



March 15, 2021

**VIA E-MAIL**

Subcommittee on the United Nations Model Tax Convention  
between Developed and Developing Countries  
[taxcommittee@un.org](mailto:taxcommittee@un.org)

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

Dear Ladies and Gentlemen,

This letter is in response to your request for comments on the discussion draft of February 16, 2021 concerning proposed changes to the definition of “royalties” under Article 12 of the UN Model Tax Convention. We appreciate the opportunity to comment on the draft.

We are including as an Appendix to this letter a copy of our prior comment letter of October 2, 2020, which set out our concerns about the version of this proposal then under discussion. All of those concerns apply equally to the current discussion draft, and we would urge members of the Subcommittee and the full Committee of Experts to consider them.

For the reasons outlined in our prior letter and further elaborated below, we have serious reservations about the proposed changes to Article 12. We would therefore strongly encourage the Committee not to rush into adoption of this proposal, which remains heavily flawed from both a policy and technical perspective.

**High-level comments**

We believe it is important to emphasize up front that this proposal reflects what appears to be a disturbing trend of expanding the UN Model’s Article 12 family of provisions to allow for gross basis taxation of categories of business profits that are likely to have a high level of associated expenses.<sup>1</sup> Such an expansion brings with it the risks of excessive taxation, double taxation, the shifting of economic cost to source country customers and/or the potential cessation of software sales into the relevant market country, as well as distortion to the efficient allocation of resources in international trade which treaties are supposed to support. As such, the proposal directly undermines what is supposed to be a clear objective of the UN Model: “the protection of taxpayers against double taxation with a view to improving the flow of international trade and investment and the transfer of technology.”<sup>2</sup> As we also note further below, the potential overlaps and unclear distinctions among the expanded array of the Article 12, 12A, and 12B provisions creates a muddled policy statement and a likely source of disputes.

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<sup>1</sup> This would include the recently added Article 12A (Fees for Technical Services) and the proposed Article 12B (Automated Digital Services).

<sup>2</sup> UN Model Double Taxation Convention, Introduction, paragraph 6.

The proposal to subject all software payments to gross basis taxation, including those from the sale of copyrighted software programs, likewise fails to recognize the appropriate balance between source and residence country taxation which is also supposed to be a guideline for the UN Model:

The United Nations Model Convention seeks to be balanced in its approach. As a corollary to the principle of taxation at source the Articles of the Convention are based on a recognition by the source country that (a) taxation of income from foreign capital should take into account expenses allocable to the earnings of the income so that such income is taxed on a net basis, that (b) taxation should not be so high as to discourage investment and that (c) it should take into account the appropriateness of the sharing of revenue with the country providing the capital.<sup>3</sup>

Such a fundamental change should not be made without analyzing whether the revenue stream proposed to be subjected to gross basis taxation is appropriate for that treatment. Gross basis taxation, if applicable at all to business profits, should be limited to cases where the income recipient has no need to incur significant ongoing costs to maintain the value of the asset being exploited (e.g., further development costs) or to generate the revenue stream (e.g., payroll, marketing, and distribution expenses). Software companies are among the most R&D-intensive businesses in the world, with also typically a substantial corps of employees devoted to marketing and distribution activities. The proposal lacks a fact-based analysis to support its recommendation for singling out this sector for gross basis taxation treatment of business profits.

The Committee should also hesitate to introduce radical changes to the UN Model based upon proposals that have no reliable basis in established treaty practice. The proposal does not cite, and we are not aware of, any significant treaty practice of treating software payments as royalties, beyond payments for the use of, or the right to use, copyrights of software programs. We note, too, the important decision issued by the Supreme Court of India on March 2, 2021,<sup>4</sup> holding that payments by Indian distributors and end users for the acquisition of copyrighted software copies did not constitute royalties under India's treaties. That decision undercuts the views expressed by supporters of the discussion draft's proposal that such payments are the equivalent of "letting" intangible property. The proposal also goes against a general trend in treaty practice in favor of reducing gross basis taxation by reducing or eliminating withholding tax rates. The UN Model should be designed to reflect compromises that are likely to be acceptable to both software-importing and software-exporting countries, as most reliably shown by some history of treaty practice. A failure to reflect policy choices likely to be found acceptable in actual treaty negotiations between developed and developing countries will strip the UN Model of its status as a useful guide to negotiators.

