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16th March 2021

The Sub-Committee on the United Nations Model Tax
Convention between Developed and Developing Countries

Re: Comments on discussion draft on the inclusion
of software in the definition of royalties

Dear Committee Members,

The speed with which the UN Committee of Experts is progressing in the ongoing work on the proposed changes Article 12 and its Commentary is laudatory. The UN work in this area on allocating taxing rights on software payments between jurisdictions based on new rules is path-breaking. My comments below deal with (a) changes to the Commentary dealing with software payments and (b) the proposed change to the definition of royalties as laid out in the Discussion Draft released on 16th February, 2021.

1. Existing Commentary - Need for change

1.1 Rationale for the suggestion

1.1.1 Paragraph 8.2 of the OECD Model Commentary on Article 12 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. It is suggested that this paragraph be quoted in the UN Model Commentary as 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, to determine when there is a use of copyright.

1.1.2 However, further elaboration of the position under the copyright law to achieve consistency in treatment for characterising a payment as for the use of or right to use copyright is not a simple task considering that there are variations in the national copyright laws. The elaboration attempted in the OECD Commentary on Article 12 has only ended up departing from the legal provisions in the national copyright laws of countries and that has led to litigation.

1.1.3 An attempt to declare a position in the Commentary (with an aim to achieve consistency of treatment for the purposes of taxation) but which deviates from the provisions under national copyright laws is illogical. Provisions under copyright laws are intended to strike a balance between incentivising the copyright owner and the public interest by encouraging creativity. The protection afforded by statute in a jurisdiction provides the opportunity to the copyright owner to reap financial benefits by exploiting his work himself or by allowing others to exploit the exclusive acts which are reserved for him. Thus, the 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, doing of any of the exclusive acts reserved for the copyright owner will amount to an infringement of the copyright in his 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.

1.1.4 The various national copyright laws 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. One such variation in treatment is the extent of principle of exhaustion: some countries apply exhaustion nationally while some apply it internationally. The national copyright law that applies 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.

1.1.5 This attempt at consistency in treatment of consideration for software payments under the OECD Commentary is to be eschewed as they do not consider the effect of the variations in the extent of protection available to the copyright owner which he can

legitimately exploit to earn income therefrom. The model double tax conventions should ideally avoid making pronouncements on what is the use of copyright and what is not. These are best left to the applicable national copyright law which is the law dealing with the subject. The differences in these national laws cannot be normalised by the Commentary to give one standard result.

1.1.6 Several paragraphs of OECD Commentary and quoted in the UN Model Commentary deviate from the national copyright laws while allocating taxing rights.

1.2 Fair use and fair dealing provisions mistaken for copyright.

1.2.1 The following paragraphs of the OECD Commentary on Article 12 mistakes the *user rights* (which are permitted acts) with the copyright owner's rights. The OECD Commentary confuses the 'fair use' by a lawful owner of a copy of a computer program as a use of copyright. The paragraphs deal with "just enough copyright"[1] 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 paragraphs are reproduced below for ready reference:

1.2.2 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].*

1.2.3 Paragraphs 17.2 and 17.3 are reproduced below:

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

> *"17.2 Under the relevant legislation of some countries, transactions which permit the customer to electronically download digital products may give rise to use of copyright by the customer, e.g. because a right to make one or more copies of the digital content is granted under the contract. Where the consideration is essentially for something other than for the use of, or right to use, rights in the copyright (such as to acquire other types of contractual rights, data or services), and the use of copyright is limited to such rights as are required to enable downloading, storage and operation on the customer's computer, network or other storage, performance or display device, such use of copyright should not affect the analysis of the character of the payment for purposes of applying 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 the act of copying the digital signal onto the customer's hard disk or other non-temporary media involves the use of a copyright by the customer under the relevant law and contractual arrangements, such copying is merely the means by which the digital signal is captured and stored. This use of copyright is not important for classification purposes because it does not correspond to what the payment is essentially in consideration for (i.e. to acquire data transmitted in the form of a digital signal), which is the determining factor for the purposes of the definition of royalties. There also would be no basis to classify such transactions as "royalties" 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].*

1.2.4 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 Berne Convention[2] 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.[3] 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. These acts are not copyright but a limitation on copyright. 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

[2] 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").

[3] Berne Convention, Article 9(2).

consideration which can properly be characterised as royalty under Article 12(3) of the OECD/UN Model.

1.2.5 Recommendation:

1.2.6 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, these paragraphs as they exist currently may be omitted as, even if redrafted, they do not add any further clarity to the position under national copyright laws.

1.3 Distribution intermediaries

1.3.1 Paragraph 14.4 of the OECD Commentary (reproduced by the UN Commentary) 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 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.

1.3.2 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.[4] 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.

1.3.3 Further, the said paragraph does not recognise the differing treatments in countries of the exhaustion of distribution rights as national or international exhaustion. The absence of acknowledgment of the difference in treatment of exhaustion and a prescription to treat distribution (without a right to reproduce the work) as commercial profits could

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[4] Paul Goldstein, *Goldstein on Copyright* (3rd edn, Aspen Publishers, 2006) 7:122.2, while describing Title 17 of the United States Code; see also, Laddie, Prescott & Vitoria, *The Modern Law of Copyright* (5th edn, Lexis Nexis) M.No. 15.4 while describing the distribution right under the UK CDPA, 1988.

lead to results that are at variance with the reality of the transaction. This often leads to the copyright owner not paying tax in the source country following the Commentary's prescription that the same are commercial profits and not for the use of copyright but still pursuing infringement proceedings against others who infringe that very right. On the other hand, where a national copyright law provides for international exhaustion, a characterisation of the relevant consideration as towards the use of copyright would give an unacceptable result. Thus, it is intuitive that a country-by-country treatment is to be preferred over any sweeping declaration that the transaction is to be characterised as royalty, or otherwise.

1.3.4 Further, the presence of Paragraph 14.4 has resulted in the (minority) view described in the Annex to the Discussion Draft. If paragraph 14.4 can be deleted, the Annex too will not be required.

1.3.5 Recommendation:

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. If omitted or suitably amended as suggested above, the Minority view in the Annex too can be omitted.

2. Proposed Change to the Definition of Royalties

2.1 Background

2.1.1 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.

2.1.2 In several treaties, countries have agreed to the inclusion of the use of computer software in the definition of royalties but their domestic law do not tax such payments as royalties without being attributed to the existence of a permanent establishment. In such cases, the inclusion of these terms appears to be not immediately relevant until the domestic laws impose taxation on such payments.

2.2 Cascading effect

2.2.1 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.

2.2.2 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.

2.2.3 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.

2.2.4 Recommendation:

2.2.4.1 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:[5]

> "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]

2.2.4.2 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.

2.2.4.3 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.

2.2.4.4 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 Proposed deletion in clause (c) for the Minority view relating to intermediaries-

2.3.1 The Discussion Draft suggests that clause (c) of the proposed definition be modified by deleting the words "for the purpose of using it" where countries subscribe to the minority view that distribution intermediaries use copyright.

2.3.2 Where the countries subscribe to the minority view, the proposed omission of the words "for the purpose of using it" may not even be necessary since the payments by the intermediary to the copyright owner would be covered under clause (i); i.e., the use of or right to use any copyright of literary, artistic or scientific work.

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

I thank the Sub-Committee for this opportunity to give my comments and hope they are considered positively. I shall be happy to provide any clarification that may be required in this connection.

Yours Sincerely,

Ganesh Rajgopalan