges in legal matters and the organization of lectures, congresses, seminars,

events and meetings between its members, the different members of ITALCAM and third parties, encouraging and promoting the improvement and expansion of legal knowledge, both at the national and international levels.

216. In its structure, COJUR has thematic working groups, among which the Tax Working Group, responsible for the elaboration of this comment.

217. Please find below our comments on the discussion draft which includes a proposal by a number of members of the Committee for a change to the definition of royalties included in Article 12 of the United Nations Model Double Taxation Convention Between Developed and Developing Countries.

218. Allocation of taxing rights to source countries can indeed be justified whenever such jurisdictions offer: (i) the owners or creators of the software national laws protecting their intellectual property rights and/or copyrights (including practical measures to avoid illicit reproduction / download); (ii) appropriate infrastructure, mainly telecom, to enable the use of the licensed technology; and (iii) support to create, maintain and increase an attractive local market eager and qualified to consume software and digital solutions. Article 12 should, however, be applied in a subsidiary manner and contemplate only those situations where the licensee is granted with the right to reproduce and distribute software (exploitation rights) or where payments are made to allow the licensee to not only use the program but also access the relevant source code. Other situations, for instance, where transactions, in their essence, approximate more to a trade of a good, should be included under the scope of other articles of the treaty.

219. Mixed contracts which cover the acquisition of the right to use software together with the acquisition of goods and services should be taxed according to the most preponderant element of such contracts. The main purpose of the licensee (or purchaser) or the main rights granted to him are, therefore, relevant for determining the article of the treaty to be applied in each case. The vehicle used to transfer the software (physical or digital media, disk, magnetic tape, CD-ROM, download, SaaS) to the licensee (or purchaser) should, however, not be relevant. In such a context, Articles 7 or 13 should apply if the transaction, in essence, approaches more of a purchase or import of a good. Articles 12 and 12A (technical services) should not apply if the main purpose of the licensee is of merely using a software. Article 12 should apply to situations involving technology transfer (e.g., agreement allowing the disclose of the program’s source code) or the exploitation of rights connected to software.

220. Splitting a mixed contract in different pieces and imposing the correspondent taxation to each part of the contract exposes the business strategy of software developers and opens room for non-desired negotiations between them and their customers. Also, this solution increases tax compliance and give unnecessary complexity to such transactions.

221. The use of shrink-wrapped or widely supported standard software, either being formalized through a license agreement or through the acquisition of: (i) a single copy, (ii) the right to download the software or (iii) the permission to use it under a SaaS arrangement, should

be regarded as a purchase or import of property and ruled by Article 7. There is no reason to differentiate payments for a standard software, not tailor-made for a specific customer, but, instead, equally offered to all potential customers from payments for the purchase or import of other types of (tangible or intangible) goods.

222. The transfer (or license for the use) of a software as an integral part of a computer hardware (software embedded in other products, such as those already pre-installed in an equipment, computer or a mobile phone) should be regarded as purchase or import of a good and ruled by Article 7.

223. In all situations above, Article 13 should only apply when the core business of the seller (or licensor) the software does not encompass the development and/or selling or licensing of software and/or hardware (as the case may be).

224. The acquisition of a software, in cases where the full ownership over the intangible is transferred to its acquiror, involves no payment in consideration for the use of or the right to use a software and, thus, cannot be qualified as royalty. Such type of transaction, whenever it is structured as a sale (alienation of the entire rights in the copyright and withdrawal of all restrictions on its use by the acquiror), should give rise to payments for the acquisition of property of an intangible and, therefore, ruled by Articles 7 or 13.

225. License granted to a distribution intermediary, whereby the latter only receives the right to distribute copies of the software without the right to reproduce it, entitles him to the performance of a mere commercial activity and gives him no right to exploit any software copyright. Pure distribution rights should be disregarded for tax purposes and this type of arrangement should not qualify as royalty, but rather be subject to Article 7.

226. In all other situations, the license for the use of software should be under the scope of Article 12 and treated either as a copyright or royalty, according to the domestic legislation of the Contracting State applying the relevant treaty.

227. We remain at your disposal should you need any clarification on our comments.

J. NASSCOM

1. Objective

228. The purpose of this document is to discuss Public Consultation Document prepared by the United Nations Committee of Experts on International Cooperation in Tax Matters for Inclusion of software payments in the definition of Royalty.

2. Background

229. During the 20th session of the United Nations (UN) Tax Committee (Committee) meeting held online from 22-26 June 2020, it was recommended by members that the Committee should focus its attention on amending the current definition of royalties included

in Article 12 of the United Nations Model Double Taxation Convention Between Developed and Developing Countries (Article 12 of UN Model).

230. Accordingly, the definition of term "royalties" in paragraph 3 of Article 12 of UN Model is proposed to be amended 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.

231. In order to solicit views from stakeholders, UN has released this Discussion Paper.

3. Summary of NASSCOM's response

1. All software payments cannot be characterised as "royalty"

232. All software payments cannot be generalised and characterised as "royalty".

2. Characterization of software

- If the consideration paid is for purchase of a standard software / shrink-wrapped product, i.e. a mere user right other than a right in the Intellectual Property (IP), then the payment made should not be treated as royalties, instead the same should be classified as business income. However, if the consideration is for right to commercially exploit the IP in the software, then the same would tantamount to royalty.
- If the grant is of a copyright in computer program (i.e. an intangible or IP), then the source country can tax it as royalty on a source basis. If instead, it is a sale of a copyrighted article (i.e. a product), the source country can tax it only in the event the foreign company has a permanent establishment in the source country. This approach / jurisprudence has also been considered in multiple cases by various courts.

233. If we analyse the existing term 'royalty' as defined in the tax treaty, we find that the intent of royalty is to include the 'copyright' and not the 'copyrighted article'. Accordingly, if the word" 'computer software' (which is a wider term) is added as proposed in the existing definition under Article 12 of UN Model, the intent of the term 'royalty' which includes "copyright' and not the 'copyrighted article' will be defeated.

4. Interplay and need to address overlaps of proposed taxation of software payments

234. : Interplay and overlaps of proposed taxation of software payments under Article 12 with taxation of digital economy under Organisation for Economic Co-operation and Development's (OECD) Pillar 1 and 2 guidance and unilateral measures of some countries as

well as proposed Article 12B by the UN Committee on Automated Digital Services need to be addressed.

5. Administrative difficulties

235. There would be difficulties to implement the proposal such as considering characterisation issues in case of software embedded in products or mixed contracts or administrative issues such as imposing withholding tax obligations in cases of individuals purchasing computer software for personal use. These would need to be addressed to maintain consistency.

4. NASSCOM's Detailed Response

1. Characterization of software - Fundamental differentiation between copyrighted product or copyright in the product

236. The issue of taxation of cross border software licensing transactions has been a bone of contention between the tax authorities and taxpayers over the years. The controversy is pursuant to the difference between the broader definition of Royalty under the domestic tax laws of some countries and the narrower definition under Double Tax Avoidance Agreements (tax treaties). The principal issue relates to characterization of software payments, thereby resulting in determination of what is being procured when payment for software is made and what rights are granted to a user.

237. In order to determine whether a software payment qualifies as royalty or not, it is important to first understand the character of the transaction for which payment is being made i.e. whether the software is:

- a copyrighted product with only limited user right granted to the user or
- a transfer of some or all the rights in IP to the user.
- such software is used for providing / delivering the services (where the user / customer downloads the computer software / app onto its device for free for the purpose of availing services from the service provider).

238. Depending on the nature of transaction, software payments made to a foreign company could be characterised either as

- Royalty,
- Fees for Technical Services (FTS),
- Business profits or
- Capital gains.

239. Following are some examples demonstrating and differentiating between various types/categories of software payments:

S.No.	Description
1.	Transfer of a copyright in the computer program (outright sale of software by transferring all rights including ownership rights in IPR of software without any restriction)
2.	Transfer of certain rights in copyright of a computer program (wherein the licensor retains ownership of software / computer program and licenses certain rights in IP, without outright sale of software)
3.	Transfer of a copy of the computer software (Sale of standard software with only usage rights and no IP rights i.e. a copyrighted product
4.	Provision of services for development/ modification/ customization of the computer program/software
5.	Provision of software related services (such as installation, maintenance, testing, etc.)
6.	Provision of services through software where user / customer downloads the software / app onto its device for free for the purpose of availing services from the service provider

240. Where the consideration paid is for purchase of a product, as envisaged in category 3 above, and not for transfer of rights in IP per se, it should not be regarded as "royalty". However, consideration received for services provided in relation to software or using the software for providing services as envisaged in category 4 to 6 above should generally be regarded as 'service' and hence, cannot be classified as royalty.

241. The character of payments received for transactions involving transfer of computer software depends on the rights that the transferee acquires for use and exploitation of the program.

- Where rights acquired in relation to a copyright are limited to those necessary for the user to operate the program (for example, where the transferee is granted limited rights to download or store the program for use), the payments would not qualify as royalties. In this scenario, the rights granted are those which are essential for effective operation of the computer program.
- In cases where the payer obtains all or any of the copyright rights of the literary work being software i.e., computer program or codes for commercial exploitation, it could qualify as royalty. For example, purchase of a book by a customer does not tantamount to purchase of copyright in the book, even though the publisher publishes the book by purchasing the copyright. Similarly, purchase of a canned or standard software should not be regarded as purchase of copyright, but as *purchase of a copyrighted article*; and thus the payment therefore should *not be classified as royalty.*

242. Likewise, where any person acquires the right to use a copyright in software (i.e., computer program), the payment so made would amount to royalty. However, in cases where the payments are made for purchase of software as a product (without any underlying rights in copyright in software), the consideration paid cannot be considered to be for the use or right to use the copyright in software. It is well settled that where software is sold as a product, the same would amount to sale of goods.

243. The *Hon'ble Supreme Court of India* in the case of Tata Consultancy Services (TCS) (271 ITR 401) held that a transaction of sale of computer software is clearly a sale of 'goods' within the meaning of the term 'goods' used in Article 366(12) of the Constitution of India and as defined under the Andhra Pradesh General Sales Tax Act. Relevant extract of the decision is reproduced below:

> *"a transaction of sale of computer software package off the shelf is clearly a sale of "goods" within the meaning of that term in section 2(n) of Andhra Pradesh General Sales Act, 1957. The term "all materials, articles and commodities" in section 2(h) of the Act includes both tangible and intangible/incorporeal property which is capable of abstraction, consumption and use and which can be transmitted, transferred, delivered, stored, possessed, etc. The software programmes have all these attributes."*

244. Accordingly:

- IP once put on media, whether it be in form of books or canvas (in case of paintings) or computer discs or cassettes or software/ apps downloaded from servers, and marketed, it would become 'goods'. Thus, a transaction of sale of computer software is clearly a sale of 'goods'.
- There is no distinction between 'branded' and 'unbranded' software. In both cases, the software is capable of being abstracted, consumed and used.
- The canned software (i.e., computer software packages off the shelf) are also 'goods' and as such assessable to sales tax.

