

Comments on CRP.13 - Update of the UN Model Double Taxation Convention between Developed and Developing Countries - Application of Article 12 of the UN Model to software payments Note by the Subcommittee on the UN Model Tax Convention between Developed and Developing Countries

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I was the Coordinator of the software Royalty subgroup. CRP 13 is mainly about the Note or Paper I had prepared for the Subcommittee and the Committee. This was the second Note prepared by me, first being E/C.18/2018/CRP.9 presented by me in seventeenth session. As mentioned in para 13 of CRP13, new note by the Coordinator primarily dealt with the following three issues and included an analysis of these issues and specific recommendations:

- (i) Whether there is any difficulty in classifying software as literary, artistic or scientific work for the purposes of the phrase “any copyright of literary, artistic or scientific work” in the definition of royalty in paragraph 3 of Article 12;
- (ii) Whether there should be any elaboration of the view of some former members of the Committee which is expressed in paragraph 12 of the Commentary and which reflects a disagreement with paragraphs 14, 14.1, 14.2, 14.4, 15, 16, 17.2 and 17.3 of the quoted OECD Commentary, indicating that the payments referred to in these paragraphs may constitute royalties;
- (iii) Whether payments for the use of, or the right to use, software itself or a more general concept of “intellectual content” should be treated as “royalties”.

As per paragraph 16 of CRP13, after discussion, the Subcommittee decided that further work was needed before it could present to the Committee a note that would eventually allow decisions to be taken on the issue of the application of Article 12 to software-related payments and some broader policy issues related to the definition of royalties. The Subcommittee has identified three issues in para 16 for further work:

A. Elaboration of the minority view reflected in of paragraph 12 of the Commentary on the UN Model

B. Reconsideration of the part of the Commentary on Article 12 dealing with the application of the definition of royalties to software payments and payments for other digital products.

C. Possible modification of the definition of royalties.

Points or issues A and C had been dealt at length with analysis and recommendations in my Note/Paper submitted as Coordinator of Royalties Subgroup. I had also recommended to drop work on (i) above ie whether there is any difficulty in classifying software as literary, artistic or scientific work in definition of royalty in Article 12.3. This recommendation has been accepted by Subcommittee as part of Issue B in paragraph 16.

Issues A & C are kind of two alternatives, as I had indicated in my Note. If it is decided to expand definition of royalty as per Issue C and as suggested in my Note, the existing UN Commentary referring to OECD Commentary paragraphs 14, 14.2, 14.4, 17.2 & 17.3 itself would undergo a change and may not even survive. In such case, there would not be any majority or minority view left and as such there may not be need to elaborate on minority view.

2. Unfortunately, the Subcommittee has not forwarded the Note to the Committee. This analysis and recommendations could be very useful and relevant for this important work, which is pending for quite some time, i.e. much before present Committee's term started. The portion of the Note containing analysis and recommendations on Issues A & C are reproduced below for the information of the Committee. These are my views and not of Subcommittee so far. It is requested that the Committee may please go through this analysis and recommendations.

Issue A: Elaboration of the minority view reflected in of paragraph 12 of the Commentary on the UN Model:

"17. Use of copyright versus copyrighted article (Paras 14 and 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 and transactions where copyright is transferred to enable the operation of the software are not covered. In the view of the OECD, the rights in the copy of program are considered to comprise too few entitlements to be regarded as full copyright and therefore payments for the rights in the copy of a program are not automatically royalties. Paragraph 14.2 of OECD Commentary in respect of site licenses etc. is on the same lines i.e. it lays down that payments in question are not royalties, even though the licensee gets the right to make copies or reproduce for own use. 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. As noted in para 14 of OECD Commentary, protection afforded in relation to computer programs under copy-right law may differ from country to country and 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 breach of copyright. The Commentary notes that copyright laws of many countries automatically grant this right to the owner of software which incorporates a computer program. The Commentary wraps up this issue by stating 'Regardless of whether this right is granted under law or under a license agreement with the copyright holder, copying the program onto computer's hard drive or random access memory or making an archival copy is an essential step in utilizing the program. Therefore, the rights in relation to these acts of copying, where they do no more than enable the effective operation of the program by the user, should be disregarded in analyzing the character of the transaction for tax purposes. Payments in these types of transactions would be dealt with as commercial income in accordance with Article 7.' As mentioned before, the UN/OECD Models contain definition of 'royalties' in Article 12. Since the Model or DTC itself contains an autonomous definition, as such,

