Comments on the discussion draft on the inclusion of software payment in the definition of royalties

- Radhakishan Rawal[1]

1. General observations

1.1 Importance of stable tax environment and tax certainty

Tax litigation or unilateral taxes are not conducive to international trade and commerce. What MNEs need is tax certainty. This certainty can be achieved by adopting a very clear position on taxability of software payments and fair distribution of taxing rights in the UN Model.

1.2 Contemporary international thinking (Pillar 1 and 2)

It is now well understood that permanent establishment as a base for distribution of taxing rights is no more sacrosanct. With the increased digitization, the concept of permanent establishment has become outdated.

The Inclusive Framework (Pillar One) has proposed a new taxing right Amount A not only for Automated Digital Services (ADS) but even for Consumer Facing Business (CFB). Software if downloaded through internet may qualify as ADS and if is copied on a media could be CFB. Although final political agreement on Pillar One is pending, 138 countries can be said to have broadly agreed for fair allocation of taxing rights to the market jurisdictions. This allocation is neither constrained by the non-existence of permanent establishment or the scope of Copyrights under the domestic law.

It would not be desirable to completely disregard what is broadly agreed by 138 countries in the Inclusive Framework. *The Inclusive Framework can be said to have broadly agreed on allocation of taxing rights to the market jurisdictions as regards consideration for computer software* (either as ADS or CFB) and the UN Tax Committee can take that thinking forward.

1.3 Unfair distribution of taxing rights results in unilateral measures and dilutes importance of tax treaty network

It is important to note that the current chaos in the international taxation in the form of unilateral taxes on digital services (DSTs), outside the tax treaty network, is mainly attributable to unfair tax allocation of taxing rights. Distribution of taxing rights under the current treaty structure is not compatible with the current business models and that resulted in unfair

[1] Radhakishan Rawal is a Mumbai, India based Chartered Accountants and the comments made are made in the personal capacity. These comments do not represent views of any organization.

distribution of taxing rights. This unfair distribution of taxing rights resulted in various sovereigns introducing unilateral DSTs. Both developed and developing countries have done this.

Accordingly, it needs to be noted that if the UN Model does not do fair allocation of taxing rights to the source countries, the potential adverse implications could include:

- The countries will be encouraged to recover taxes outside the treaty network by levy of unilateral taxes such as DSTs
- The tax treaty network will start losing its importance due to increasing unilateral taxes
- In the country of residence, the MNEs will not be able to claim credit for the unilateral taxes paid in the source country (market jurisdictions).
- The MNEs may make attempts to pass the costs to the end customers, which will make them less competitive.
- International trade and commerce will be adversely impacted.

Thus, prima facie the residence countries may gain higher share of tax revenues, but in the long run the unfair distribution of taxing rights generates adverse outcomes for international trade and MNEs.

2. Specific observations on the proposed changes to the Article and Commentary

2.1 Simplification by delinking computer software from copyright law?

Consideration for computer software may get covered in either of the following three:

- Sub-division (a)(i)
- Sub-division (a)(iv)
- Sub-paragraph (c)

This makes article little difficult, confusing overlaps (see ***para 2.4***). Several paragraphs of the commentary deal with implications under the copyright law and these are relevant for sub-division (a)(i). Considering the fact that the source country is given taxing rights even in cases where there is no use of copyright, the Committee may evaluate the possibility of simplifying this by:

- Specifically excluding computer software related payments from sub-division (a)(i) and removing references to copyright in context of computer software. The implications of this approach would be as follows:

- Article 12 will be less confusing and easy to implement in the context of computer software.
- It would not be possible to negotiate a different rate of tax for cases involving usage of copyright of computer software and cases not involving usage of copyrights. However, existence of such different rates for computer software can be a subject matter of future litigation (classification issues) and different rates may not be desirable from that perspective.
- Where the treaty does not give taxing right to the source countries as per the proposed provisions, in the future reference will have to be made to the old UN Commentary for copyright related guidance.

2.2 Reduce reliance on copyright law for distribution of taxing rights

Historically significant reliance has been placed on copyrights law for allocation of taxing rights and that has resulted in litigation of over two decades, produced hundreds of judicial precedents.

This approach (i.e. reliance on copyrights law) was probably justified 20-30 years back but certainly not in the year 2021. The business models have significantly changed and need for fair distribution of taxing rights in favour of market jurisdictions, beyond the current treaty rules, is now globally recognized. The work in the Inclusive Framework on Pillar One is on this basis.