245. From the above, it is abundantly clear that computer software that is provided as a copyrighted product shall be "goods" and therefore, generalisation and characterisation of all computer software payments as "royalties" is unwarranted and unjustified.

246. Only those payments which are made for use of or right to use any copyright in computer software should be covered within the meaning of 'royalty'. Payment for a copyrighted article should not be covered within the meaning of 'royalty'.

247. The above principle has been recognized in the case of Infrasoft Limited, 220 Taxman 273 [Delhi HC] (and also followed in several other Indian court rulings), wherein it has been stated that payment towards copyright in computer software should be considered as royalty and not the payment made towards the copyrighted article; which would be business income. The relevant extract is reproduced herein below for ready reference:

"90. The license granted to the licensee permitting him to download the computer programme and storing it in the computer for his own use is only incidental to the facility extended to the licensee to make use of the copyrighted product for his internal business purpose. The said process is necessary to make the programme functional and to have access to it and is qualitatively different from the right contemplated by the said paragraph because it is only integral to the use of copyrighted product. Apart from such incidental facility, the licensee has no right to deal with the product just as the owner would be in a position to do.

....

97. What is transferred is neither the copyright in the software nor the use of the copyright in the software, but what is transferred is the right to use the copyrighted material or article which is clearly distinct from the rights in a copyright. The right that is transferred is not a right to use the copyright but is only limited to the right to use the copyrighted material and the same does not give rise to any royalty income and would be business income."

248. Payment for purchase of software being similar to payment for purchase of any 'product/ goods' (provided it is without any specific right i.e. copyright) is in the nature of business income and cannot be characterised as payment of royalty.

249. Transfer of all/ any right in a copyright of computer software is a mandatory pre-requisite for a consideration to take the colour of "royalty". Thus, there needs to be a transfer of any or all of the copyrights which are listed under Section 14 of the Indian Copyright Act, 1957 viz.

- Rights to make copies of a computer program for distribution to public by sale or other transfer of ownership, or by rental, lease or lending
- Right to make derivatives of the computer program
- Right to make public performance of the computer program; or
- Right to publicly display the computer program etc.

250. A purchaser of software does not get any of the rights referred to above and hence, the purchase is not of any copyright per se, but merely of a product which is copyrighted.

251. Hence, it is necessary to look at the predominant purpose for which consideration is paid in a transaction. Where the consideration is primarily for purchase of the product and not for use of IP therein, and the use of such IP is merely incidental to purchase of the product, the payment should be characterised as purchase of a product and thus, business income and not as royalty. This fundamental difference for nature of rights in software granted to user – i.e., whether user receives copyrighted product vs certain rights in copyright or computer program for exploitation, needs to be respected, and merely granting the taxation rights to the source state for any computer software to avoid or reduce litigation and achieve tax certainty, may not be in the spirit of international taxation framework.

252. Additionally, it may be difficult to apply the above proposed taxation framework in case of more nuanced issues such as characterisation of payments in cases of software embedded in a hardware product (for instance, computer hardware and telecommunication equipment) or where there are mixed contracts including software, without specific allocation amongst different components of the product sold. The uncertainty would still continue and would lead to larger disputes and inconsistency in taxation and application of above principles.

2. Interplay and need to address overlaps of proposed taxation of software payments under Article 12 of UN Model with taxation of digital economy under OECD Pillar 1 and 2 guidance, unilateral measures of some countries as well as proposed draft of Article 12B on Automated Digital Services introduced by the UN Committee

253. Under OECD's Inclusive framework, there is a significant amount of work underway on developing taxation framework for digital economy through OECD's Pillar 1 and Pillar 2 approach and work on this is expected to be completed soon with consensus from participating countries (i.e, 138 countries which are part of the Inclusive Framework of OECD and includes several developing countries which are mostly signatories and members of UN Model as well). The participating countries are contributing significantly to this OECD project and it is unclear and surprising to see the need for such a proposal now to include software payments of any kind within the definition of 'royalty' under the UN Model.

254. As such, Pillar 1 of OECD is being developed to address broader tax challenges of digitalized economy and focuses on re-allocation of taxing rights to market jurisdictions; Pillar 2 on the other hand, deals with other remaining Base erosion and profit shifting (BEPS) issues and addresses the issue of continued risk of profit shifting to entities subject to no or very low tax. The scope of OECD's Pillar 1 is focused on (i) 'automated digital services' – i.e., services that are provided on standardised basis to customers or users and (ii) 'consumer-facing businesses' - businesses that generate revenue from sale of goods and services of a type commonly sold to consumers, which satisfy a certain nexus threshold.

255. Provision of software is also likely to get covered under the categories prescribed under Pillar 1 and the allocation of profits to market jurisdictions will address the rationale given in the UN paper for granting taxation rights to source countries in respect of software payments. Hence, there is likely to be an overlap of taxation of computer software considering the work done by OECD and amendment proposed by UN Model to the definition of 'royalty'. This may end up in complicating tax framework further instead of providing clarity and certainty.

256. Given this, it will be imperative to appropriately address overlap of the proposed taxation of software payments with the consensus proposal to be adopted by the OECD on this matter.

257. Even the UN Committee has recently proposed insertion of Article 12B – Income from Automated Digital Services in the UN Model Convention, to deal with the tax treatment of payments for digital services. This proposed article has illustrated the services falling under 'automated digital services' which include automated provision of computer programmes/ software. This could result in an overlap with the proposed amendment to Article 12 of UN Model and therefore, requires to be addressed adequately. Also, it may be noted that a number

of countries have taken unilateral measures under their domestic laws (e.g. Digital Services Tax (DST), Equalization Levy (EL), etc.) with most of them committing to withdraw such unilateral measures once consensus approach under the OECD framework is reached. Interplay of the same with the UN proposals, however, will need to be given careful consideration and any provisions leading to situations of double taxation should be avoided.

258. Hence, it is imperative for the Committee to re-think whether such a proposal to amend definition of royalty is indeed needed and how such overlaps would be addressed. In absence of a coordinated approach on this front between the countries, the OECD and the UN, the tax world would be far from achieving certainity and would be instead stuck with more disputes and a less conducive environment for businesses to thrive. This could be one of the reasons why there is lack of consensus amongst members of the UN Committee on this proposal and the views expressed by dissenting members seem completely justified on fundamental principles.

3. Administrative difficulties

259. Proposed amendment provides that the payer withholds taxes on software payments made to non-residents. This proposal would give rise to practical challenges with respect to individuals purchasing standard computer software for their personal use (as against business use) who may not have the necessary infrastructure to comply with withholding tax obligations.

5. Conclusion

260. All computer software payments cannot be classified under the definition of "royalty" without analysing the real characteristics of a transaction. Hence, mere "computer software" should not be added in the royalty definition as it would lead to unintended consequences for the taxpayers. This may also not be in the spirit of international taxation framework.

261. If the word "computer software" needs to be added in the royalty definition for any reason, then, the following wordings should also be added along with "computer software" in order to be qualified as royalty:

262. 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 with rights to commercial exploitation of the copyright or any rights forming part of the copyright pertaining thereto or for the use of, or the right to use, industrial, commercial or scientific equipment or for information concerning industrial, commercial or scientific experience."*

263. Notwithstanding the above, if UN Committee goes ahead with such a proposal based on consensus from members, guidance should be provided to ensure that interplay and overlaps are carefully considered in situations where the software payment is subjected to tax under the new taxing right (Pillar 1 and 2 of OECD / UN Article 12B) as well as under Article 12 of UN

Model as royalties and there is no undue double taxation and tax uncertainty. Guidance should also ensure consistency across different industries and operating models.

6. About NASSCOM

264. The National Association of Software and Services Companies (NASSCOM), a not-for-profit industry association, is the apex body for the 180-billion-dollar Information Technology (IT) and Business Process Management (BPM) industry in India. Established in 1988, NASSCOM helps the technology products and services industry in India to be trustworthy and innovative across the globe. NASSCOM's members, 2800+, constitute 90% of the industry's revenue and have enabled the association to spearhead initiatives at local, national and global levels.

K. RAWAL RADHAKISHAN

1. Taxation of software : Current Status and desired level of certainty

265. The disagreement on interpretation adopted in the OECD Commentary on Article 12 as regards software payment is captured in the UN Commentary. Currently, there is significant litigation and uncertainty on the taxability of software in the source country.

266. This litigation is not conducive to international trade and commerce. What MNEs need is tax certainty. This certainty can be achieved by adopting a very clear position on taxability of software payments in the UN Model and UN Commentary.

2. Current international chaos on taxation of digitalized economy and related lessons

2.1 Outdated tax system

267. In last five years it is recognized that tax laws have not kept pace with the development of technology. The distribution of taxing right under the OECD or UN Model is not fair and is not acceptable now. The Inclusive Framework has accepted that there is a need to give a new taxing right to the source countries.

2.2 Emergence of Unilateralism

268. Delay in designing and getting consensus over the design of new taxing right (Amount A of Pillar One) has resulted in several countries (not only developing but also most developed) adopting unilateral measures such as Digital Service Tax (DST) or Equalisation Levy.

269. Thus the most important lesson from the BEPS Action One episode is that *when the multilateralism fails and fair distribution of taxing right is prevented, the unilateralism takes over*. Such unilateral measures are more harmful to international tax as the country of residence would not give tax credit.

3. *Certain observations on arguments in para 15 of the UN Software Royalty discussion draft*

3.1 Why software payments need to be differentiated from payments for other goods?

270. This question is predominantly based on the understanding that current distribution of taxing rights on the basis of existence of permanent establishment is sacrosanct. However, this basic premise is now significantly challenged.

271. The Inclusive Framework (Pillar One) has proposed a new taxing right Amount A even for Consumer Facing Business (CFB). Thus 138 countries believe that current taxing norms based in permanent establishment need to be changed even for CFB, CFB will include normal physical goods (e.g. cars) and also licensing arrangements.

272. Unlike other goods, software also enjoys IPR protection.

3.2 Challenges of coordination with work on digitalization of economy

273. This co-ordination may not create any difficulties. There fact that OECD IF is working on Pillar One should not stop the UN Tax Committee to work on software taxation or any other issue. Pillar One work is extremely meticulous but complex and complicated. It is not completed and an uncertainty of lack of political consensus / approval always exist for that work, in addition to the uncertainty related to participation by USA. It is possible that Pillar One fails and hence UN Tax Committee must parallelly work on these issues.

