Dated: 16 March 2021

Confederation of British Industry (CBI)

Response to:

United Nations Committee of Experts on International Cooperation in Tax Matters DISCUSSION DRAFT:

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

Period for comments: 16 February to 16 March 2021

Introduction

The CBI welcomes this consultation and the opportunity to input into the consideration of the proposed revisions to the UN Model Double Taxation Convention.

The CBI is the UK's leading business organisation, speaking for some 190,000 businesses that together employ around a third of the private sector workforce. With offices across the UK as well as representation in Brussels, Washington, Beijing, and Delhi, the CBI communicates the British business voice around the world.

Key points

The following summarises our key points with respect to our submission. We do not believe this proposal should be adopted as:

- Fundamentally, we do not believe that purchases of software copies should be treated as royalties, regardless of the context i.e. computer or not computer.
- It is not possible in practice to delineate, in a plethora of scenarios, between value attributable to software and that attributable to hardware in any particular product (see Annex A for examples).
- Therefore, the proposal is likely to create enormous amounts of extra compliance-related activity for both taxpayers and tax administrations, who may remain locked in disputes for many years to come.
- The proposal is likely to have significant and serious negative impacts on beneficial cross-border software licensing.

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Summary of background

The UN Committee has issued a further consultation, following on from the consultation undertaken in September 2020, into the possibility of amending the definition of royalties within paragraph 3 of Article 12 of the UN Model. The proposed amendment between the September 2020 version and the current consultation has changed from and to the following:

Original proposed change within UN discussion draft (1 September 2020)

"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."

Revised proposed change within UN discussion draft (February 2021)

"The term "royalties" as used in this Article means payments of any kind received as a consideration for***:***

(a) the use of, or the right to use,

i) any copyright of literary, artistic or scientific work including cinematograph films, or films or tapes used for radio or television broadcasting*;*

ii) any patent, trademark, design or model, plan, or secret formula or process*;*

iii) or for the use of, or the right to use, industrial, commercial or scientific equipment; or

iv) **computer software**;

(b) information concerning industrial, commercial or scientific experience, ***or***

(c) the acquisition of any copy of computer software for the purposes of using it."

Our position

Having reviewed the previous consultation and the current consultation, we remain strongly oppose the propose adjustments and consider that the proposal to broaden the scope of Article 12 does not sufficiently take into consideration the operational tax technical position, economic impacts or increase in the amount of additional complexities which result from the proposals. Overall, this proposal will increase tax uncertainty and is a considerable move away from the existing position adopted by countries, and also confirmed within many court cases. The scope of the proposal will also risk increasing economic distortions in which developing nations may not be able to access critical software at the same prices and same conditions as currently available.

In our response of September 2020, points raised in concerns and objection to the proposals raised by the United Nations discussion draft remain valid. These include:

- **The proposed change to Article 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.**
- **Potential overlap with Pillar I leading to increased risk of computer software being taxed twice in the source/ market jurisdiction.**

- **Definition of computer software payments is not adequately defined within this discussion draft**
- **Taxation of payments on a gross basis can lead to double taxation and lead to misallocation of taxation rights.**
- **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.**

We would also add to our previous comments that:

Software is used by businesses to increase efficiency etc and as such is no different from any other business input, therefore there is no justification on this basis for treating it differently from a WHT perspective.

Gross basis taxation ignores expenses incurred in development and maintenance of the software, which in early years in particular can be substantial. Further, experience with Digital Services Taxes (e.g. in the UK) shows that such costs will likely be passed on to sellers or local customers.

We commend the desires of the Committee to ensure that the Model Treaty remains appropriate. The treatment of Computer Software has been considered by many United Nations working parties over the years, as well as by working groups at the OECD and other international organisations. Such work has helped give solid and grounded reasoning that the consideration for the distribution of Computer Software should not be treated as a royalty, and the use of software for the ordinary envisaged purpose is not an exploitation of the intellectual property over the Software. Such a bedrock has enabled companies around the world from all sectors of society to start, grow and develop successful software related businesses. The growth in the use of software within different products continues to offer opportunities for people in countries everywhere to develop and thrive.

Placing obstacles in front of such opportunities does also increase the risks of increasing the costs of software and risks making it disproportionately less accessible to developing countries as tax collected gets passed back on to customers (e.g. UK DST as per above), thus stifling economic development at a time when it is critically important for all countries to be supporting communities and economic development. Coming on the back of a medical pandemic, Software has also shown itself as a vital link in the ability to trace and trace viral movements, proving the real tangible benefits of allowing software trade across borders without the serious inhibitions that this proposal would create.

The positions raised within the discussion draft do represent a fundamental move away from the existing positions and are considerably more than a ‘clarification’. These changes will result in the introduction of substantially more uncertainty amongst countries and, with an increasing difference between how OECD and UN treat such transactions, can also result in economic migration away from developing nations in relation to investments in software businesses.

There are many points within the discussion draft proposals and supporting commentaries that are confusing, conflicting and open to significant differences in interpretation and application. We recommend that these proposals are not advanced. Instead, we recommend an endorsement that countries support the investment into Software related businesses which helps the continued growth in alignment of the treatment of multinational software transactions.