domestic law is not required to be used for its interpretation as per Article 3(2). Domestic law, however, has to be used for the interpretation of different terms in the catalogue of the paragraph, as they do not have autonomous definition in the treaty. Domestic law here would be the tax law and if required, the domestic copyright law. The OECD Commentary acknowledges need for referring to national or domestic law in paragraph 8.2 with reference to software royalties. Since as acknowledged in paragraph 14 of Commentary, copying of the program on hard drive or random access memory may mean use of copyright under country's domestic law, there cannot be a unanimous conclusion as in paragraph 14 to not treat such payments as royalties. The position would depend on a country's domestic law as far as use of copyright is concerned. The Commentary in paras 14 and 14.2 does not seem to be adequately addressing this aspect. The Commentary gives more weightage on aspect of acts of copying involving use of copyright being only for enabling effective operation of program by the user. The Commentary in paragraphs 14, 14.2 etc. was added on the basis of 2001 Report by Technical Advisory Group to Working Party No. 1 of the OECD Committee on Fiscal Affairs titled ' Tax Treaty Characterization Issues Arising from E-Commerce' ('OECD Characterization Report'). As per paragraphs 14 and 15 of OECD Characterization Report, whilst electronic downloading of the program may constitute the use of a copyright by the user, the payment is not towards use of the copyright but is towards downloading and operation of copy of the program. It is difficult to agree with this justification. The payment is for the use of software or other digital product, which necessarily involves copying. Copying on hard disk or random access memory is not possible without the use of copyright. It cannot be said that the consideration was not towards use of copyright at all. In this regard, it is also relevant that the copying right stands independently and is not dependent on other rights including the right to use the software or the copyrighted product. Purpose of use of copyright is irrelevant for characterizing the payment. Further, commercial exploitation of copyright is not a requirement for characterizing payment for the copyright as royalties. The disagreement by Members of erstwhile UN Committee to the OECD position on paragraphs 14 and 14.2 appears to be on these considerations.

18. Electronic downloading of digital products (Paragraphs 17.2 and 17.3): Paragraphs 17.2 and 17.3 of the OECD Commentary deal with downloading of digital products (such as software, images, sounds or text). Here also the Commentary takes the position that even though the act of copying digital signal onto the customer's hard disk or other non-temporary media involves use of copyright under the law and relevant contractual arrangements, it would not give rise to royalties under Article 12. The reasons assigned for this inference are that use of copyright is limited to enable downloading, storage and operation on the customer's computer, network or other storage. And it is merely the means by which digital signal is captured or stored. Further, it does not correspond to what the payment is essentially for. The analysis for paragraphs 14 and 14.2 as above applies here also. Admittedly, there is use of copyright here. And purpose behind use of copyright is irrelevant for characterizing the payment. It is also not possible to say that the payment is not for use of copyright and

such boundary drawing is far from clear. The disagreement by Members of erstwhile UN Committee appears to be on these considerations.

19. Distribution Intermediaries (Para 14.4 of the Commentary) : Arrangements between a software copyright holder and a distribution intermediary granting the latter, right to distribute copies of the program without the right to reproduce the program are discussed in paragraph 14.4 of the Commentary. The argument behind paragraph 14.4 of OECD Commentary is that 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 paragraph of Commentary does not take into account that copyright is as per respective domestic laws. 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. Under domestic IP law of most countries, copyright is a bundle of rights comprising of right to copy, right to distribute and right to exhibit. The right to distribute is a copyright, which is a valuable economic right of copyright owner. It exists independent of other rights in the copyright including the right to copy. Copyright holders of software have moved the Courts world over to counter unauthorized distribution and establish their copyrights. There appears to be a very strong justification for the disagreement by Members of erstwhile UN Committee on para 14.4.