274. UN Tax Committee has also started working on Article 12B and overlap would be avoided there as well.

Sr. No.	Possibility	Co-ordination
1	UN Article 12 changes are adopted and Pillar One is accepted by all the countries	**Where there is no overlap** There could be several MNEs out of scope as a result of Euro 750mn (or other) threshold. Similarly, there could be several market jurisdictions who would not get taxing rights as they do not satisfy Nexus threshold. Article 12 will enable the source countries to levy tax on software payments in these cases. **Where there is an overlap** The source country may be able to levy tax on Amount A allocation as well as under Article 12. Pillar One contemplates such overlaps and also

		has (getting developed) solutions to address such overlaps[25].
2	Pillar One is not accepted Article 12B is not accepted Article 12 is amended	Source country will get taxing right under Article 12
3	Pillar One is not accepted Article 12B is accepted Article 12 is amended	Source country will get taxing right under Article 12. Article 12B is likely to be applied[26] when Article 12 and Article 12A does not apply.

275. Thus it can be observed that coordination with other work on digital economy is not difficult. On the contrary Article 12 could complement Pillar One work for the reason that Pillar One does not resolve all the issues and several countries / MNEs may remain out of Amount A as a result of thresholds.

3.3 Rationale or policy principal for taxing rights to source country

276. Blocking the proposal by questioning the rationale for giving taxing right to the source country is like completely ignoring the contemporary international tax developments and remaining in constant state of denial.

277. About 138 countries in the inclusive framework have agreed that the old principles do not result in fair distribution of taxing tights not only for ADS but also CFB. Such development and current thinking cannot be completely ignored.

278. The rationale for allowing source country to levy tax on software is not significantly different from other provisions of the UN Model.

- Income in the nature of "software payment" arises in the source country,
- is paid by a tax resident (or a PE in) the source country
- it erodes the tax base in the source country as deduction is allowed for such payment from taxable income in the source country

279. Such features are present in the following Articles:

- Article 11 – Interest

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25 Refer the Issue of Double Counting in Chapter 6 of Pillar One

26 This aspect should be categorically clarified in Article 12B or its Commentary

- Article 12 – Royalties
- Article 12A – Fees for Technical services

3.4 Additional cost to the end user

280. The apprehension that levy of tax by the source state will increase the cost to the end user does not appear to be correct.

3.4.1 Tax Credit

281. In the country of residence, if the MNE is allowed credit for taxes paid in the source country, the costs do not go up for the MNE and hence levy of tax by the source country will not increase the cost.

3.4.2 Market competition

282. The argument that cost to the end customer will go up presumes a monopoly and ignores market competition. The price for the product would be influenced by the market competition.

3.4.3 Elasticity of demand

283. The argument that cost to the end customer will go up also ignores the concept of elasticity of demand. Prices can go up only when the demand is completely inelastic.

3.5 Initial year losses

284. The argument of initial year losses would be reasonable and gross taxation may create some difficulties depending on the cost structure of the MNE. Approaches to address this issue would include the following:

3.5.1 Option of net basis taxation

285. The MNE may be allowed the option of gross or net basis of taxation. Proposed Article 12B contains such an option.

3.5.2 Calibration of tax rates

286. The rate at which the source country is allowed tax in terms of Article 12 on gross basis can be calibrated to address this issue.

287. The rate of tax may be kept lower in the first 1-2 years to allow the MNE to recoup initial costs etc. and the tax rate may be increased subsequently. Further work would be required to conceptualize this suggestion.

3.6 When the software provider stops selling software in other countries

288. One of the observations in the second last bullet of para 15 is that the software provider will cease to sell its software in the source country if the source country starts taxing such software.

289. This does not appear to be appropriate. The software providers certainly need markets in the source country to sell its products and earn profits. The above statement pre-supposes that only the customers in the source country are in need of software. However, the software sellers are equally in need of the markets in the source country.

290. It also needs to be noted that if the software companies stop selling software in the market jurisdictions, there would not be any income on which the country of residence would be in a position to levy tax. *The resident country would completely lose its taxing right as there would be no profits to tax.* A more logical approach would be to give fair share of the tax on such income to the source country.

3.7 Individual user

291. One of the issues highlighted is how would such rule work when the purchaser of software is an individual. This may be a pure domestic law issue and should not be a parameter for distribution of taxing rights.

4. Need for UN MLI

292. Amendment of Article 12 and its commentary to give taxing right to the source countries would have no practical implications unless the treaty provisions are amended.

293. To quickly implement such changes in the tax treaties, it is desirable that UN Tax Committee also adopts and implements MLI mechanism.

5. Avoid Unilateralism

294. OECD BEPS Action 1 has made it absolutely clear that adoption of rigid approach based on old treaty rules to avoid fair distribution of taxing rights results in unilateralism. Several developed and developing countries have adopted unilateral measures to protect its tax revenue.

295. It is desirable that the UN tax Committee considers the lessons from BEPS Action 1 and adopts a practical approach to achieve a fair distribution of taxing rights, consistent with the contemporary international thinking.

L. SILICON VALLEY TAX DIRECTORS GROUP

296. The Silicon Valley Tax Directors Group ("SVTDG")[27] is pleased to submit our comments in response to the United Nations Committee of Experts on International Cooperation in Tax Matters (the "**Committee**") discussion draft (the "**Discussion Draft**") on the inclusion of "computer software" in the definition of royalties in Article 12 of the United Nations Model Tax Convention between Developed and Developing Countries (the "**UN Model**") published on September 1, 2020.

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

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

[Letter]

PART I: Introduction

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

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

300. Generally, the Proponents justify including "computer software" in the definition of royalties and cite to the allocation of taxing rights to market countries. Although the

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

justifications and arguments underlying the proposal in the Discussion Draft are new for the most part, none of the Proponents' arguments in favor of the change withstand scrutiny.

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

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

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

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

PART II: Specific Concerns with the Discussion Draft

1. Engagement in the economic life of market countries

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

306. We agree with the Opponents that this justification is "problematic."[28] A "significant level of engagement in other State's economy" is not unique to software, yet the Discussion Draft would seek to use a justification that applies to any sector to single out companies that sell software. Even if this rationale were unique to software, or if the Discussion Draft sought to impose its proposal on a more inclusive swath of industries and companies, it does not justify treating such payments as royalties. Suggestions that software or any other product has

28 See Discussion Draft, Paragraph 15 (third bullet).

"engagement" with a market country is not relevant to whether a transaction involves a payment for the grant of rights to exploit a copyright or involves a payment for the use of a copyrighted article.

307. Although the increased use of software by businesses does increase efficiency, which in turn increases profitability, that is the primary goal of a business purchaser of any product or service. We agree with the Opponents' point that it is not clear in Paragraph 7 why payments for software should be treated differently from payments for other goods. There is no principled justification for treating software differently than payments for any other tool or service.[29]

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

309. Finally, Paragraph 7 states that the distinction between payments for the acquisition of a copyrighted article and the rights to exploit a copyright have "blurred" and that the proposal would therefore "promote tax certainty and reduction of disputes." We respectfully disagree. It is true that copyright law is not monolithic and may vary from country to country, but there is a long-standing general consensus among developed and developing countries which incorporates the distinction between the acquisition and use of copyrighted articles and the acquisition of the right to exploit copyright rights.[30]

2. Reliance on the protection of market country intellectual property laws

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

311. Again, companies that sell software to customers in market jurisdictions are not unique in relying upon the legal systems of (i) their own country of residence and (ii) market countries to ensure that their contracts are honored. We agree with the Opponents that neither the prevalence of the use of software in a given country, the fact that producers of software rely on the legal system in that country for the protection of intellectual property rights, the reliance on telecommunication networks for the delivery of software, the ease of reproduction and the relatively low cost of downloading software, nor the level of education or proficiency with

29 See Discussion Draft, Paragraph 15 (first bullet).

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

computers in the market countries justify reallocating taxing rights to the market country.[31] More specifically, none of these factors justify treating the non-residents' normal business income from the sale of software as royalty income instead of business profits. Like other companies, software companies deploy personnel and assets, and their sales of products are burdened with the same development, sales and marketing, and distribution costs, as any other industry. Accordingly, there is nothing in the nature of the software business which justifies that their business income should be taxed any differently.

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

312. Paragraphs 9 and 10 set forth the argument that payments for software are "payments for the use or right to use" software and are not payments for the purchase of property. We agree with the Opponents that the use of software should not be compared to the use of ICSE.[32]

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

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

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

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

31 See Discussion Draft, Paragraph 15 (fifth bullet).

32 See Discussion Draft, Paragraph 15 (sixth bullet).

reflects the predominant view among all UN Member States, we do not believe that this proposal should be included in the UN Model.

5. Market country taxation on gross payments for software

316. In Paragraph 12 the Proponents appear to be responding to points made by the Opponents. The Opponents observe that the high development costs of software may result in losses in the country of residence of the company engaged in development activities.[33] Gross basis taxation would not take into account the significant expenses for development, sales and marketing, distribution, and customer support to name a few. The Proponents assert that the risk that taxes levied in the market country may be passed on to residents of the market country who acquire software is no different than payments for any other intangible property referred to in Article 12(3).

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

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

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

Part III: Conclusion

319. Adopting the proposal put forth in the Discussion Draft would result in a fundamental and unjustified change to the existing law on the characterization and taxation of royalties. We do not believe that the Proponents have set forth arguments that justify revising Article 12(3) to include "computer software" in the definition of royalties. The potential difficulties that the proposal in the Discussion Draft would create do not appear to have been properly or carefully

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33 See Discussion Draft, Paragraph 15 (tenth bullet).

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

1. List of SVTDG Members

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

Cisco Systems, Inc.	Keysight Technologies, Inc.	The Walt Disney Company	
Confluent	KLA	TiVo	
CrowdStrike Holdings, Inc.	Kraken	Twilio Inc.	
Cypress Semiconductor	Lam Research	Twitter	
Dell	LiveRamp	Uber	
Dolby Laboratories, Inc.	Intuitive Surgical	Unity Technologies	

M. SOFTWARE COALITION

320. The Software Coalition[34] thanks you for the opportunity to provide comments on the Discussion Draft (the "**Discussion Draft**") on the inclusion of software payments in the definition of royalties in Article 12 of the United Nations Model Tax Convention between Developed and Developing Countries (the "**UN Model**"). We appreciate that the UN Tax Committee has invited public comment at a stage before the Committee has formed a view on the topic. We note that the proposal does not reflect the consensus views of members of the Committee and that other members of the Committee in fact have objected to it. We believe that now is an appropriate time for the Committee to request and consider public input on the proposal.