The current and proposed approach for taxing rights in favour of the source countries is tabulated hereunder:

Para no.	**Current approach – justification for taxing rights**	**Suggested approach**
14	Usage of computer software is treated as "letting of intangible property"	Negotiate taxing right in favour of source country on the basis that the market jurisdiction should get fair allocation of taxing rights.
19 & Annex	Distribution intermediaries	

	Provisions of copyright law – distribution rights	

Inherent conflicts in the arguments

The table brings out the obvious conflict in the arguments for giving taxing rights to the source country:

- For the purpose of Sub-division (a)(iv) and sub-paragraph (c) the requirements of copyright law are ignored and taxing right is claimed even where there is no usage of copyright related to computer software.
- For levying tax on distribution intermediaries, reliance is placed on copyright law.

Such obvious inconsistencies need to be avoided.

2.3 Definition of "computer" and "software"

This could be an extremely complex area considering the rapid changes in technology.

Para 17 of the proposed Commentary accepts that several electronics items have inbuilt software and several items / instruments / things may qualify as computer e.g. an automobile has an on-board computer. What qualifies as "computer" could also be a complex debatable issue. For example a smart phone has all the features of a computer and has practically become a substitute of a computer. Similarly, several functions are now also available in smart watches.

While deciding this issue, arising predominantly on account of technology advancement, the time gaps between defining the term and application of tax treaty should be kept in time. The real issue can be understood on the basis of the following:

- The UN Model adopts the definition of "computer software" in the 2021 update.
- This definition may be adopted in a tax treaty in the year 2025 and
- There may be an occasion to apply this definition in the year 2030.

The business models and technology may have advanced by few generations by 2030 and the definition adopted in the year 2021 may have lost its relevance.

The Committee may consider the approaches described in the following paragraphs to address this issue.

2.3.1 Approach 1 - Adopt specific definitions for "computer software"

Under this approach, terms "computer" and "computer software" will be specifically defined in the tax treaty. The definitions could be included in Article 12 or in Article 3. The definition needs to be futuristic (i.e. should be comprehensive enough to encompass future technologies).

The advantage of these definitions will be that are no disputes as regards what constitutes "computer software".

However, it could be difficult to define these terms considering the wide variety of electronic instruments with software in it. Further, such definitions may not keep pace with the rapid technology.

2.3.2 Approach 2 - Domestic law meanings to prevail in terms of Article 3(2)

Under this approach, the tax treaty (UN Model) will not contain the definitions for the terms "computer" or "computer software". In terms of Article 3(2) of the treaty, the meaning of these terms as prevalent in the domestic law of the source country will prevail.

The country of residence will have the obligation to give credit for taxes paid in the source country, even when the definition of computer software is different under the domestic laws of both the countries. Paras 32.2 and 32.2 of the OECD Commentary on Article 23A and 23B addresses the issue of "conflicts of qualification". These paragraphs are adopted in the UN Commentary as well. Under this approach, taxation by the source country in such cases[2] will be treated "in accordance with the provisions of the Convention".

Advantages

- What constitutes computer software need not be settled in the UN Model and the meaning adopted in the domestic law of the source country, which can be expected to be keeping pace with the rapid developments in technology.
- If Article 3(2) adopts "ambulatory approach" the most recent meaning adopted in the domestic law would be applicable.

[2] i.e. the cases where the source and residence country adopt different classifications

- Even if Article 3(2) text suggests “static” as against “ambulatory” approach, the meaning adopted in the tax treaty could be comparatively of recent origin. Thus in the above example, the domestic law meaning prevalent in the year 2025 (when treaty is signed) would be applicable, as against meaning adopted in the UN Model in the year 2021.
- This approach will lead to fair allocation of taxing rights in favour of the source country.

Disadvantages

- Domestic law of some countries may not contain definition of “computer software”. However, this can be cured easily.
- The country of residence may not be comfortable presuming that the source country may adopt a very broad definition of the term “computer software”. However, such broad definition cannot be seen as resulting in unfair allocation of taxing rights. The country of residence always retains the right to levy tax on the global income and the source country gets taxing rights under Article 12 only for base eroding payments.

2.3.3 Approach 3 – Inclusion of protocol in tax treaties

Under this approach, the term “computer software” will not be defined in the UN Model. The Model will contain a place holder for the definition in the protocol. The countries negotiating the treaty can adopt the meaning of the term “computer software” considering the technology which is prevalent at the time of treaty negotiation.

This approach will only partially solve the issue.