Recommendations:

20. Expansion of UN Model Commentary on Paragraphs 14, 14.2, 14.4, 17.2 and 17.3: The possible reasons for disagreement by members of former UN Committee on paragraphs 14, 14.2, 17.2 and 17.3 are discussed in paragraphs 16 to 18 of this Paper above. Accordingly, it is proposed to expand the existing remark in UN Model Commentary as below, so as to provide more clarity in the matter:

“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. The main reason for this view in respect of paragraphs 14, 14.2, 17.2 and 17.3 is that there is a use or right to use copyright in these situations, even though it may be to enable the user to operate the program or download the digital product. It cannot be said that payment is a consideration for use of software or copyrighted article only and not for using the copyright, when without use of copyright there cannot be any use of copyrighted article. It is not practicable to disaggregate the payment towards consideration for various uses in such situations. Purpose of copying is irrelevant for characterizing the payment. Further, commercial exploitation of copyright by user is not a requirement for characterizing payment for the copyright as royalties. In respect of para 14.4, the payments in question were felt to be in the nature of royalties as the right to distribute is a copyright, which is a valuable economic right of copyright owner. It exists independent of other rights in the copyright including the copying right and the exhibition right.

Copyright holders of software have moved the Courts world over to counter unauthorized distribution and establish their copyrights.”

Issue C: Possible modification of the definition of royalties:

Recommendations:

“21. Characterization of payment for use or right to use software itself as ‘Royalties’:

The dividing line between use of copyright in a software work and use of software itself is blurred. There is also an issue whether the payment under an indivisible contract of software licensing is towards the use of copyright or for the use of software itself or for both and if it is for both, then how much for each. Disaggregation of consideration into separate elements would be dispute prone and administratively cumbersome. Commercial exploitation by the owner or creator of software is heavily dependent on the laws on protection of intellectual property rights in the territory of exploitation, i.e. where the user is. Non-residents that do not maintain a physical presence in the source country nevertheless benefit from the source country’s legal system inasmuch as they rely upon it to protect 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 of intangible products and the need for protection of these rights arises independently of the need for any physical presence to be maintained in the source country. Likewise vendors of digitized content (including music and computer games) would not have a market in source countries that did not have a suitable telecommunication infrastructure or whose population lacked competence in computers. Given that reproduction is so cheap and easy for these intellectual supplies i.e. computer software and other digital products, 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 intellectual supply or product such as computer software itself rather than on use or right to use the intellectual property right is all the more justified when reproduction is easy and cheap in era of downloading. The main use of copyright is copying digital goods containing images and sounds, and this use is as easy and common as a mouse click. As per OECD Commentary, this may be an incidental use of a copyright. But actually, that does not remain the issue any longer. *The issue is that the use of a copyright as a threshold warranting source taxation has little material meaning in the digital age.* Intellectual content is purchased in an environment that increasingly requires the source state’s protection of the value of that content. If the purpose of royalty taxation at source is to tax income from intangible with a substantial intellectual content, then it may be an odd outcome if the rock band sells the same music (eg. from the 1970s), derives the same amount of source profits, enjoys the same or more source legal protection, but pays a much lower amount of source tax. The definition of royalties should thus be broadened to apply to intellectual supplies digitally made over the internet or similar media. This will be a natural extension of the concept of royalties and its adaptation to the realities of the digital age.

22. These aspects indicate that taxation of intellectual supplies such as computer software or other digital products should hinge on intellectual content rather than intellectual property rights. Existing definition of 'royalties' in Article 12 may hence be modified for taxing intellectual supplies such as computer software and other digital intellectual supplies by including payments for use or right to use such digital intellectual supplies i.e. computer software and other digital products referred to in paragraph 14.2 of OECD Commentary, as against the present system of taxing payments for consideration to use copyright in respect of intellectual supplies. Already, many countries treat payments to non-residents in consideration for use or right to use computer software as royalties under their domestic law. Many existing bilateral tax treaties also have such definition under Article 12. It is hence for UN Committee's consideration to make this change in the definition of 'royalties' by including payments as consideration for use or right to use computer software. As mentioned in paragraph 4 above, this view was supported by some of the present Committee members in 17th Session at the time of presentation of last Paper by the Coordinator. If this recommendation is acceptable to the Committee, the modified Model definition of 'royalties' for Article 12 and corresponding Commentaries can be prepared."