We are firmly of the opinion that there are significantly more issues to address within the discussion draft than those limited to these questions raised by the Committee. For example, the questions are asking for comments into the new paragraph 16 and 17 within the commentary, but failing to ask about the other new paragraphs – such as paragraphs 18 – 24 where there are fundamental departures from the existing position which we consider contains positions which are enforceable, damaging to trade and investment in developing countries, considerable amount of additional complexity and confusion and multiple cases where the rules will be unable or unlikely to have

consistent application throughout countries. Overall, all such points would need to be taken into proper consideration in first instance. This therefore becomes an additional reason why we are in objection to this discussion draft and recommend its rejection.

Addressing the questions raised by the Committee

In the response below, we have addressed the three questions raised by the Committee, but must also stress that the proposal also contains many additional points which need to be fundamentally addressed. It is recommended that any consultation into this topic is thoroughly expanded to permit a full and proper review and discussion over each of the points.

Further, we also must highlight that the tone of the current discussion draft is potentially open to negative bias, with many of the points drafted being on the premise that a conclusion to include Software within a revised Article 12 is fait accompli, which we believe is strongly misrepresenting the current status and interest of many parties. It is recommended that this proposal is not accepted.

Questions to be addressed

A. Is the description of “software” in paragraph 12.1 of the Commentary on Article 12 of the OECD Model (extracted in paragraph 12 of the proposed UN Commentary) (a) consistent with current business practice and (b) appropriate for use as a definition in this context, perhaps by adding the definition to Article 3?
B. Do paragraphs 16 and 17 of the proposed UN Commentary adequately distinguish between goods that constitute “computers” and those that are not “computers” notwithstanding that they incorporate software to execute their functions or provide some degree of connectivity? What additional language or examples would help to clarify the distinction?
C. The proposed Commentary continues to adopt paragraph 14.4 of the Commentary on Article 12 of the 2017 OECD Model on distribution intermediaries. Some participants in the Subcommittee do not agree with the analysis in that paragraph for the reasons set out in the Annex to this Discussion Draft. Do you agree with the position set out in paragraph 19 of the proposed Commentary or with the analysis in the annex? If the latter, do you agree that the appropriate approach is to delete the words ‘for the purposes of using it’ at the end of subparagraph (c)?

Response to questions

Is the description of "software" in paragraph 12.1 of the Commentary on Article 12 of the OECD Model (extracted in paragraph 12 of the proposed UN Commentary) (a) consistent with current business practice and (b) appropriate for use as a definition in this context, perhaps by adding the definition to Article 3?

To address this question, it is necessary to break the question into the component parts, which includes considering:

- What are each of the components of paragraph 12.1 and are they individually and collectively consistent with current business practice?
- What are the proposed changes to Article 3 and are they appropriate for the intended context?
- Is the definition within Article 3 representative of business practice?
- Will the descriptions of software within paragraph 12.1 appropriately support the proposed Article 3 amendments?
- What are each of the components of paragraph 12.1 and are they individually and collectively consistent with current business practice?

In addressing this question, it is necessary to split the statement in 12.1 into the individual components and comment on whether they are consistent with current business practice.

The description of "software" in paragraph 12.1 of the Commentary on Article 12 of the OECD Model is 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."

Analysis of the four statements within paragraph 12.1 of the Commentary on Article 12 of the OECD Model

Statement One: 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).

Consistency with current business practice

This existing language from the OECD commentary describing software, and adopted within the United Nations Model, is largely representative of current business practice. It should be noted that the boundaries between operational and application software continue to merge, especially with the advancement in practices such as Machine Learning, Artificial Intelligence and Quantum Computing. Clear delineations between the different categories of aforementioned software are not always clear, viable to be separated or independently valued.

Statement Two: 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.

Consistency with current business practice

Software is capable of being transferred through a variety of media. In addition to the above mechanisms, it is feasible for certain Software to not requiring transferring, but may be able to be self-developed in-situ. Advancements in interaction models such as via cloud based access should not be determinative of the taxing rights where software is capable of being delivered in various different methods.

Statement Three: It may be standardised with a wide range of applications or be tailor-made for single users.

Consistency with current business practice

This position is reflective of current business practice. Standard Software is also capable of being delivered in many forms, and we agree with other work undertaken which also supports the segregation between customised (tailor-made) Software and configured software. To be clear, we do not agree that standard software which is configured in accordance with the requirements of a user is subject to a royalty. This is akin to taking off-the-shelf component and compiling an order for the user, which is different than the fundamental design and writing of customised bespoke software for a client – which under certain circumstances the payment for which could be within the capture of a royalty payment.

Statement Four: It can be transferred as an integral part of computer hardware or in an independent form available for use on a variety of hardware."

Consistency with current business practice

Software can be accessed in various methods, so not always needing to be 'transferred' in order for a customer to interact with the software. If transferred, it is correct that the computer software could be as an integral part of computer hardware or in an independent form, but this does not represent the totality of the way in which the computer software is able to be transferred.