2.4 Internal overlaps

2.4.1 More guidance for addressing overlaps

Para 20 of the proposed Commentary recognizes the overlap between sub-division (a)(i) and (a)(iv). There could be overlaps with sub-paragraph (c) as well. In a situation where different rates are adopted in the tax treaty for the sub-divisions [say 10% for sub-division (a)(i) and 7.5% for sub-division (a)(iv)] disputes may arise. The taxpayer may claim 7.5% and source country tax authorities may apply 10%. It may be clarified that in case of such overlaps, the sub-division which is more beneficial to the taxpayer may be applied.

This issue can be avoided altogether if the computer software is completely delinked from copyright as suggested in ***para 2.1*** above.

2.4.2 Obligation of the country of residence

A situation may arise where the country of source applies tax rate of 10% under sub-division (a)(i) and the country of residence believes that the sub-division (a)(iv) is applicable and hence the rate applicable is 7.5%. Would the country of residence by justified in restricting credit for taxes paid in the source country to 7.5%?

It should be clarified that the difference (conflict of classification) arises on account of domestic law and hence the country of residence should give a full credit for 10% taxes withheld in the source country. Levy of 10% tax by the source country in such cases should be treated as "in accordance with the provisions of the Convention" for the purpose of Article 23.

This issue can be avoided altogether if the computer software is completely delinked from copyright as suggested in ***para 2.1*** above.

3. Comments on specific issues on which response is requested

3.1 Meaning of "software"

Question:

> *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?*

Response:

Please see approaches suggested in ***para 2.3*** above. Additionally, it is desirable that more guidance is given in the Commentary on this issue.

3.2 Meaning of "computer"

Question:

> *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?*

Response:

Please see approaches suggested in ***para 2.3*** above. Additionally, it is desirable that more guidance is given in the Commentary on this issue with more examples.

3.3 Distribution intermediaries

Question:

> *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:

While addressing the issue the Committee requested to consider the following:

- Decide the issue in a manner that it results in fair distribution of taxing rights. The adverse implications of unfair distribution are summarized in ***para 1.3*** above. It results in unilateralism and which is not in the interest of MNEs, international trade and commerce. The distribution intermediaries may be better of by claiming credit within the treaty network in the country of residence for the taxes paid on software payment in the market jurisdiction, as against paying DSTs in the market jurisdictions which are not creditable.
- Consider the contemporary international thinking on taxing rights in favor of market jurisdictions. This is analysed in ***para 1.2*** above. Computer software is an integral element of digital economy. It would

not be desirable that the UN Tax Committee (25 members) completely ignore what is agreed in the Inclusive Framework (138 members which includes some or all of 25 countries as well).

- Excessive (or any) reliance on copyright law is not desirable. The purpose of Article 12 is to distribute taxing right and reference to use of copyright was only one of the means to it. Interpretation of copyright law has become an end it itself (rather than a means to an end) and appears to have completely taken over Article 12. The original purpose of Article 12 need not be side tracked.
- As explained in ***para 2.2*** above the taxing rights should ideally negotiated on the basis of desirability of taxing rights to the market jurisdiction without getting lost in the copyright law.

3.3.1 Additional issues – Need for additional guidance

In this context the Committee is also requested to address the following issues:

Issue 1 – Article 12 or Article 12B?

If income earned from reselling (distribution of) the computer software is not subject to tax in terms of Article 12, will such income be covered by Article 12B of the UN Model? Which article will be easy to implement, give better results for the taxpayers?

Issue 2 – Does distribution also result in "letting of intellectual property"?

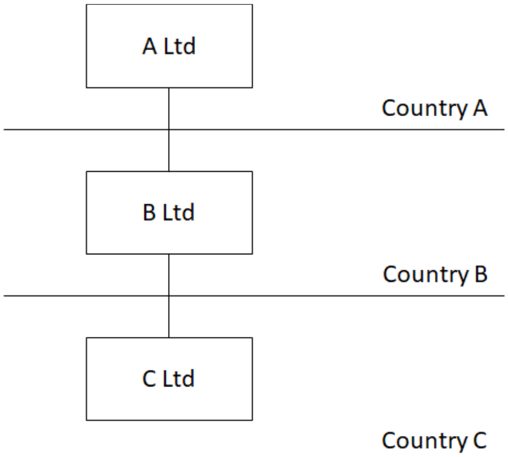
Para 14 of the proposed UN Commentary on Article 12 gives "letting of intellectual property" as a justification for sub-division (a)(iv). Analogy is drawn from sub-division (a)(iii).