1. Introduction

321. The Software Coalition has been actively involved in international tax policy discussions regarding the characterization of payments for software since its inception, more than 30 years ago. We appreciate the opportunity to offer the perspectives of the software industry on the Discussion Draft.

322. Our comments are based on our industry expertise on software business models and the nature of software transactions. In this letter, we will address the novel justifications for the proposal in the Discussion Draft. We will describe how, although software delivery models continue to evolve, there have been no recent industry developments that suggest that the revenue characterization principles relating to software transactions should change. We will further describe how, as a technical matter, copyright laws around the world accept the distinction between copyrighted articles and copyright rights, and why the international tax law should continue to respect that distinction. In particular, we will address the arguments raised by proponents and opponents of the proposed change in the Discussion Draft. We believe that the Committee should not adopt the proposal in the Discussion Draft.

34 The Software Coalition, which was originally formed in 1988, is an industry association representing many of the world's leading computer software companies. Members are listed on Appendix 1.

2. *Article 12 of the UN Model Reflects the Distinction between Copyright Rights and Copyrighted Articles*

323. Paragraph 3 of Article 12 of the UN Model defines royalties to include "payments of any kind received as 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." Under this paragraph, a payment for the use of, or the right to use, a *copy* of a literary, artistic or scientific work is not a royalty. A payment for the use of, or the right to use, a *copyright* is a royalty. Thus, under this paragraph, a payment for the right to use a copy of a film by privately viewing the film is not a royalty, whereas a payment to use a film copyright by publicly displaying the film or making copies of the film and distributing them to the public is a royalty.

324. As software is protected by copyright in virtually every country of the world, the same principles apply to distinguish transactions in a software copy from transactions in a software copyright. A payment for the use of, or the right to use, a software copyright is a royalty because a software copyright falls within the scope of a "copyright of literary, artistic or scientific work." A payment for the use of a software program copy is not a royalty, for the same reason that a payment for the use of a book, record or videotape is not a royalty.

325. The Discussion Draft would amend the definition of the term "royalties" in paragraph 3 of Article 12 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.

326. The proposed addition of the term "computer software" is not consistent with the structure of Article 12(3). If the addition is meant to refer to the use of a copyright on software, then the addition is superfluous. If the addition is meant to refer to a copy of computer software, then the proposed language improperly inserts into Article 12(3) a reference to a copyrighted article that does not exist for any other copyrighted material.

3. *The Committee Has Previously Addressed the Software Classification Issue*

327. We note that the issue of the classification of payments for software was thoroughly discussed in the preceding Committee of Experts. That Committee did not reach a consensus for change, and accordingly did not propose a change to the current classification principles.

328. In 2016, the Subcommittee on Royalties requested comments on Possible Amendments to the Commentary on Article 12 (Royalties) (the "**2016 Note**"). The 2016 Note proposed that copyright protection of software is relevant to the question of whether a payment for a software

program represents consideration for the use of, or the right to use, a copyright because copyright protection increases the value of software. In our comment letter dated January 12, 2017, we noted that whether a copyrighted article costs more than one that is not copyrighted does not affect the character of a payment to acquire the copyrighted article.

329. The Committee ultimately took no action on the proposal. We believe that there have been no developments in the copyright law around the world, or in the delivery methods used by software companies, which would warrant a different result today. Software providers continuously improve their delivery methods, the principal effect of which is to decrease the cost to customers, thereby making business customers more profitable and preserving disposable income for individual consumers. Increases in network capacity and coverage enable software developers to download their software directly onto an end user's device, essentially eliminating the need for, or the ability of, the end user to make a copy of the computer program. These enhancements creating efficient delivery methods do not change the fundamental distinction between a market exploitation license of a copyright right versus the acquisition and consumption of a copyrighted article. Accordingly, we believe that there is no basis in industry developments that warrant a change in the classification principles as applied to software transactions from the last time the Committee considered this issue.

4. Role of a Model Treaty

330. We note the candid statement in the Discussion Draft that members of the Committee have objected to the proposal, and that the proposal does not represent the consensus views of Committee members. We also note the cogent and persuasive arguments advanced in section 3 of the Discussion Draft why the proposal should not be adopted.

331. It seems clear that this is an issue on which Committee members ultimately may disagree. Under those circumstances, we believe that there cannot be an addition to a model tax convention on which there is such disagreement. The purpose of a model convention is to provide guidance to states negotiating their own bilateral conventions of terms and a framework that enjoys a broad, perhaps universal, consensus. Any pair of contracting states may, of course, choose to deviate from any model when negotiating their own bilateral treaty. The provisions of the model itself, however, need to enjoy consensus support for it to remain valid as an expression of broadly agreed principles.

332. We do not believe that this proposal is likely to enjoy consensus support from a large majority of those jurisdictions principally involved in the cross-border supply of computer software. Accordingly, we do not regard this proposal as one which could be included in a model treaty.

5. Addressing Arguments of the Proponents

333. The proposed change to the text of Art. 12(3) expressed in the Discussion Draft seeks to achieve the same result as was proposed in the 2016 Note. The proponents of this change (the

"**Proponents**"), however, present novel arguments to support that result. In this section, we will comment on these arguments.

a. Advances in communication technology and engagement of computer programs

334. The Proponents first observe that, with advances in "communication and information technology," software constitutes a key tool in the conduct of most businesses and allows enterprises to operate more effectively and efficiently. Based on those points, the Proponents conclude "that there is an increasing level of engagement of computer programs and other software in the economic life of States where they are used." The Proponents conclude that this statement justifies the allocation of taxing rights over software payments to source countries.

335. Observing that there is an "increasing level of engagement" with software in a given country only suggests that businesses and consumers increasingly regard software as an important commercial good, not that software should be treated differently from any other important commercial good. For example, we assume that the Proponents would not argue that payments for books (in either physical or digital form) should be treated as a grant of rights to exploit a copyright in the market even though books embody knowledge and information which may evidence a high "level of engagement" of books in market countries and are central to the "economic life of States."

336. The Proponents' argument that advances in communication technology have resulted in an increased "level of engagement of computer programs … in the economic life of States" has no relevance to the issue of whether a given transaction is a payment for the grant of rights to exploit a copyright in the market, which should be characterized as a royalty, or is a payment for the use of a copyrighted article, which should be characterized as business profits.

337. By referencing "an increasing level of engagement of computer programs" in the economic life of States, the Proponents appear to adopt theories similar to those being used to justify the implementation of digital services taxes ("**DSTs**") in a number of countries. In particular, the underlying justification for a number of DSTs is that, for some digital service suppliers, value is created through sustained user "engagement". Computer programs and software are valuable due to the work of software developers, not from sustained user engagement. Accordingly, this is not an appropriate justification to reallocate to the location of purchasers taxing rights over software payments.

b. Increased efficiencies of users

338. The Proponents also suggest that the characterization of payments should be influenced by the fact that a purchaser's acquisition of computer software makes the purchaser more efficient. Creating or facilitating efficiencies is not, and has never been, a determinant of whether a payment should be characterized as a royalty.

339. Increasing efficiency, productivity and reducing costs allows local business purchasers to increase their own profit potential which leads to a more competitive and profitable market

with more employment opportunities for source-state residents. This increased economic activity leads to increased tax collections from both the more efficient businesses and their employees. Generally, any business will choose to purchase products or services in order to increase profitability by improving productivity, increasing customer revenue, or reducing costs. Software products and services are tools purchased for the same reasons as any other business input. As such, payments for software products and services should not be treated or taxed differently than any other business input.

c. Distinction between copyrighted articles and copyright rights as "blurred"

340. The Proponents assert that the distinction between the acquisition of a copyrighted article and the rights to exploit a copyright is "blurred." We see little basis for the claim that the distinction is no longer clear. While copyright law varies somewhat from country to country, a broad international consensus has evolved over time, in both developed and developing economies, regarding the recognition and protection of copyright rights.[35] The copyright law of the vast majority of countries incorporates the distinction between the acquisition and use of copyrighted articles and the acquisition of the right to exploit copyright rights, and taxpayers and tax administrations around the world have managed to apply the distinction for many years. We have not observed any meaningful shift in the general international consensus since we commented on the 2016 Note.

341. In general, the copyright law reflected in international copyright conventions and the domestic copyright laws of most countries grants to the holder of a copyright certain exclusive rights, including: (i) the right to reproduce the copyrighted work; (ii) the right to prepare derivative works based on the copyrighted work; (iii) the right to distribute copies of the copyrighted work to the public; and (iv) the right to communicate, perform or display the copyrighted work publicly.[36] These rights are inherently market exploitation rights, as the objective of copyright law is to allow the creator of the copyrighted work a monopoly with respect to the commercialization of the work in the market. The acquisition and use of a software program for personal or business use, therefore, does not entail the market exploitation of a software copyright right, even if such use involves an incidental copying of the application to facilitate access to or ongoing use of the program.[37] In contrast, reproducing software for sale to the public does entail the exploitation of a copyright right because the objective of the reproduction activity is to commercialize the software copyright.[38]

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35 See, e.g., Berne Convention for the Protection of Literary and Artistic Works, opened for signature Sept. 9, 1886, 828 U.N.T.S. 221 (revised at Paris, July 24, 1979) (the "Berne Convention"); WIPO Copyright Treaty, adopted Dec. 20, 1996, WIPO Doc. CRNRIDC/94 (the "WIPO Treaty"). The World Intellectual Property Organization currently has 189 member states.

36 See, e.g., Berne Convention, arts. 9, 11, 12, 14; WIPO Treaty, arts. 6, 8; 17 USC §106 of the United States Copyright Act.

37 See 17 USC §117 of the United States Copyright Act.

38 Respecting the economic distinction between the acquisition of a copyrighted article for consumption or resale and the acquisition of a right to make a market exploitation of a copyright means that de minimis uses of copyright do not cause a transaction to be characterized as a license giving rise to royalties. See,

342. The distinction between copyrighted articles and copyright rights applies equally to books, records, videotapes, and similar copyrighted works. For example, a customer who purchases a book does not acquire any of the copyright rights noted above, and would infringe the copyright in the book if that customer were to make and distribute copies of the book. The customer's payment for the book would not constitute a royalty under Article 12 of the UN Model. In contrast, a payment from a publisher for the right to reproduce and distribute the book would constitute a royalty under Article 12, because that payment would be in exchange for the right to exploit some of the copyright rights noted above.

d. Protection under market state intellectual property law

343. The Proponents argue that commercial exploitation by the software supplier is dependent on the intellectual property laws in the territory where the software user is located. The Proponents continue that non-residents benefit from the market country's legal system in that they rely upon it to protect and uphold intellectual property rights and enforce payments for transactions. The "realities of the digital age", the Proponents continue, require that the definition of royalties be expanded to apply to payments for the use of or right to use software because (i) protection afforded by the market country's intellectual property law system is critical and necessary for vendors; (ii) the telecommunication infrastructure in the market country and the market country population's competency in computers promotes the use of software; and (iii) "cheap and easy" software duplication means that software companies increasingly rely on market state protection.