Summary of points on para 12.1

On an individual basis, we do not foresee any of the above points being particularly unaligned with business context, albeit it is important to understand that the interface and interaction with software is an evolving topic. However, in isolation, reviewing 12.1 does not provide an answer whether it is appropriate to apply to it to the proposed Article 3. Therefore, it is necessary to recommend that an isolated review of 12.1 for the purposes of this scenario is inappropriate and should not be pursued. It may be more feasible to initially consider the intents of Article 3 and whether any revisions are required as opposed to commencing the request on a presumption that Article 3 is required to be adjusted and requesting input on the comments to support the position.

What are the proposed changes to Article 3 and are they appropriate for the intended context?

It is important to note that the discussion draft has changed its recommended text for Article 3 between the two discussion drafts (September 2020 and February 2021). As noted above, many of the objections raised in our prior response are still applicable to the revised draft Article 3.

Original proposed change within UN discussion draft (1 September 2020)

"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."*

Revised proposed change within UN discussion draft (February 2021)

"The term "royalties" as used in this Article means payments of any kind received as a consideration for***:***

(a) the use of, or the right to use,

i) any copyright of literary, artistic or scientific work including cinematograph films, or films or tapes used for radio or television broadcasting***;***

ii) any patent, trademark, design or model, plan, or secret formula or process***;***

iii) or for the use of, or the right to use, industrial, commercial or scientific equipment; or

iv) **computer software**;

(b) information concerning industrial, commercial or scientific experience, ***or***

(c) the acquisition of any copy of computer software for the purposes of using it."

We do not have an objection in splitting out the separate types of property referred to in the definition of "royalties" for the purposes of this Model. More fundamentally, the question arises whether it is appropriate to include "computer software" within the definition.

We reaffirm our previous position that:

- **The proposed change to Article 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.**
- **Potential overlap with Pillar I leading to increased risk of computer software being taxed twice in the source/ market jurisdiction.**
- **Definition of computer software payments is not adequately defined within this discussion draft**
- **Taxation of payments on a gross basis can lead to double taxation and lead to misallocation of taxation rights.**
- **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.**

In addition to the previously raised points, for the updated modification we also consider that the inclusion of the point "…the acquisition of any copy of computer software for the purposes of using it.**"** is a fundamental departure from the existing taxing rights. This point is addressed further below, but, in conjunction with the points made above, results in a proposed draft which is going to substantially increase tax uncertainty whist also not addressing the objectives of the Committee.

Is the definition within Article 3 representative of business practice?

On its most basic level, we consider the inclusion of the wording in Paragraph 3 will not be an appropriate definition for the taxation of Software, so any supporting statement cannot be an appropriate use of such wording.

In its own context, many of the points raised within paragraph 12.1 can support explanations of business practice, but when applied to the previous and current draft of Article 3 will be unsupportable and distortive. We do not support such application.

The proposed adjustments in Article 3 will increase tax uncertainty due to the level of conflicting interpretations and will not be easy to administer consistently by either tax administrations or taxpayers. This is due to a combination of reasons, including, *inter alia,* the challenges that would arise from applying the Article to various business scenarios, difficulties in bifurcation of different software models, increased lack of clarity when certain transactions are caught, distortive economics whereby transactions between different countries can be treated differently, increased economic pressure to increase prices / change trade patterns with (developing countries) where this rule applies, conflicts at international level between OECD and non-OECD positions.

Will the descriptions of software within paragraph 12.1 appropriately support the proposed Article 3 amendments?

For the aforementioned reasons, Article 12.1 is not appropriately suited to support an explanation of Article 3 and we recommend that the proposals to change Article 3 are not adopted. On its own and used within an appropriate context, Article 12.1 can have its own merits, but when applied to this draft of Article 3, becomes unsupportable.

Do paragraphs 16 and 17 of the proposed UN Commentary adequately distinguish between goods that constitute "computers" and those that are not "computers" notwithstanding that they incorporate software to execute their functions or provide some degree of connectivity? What additional language or examples would help to clarify the distinction?

Addressing this question will look at the two components:

Question 1: Does paragraphs 16 of the proposed UN Commentary adequately distinguish between goods that constitute "computers" and those that are not "computers" notwithstanding that they incorporate software to execute their functions or provide some degree of connectivity? What additional language or examples would help to clarify the distinction?

Question 2: Does paragraphs 17 of the proposed UN Commentary adequately distinguish between goods that constitute "computers" and those that are not "computers" notwithstanding that they incorporate software to execute their functions or provide some degree of connectivity? What additional language or examples would help to clarify the distinction?

Prior to commenting upon these paragraphs within the proposed draft, it is worth reminding that these articles are not necessarily representative of any agreement between the Committee of Experts, nor representative of the views of many of the parties. The current draft fails to take into consideration many of the key factors which support why Software should not be included within the definition of royalties.

We feel that the order of logic of addressing this question could be undertaken in an alternate way to firstly consider the wider issue, and then consider the supporting commentary narrative. Using the approach of seeking comments on the supporting commentary narrative first risks receiving a distorted understanding whether there is agreement with the basic concepts of whether there should be an adjustment to Paragraph 3, and, if so, what could an appropriate revision look like.

Paragraphs 16 and 17 are drafted on the premise that Article 3 should be changed to include Subdivision 3(a)(iv) "…payment for the use or right to use… software…' within the definition of a royalty. We recommend such analysis is firstly taken and the points raised within the previous responses fully considered and addressed.