As we stressed in our prior letter, the UN should not act precipitously to introduce such a far-reaching change just before the OECD's Inclusive Framework reaches the conclusion of its years-long effort to reach a wide international consensus on new international tax rules aimed at addressing the challenges arising from the digitalization of the economy. That recommendation is even more urgent now, as recent reports suggest rising chances of a successful conclusion to the Inclusive Framework's discussions shortly after the term of the current Committee of Experts expires. The UN should not take steps in this

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<sup>3</sup> *Id.*, paragraph 13.

<sup>4</sup> *Engineering Analysis Centre of Excellence Private Limited et al. v. The Commissioner of Income Tax & ANR*, Civil Appeals Nos. 8733-8734 of 2018 *et al.* (Supreme Court of India, March 2, 2021); see paragraphs 52, 144, and 169.

critical period that would undermine that effort, nor should it mislead governments or stakeholders into believing that this recently articulated Article 12 proposal represents a realistic alternative to an actual international consensus involving almost 140 countries on new tax rules for the digitalizing economy.

**The draft Commentary is confusing and appears intended to camouflage the radical nature of the proposed changes**

The discussion draft's approach to revising the Commentary on Article 12 as it relates to software is to retain most of the prior Commentary, with only minor tweaks to pre-existing paragraphs. This approach is wholly unsuited to address the radical nature of the proposed changes to the Article. Those changes would effectively render irrelevant all distinctions based on the difference between use of a copyright and use of a copyrighted article, at least where payments taxable under proposed Article 12(3)(a)(i), 12(3)(a)(iv), and 12(3)(c) are subject to the same rate. The Subcommittee should revisit the drafting of the proposed Commentary so that it communicates more clearly the radical nature of the proposal's intention to single out one particular product, copyrighted computer software programs, and to subject the sale of that product to gross basis taxation.

**The discussion draft does not adequately address the administrative challenges of implementing the proposed taxing right**

We support the views described in paragraph 15 of the draft Commentary concerning the disadvantages of expanding Article 12(3) to cover payments for the use or acquisition of copyrighted computer software (i.e., as distinct from the use of the copyright itself), including the particular challenges of trying to exercise such taxing rights over payments by individuals. There are enormous practical implications for trying to effectively implement the new rules in the case of payments by individuals, who would be required to perform a withholding tax obligation. Moreover, the proposed taxing right would be much broader than the taxing authority exercised by most jurisdictions under their domestic law, which itself calls into question the basic rationale for the proposed change. The UN should not adopt such a ground-breaking rule without a credible analysis of the implications for all affected parties.

**The discussion draft does not adequately address potential overlaps among Articles 12, 12A, and 12B**

The proposal does not adequately address the principles underlying the interaction among proposed Article 12 as amended, Article 12A on fees for technical services, and proposed Article 12B to the extent of overlap.

There is no priority rule between existing Article 12 and Article 12A, presumably on the theory that payments for the use of a copyright (i.e., royalties under existing Article 12) are relatively easy to distinguish from payments for technical services, covered by Article 12A. If, however, Article 12 is expanded to cover payments for the use or acquisition of software, the potential for overlap between Articles 12 and 12A becomes much greater. The possibility of different rates in those two Articles, as well as potential differences in design, will put a lot of pressure on being able to determine whether a particular payment falls under only one of those Articles or both of them.