344. Like other suppliers of copyrighted content, software companies advocate for strong, enforceable copyright law protection and respect for commercial contracts in all countries in which they have users. That desire does not distinguish software transactions from any other commercial transaction and does not justify the reallocation of taxing rights. Suppliers of copyrighted books, records, video content or other materials desire the same legal protections. Trademark owners and patent holders expect and rely on market state legal systems to prevent trademark infringement for trademarked goods and patent infringement for products incorporating patented inventions. Moreover, all commercial sellers (and purchasers for that matter) expect and rely on the legal systems of both the vendor and purchaser countries to enforce the terms of their contracts. There is no difference in the expectation of legal protection by the vendors and purchasers of copyrighted articles, trademarked goods and patented products; accordingly there is no difference in the expectation of legal protection that is relevant to the characterization of payments as royalties or business profits. Software companies rely more on end user license agreements ("***EULAs***"), as discussed in further detail below, than they do on the protections of copyright laws because the EULA between a software

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e.g., Berne Convention, art. 9(2); see also, WIPO Treaty, art. 10(1), providing that the holder of a copy of a copyrighted work can make copies without exercising the rights of the copyright holder, because "reproduction does not conflict with a normal exploitation of the work and does not unreasonably prejudice the legitimate interests of the author"; Paragraph 12 of the Commentary to Art. 12 of the UN Model, referencing Paragraphs 13.1 and 14.4 of the Commentary to Art. 12 of the OECD Model; Treas. Reg. § 1.861-18(c)(1)(i) providing a de minimis rule that states that a transfer of more than a de minimis right to prepare derivative computer programs will be characterized as the transfer of a copyright right giving rise to royalty income.

company and a given purchaser provides a more direct and enforceable commercial restriction on the user than does the copyright law, and can cover acts that are harmful to the software supplier which are not prohibited by the copyright law. Because software products are normally distributed subject to a EULA, software companies rely on market country intellectual property law remedies to police infringing behavior less than other vendors of trademarked goods and patented products which do not sell their products subject to user restrictions.

345. Because of the ease of reproducing software copies, software suppliers in fact suffer greater piracy of their products than do suppliers of other copyrighted articles. Accordingly, as a factual matter, the effective legal protection for software is not as strong as for other forms of copyrighted content.

e. Form of user agreement

346. The Proponents refer to the fact that software products normally are distributed subject to an end user license agreement ("**EULA**"). Despite the title of the agreement, a EULA does not represent a license of rights to exploit a copyright. The purchaser of a software copy does not exploit the copyright on the market; the user simply uses the copy for its intended purpose. On one level, the purpose of the EULA is similar to the copyright notice that appears at the beginning of a book, or the warning against unlawful reproduction that appears at the beginning of a video, in that the EULA cautions the customer against infringing any of the exclusive copyright rights of the copyright holder, because the customer has not been granted any of these rights.

347. The most important function of the EULA is to impose restrictions on customers that are *in addition to* the restrictions that copyright law already imposes. Specifically, a software supplier requires users to agree to the EULA in order to prohibit activities that either do not, or may not, rise to the level of copyright infringement. Under the "first sale" doctrine, for example, a purchaser of a software copy could legally resell the software copy without infringing the software copyright. The copyright holder may be able to prevent the application of this doctrine by including in the EULA a contractual provision prohibiting further sales of the software program copy. Similarly, the EULA may include a contractual provision prohibiting reverse engineering of the software source code, because such activity may not literally infringe the software copyright under copyright law alone.

348. There are, of course, many transactions involving software that do give rise to royalties. For example, a software copyright holder that licenses to a hardware manufacturer the right to reproduce and sell copies of the software loaded on the hardware in exchange for periodic payments receives royalties within the meaning of Article 12 of the UN Model. In that case, the payments are for the use of, or the right to use, the copyright for the purpose of reproducing and distributing the software to the public, and thus properly fall within the scope of "consideration for the use of, or the right to use, any copyright".

349. From both the economic and intellectual property law perspectives, the use of a copyrighted article, such as a software program, does not entail the exploitation of a copyright right, just as reading a book, watching a movie, or listening to music does not entail the exploitation of a copyright right. If every payment for the use of an article that enjoys copyright protection constitutes a royalty, every payment for a book, a movie, a song, and a software application would represent a royalty that is potentially subject to withholding at source. That result is contrary to the economic substance of the transaction.

f. Analogy to lease of equipment

350. In Paragraphs 9 and 10 of the Discussion Draft, the Proponents note that the definition of royalties in Art. 12 of the UN Model applies to payments for the use of, or the entitlement to use, elements of intellectual property, on the one hand, and payments for the use of or the right to use industrial, commercial or scientific equipment ("**ICSE**"), on the other. The ICSE clause does not justify treating payments for the use of copyrighted articles as "royalties", for the simple reason that software is not equipment. The term "equipment" refers to a tangible property. Paragraph 13.2 of the commentary to Art. 12 of the UN Model confirms that software cannot be "equipment". The fact that a digital product (i.e., software) may be provided on a tangible medium does not change the fact that the object of the transaction is the acquisition of rights to use the digital content and not the rights to use the tangible medium.[39]

6. Addressing Arguments of the Opponents

351. We note that the Discussion Draft does not represent a consensus view, and in fact members of the Committee have objected to it. We believe that the members that oppose the proposal (the "**Opponents**") raise valid objections.

352. The Opponents argue that it is not clear why payments for software should be treated differently from payments for other goods. We agree that there is no basis to treat payments for software products differently from payments for any other good. Indeed, software copies are economically equivalent to any other manufactured good which incorporates intangible property elements. As discussed above, the sale of the right to use a software program, without the right to exercise one of the market exploitation copyright rights noted above, represents the transfer of a copyrighted article – that is, a product – and not of a copyright right. Receipts for the sale or other use of a copyrighted article are the normal business income of enterprises which supply such products. Accordingly, such payments should be considered "business profits" under Article 7.

353. The Opponents also observe that the argument that allocating taxing rights to the market state based on the argument that the services or goods purchased by the payor create "an increasing level of engagement in the economic life of States where they are used" is problematic. We agree that this justification is flawed. As discussed above, a software copy

39 See "Tax Treaty Characterisation Issues Arising from E-Commerce: Report to Working Party No. 1 of the OECD Committee on Fiscal Affairs," Technical Advisory Group on Treaty Characterisation of Electronic Commerce Payments, 11-12 (Feb. 1, 2001).

is a product; it does not result in "engagement in the economic life of States" by its supplier any more than does any other popular product. Even if many persons in a market state purchase software products, that does not distinguish software from any other commercial good, service or raw material.

354. The Opponents further argue that the "underlying principles, and consistency with approaches taken elsewhere, must underpin" a reallocation of taxing rights to market countries. We agree that the Committee should seek to align the definition of royalties and the treatment of software payments with approaches taken by other bodies and in other contexts. As discussed above, most jurisdictions recognize the distinction between copyrighted articles and copyright rights and do not treat differently the acquisition for internal use of a copyrighted software article and the acquisition for internal use of a copyrighted literary article or a copyrighted artistic work.

355. Further, the Opponents correctly observe that the development of software is expensive and may result in tax losses in the country in which the development is undertaken, making "it particularly important that income from the licensing of software is taxed on a net basis in the state where it is developed." Any business which commercializes software products incurs more expenses than just development costs. Software suppliers which sell copyrighted software products also incur significant expenses for production and distribution, sales and marketing, customer support, G&A, and other ordinary and necessary business expenses. The nature of the revenue and expense profile of software companies is the same as any other enterprise which develops, markets, sells and supports its products. This income is income from a business, which is why payments for software products should remain classified as "business profits" under Article 7.

356. For the reasons discussed above, we agree with the Opponents that none of the Proponents' justifications regarding the level of use of software in a given country, the fact that software piracy is in principle prohibited by local law, the existence of a telecommunication network which allows users to download software and other content, the ease of reproduction, a low cost of downloading software, or the education or computer proficiency of the population of that country, justifies treating the normal business income of a software product supplier as anything other than business profits.

357. We also agree with the Opponents conclusion that software copies should not be compared to the use of ICSE for the reasons discussed above.

7. Conclusion

358. The distinction between exercising a copyright right and using a copyrighted article is a fundamental distinction in intellectual property law, tax law, and economic reality that applies equally to all articles that enjoy copyright protection. We do not believe that the Proponents have provided arguments that justify excluding payments for software copies and on-line software from "business profits."

359. We agree with the Opponents that the proposal in the Discussion Draft gives rise to a number of practical difficulties and technical challenges that are not addressed in the Discussion Draft. Given that the Committee has analyzed the issue of software revenue characterization for several years, given the absence of any plausible justification for treating payments for copyrighted articles as if they were royalties, and the clear lack of consensus for a significant proposed change to the Model Treaty, we recommend that the Committee conclude that the proposed change should not be made to Article 12(3).

360. If this Committee decides to continue considering this issue, we respectfully submit that this issue requires more time and consideration to be sure that the challenges the Opponents have noted in the Discussion Draft and those we have noted in this letter are properly addressed. We note that the term of the current Committee ends in the fall of 2021. Accordingly, there is not enough time to properly address this issue in the current Committee. If, contrary to our suggestion, the Committee chooses to continue to review the software revenue characterization issue, we suggest that the Committee undertake additional factual development as to the nature of software product transactions and consult with both public and private sector stakeholders. We would be happy to assist in any such effort.

361. We would welcome the opportunity to meet with the Subcommittee to discuss our comments and are prepared to provide additional input as needed. In particular, we would be pleased to provide a presentation on our paper at the Subcommittee's next meeting in advance of the Committee's 21st session currently scheduled for the end of October 2020.

Appendix A

Software Coalition Members

Adobe Inc.

Amazon.com, Inc.

Autodesk, Inc.

BMC Software, Inc.

Broadcom Inc.

Cisco Systems, Inc.

Electronic Arts Inc.

Dell/EMC

Facebook, Inc.

GE Digital

IBM Corporation

Mentor Graphics Corporation

Microsoft Corporation

Nuance Communications, Inc.

Oracle Corporation

Palo Alto Networks, Inc.

Parametric Technology Corporation

Pivotal Software, Inc.

ResMed Inc.

Salesforce.com, Inc.

SAP America, Inc.

Synopsys, Inc.