In relation to this question (B), we propose that it could make more logical sense to first address whether there is there a need for a distinction between goods that constitute "computers" and those that are not "computers" notwithstanding that they incorporate software to execute their functions or provide some degree of connectivity. Only once this question has been considered, should paragraphs 16 and 17 be considered.

We have not seen any analysis from the Committee of Experts which raised the merits of the case whether there is a requirement for such as a distinction and would recommend this is undertaken in first instance.

As mentioned above, and in our response of September 2020, the approach of adding 'software' to the UN Model (and also with the current Article 3 amended proposals), consistency is not obtained, but increased uncertainty does arise. The wording will not address the taxation of software in many different taxation models, differences between OECD and UN countries, the interaction with the BEPS project, software integrated into different products, why standard software should be differentiated from other standard distributed products etc. The overall introduction of subparagraph (c) has much wider ramifications than the statement made within the paragraph 16 note.

Question 1: Does paragraphs 16 of the proposed UN Commentary adequately distinguish between goods that constitute "computers" and those that are not "computers" notwithstanding that they incorporate software to execute their functions or provide some degree of connectivity? What additional language or examples would help to clarify the distinction?

"16. Subdivision (a)(iv) is intended to apply to direct payments for computer software, whether installed on a mainframe computer, desktop or laptop or accessed over the internet or an intranet through such computers. As noted in paragraph 14.1 of the Commentary on Article 12 of the 2017 OECD Model set out above, the method by which the computer software is transferred to the transferee is not relevant to the categorization for purposes of Article 12. Therefore, it should not matter whether a user downloads a copy of computer software pursuant to what is legally a "license" under domestic law, or "purchases" a copy of computer software. In the latter case, any CD-ROM or other medium containing the computer software that is purchased is the means by which the user can access the computer software, which is the object of the transaction. Because the domestic law can vary in how it treats these economically equivalent transactions, and to provide a consistent treatment of these transactions, subparagraph (c) was added to paragraph 3.

The question will benefit from a firmer understanding of what is within the scope of a "good" and why such a distinction is required before it is feasible to provide a more robust input.

We agree with the statement in paragraph 16 that "…***the method by which the computer software is transferred to the transferee is not relevant to the categorization for purposes of Article 12."*** However, we disagree with the subsequent conclusion that "…***it should not matter whether a user downloads a copy of computer software pursuant to what is legally a "license" under domestic law, or "purchases" a copy of computer software…"*** . Such a statement fails to take into consideration these (license and purchase) can be fundamentally different transaction models. It is still important from a legal perspective to review the nature of the transaction to determine what is being licensed to the customer and ensure that the application of the law is based upon a solid and fair application to the actual facts of the case.

We acknowledge the intent to align international consistency on the treatment of software transactions, yet we believe that it is unclear how to interpret and apply the following section of Article 16: "***Because the domestic law can vary in how it treats these economically equivalent transactions, and to provide a consistent treatment of these transactions, subparagraph (c) was added to paragraph 3."*** As noted within this response, we consider that paragraph 3 does not create a consistency between countries approach to this topic, but creates a wider gap between the approaches taken due to the levels of uncertainty created on many areas of the drafting and potential applications.

We do not consider that the above paragraph distinguishes between "**goods that constitute "computers" and those that are not "computers"".** The above discusses various scenarios of accessing Software but does not address the distinction requested in the question.

Question 2: Does paragraphs 17 of the proposed UN Commentary adequately distinguish between goods that constitute "computers" and those that are not "computers" notwithstanding that they incorporate software to execute their functions or provide some degree of connectivity? What additional language or examples would help to clarify the distinction?

See also Annex A.

17. Many consumer goods contain software that improves the performance of the good or provides additional functionality (such as advanced electronics in an automobile or an automatic timer on a coffeemaker), but such goods generally would not be viewed as "computers" (although they may contain computers, such as the computer that controls an airplane). The reference to "computer software" in paragraph 3 is not intended to encompass such software when the fundamental purpose of the transaction is the purchase of the good and such software cannot be purchased independently of the good. (See paragraph 17 of the OECD Commentary on Article 12, extracted in paragraph 23 below, for guidance with respect to software bundled with the sale of computer hardware.) However, the separate purchase of a copy of computer software, for example a navigation program that can be downloaded to an automobile's on-board computer in the normal use of that computer, would be covered by the definition in paragraph 3." (Emphasis added)

It is noted that the intent is not to capture computer software "when the fundamental purpose of the transaction is the purchase of the good and such software cannot be purchased independently of

the good". There is already sufficient guidance and rules on there been a necessity for a 'reasonable apportionment' where bundled transactions are required to be separated for tax purposes.

We do not consider this an appropriate basis to segregate software transactions. There are many cases whereby comparable or competing products contain either software which can / cannot be purchased independent of the good. For example, there is not necessarily an easy 'bright line' test that can be applied to many products that contain software (e.g. computers where different operating systems can be used, phones which could work on open or closed systems, even domestic products where the original software may change over time). This suggested approach of segregation will result in unintended consequences around challenges for 'unbundling' parts of software and then to subject individual components to different taxation principles in an arbitrary and artificial manner. Such a complex and unnecessary practice should be avoided. See Annex A for examples of the impossibility of such a separation in many cases.