3. The purpose of sending the above extracts to the Committee is now explained. As the experience has shown, the specific Subcommittee (earlier i.e. before present Committee's term) and the Subgroup are unlikely to be ever able to come up with any agreed recommendations. It may be recalled that the earlier Subcommittee (2013-17) had prepared detailed recommendations. The Committee never got to see or discuss these recommendations. During the 14th session of the Committee in April 2017, the Coordinator of the Sub-Committee reported that the Sub-Committee had been unable to reach a final decision with respect to characterization of software related payments. The Sub-Committee had therefore issued 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. This time also, the comments received on my Note indicated strong resistance to the Note going to Committee *even as my Note* along-with comments of members and not of the Subcommittee. This way, the proposals if any favouring developing countries from point of view of allocation of taxing rights in the software royalty related provisions in UN Model and commentaries thereto are unlikely to be placed before the Committee ever. The matter will remain embroiled in procedural aspects and aspects such as wider consultations etc. at level of Subcommittee. I would like to quote below comments of Mr Jorge Rachid, Committee member at Subcommittee stage in May 2020, which are very germane in this respect:

‘ 2. I do not believe there is a consensus on the taxation of software payments in the OECD and UN models over several decades. I am also not sure that developing countries are fully aware of the reach of the options of interpretation of software payments. In other words, it is likely that potential lack of awareness has led developing countries not to explore the different options to tax software payments. As the UN Commentaries stand nowadays, their bargaining position in DTC negotiations seems to be weak due to the lack of clear guidance. It would not surprise us if developing countries are not fully of the dimensions and complexity of this relevant issue.

3. It might be necessary to consider whether current practice or theoretical consistency should guide the elaboration and reform of the UN Model and its Commentaries. Recently, some of the relevant changes of the UN Model and Commentaries were not preceded by widespread country practice but rather on theoretical justification and a combination of policy principles. The recent adoption of Art. 12-A, for instance, has influenced countries’ practices and it had not been widely spread before the amendment of the UN Model. In other words, the Committee should not only look backwards, but anticipate problems or raise awareness of unnoticed issues, what can be the case with the taxation of software payments.

4. Thus, deciding on how to proceed based only on the number of countries for which the qualification of software payments as royalties is already a material issue could distort the approach of the Committee to anticipate problems before they become unsolvable controversies and, moreover, the issue could have been unnoticed so far. Reservations and observations of countries support the view that we have to continue to investigate the taxation of software payments and not to close the discussion at the current stage. The main question seems to be whether we should ask for a feedback from the Committee at the current stage.”

4. Mr. Jorge Rachid had also made very relevant observations on role of Subgroup and Subcommittee vis a vis role of Committee as below:

“ 5. A relevant issue is whether there has been enough and productive discussion in the Sub-Group and whether such debate would be a condition to allow the Committee to deliberate or to receive a feedback on the work of the Sub-Group.

6. One must remember that the original legitimacy to deliberate on any topic lies with the Committee members rather than the sub-group members. The purpose and intent

of setting up sub-groups is always to help the Committee members who are originally responsible for any initiative to reform the UN Model or its Commentaries. The sub-groups are not entitled to finally decide or to prevent the Committee from deciding on any subject matter. “

5. I therefore request the Committee that there is urgent need to discuss the matter directly at Committee level now in this Committee’s remaining life and take a decision on substantive issues rather than leaving at Subcommittee level. Still three sessions of this Committee are left and it would be best if Committee can decide on substantive issues themselves rather than just deciding which areas to work on as proposed in CRP13. It is all very well known for very long on which issues to work upon. [Previous Notes by Subcommittee Coordinators will bear me on this.]