VMware, Inc.

N. SOUTH CENTRE TAX INITIATIVE

Background

362. The South Centre, an intergovernmental organisation of, by and for the Global South in 2016 launched the South Centre Tax Initiative (SCTI) (https://taxinitiative.southcentre.int) This is the organisation's flagship program for promoting cooperation among developing countries on international tax matters. The program aims at the important need to increase collaboration among developing countries on international tax issues and reform processes.

363. With a focus on network building, the SCTI is centered on activities to promote and support intensified, better coordinated, and more institutionalized approaches to South-South cooperation in tax matters, so as to enable developing countries to become full participants for substantive norm-setting in international taxation matters.

Overview

364. The SCTI offers its comments on the discussion draft on inclusion of software payments in the definition of royalties. As is well known, this is an important issue that developing countries have been fighting for, for a while now. **The SCTI supports the proposed change which seeks to insert the phrase "computer software" in article 12(3) of the UN Model Double Taxation Convention Between Developed and Developing Countries.** The COVID-19 pandemic adds special urgency to resolving this long-pending issue as revenue from software payments made from developing countries continues to increase.

Arguments to strengthen reasons for the proposal

365. The SCTI supports the reasons for the proposal mentioned in the discussion draft and provides additional arguments in favor as provided below.[40]

40 Acknowledgements are due to the BEPS Monitoring Group for sharing their draft which has helped in preparing this submission.

Payments for computer software already accounted for as royalties by international institutions

366. The IMF and the World Bank's definition of royalties makes it clear that payments for computer software comes under this category. The IMF's Balance of Payments Manual measures royalties and license fees payments as follows:[41]

> Receipts are between residents and nonresidents for the authorized use of intangible, nonproduced, nonfinancial assets and proprietary rights (such as patents, copyrights, trademarks, industrial processes, and franchises) and for the use, through licensing agreements, of produced originals of prototypes (such as films and manuscripts).

367. A related, broader indicator that measures 'Charges for the use of intellectual property, receipts (BoP, current US$)' specifically mentions computer software in the definition:[42]

> Charges for the use of intellectual property are payments and receipts between residents and nonresidents for the authorized use of proprietary rights (such as patents, trademarks, copyrights, industrial processes and designs including trade secrets, and franchises) and for the use, through licensing agreements, of produced originals or prototypes (such as copyrights on books and manuscripts, computer software, cinematographic works, and sound recordings) and related rights (such as for live performances and television, cable, or satellite broadcast). Data are in current U.S. dollars.

368. Thus, payments for rights to use computer software can validly be considered as royalties from intellectual property rights.

Source state contributions must be accounted for

369. The discussion draft rightly highlights the source state's contributions by enforcing intellectual property rights, facilitating payments, providing telecommunications infrastructure and population competence in computers, all of which are important factors. However in the reasons against the proposal, critics have dismissed these factors without providing any explanation why. Till such explanation is forthcoming the argument can be seen to continue remaining valid.

False analogy with sale of goods

370. Critics of the proposal state that payments for software are the same as payments for goods and hence should be taxable under article 7. This overlooks the fact that software payments are for the 'use or the right to use' software and not the software itself *per se*. The analogy with sale of goods is accordingly invalid. Whether a product is standardized or customised is also irrelevant as, again, the payment is for the 'use or the right to use', and hence like other payments involving intellectual property rights should be taxable as royalties.

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41 https://tcdata360.worldbank.org/indicators/h6b089e58?country=BRA&indicator=40521&viz=bar_chart&years=2015

42 https://data.worldbank.org/indicator/BX.GSR.ROYL.CD

Large number of treaties allow for software payments to be taxed as royalties

371. As mentioned by the BEPS Monitoring Group, the Tax Analysts' database *Worldwide Tax Treaties* identifies 669 bilateral agreements (including protocols) which refer to computer programs or computer software in a paragraph referring to royalties. These usually involve a capital-importing country (which are mostly developing countries), although it is notable that OECD countries have often accepted the inclusion of software payments in article 12, e.g. in 24 agreements with the UK, 36 with the US, 23 with France, 27 with the Netherlands. Hence state practice of some major developed countries too supports this position.

Practical difficulties are not insurmountable

372. Critics say the proposal gives rise to practical difficulties such as how would it work when individuals purchase software, etc. These can be dealt with in the commentary and are not insurmountable. For example financial intermediaries such as banks can be made to withhold and remit taxes when individuals are involved.

Contributions to clarifying the relationship between article 12 and 12B

373. A simple way to deal with potential overlap between the two articles would be to make clear in the Commentary to article 12B[43] that any income taxable under article 12 should not also be taxed under 12B.

Source taxing rights can be based on increasing engagement in economic life

374. Critics of this proposal say it is problematic to argue that services or goods delivered by the payee create "an increasing level of engagement in the economic life of States where they are used". An analogy is drawn with the extractives industry and the rhetorical (unsaid) implication is that commodity exporting countries would lose their source taxing rights if this train of thought is taken to its logical conclusion.

375. The supply of services, including software, creates a close economic relationship with source countries, and this has now been widely accepted in the discussions on tax implications of digitalisation of the economy. The counter example of extractive industries is misleading as proposals for an increased allocation of taxing rights to market countries exclude extractive industries. Source state taxing rights on natural resources are in any case protected under article 6 of the model conventions.

Issue of gross taxation already dealt with in commentary

376. Critics raise concerns that imposing withholding taxes on gross payments could cause difficulties for software companies as it ignores expenses incurred by the payee. They argue it is compounded by the inability of the taxpayer to obtain full credit in certain states of residence where the taxation would be on a net basis.

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43 https://data.worldbank.org/indicator/BX.GSR.ROYL.CD

377. Paragraphs 8-10 of the Commentary on Article 12 clarify that the withholding tax rate on gross royalty should be set recognising both current expenses allocable to the royalty and expenditure incurred in the development of the property whose use gave rise to the royalty. This addresses the underlying concerns made with reference to software.

378. The concern on the inability of taxpayers to obtain full credit in certain residence jurisdictions in fact strengthens the case for more countries to adopt this method of elimination of double taxation. It is problematic that there are arguments being made in the opposite direction, *i.e.,* that the option of full credit in the state of residence should be removed altogether from the UN Model Convention. The opposite in fact is what should happen especially as more and more countries are seeking to ensure that highly digitalized MNEs pay tax in line with their global profits.

O. TATA CONSULTANCY SERVICES LIMITED

Background

379. The UN Tax Committee has invited public comments on the draft discussion paper which includes a proposal by a number of members of the Committee for a change in the definition of "royalties" included in Article 12 of the United Nations Model Double Taxation Convention Between Developed and Developing Countries.

380. The proposed change is to include the wording "computer software" in the definition of royalties in paragraph 3 of Article 12 of the UN Model

Issue

381. The issue of taxation of cross border software licensing transactions has been a bone of contention between the tax authority and the taxpayer over the years. The controversy is pursuant to the difference between the definition of royalty under the various domestic tax laws of respective countries, and the definition under the tax treaties. The principal issue relates to the characterization of software, which leads to the determination of what is being procured when payment for software is made and what rights are granted to a user.

Discussion

382. In order to determine whether a software payment is a royalty or not, we need to understand the character of the transaction for which the payment is being made i.e. whether that software is a service or a product or the transfer of IP or the software is being provided for a limited purpose or time. All software payments cannot be generalized and characterized as "royalty".

383. Software payments made to a foreign company could be in the nature of / characterized either as royalty, business profits, capital gains, etc. depending on the nature of the transaction. Following are some examples demonstrating and differentiating types/ categories/ of software payments:

- Transfer of a copyright right in the computer program (outright sale of software including IPR of software without any restriction)
- Transfer of a copy of the computer program (Sale of standard software under license model i.e. a copyrighted software)
- Provision of services for the development or modification or customization of the computer program
- Provision of software related services (such as installation, maintenance, testing, etc.)

384. All of the above may be provided in physical form or electronically. As stated hereinabove, the payments made towards such transactions could be characterized either as royalty, or fees for technical services, or capital gains or business profits depending upon the nature of the transaction.

385. It is evident that where the consideration paid is for the purchase of a product, as envisaged in category (2) described above, and not for the transfer of the intellectual property per se, it should not be regarded as "royalty". For example, purchase of a book by a customer does not tantamount to the purchase of the copyright in the book, even though the publisher publishes the book by purchasing the copyright. Similarly, drawing a parallel from this example, purchase of a canned or standard software should not be regarded as purchase of a copyright but as a purchase of a copyrighted article; and thus the payment therefor should not be regarded as royalty.

386. Where any person acquires the right to use a software, the payment so made would amount to royalty. However, in cases where the payments are made for purchase of software as a product, the consideration paid cannot be considered to be for the use or the right to use the software. It is well settled that where software is sold as a product, the same would amount to a sale of goods.

387. The Hon'ble Supreme Court of India in Tata Consultancy Services (TCS)'s case (271 ITR 401) has held that a transaction of sale of computer software is clearly a sale of 'goods' within the meaning of the term 'goods' as used in Article 366(12) of the Constitution of India and as defined under the Andhra Pradesh General Sales Tax Act. Relevant extract of the decision is reproduced below:

> *"a transaction of sale of computer software package off the shelf is clearly a sale of "goods" within the meaning of that term in section 2(n) of the Andhra Pradesh General Sales Act, 1957. The term "all materials, articles and commodities" in section 2(h) of the Act includes both tangible and intangible/incorporeal property which is capable of abstraction, consumption and use and which can be transmitted, transferred, delivered, stored, possessed, etc. The software programmes have all these attributes."*

388. Summary of the above case is as follows:

- Intellectual property once put on media, whether it be in form of books or canvas (in case of paintings) or computer discs or cassettes, and marketed, it would become 'goods'.
- Thus, a transaction of sale of computer software is clearly a sale of 'goods'
- There is no distinction between 'branded' and 'unbranded' software. In both cases, the software is capable of being abstracted, consumed and used.
- The canned software (i.e., computer software packages off the shelf) are also 'goods' and as such assessable to sales tax.

389. From the above, it is abundantly clear that software can also be “goods” and therefore, generalization and characterization of all computer software payments as “royalties” is unwarranted and unjustified.

390. Only those payments which are made for the use of or the right to use any copyright etc. should be covered within the meaning of ‘royalty’. Payment for a copyrighted article would also not be covered within the meaning of ‘royalty’.

391. The above contention has been recognized in the case of Infrasoft Limited, 220 Taxman 273 [Delhi HC, India], wherein it has been stated that the payment towards copyright should be considered as royalty and not the payment made towards the copyrighted article; which would be business income. The relevant extract is reproduced herein below for ready reference.