As noted above for paragraph 16, it is important to also understand whether it is appropriate to link in paragraph 16 to Article 3. As we do not support the draft Article 3, linking in paragraph 16 at this point would not be a supportable recommendation.

Paragraph 17 also fails to provide such a distinction between goods that constitute "computers" and those that are not "computers" notwithstanding that they incorporate software to execute their functions or provide some degree of connectivity". The examples used within Paragraph 17 do not appear to follow any scalable or extractable logic, which could be applied to specific goods.

Fundamentally, we do not foresee this separation between when a product contains software but is not deemed to be a computer, and when it is a computer, as the key factor that should determine the taxation consequences thereof. The approach to such a split is very arbitrary and something that would be required to be considered on a case-by-case basis, where there are already 'reasonable apportionment' rules in place. We support the position that the principle of whether a transaction including software is subject to a royalty would be determined based upon is there is a transaction for the alienation and exploitation of the protected intellectual property rights, as opposed to the physical container containing the software. The physical container itself could also be subject to a royalty in certain circumstances – for instance in relation to payments for trademarks or protected design rights.

There are many cases where the 'good' and the 'software' are inextricably linked within the customers' decision making logic. The evolution in different products over the years has also made the delineation between when an item is / is not a computer is far more difficult than before and risks creating significant uncertainty how such rules could be systematically applied. It is likely there will continue to be many 'goods' that contain Software where the relative importance of the Software changes over time and this approach recommended in the discussion draft only adds to unnecessary levels of complexity that will need to remain under continual evaluation and customer decision making capacity reviewed with retrospective application via tax audits – both very impractical, full of uncertainty and avoidable by not pursuing this avenue.

Overall, we are unable to support Paragraph 17 as either being in appropriate support of Article 3, or as a stand-along paragraph on its own and recommend it is not retained.

The proposed Commentary continues to adopt paragraph 14.4 of the Commentary on Article 12 of the 2017 OECD Model on distribution intermediaries. Some participants in the Subcommittee do not agree with the analysis in that paragraph for the reasons set out in the Annex to this Discussion Draft. Do you agree with the position set out in paragraph 19 of the proposed Commentary or with the analysis in the annex? If the latter, do you agree that the appropriate approach is to delete the words 'for the purposes of using it' at the end of subparagraph (c)?

Addressing this question is required to be done in the following stages:

- **Question 1**: Do you agree with the position set out in paragraph 19 of the proposed Commentary?
- **Question 2**: Do you agree with the position set out with the analysis in the annex?
- **Question 3**: Are the positions set out in questions 1 and 2 mutually exclusive, and is either acceptable?
- **Question 4**: If in agreement with the position in the annex, do you agree that the appropriate approach is to delete the words 'for the purposes of using it' at the end of subparagraph (c)?

It is worth mentioning that consensus is desirable, but not always feasible. This is one of the reasons that countries are able to submit opinions and reservations to Models. Just because all countries are not necessarily in alignment with every part of an Article and the commentary, this should not be reasonable grounding for turning away from the practice on the treatment of Software, which has been developed over decades of continued work. The proposal draft in circulation represents a fundamental change in approach to the assignment of taxing rights and application of how to subject Software to taxation. We do not agree with the content or the timing of such proposal.

Question 1: Do you agree with the position set out in paragraph 19 of the proposed Commentary?

Paragraph 19: The words "for the purposes of using it" at the end of subparagraph (c) are intended to produce the same result as in paragraph 14.4 of the Commentary on Article 12 of the 2017 OECD Model with respect to distribution rights in the absence of reproduction rights. A [minority] of the members of the Committee disagree with the analysis in paragraph 14.4 of the Commentary on Article 12 of the 2017 OECD Model Convention. In their view, distribution is an integral part of copyright rights in many countries and payments with respect to such rights should be covered by Article 12 even in the absence of reproduction rights. Those taking this position therefore would delete the words "for the purposes of using it." (Emphasis added)

The discussion draft contains the following proposed wording to Article 3 "The term "royalties" as used in this Article means payments of any kind received as a consideration for***: (c) the acquisition of any copy of computer software for the purposes of using it."***

For comparison and reference, paragraph 14.4 states: *"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." (Emphasis added)

The purpose and application of paragraph 14.4 is much wider than the scope which the discussion draft where paragraph 19 is applying this commentary for a new and out-of-context approach whereby it appears to be seeking to apply it to cases with **"…distribution rights in the absence of reproduction rights…".**

The guidance to the Model is not legislation. Whilst the Model itself may not be legislation in many countries, it may form the foundation of what becomes the basis of legislation.

There is nothing within subparagraph (c) that states or even indicates that the intent of the wording is "…**intended to produce the same result as in paragraph 14.4 of the Commentary on Article 12 of the 2017 OECD Model with respect to distribution rights in the absence of reproduction rights…"** Instead, subparagraph (c) appears to overtly aimed at capturing payments made as consideration for "…**the acquisition of any copy of computer software for the purposes of using it".** There does appear to be a significant misalignment between the reading of subparagraph (c) and the stated intent contained within paragraph 19, with the risk that more transactions are inadvertently captured than intended.