The Committee may want to give guidance on whether the same theory "letting of intellectual property" be applied by the source country an intermediary is involved?

This can be explained on the basis of the following two examples:

Example 1

A Ltd, B Ltd and C Ltd are tax residents of Country A, Country B and Country C respectively. A Ltd. has developed the software and the same is distributed by B Ltd to various parties. C Ltd. has purchased the software from B Ltd. While the purchase is from B Ltd, the software license is between A Ltd and C Ltd i.e. A Ltd. has granted rights to use software. The tax treaty between Countries A, B, and C are on the basis of UN Model.



The relevant provisions of the UN Model are reproduced hereunder:

> *1. Royalties arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other State.*
>
> *2. However, such royalties may also be taxed in the Contracting State in which they arise and according to the laws of that State, but if the beneficial owner of the royalties is a resident of the other Contracting*
> *State, the tax so charged shall not exceed 10% of the gross amount of the royalties. The competent authorities of the Contracting States shall by mutual agreement settle the mode of application of this limitation.*
>
> *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)*** *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.***

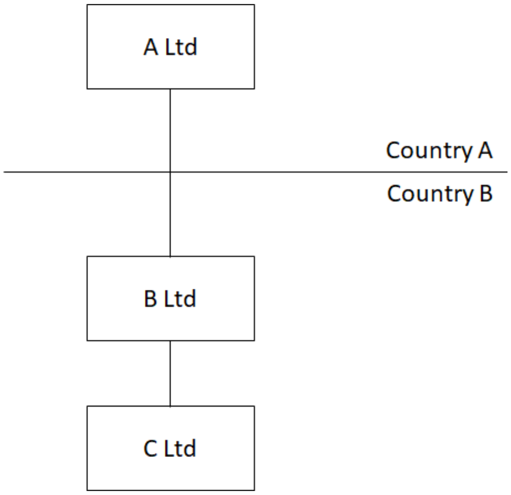
The following issues arise:

- Does Article 12 of Country C-Country A tax treaty allow Country C to tax the consideration paid by C Ltd. in the hands of A Ltd?

- Whether it is possible to take a view that the license arrangement is between C Ltd and A Ltd whereby C Ltd is allowed to use software and hence the consideration (substantial part of it, excluding B Ltd's margin) paid by C Ltd is effectively paid to A Ltd which is the beneficial owner of the payment? Payment is routed through B Ltd.
- Whether sub-division (a)(iv) be invoked on the basis that consideration paid by C Ltd. is for "right to use computer software" and the consideration is effectively paid to A Ltd.?

Example 2

The facts are same as Example 1 except that B Ltd is established in Country C.



Whether it is possible for Country C to levy tax on payment made by B Ltd to A Ltd invoking sub-paragraph (c)? This could be on the basis that B Ltd is in the business of distribution (sale) of computer software and any copy sold / distributed by B Ltd can be said to be "used" by it. What constitutes "use" may be interpreted on the basis of the domestic law.

It is advisable that the UN Tax Committee specifically addresses these issues in the Commentary to avoid protracted litigation on such issues.

4. Mechanism to quickly adopt changes to the UN Model in existing tax treaties

Amendment of Article 12 and its commentary to give taxing right to the source countries would have no practical implications unless the treaty provisions are amended. Amendment of existing treaties through the normal bilateral negotiation mechanism could take several years.

To address this issue and for quick amendments to the existing tax treaties, a Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (referred to as "***BEPS MLI***" for the purpose of this discussion) was developed as a part of OECD/G20 BEPS Package. BEPS MLI is currently operational and has been signed by more than 90 countries.

4.1 Need for UN MLI

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

4.2 Collaboration between UN and OECD for MLI?

Even if a new MLI is created for the UN Model, amending existing tax treaties through two MLIs (existing BEPS MLI and proposed UN MLI) could be a complex exercise.

The possibility of collaboration between UN and OECD for the use of BEPS MLI can be explored. The mechanics of this approach could be as follows:

- The UN Tax Committee will decide whether the changes made to the UN Model are critical in nature and deserve to be adopted in the existing tax treaties.
- Joint work by UN and OECD secretariats to facilitate usage of BEPS MLI for incorporating amended provisions of the UN Model in the existing tax treaties.
- New Articles / provisions in the UN Model can be added to the BEPS MLI which will correspond to the changes in the UN Model.

It needs to be noted that even without specific collaboration, it may be possible for any party to the BEPS MLI can initiate the process of amendment of BEPS MLI (Article 31 and 33 of MLI).