> *“90. The license granted to the licensee permitting him to download the computer programme and storing it in the computer for his own use is only incidental to the facility extended to the licensee to make use of the copyrighted product for his internal business purpose. The said process is necessary to make the programme functional and to have access to it and is qualitatively different from the right contemplated by the said paragraph because it is only integral to the use of copyrighted product. Apart from such incidental facility, the licensee has no right to deal with the product just as the owner would be in a position to do.*
>
> ….
>
> *97. What is transferred is neither the copyright in the software nor the use of the copyright in the software, but what is transferred is the right to use the copyrighted material or article which is clearly distinct from the rights in a copyright. The right that is transferred is not a right to use the copyright but is only limited to the right to use the copyrighted material and the same does not give rise to any royalty income and would be business income.*

392. The payment for purchase of software being similar to payment for purchase of any ‘product/ goods’ (provided it is without any specific right i.e. copyright) is in the nature of business income and cannot be characterized as payment of royalty.

393. Transfer of all or any right in a copyright is a mandatory pre-requisite for a consideration to take the colour of "royalty". Thus, there needs to be a transfer of any or all of the copyrights which are listed u/s 14 of the Indian Copyright Act, 1957 viz.

- Rights to make copies of a computer program for distribution to public by sale or other transfer of ownership, or by rental, lease or lending
- Right to make derivatives of the computer program
- Right to make public performance of the computer program; or Right to publicly display the computer program etc.

394. A purchaser of software does not get any of the rights referred to above and hence, the purchase is not of any copyright *per se* but merely of a product which is copyrighted.

395. Hence, one should look at the predominant purpose for which the consideration is paid in a transaction. Where the consideration is primarily for the purchase of the product and not for the use of the intellectual property therein, and the use of such intellectual property is merely incidental to the purchase of the product, the payment should be characterized as purchase of a product and not as royalty. Accordingly, such payment would be classified as business income.

Summary of the above discussion

- All software payments cannot be generalized and characterized as "royalty". Software payments made to a foreign company could be in the nature of / characterized either as royalty, business profits, capital gains, etc. depending on the nature of the transactions.
- If the consideration paid is for purchase of a standard / shrink-wrapped product i.e. a right other than a right in the intellectual property, then the payment made should not be treated as royalties, instead the same should be classified as business income. However, if the consideration is for right to commercially exploit the intellectual property in the software, then the same would tantamount to royalty.
- If the grant is of a copyright (i.e. an intangible), then the source country can tax it as royalty on a source basis. If instead, it is a sale of a copyrighted article (i.e. a product), the source country can tax it only in the event the vendor has a permanent establishment in the source country. This approach / jurisprudence has also been considered in multiple cases by various courts.
- If we analyze the existing term 'royalty' as defined in the treaty, we find that the intent of royalty is to include the 'copyright' and not the 'copyrighted article'. Accordingly, if the word" 'computer software' (which is a wider term) is added as proposed, in the existing definition, then the intent of the 'royalty' term which includes "copyright' and not the 'copyrighted article' will be defeated.

Conclusion

396. All computer software payments cannot be classified under the royalty definition without analyzing the real characteristics of the transaction. Hence, mere "computer software" should not be added in the royalty definition, else it would lead to unintended consequences.

397. If the word "computer software" needs to be added in the royalty definition for any reason then, the following wordings should be added along with "computer software" in order to be qualified as royalty:

> *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 with rights to commercial exploitation*** *or for the use of, or the right to use, industrial, commercial or scientific equipment or for information concerning industrial, commercial or scientific experience*

398. Above suggestion, if implemented, will ensure certainty and put to rest the tax controversy to a significant extent.

P. TAX POLICY RESEARCH LABORATORY AT RANEPA AND THE GAIDAR INSTITUTE (RUSSIA)[44]

399. The key argument backing the tax policy reasons behind the Proposal is reflected in wording of Par. 7 of the Proposal claiming that "…there is increasing level of engagement of computer programs and other software in the economic life of States where they are used. That increasing engagement with the State where the software is used justifies the allocation of taxing rights to that State." This argument is very weak for several reasons outlined below.

400. It is true that the digitalization of global economy is associated (a) with the increased use of both domestically and foreign-developed software for business, professional and private purposes and (b) with the remote access for supplier to the foreign users of such software (both B2B and B2C). However, if the proposed reform is implemented it shall be based on the clear tax policy and economic considerations which are currently lacking.

401. "Software payments" wording reflects only the form (but not the economic nature!) of the transaction. Economic nature of transactions hidden under this "software payment" form can vary substantially: from B2B transactions (such as providing rights for the business use of the copyrighted software under exclusive license, supplying cloud computing services or online advertisement) to B2C digitalized services (such supplying audiovisual content, giving access to free digital products or providing unexclusive license to use wording processor at home with constant updating). Such economically different transactions should be classified differently for the purposes of double tax treaties, based on the amount of rights transferred to the recipient

44 Prepared by Nikolai Milogolov (RANEPA) and Azamat Berberov (Gaidar Institute for Economic Policy)

(for example, by comparison with the conditional "de minimis" level). Such principle is already described in the comments to both the OECD MC (2017) and the UN MC (2017). This distinction is also used in tax law of various countries. Otherwise, separate “software payment” article can be considered.

402. The key economic foundation on which the distributions of taxing rights between the states are based is the principle of taxation in accordance with the part of the economic value which is created (or deemed created) in any state. This value creation concept was historically understood based on the analysis of the supply value chain and this was reflected in the provisions of the OECD MC, UN MC and OECD TP Guidelines. However, recently we can observe the shift in the understanding of this concept and articulation of the growing importance of the demand side arguments as justifying the economic value created in the state where the consumers (or users in case of digital products) reside. This shift in argumentation reflects the broader economic interests of some (not all!) emerging and developing economies with large and growing number of population (Chinese transfer pricing concept of “market premium” and Indian emerging approach of profit attribution to PEs are two examples of such kind of demand-side developments).

403. Another important economic consideration in the background of distribution of taxing rights between states is the differentiation between the income (a) earned by the owners of factors of production (such as the physical and financial capital in broad meaning and intellectual property) and (b) earned by the enterprise itself resulting from its own “usual” business (through the working of its employees). This is mostly reflected in the different treatment of (a) passive income such as dividends, interests, royalties and capital gains and (b) active income such as business profits.

404. Thus, the implementation of the Proposal can give source countries a simple administrative tool to replenish the budget through taxation of any B2B payments for the software at source. However, its significant disadvantage is a contradiction with the existing rules and economic concepts in the foundation of these rules. The proposed solution is also not universally beneficial for all developing and emerging countries: in particular, Russia is a net exporter of computer services and will not gain many revenues resulting from the potential Proposal implementation. The potential introduction of such «simple withholding tax» may also have detrimental consequences for businesses from developing countries, as such tax creates a barrier to the inflow of advanced technical solutions from more developed countries. The economic importance of this barrier will be increasing in the future with the accelerating speed of the global digital transformation.

Q. UNITED STATES COUNCIL FOR INTERNATIONAL BUSINESS (USCIB)

Overview

405. USCIB believes that the current guidance provided by Article 12 and the Commentary to Article 12 of the UN Model[45] is generally correct and does not need to be updated. USCIB, therefore, believes the proposals in the discussion draft should be rejected. If, however, the UN decides to proceed, then the work of the OECD Inclusive Framework on the taxation of the digitalizing economy should be completed and considered before proposing changes with respect to the definition and the taxation of software payments within the context of the royalties article. The OECD's work is expected to have an impact on the current tax treatment of digital transactions and intangibles of all types, including the role of withholding taxes on royalties. Any updates to the royalties article would, therefore, be premature before this work is completed.

406. Software distribution and usage has changed dramatically, minimizing the need for, and the ability of, the vast majority of software users to make a copy of the computer program to use the software. These changes should be carefully considered in deciding the appropriate tax treatment of payments for software particularly when the proposal represents such a fundamental change from the existing treaty guidance, and domestic law in many jurisdictions. Input from industry to understand current and continually evolving software business and distribution models should be sought and considered.

407. The draft report overestimates the ability of companies to achieve market penetration in their significant markets for sales or licensing of software without a local presence. In order to develop a market, business needs a local presence including local marketing, sales support, and customer support. Without a local presence there will be a natural limit on what can be sold into the market, as all sales will only be to those persons who are able to find the remote vendor, and install, configure and optimize software programs, in the absence of local presence and support.

408. Gross basis withholding taxes take no account of the costs of developing, selling, distributing, updating the software, and providing customer support. Even though this important consideration was mentioned in the discussion draft, it bears repeating that, these costs are significant, often resulting in tax losses in the early years of development in the country where development occurs and where other unsuccessful software projects may be undertaken. In order to recoup such losses, it is essential that income from the selling and/or licensing of software is taxed on a net basis in the state where it is developed. As taxation on a gross basis does not take into account expenses incurred by the taxpayer in earning the payments for use of that software, it may not be possible to get full credit for taxes paid in the country where the software was developed (which taxes on a net basis). Taking this into account, imposition of withholding taxes may cause vendors to pass such taxes on to customers through price increases adversely impacting source country economic growth. Gross basis

45 UN Model Commentary on Article 12, paragraphs 12 through 17.4.

withholding taxes may also "cascade" if that software is used to create other software (e.g. developer tools), digital content, or end-products incorporating software (e.g. imbedded software). This would be more likely if the value-chain is split among multiple jurisdictions. Passing on the cost of the withholding tax may be more likely or even essential if the tax "cascades" as the cost of the tax could easily exceed profit, especially for software start-ups.

409. The proposal will likely result in a higher tax burden due to the generally higher withholding tax rate in source jurisdictions compared to the average corporate income tax rate in developed countries. Now is not the time for tax increases (whether borne by companies or consumers) which will act as a barrier to the economic growth which is needed to pull economies out of post COVID-19 recession and restore country tax bases. The ability of technology companies to efficiently distribute their software and other products will be key drivers of economic recovery.

The current UN Model Convention generally achieves correct administrable results

410. As stated above, USCIB believes that the current guidance provided by Article 12 and the Commentary to Article 12 of the UN Model[46] is generally correct and does not need to be updated. USCIB also generally supports the arguments against the proposal (beginning on page 6). Article 12 of the current Model includes within its scope royalties as defined under Article 12(3) which provides:

> 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 copy-right 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. (Emphasis added.)

411. Copyright rights exist to protect the copyright owner and prohibit others from exercising copyright rights with respect to the copyrighted work (such as a computer program). Copyright protection applies to the software source code. Copyright rights are protected by the national copyright laws of the country in which the author seeks protection, regardless of where the author lives or where a work was first published.