Thus, consideration paid under subparagraph (c) must be (i) for the acquisition of any copy for computer software, and (ii) the purpose of the acquisition must be for the purpose of using it. Per the drafting, these cannot be tangential impacts, but the reason for the transaction. This point is considered in further detail below.

Also, we do not see a reason to aim the drafting within paragraph 19 at the restricted case of "…**distribution rights in the absence of reproduction rights…"**

The drafting risks changing to some basic principles around the distribution of Software and when it should be classified as a royalty in regard to the alienation and exploitation of protected property rights, which we consider to be a principled logic for the application of the rules.

We respect there may be a minority which have a restrictive view that "…**distribution is an integral part of copyright rights in many countries and payments with respect to such rights should be covered by Article 12 even in the absence of reproduction rights…"**

We consider it an important foundation that there is a separation of the rights over property and the property that is being distributed. The rights over Software include both moral and economic rights. These rights, especially the economic rights, can be bifurcated and transacted separately. It is well established that the economic rights are subject to separate intellectual property protection and each right capable of individual (or collective) exploitation or restriction. There is not a necessity to group a reproduction right and a distribution right as these are separately identifiable components. Each of these rights can be separately protected, restricted, exploited and defended. We do not follow the logic of there being a need for these to be grouped together and propose that such wording is rejected from Paragraph 19.

From our position, however, we do not agree with this minority view position, and unable to agree within the position in Paragraph 19. Although we disagree with the proposed expansion of the definition of royalties within the article, if it is included in the Model, regarding distributors of computer software, we support the conclusions of paragraph 14.4 of the Commentary on Article 12 of the 2017 OECD Model and therefore would support the inclusion of the words "for the purposes of using it" if paragraph (c) is added to Article 12(3) of the UN Model.

Question 2: Do you agree with the position set out with the analysis in the annex?

The position in the Annex (pages 25 – 27 of the discussion draft) is split into two parts:

- **Issues with para 14.4 of the OECD Model Commentary adopted at present in the UN Manual Commentary**
- ***Issues with exclusion of distribution cases under new definition of Royalty under para 3 of Article 12 due to clause (c) –Possibility of abuse***

Part A is split into 10 paragraphs spread over 3 sections:

i. *The reproduction right and the distribution rights (for literary works incl. computer software)*
ii. *On First sale/exhaustion-*
iii. *Exhaustion - national or international*

Part A (i): Reproduction Rights

We agree with the extract from Golstein that "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 copyright rights…"., but we are not in agreement the extracts from the 27 countries on the distribution rights (Appendix to the Annex) all represent distribution rights – for example, there are highlighted rights such as the rights to 'publish', which are different to 'distribution' rights. There are businesses who have publishing but not distribution rights.

Part A (iii): First Sale / exhaustion' doctrine

The 'First Sale / exhaustion' doctrine identifies there are cases whereby certain intellectual property rights can be confined by future sales. This section has not necessarily considered all of the interactions between when rights are granted, expire, and exemptions – for instance with Droite de Suite as contained in countries' rules. As such, we consider it could be useful to consider how rights such as Droite de Suite may interact with First Sale / exhaustion when considering guidance.

Part A (iii): Exhaustion - national or international

We do not consider there is wide acceptance with the statement in paragraph 7 about an owner of copyright retaining distribution rights after the first sale of that particular software, and also do not consider that the conclusion is widely accepted that *"…the argument that the consideration received by the software supplier is for a copyrighted article, and not the copyright itself, and hence cannot be characterised as royalty under the domestic tax law or a tax treaty, is not available.*"

As is noted by Copinger and Skone James on Copyright (14th Edition) (1999) (pp613-614) "…For the purposes of the Software Directive, certain forms of distribution of electronic copies are considered to exhaust the distribution right in respect of such copies."

"Exhaustion: computer programs. Similar considerations apply in relation to tangible copies of computer programs as to other works: the first sale of a copy of a program by the rightholder or with his consent exhausts the distribution right with the exception of the right to control further rental of the program or a copy thereof. As to copies made available in intangible form (e.g. by downloading from a website), for these purposes the word "sale" is to be given an autonomous Community interpretation. Where a seller makes a program available for download under a licence for an unlimited period in return for a licence fee, the intention is to make the copy usable by the customer,

permanently, in return for payment of a fee designed to enable the copyright owner to obtain a remuneration corresponding to the economic value of the copy of the work. Accordingly, that amounts to a transfer of the right of ownership of the copy in question and thus a sale for the purposes of the exhaustion of the distribution right. The same applies if the copy is made available by means of a material medium such as a CDROM or DVD and if the download is free but the licence is granted and paid for separately. It does not matter if the software is the subject of a maintenance agreement: the exhaustion applies to the copy as corrected and updated pursuant to the agreement. Any other interpretation would undermine the effectiveness of article 4(2) of the Directive since suppliers would merely have to call a contract a licence rather than a sale in order to circumvent the rule of exhaustion and divest it of all scope. The result is that a purchaser from the original licensee and any subsequent acquirer are lawful acquirers of the software for the purposes of article 5(1) of the Software Directive and benefit from the right of reproduction provided for in that provision."(pp. 621 – 622)

Similarly, in the case of *Vernor v. Autodesk*, the judge provided a clear distinction between cases when the users' resale of a copy of the computer software would and would not be protected by the first sale doctrine.

