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Taxation of software payments as royalties

Summary

The 2017 update of the Model did not address this issue since the Subcommittee which had been created to study the issue could not reach a decision on the characterisation of software payments as royalties. The previous membership of the Committee recommended further discussion before Article 12 of the Model dealing with royalties could be amended or updated.

The Committee formed a Subgroup within the Subcommittee responsible for the update of the Model to examine the issue of software-related payments as royalties. Mr. Rajat Bansal, the coordinator of the Subgroup, prepared this paper presenting the issue and raised some of the reservations countries have had about the current tax treatment of software payments whether based on the UN Model or the OECD Model Double Taxation Convention.

The paper invites the Committee to discuss the issue for a full understanding of the problem posed by the current definition of royalties in Article 12 of the Model, and to eventually give further guidance to the Subgroup on its work going forward to redefine and extend the term "royalties" or to reclassify "software payments" to better fit the current definition. The paper also invites the Committee to propose other possible issues related to royalties for the Subgroup to study, beyond software payments, for a more complete update of Article 12 of the Model.

TAXATION OF SOFTWARE PAYMENTS AS ROYALTIES

1. In the 7th session of the Committee in 2011, the Committee acknowledged that Article 12 (Royalties) would need further consideration. Thereafter, a Sub Committee was constituted to examine royalty related issues with the following mandate:

   "The Sub-Committee is to consider and report on possible improvements to the Commentary on Article 12 (Royalties) of the Model, and if required, the text of that Article. It is mandated to initially report to the Committee, at the October session of the Committee in 2016, addressing as its initial priority such improvements to the Commentary discussion on industrial, commercial and scientific equipment and software related payments as are most likely to be accepted by the Committee for its inclusion in the next version of the UN Model."
2. The Sub-Committee held its first meeting in February 2016 in Brussels. During the 14th session of the Committee in April 2017, the Co-ordinator of the Sub-Committee reported that the Sub-Committee had been unable to reach a final decision with respect to characterisation of software related payments. The Sub-Committee had therefore decided to issue a recommendation for the next membership of the Committee to work on the issue and review the Commentary on Article 12 in respect of software related payments.
3. On constitution of new Committee, in the 15th session of the Committee in November 2017, instead of forming a Sub-Committee, a Sub-Group was formed within the Sub-Committee on up-dating of UN Model Convention to examine the issue of software related payments as royalties.
4. The UN Model preserves the interest of developing countries as source countries in a number of aspects allowing these countries to tax income earned by non-residents who make substantial use of source country infrastructure, resources and labour etc. By providing for taxing rights in respect of royalties to be shared between the state of residence and the state of source, the UN Model Convention departs from the principle of exclusive residence State's right to tax provided in the OECD Model Convention. Even several member States of OECD have recorded reservations to exclusive residence State taxation of royalties provided by Article 12 of OECD Model

Convention. Another aspect from source country taxation point of view is scope of royalties covered by Article 12, in particular with reference to software payments.

5. Paragraph 3 of Article 12 of UN Model reproduces paragraph 2 of Article 12 of OECD Model to define the term "royalties" as under:

   "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."

6. Regarding the treatment of payments for software, the UN Commentary largely reproduces the OECD Commentary. Some OECD countries have made Observations / Reservations to the OECD Commentary in respect of treatment of software payments as royalties (see paras 28,30,31,31.1,31.2,31.5,46.1 and 50). There are Positions contrary to the OECD Commentary relating to software by non-OECD countries as well (see paras 13, 15,17,17.1,19 and 24)

7. There are some paragraphs in the OECD Commentary which have not met with unanimous agreement among the Committee members. A paragraph was included in the UN Commentary on Article 12 owing to this disagreement (see para 12 of UN Commentary on Article 12):

   "Some members of the Committee of Experts are of the view that the payments referred to in paragraphs 14, 14.1, 14.2, 14.4, 15, 16, 17.2 and 17.3 of the OECD Commentary extracted above may constitute royalties."

8. Issues for consideration of Sub group:

8.1 <u>Classification of software as literary, artistic or scientific work:</u> There may be difficulties in applying the copyright provisions of para 3 of Article 12 of UN Model to software payments due to the requirement of classifying software as a literary, artistic or scientific work. None of these categories entirely fit in, though "scientific work" seems to be the most appropriate category. The Commentary in paragraph 13.1 refers to classification of software as a literary or scientific work under

copyright law of many countries. It further suggests that countries which cannot attach software to these categories may use amended version of paragraph 3 referring specifically to software. There are many treaties already including the use of or the right to use software in the definition of royalties or in the protocol elaborating on the definition. There may be a case to include use or the right to use software in the definition of royalties in Article 12.3.

8.2 Distinction between the use of or the right to use software from the use of or the right to use copy-right underlying software and the use of or the right to use a "programme copy" (Paras 14,14.1 & 14.2 of Commentary):

OECD view is that not any payment for the use of or the right to use copyright underlying software will constitute royalties. Only the granting of comprehensive rights in the underlying software will be covered by Article 12, and transactions where copyright is transferred to enable the operation of the software are not covered. In the view of OECD, the rights in the copy of programme are considered to comprise too few entitlements to be regarded as full copyright and therefore payments for the rights in the copy of a programme are not automatically royalties. The distinction between the use of copy-right underlying software (royalties) and the use of just enough copy-right to operate the software (no royalties) is not straight forward and impinges adversely on source state taxing rights. The need for this distinction is not necessarily derived from the wording of Article 12(2)(OECD Model) or Article 12(3)(UN Model). Limitation of scope may not be in every country's interest as well. In view of this, there may be a need for alteration of Commentary. One option would be to explicitly include payment for software in Article 12.

8.3 Distribution Intermediaries (Para 14.4 of Commentary):

Arrangements between a software copyright holder and a distribution intermediary are discussed in paragraph 14.4 of the Commentary. This paragraph has important tax consequence for developing countries. The argument behind para 14.4 of the OECD Commentary appears to be same as led to a distinction between copyright underlying software and rights embedded in a program copy. Even though the distribution intermediary receives permission to distribute copies, an action that

could –without prior consent by the owner- possibly constitute a copyright infringement, it is perceived that not enough rights have been granted to qualify as use of, or the right to use, a copyright. This needs to be examined for the purpose of UN Model Commentary. Further, the explanation in 14.4 that "distributors are paying only for the acquisition of the software copies and not to exploit any right in the software copyrights" does not seem to apply to downloaded software as it usually happens nowadays. The distributor no longer holds software copies but receives payments for every download it enables customers to perform. The payment for this right can be treated as royalties under Article 12. This is a different view from the OECD Commentary, which needs evaluation.

9. It is proposed to identify further issues for consideration of Subgroup and work on them.