For example, paragraph 22 of the proposed Commentary on Article 12 suggests there is little chance of overlap between amended Article 12 (covering all computer software payments) and Article 12A, on the grounds that Article 12A applies "to the provision of services, such as software consulting, that involve human input, while Article 12 relates to the use of property." It is not clear, however, that Article 12A is

as limited as this proposed Commentary suggests. Even standardized software-as-a-service (SAAS) contracts may cover a broad range of services, including direct human support to enable the customer to set up and continue to use the software, thus risking overlap of Articles 12 and 12A. Moreover, other proposed Commentary, such as paragraph 39 of the proposed Commentary on Article 12B, likewise suggests that use of software through cloud computing arrangements requiring minimal human involvement may potentially fall within Article 12A as well as 12B, with Article 12A being given preference. If such transactions are now to be brought within Article 12 as well by virtue of the expansion of Article 12 to cover non-copyright-related software payments, one potentially would need to determine whether Article 12 or Article 12A should take priority. Moreover, Article 12A was designed to reflect certain policy choices as to the types of payments that should be subject to a gross basis withholding tax. One such policy choice is reflected in Article 12A(3), which excludes from the definition of fees for technical services any fees paid by an individual for services for the personal use of the individual. There is no comparable exclusion from proposed Article 12's coverage of payments for the use of software. This raises the question of the extent to which the expansion of Article 12 would undermine policy choices reflected elsewhere in the UN Model.

As for potential overlaps between an expanded Article 12 and proposed Article 12B, proposed Article 12B(4) says that payments qualifying as Article 12 royalties or Article 12A fees for technical services will not fall within Article 12B's coverage of fees for automated digital services. The existence of this priority rule, however, will not necessarily eliminate the greatly expanded tensions that could result from the proposed expansion of Article 12 to cover all software payments. Paragraph 24 of the proposed Commentary on Article 12 provides a wholly inadequate explanation for how to distinguish between payments that might be covered by Article 12 and those that might be covered by Article 12B, since it does not address the question of how to determine whether a payment falls within Article 12(3)(a)(iv) (i.e., payment for the use of computer software) rather than Article 12B (payment for automated digital services). For example, is a payment for a digital content service, such as online games, which is clearly an automated digital service, also a payment for the use of or the right to use computer software? Paragraph 15 of the Commentary on proposed Article 12B suggests that the maximum rate on automated digital services should be modest, with a recommendation for 3% or 4%. This is quite a bit lower than the withholding rate typically allowed for royalties under Article 12 in those treaties that provide for a positive rate. Therefore, it will be critical to know which, if any, payments that could fall within Article 12B will *not* now fall within the expanded Article 12. The vastly increased instances of potential overlap between Article 12 and Article 12B as a result of the proposed expansion of Article 12 will be a great source of widespread disputes.

The Committee would be well-advised not to move forward with the proposed Article 12 changes without undertaking a comprehensive review of the existing and proposed changes in the Article 12 family to ensure that the policy results make sense and that potential overlaps are better clarified. A failure to address these issues could lead to a high likelihood for increased disputes among taxpayers and tax authorities based on these substantial ambiguities and overlapping definitions. Model tax treaties should seek to *reduce* disputes, not add provisions that will create or increase disputes.

### **The proposal's limitation to "computer" software may be unstable**

Fundamentally, we do not believe that income from sales of software copies should constitute royalties, regardless of the context. We believe that no payments for software, whether in the form of separate copies or embedded in devices, should be considered royalties for the purposes of Article 12. We oppose discrimination against computer software programs.

## **The proposal appropriately excludes payments by software distributors**

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. Treating as royalties the payments made by both ultimate customers who acquire computer software for use and distributors who do not exercise copyright rights in the software would potentially result in crushing cascading taxation. We also note the well-reasoned opinion of the Indian Supreme Court in its recent decision referenced above, which undermines any suggestion by proponents of a broader Article 12(3)(c) that current treaties support a conclusion that payments by software distributors constitute royalties outside the paragraph 14.4 situation where the distributor has reproduction rights.

## **Conclusion**

For all the reasons outlined above and in our attached prior letter, we recommend against expanding Article 12’s coverage of software transactions as royalties, particularly in the very short time left to the current Committee of Experts to finalize this flawed proposal.

We appreciate the opportunity to submit this consultation letter and are available to discuss with you at your convenience the issues described in this letter in further detail.

Sincerely,

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Appendix: USCIB comment letter of October 2, 2020

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