In the case of *Bobbs-Merrill Co. v. Straus, (210 U.S. 339, 350-51 (1908))* – the Supreme court ruled that restrictive pricing on a book was only enforceable against the first sale of copies of the work (now codified into US law at *17 U.S.C. s.41 (1909)*. As per the Berne Convention, computer software is afforded protection akin to literary work.

Based upon case law (the above being only a small representation) and conflicting information available against several positions within the Annex, we are no able to reach the same conclusion as is indicated within the Annex.

Question 3: Are the positions set out in questions 1 and 2 mutually exclusive, and is either acceptable?

The positions in questions 1 and 2 are not mutually exclusive and the fact that one point is not acceptable does not mean the other point is acceptable. Based upon the aforementioned points, we are unable to support that these are appropriate positions to support a revised approach to interpreting Article 14.4. We believe that the consideration paid for the distribution of software is a different topic than the alienation and exploitation of the rights over the same software, and as such should be treated separately.

Depending upon the 'product' and also the contractual terms between the parties, the doctrine of first sale can apply differently, so a single approach is an inappropriate solution to seek to address call Software cases.

Consequentially, we foresee there are challenges with both positions taken, and more fundamentally with the divergence away from Article 14.4, which will introduce significant more uncertainty if alignment between the different positions increases. The impacts of such divergences on business uncertainty, attractiveness to doing business in a territory and requirement of additional resources (tax payer and tax authority) are noted above.

Question 4: If in agreement with the position in the annex, do you agree that the appropriate approach is to delete the words 'for the purposes of using it' at the end of subparagraph (c)?

As result of the above reasoning, we foresee challenges in the two alternatives and are not in a position to accept their current form. Additionally, we do not see it as a mutually dependent situation whereby the acceptance or rejection of 'for the purpose of using it' is predicated upon the acceptance or rejection of either or both of the positions (paragraph 19 or Annex).

Subparagraph (c) contains two components that benefit from separate analysis:

- Question 4a: Is it appropriate to treat consideration for the acquisition of a copy of computer software subject to being a royalty, and
- Question 4b: Is it appropriate to treat consideration for the purpose of using [computer software] subject to being a royalty

Question 4a has not been requested to be considered as part of this discussion. Nevertheless, we consider it is important to consider and respectfully ask this point is subject to further consultation. This question alone impacts on several essential legal principles and requires significant more clarity – especially around words such as 'acquisition' and why the treatment of a 'copy' may differ than a non-copy. Some of these points address legal issues that have been considered by courts in United Nations countries, with the conclusion that such a transaction should not be within the definition of royalties.

Question 4b: There are some essential points of this question that require further clarity prior to providing a full and reasoned answer. For instance, what is mean by 'using' computer software? – a point which is discussed above.

If the assumption is that 'using' is based upon the consideration being for the ordinary intended operational use of the software, we are strongly against the inclusion of this wording in the revised proposed subsection (c).

This alone would place countries on completely opposed paths as to the approach on taxation on software. It has been commonly accepted practice in considerable numbers of OECD and United Nations countries to treat the payments for the standard use of software as outside the scope of royalties and treated as a 'business profits' transaction. As a result of this 'accepted' treatment, Software transactions are able to be treated as a distribution of an item, whereas if the consideration is for the alienation and exploitation of the intellectual property, this would be a separate identifiable transaction and within the scope of royalties.

Businesses around the world – both successful and unsuccessful – spend $billions on research and development to get to market commercially viable Software. This Software can be created by anybody and in any place in the world. Successful developments of Software is not an issue which is the privilege of OECD countries versus non-OECD countries. Indeed, some of the largest Software patent registrations come from non-OECD countries.

This potential interpretation of subsection (c) **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, particularly when the OECD Pillar 1 process is ongoing It is also foreseeable that such change could lead to increases in prices of Software, and/or impact upon the viability of selling software into that jurisdiction.**

Further, the source taxation of software payments raises a number of practical difficulties, such as dealing with purchases of software by individuals, as well as how to deal with centrally procured software licenses that are used in a number of countries.

In summary, we are unable to agree with the position in the Annex, and do agree with the proposal to delete 'for the purposes of using it'. However, we also do not think this question goes far enough as we also recommend the deletion of subsection (c) in totality. For clarity, based upon the refreshed draft Paragraph 3, we oppose the proposal, which is far more likely to increase uncertainty, negative economic impacts on country positions, increase tax controversy and conflicts between taxpayers and tax authorities, will lead to complex bifurcation and valuation issues, which is a situation best to avoid.

Other points to note

Whilst the response below is largely confined to the question raised within the discussion draft, we must point out that there remain a considerable number of additional points within the discussion draft that merit further investigation and also appear to be in opposition with the views of many parties. We strongly recommend that this version discussion draft is not pursued as will lead to significant more complexity and misunderstandings.

We do not agree with the position within the discussion draft in many instances – for example, within the proposed paragraph 14:

Revised Paragraph 14: "In the view of a [majority] of the Members of the Committee, the addition of subdivision (a)(iv) is justified because Article 12 is intended to cover payments with respect to the "letting" of property. In their view, a person that is making payments for the use of, or the right to use, computer software described in subdivision (a)(iv) is making a payment in consideration for the "letting" of that intangible property just as a person that is making payments covered by subdivision (a)(iii) is making a payment in consideration for the "letting" of tangible property."