412. There are four copyright rights relevant to the analysis under Article 12(3) for software:

- The right to reproduce the copyrighted work
- The right to distribute copies of the work to others
- The right to make derivative works based on the copyrighted work
- The right to perform or display the work publicly

46 UN Model Commentary on Article 12, paragraphs 12 through 17.4.

413. If the software copyright owner permits the payor to exploit the copyright in the market by exercising one or more of the owner's copyright rights with respect to the work in exchange for a payment, the payment for the use of the copyright right would be a royalty under Article 12(3). This is the conclusion reached under the Commentary to Article 12(3). Whether such a right has been granted would be determined under the contract between the copyright owner and the payor. The discussion draft indicates that this distinction is "blurred." We do not believe that is the case. The customer license agreement (e.g. End User License Agreement or EULA, OEM License Agreement, etc.), which is generally more restrictive than copyright law, will either restrict the use of the computer program to internal purposes or allow the further commercialization of the copyright on the market by reproduction and distribution. The purchaser of a software copy does not require a copyright license to use the software, because personal use of a software program does not constitute copyright infringement under copyright law. The "user" of a copyrighted article (e.g. the individual copy of a computer program, book, song, movie) does not exploit the copyright rights in the market, any more than the purchaser and reader of a book exploits the copyright or the purchaser and user of a machine incorporating patented inventions exploits the patent.

414. A copyright owner may, by contract, transfer or assign all or a portion of its exclusive copyright rights to another party. In which case, the income from the transaction would be treated either as the sale of a copyright or as a royalty.

415. USCIB acknowledges that software copyright licenses permitting the copying of computer programs for sale to the public do exist, are characterized as royalties, and subject to withholding taxes depending on the treaty agreements (e.g. OEM licenses to computer manufacturers permitting them to load software onto computers).

416. A copyright owner may also give another party permission to use (or "license") a copyrighted work without transferring its copyright rights. When a copyrighted work is used under this type of license, the payor is not obtaining a copyright right, but a contractual right to use a copyrighted article. Today's technology does not require the payor/user to copy the software in order to use it. In this case the income from the transaction would be treated as business profits.

417. Software is generally provided under a license agreement that provides additional, contractually based protections for the copyright owner not available in copyright law. Nevertheless, the use of the word "license" and not "sale" does not convert a permission to use the copyrighted work into a transfer of copyright rights.

418. There should, therefore, be no difference in tax treatment between the acquisition for internal use of a copyrighted software article and the acquisition for internal use of a copyrighted literary article (e.g., a book) or a copyrighted artistic work (e.g., a photograph).

419. Similarly, the character of payments for the exercise of the right to reproduce the copyrighted article and distribute copies on the market is a royalty, regardless of whether the

copyrighted article is a software copy, a literary work or an artistic work. There should be no difference in tax treatment between the different types of copyrighted works.

Application of Article 12 to all software creates boundary issues

420. USCIB believes that the proposed definition would create far more issues concerning the application of Article 12 than it solves.

421. Applying Article 12 to all software would bring an extraordinarily large class of goods and services within scope of royalties withholding taxes. The definition of software for this purpose is as follows:

> 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.

422. In a digital world, software is ubiquitous and, in most transactions, does not require or result in any payment. Given the proliferation of digital technology, an ever-increasing number of goods (and potentially services) will incorporate some form of operational software, driver software (which allows products to interact with each other) or application software. This extends beyond personal computers, phones and tablets. It may also include goods as broad and varied as home electronics (e.g. televisions, gaming consoles and printers), electric appliances (e.g. fridges), smart utilities (such as smart meters for electricity and gas), vehicles (e.g. cars, planes and boats), industrial equipment (automated production equipment, generators) , medical devices (monitors, surgical equipment), and all manner of personal electronics, which might include device drivers to allow them to work with a computer (e.g. electronic headphones). This list only skims the surface of in-scope goods given the wide range of tools businesses might use that come with an in-built CPU, interface or function that relies on software (e.g. a barcode scanner or bank/credit card reader). In the case of goods or services that rely on or have in-built software, all of these transactions should be treated as transactions in physical goods, not software.

423. Payments for development, improvement, or maintenance of software should not be within scope of the proposal as such payments are not made to obtain copies of software (copyrighted articles) or for the right to use software. Inclusion of payments for such services would subject an even broader class of payments to withholding tax (e.g. payments for IT support).

Rationale for the proposal does not justify the special rules for software

424. There are no principled grounds for altering the current division of taxing rights. Article 7 treatment today is sufficient and applies a principled division of taxing rights between source and residence states.

425. Many of the arguments set out in section 2 of the document are equally applicable to tools, machines, appliances, and devices, especially in the age of IoT, automated features, and smart devices. Accordingly, they do not represent valid distinguishing characteristics to justify different tax treatment for software payments. In many of these examples, performance features are heavily dependent on software code, internet connectivity, data collection and transmission (e.g, cars, phones, jet engines, generators, locomotives, medical devices, robotic manufacturing, appliances).

426. Paragraph 7 of the discussion draft argues that with the advancements in means of communication and information technology, computer programs or other software constitute a key tool in the conduct of most businesses. As noted in para 7, "*Computer programs and other software allow enterprises that use them to reduce the time needed to perform their tasks, improve efficiency and cut costs*". Therefore, according to the text there is increased engagement in the economic life of States which justifies increased allocation of taxing rights to the state. In addition to the arguments outlined under section 3 of the document, it should be noted that source country tax revenues will benefit from the use of software. Such economic efficiencies and cost reductions allow local businesses to increase profitability, competitiveness, and job creation leading to increases in business taxes on profits and wage taxes from employees. More generally, businesses purchase all products and services to increase their productivity, increase customer revenue, and reduce costs. Software products and services are tools purchased for the same reasons so software should not be treated, or taxed, differently than any other business input.

427. Paragraph 8 argues that commercial exploitation of the software is heavily dependent on the IP protection laws in the source state. Software revenue is not heavily dependent on copyright protection. Software developers rely primarily on end user license agreements to limit customer use and protect their rights. These licenses are more restrictive than copyright laws. To the extent that governments do provide protection for investors relating to the enforcement of contracts, this is no different than other industries. If the contract is governed by the law of the supplier's state, then it is not the market country state which provides the forum for the supplier and customer to protect each of their commercial rights. Paragraph 8 of the discussion draft also argues that, the telecom infrastructure in the source state may also have a role in promoting the use of the software. This in itself does not justify a reallocation of taxing rights, particularly when, as is often the case, the infrastructure in question has been created and funded by significant investment by private businesses.

428. Paragraph 8 of the discussion draft also states: *"Given that reproduction is so cheap and easy for computer software, there is greater dependence on source state protection"*. Entitlement to common legal protections that are afforded by most countries to

all forms of intellectual property cannot serve as a rationale for shifting taxation rights on software to the destination state. Additionally, the assertion of greater dependence on copyright protections fundamentally misunderstands the technological evolution in the way software to delivered to users and customers. With the online platforms, app stores, and other modern software distribution and delivery models, there typically is less reliance on the copyright laws of the "source" state. Due to significant improvements in network bandwidth (funded by software developers) software users are generally prohibited from copying the software and instead download their computer software program directly from the software developer, giving the software developer greater control, based on license keys, to prevent unauthorized copying. As such, there is no justification for allocating a taxation right to the market state when there is minimal or no value added by the market state.

429. Paragraph 10 states software payments are *"payments for use or right to use" software (e.g. the acquisition of "shrink-wrap" software involves a license for the use of the software itself) and are not payments for the sale of property"*. It is a well-settled matter of law and/or rule in many jurisdictions that the payment for a computer program copy is a purchase of a copyrighted article, equivalent to the purchase of a product. As standardized software does not differ from other goods it too should be covered by Article 7.

430. The justifications advanced by proponents applied on an equal basis to other sectors would require WHT on cross-border payments for many other services, including software consulting. It is further noted that analogous arguments could be made for other, common goods, including, for example, cars, which rely on the user jurisdiction to have:

- infrastructure such as roads, traffic lights and road signs;
- a legal framework for the enforcement of road rules;
- proficiency with vehicles within the driver population; and
- further, the design or certain parts of the car may be protected by patent in the user jurisdiction.

431. Paragraph 11 states that "*that many countries already treat payments to non-residents in consideration for the use or right to use computer software as royalties under their domestic law"*. It is a sovereign right for jurisdictions to determine the treatment of software payments under their domestic law, but that does not justify any changes to the UN Model Convention. There are also many countries which do not treat payments for the use of computer program copies (copyrighted articles) as royalties under their domestic law.

Other concerns

432. Many types of software are either built-in or free to download and use. The companies that develop the software do not charge a fee for the software; they may instead earn revenue via related or unrelated goods and services. Sometimes this may be charged through an app or it could be charged separately. Such application of software can arise in a variety of industries, including financial services, food delivery, home electronics and electronic games. It is noted

that in many cases the provision of software may be purely incidental to the delivery of the service itself. As noted above, it is entirely unclear whether the provision of application software without a fee is subject to a withholding tax and, if a withholding tax were to be levied, the base upon which that withholding tax would be calculated. If a withholding tax is not chargeable where an identifiable payment is not made for the software, companies would be incentivised to adopt indirect fee models simply to avoid a withholding tax. In some cases, such as in-app purchases for computer games, such models result in greater costs for consumers when compared to one-off payments. On the other hand, if fees not directly related to software are subject to withholding tax simply because software is used in the delivery or preparation of a good or service, that would subject an impractically large class of payments to withholding tax.

433. It is unclear how individuals or small businesses would be able to efficiently deduct and pay withholding tax when they purchase software nor how governments would obtain the expertise to allow them to consider boundary definitional issues and whether to grant relief under double tax agreements. In the case of individuals, USCIB is concerned that the discussion draft may attempt to shift the burden for withholding to financial intermediaries that would not be in a position to know what is being purchased and are unlikely to have access to funds to collect any tax due.

Conclusion

434. As stated above, USCIB believes that existing Article 12 and its Commentary generally reach the correct conclusion and, therefore, the changes proposed by the discussion draft should be rejected. The discussion draft is not a consensus document and in fact members of the Sub-committee have raised significant objections which we generally support. If these changes are not rejected, differing views indicate a more thorough analysis and consideration of all the issues by the full committee is required. The Committee should also consider the potential impact of a departure from the existing UN and OECD approach. An uncoordinated change will lead to confusion, disputes and increased compliance costs. Because this topic is within the scope of the ongoing Inclusive Framework project on digitalization, which project includes many of the Committee members in their official capacities, we believe it should not be prioritized to burden the limited resources of the Committee.

435. USCIB has many members that are familiar with the software industry and we would be pleased to provide additional background or explanations if that would be helpful to the Committee.