We disagree with the points raised in the above paragraph, which fails to take into consideration many of the underlying reasons for the way Software is transacted, or the fact that different types of "letting" (e.g. different legal categories of leases) need to be taken into consideration as they result in different conclusion whether a transaction is or not within the scope of a royalty. Such a statement as contained in the discussion draft will benefit from such review prior to reaching any recommended position, which will also demonstrate how unsupportable the above statement would become if applied.

Similar disagreement has been registered by other parties within the previous response and such objections remain valid when applied to the updated discussion draft.

The use of software is not comparable to the use of equipment, with substantive amounts of commentary, case law and rulings supporting the position that software and hardware are not the same. By its nature, Software is not a physical tangible product, and as noted, the sales process is very different for both items.

In applying the above statement to Software transactions also highlights cause for concern. For instance, an end user who is licensing software for their own use would be unable to receive necessary updates, maintenance and bug-fixes if the software was 'sold' as opposed to 'licenses' – albeit the end user is economically and operationally using the software in the same capacity in both scenarios. Such delineation between when software is 'sold' and 'leased' will cause impacts upon the overall cost of the software, which is likely to be passed on to consumers and in turn risks detrimentally impacting the economics of software available. It is foreseeable that the countries' most likely to be impacted by such price increased as the developing nations.

It makes no sense to artificially treat Software in a way which will risk increasing the net cost to the consumer solely upon the basis that they are being permitted to receive standard maintenance, updates and bug-fixes.

Further, there are many cases of “letting” of property which are outside the scope of being included within the definition of royalties. Using the above proposed language is casting a wide net in a hope to capture transactions which have, rightly, never been within such a net previously and lacks the fundamental analysis required to ascertain which parts of “letting” should be captured.

The letting of property can contain a whole paradigm of different ranges of alienation of rights – from no alienation to full alienation, and potentially many combinations in the middle. It would be inappropriate to classify all “letting” with the same definition of a royalty. Indeed, doing so is feasibly foreseeable to result in an increase in transactions which could have a possible component which is circumnavigates the “lease” treatment. We consider this area of drafting will benefit from further applied analysis before any conclusion could be reached.

ANNEX A – illustrative examples

We consider the proposed method of splitting whether a transaction will be a royalty will not set a clear and consistent principle, but require considerable amounts of specialist technical resources for basic compliance and audit purposes, yet holds significant risks of still not being able to remedy the uncertainty it creates. Some examples below demonstrate this point.

Mobile phones

"Mobile phone" currently contains many computing functions which could have been undertaken by my many different products (hardware, software and services) in the past.

Navigation programs

Similarly, some of the complexities can be seen for using the basic example of the "navigation program". Both the OECD and UN commentaries have commented that the delivery mechanism of the software is not relevant in determining the taxation thereof. In paragraph 17, the downloaded "navigation program" draws the delivery mechanism back into question. Further clarity is sought on whether the royalty classification will be impacted if the software is downloaded, accessed via cloud, embedded on a product and activated by a 'key', has mixed purposes (e.g. navigation software updates may affect the core operating software of the vehicle as well as user maps).

Electric cars

On modern electric vehicles, it is difficult if not impossible to distinguish between "the onboard computer" and the vehicle, since all functions and systems are electronic.

Exercise equipment

At which point does a home exercise machine transition to a hardware/software device – is it when a home cycle is a stationary bike, has a computer, is connected to online training programs, is used outside and has electronic components (e.g. training data / navigation), has pedal assisted electronic functions, if a full electronic bike, is capable of going over a certain speed, or is a full electric vehicle?

Construction equipment

Historically, sensors on trucks could monitor all kinds of things, such as tyre pressure, whether the driver had fallen asleep, optimal loads, etc. These sensors clearly contain software but are not computers in the true sense (although they do communicate with computers).

More confusingly, many businesses now instead rely on actual software and sensors built into the trucks, because they are more reliable (i.e. individual sensors would often break or fall off when retrofitted – meaning the entire truck would be out of commission while it was reinstalled). Therefore the software running the sensors is inseparable from the trucks.

Another example is mining sorting machines that identify rocks of the right size or quality to be processed in different ways. This is much like with medical devices – the software is integral to the machine and can be constantly improved, to improve the underlying machine.

Internet of things (IOT)

With IOT being integrated into daily objects – e.g. light switches, heating, CCTV, door locks – it is not clear whether these items would be hardware / software or mixed items.

Moving walkways and lifts

It is not clear when the equipment will transition from being a hardware item and elevate itself into being mixed hardware / software. How much software and functionality is needed to be included in the equipment? How much data analytics is required on customer capacity usage is required (which minimises unplanned downtime of the equipment)?

Sophisticated scales

Scales that measure weight, body fat %, body water, BMR etc. The value is not in the physical product, but in the software that produces the data analysis. A consumer could instead buy basic scales without the sophisticated data analysis but that, then, is much less valuable. Again the software is inseparable in value from the physical product.