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:
1 September 2020 to 2 October 2020

The United Nations Committee of Experts on International Cooperation in Tax Matters (UN Tax Committee) invites public comments on the attached discussion draft which includes a proposal by a number of members of the Committee for a change to the definition of royalties included in Article 12 of the United Nations Model Double Taxation Convention Between Developed and Developing Countries.

This proposal does not represent the consensus views of the members of the UN Tax Committee and other members of the Committee have in fact objected to it. The publication of this proposal at this stage is intended to allow stakeholders to comment on the proposal before it is considered by the Committee at its 21st session currently scheduled for the end of October 2020.

Comments should be sent **by 2 October 2020 at the latest** by email to taxcommittee@un.org in Word format (in order to facilitate their inclusion in a revised version of the note that will be distributed to members of the Committee). These emails should be entitled "Comments on discussion draft on the inclusion of software in definition of royalties" and the comments should be addressed to the "Subcommittee on the United Nations Model Tax Convention between Developed and Developing Countries".

Please note that, with the exception of comments from United Nations member States, all comments received regarding this discussion draft will be made publicly available.

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Background

1. Note E/C.18/2020/CRP.13 on the "Application of Article 12 of UN Model to software payments", which was prepared by the Subcommittee on the United Nations Model Tax Convention between Developed and Developing Countries, was discussed during the 20th session of the UN Tax Committee held online from 22 to 26 June 2020. During that discussion, a number of members recommended that the Committee focus its attention on amending the current definition of royalties so as to include a reference to software payments in that definition. For some of these members, such a change could even be approved at the next session of the Committee. It was noted, however, that different views had been expressed, within the Subcommittee, on whether such a change would be appropriate.

2. It was decided by the Committee that the next step should be the preparation of a note that would include a drafting proposal for such a change to the definition of royalties as well as a policy discussion of that proposal and a discussion of its practical application in order to circulate that note for written comments by all stakeholders. These comments would be discussed at an online meeting of the Subcommittee with a view to presenting a note to the Committee at its 21st session, currently scheduled to be held online between 26 October and 6 November.

3. This discussion draft has been produced in accordance with that decision. Section 1 includes the proposal for change to the definition of royalties found in Art. 12(3) of the UN Model. Section 2 includes the reasons for that proposal that have been put forward by the members of the Committee who drafted it. Section 3 includes some of the arguments that have been raised by members who oppose the proposal.

1. Proposal for change to the definition of royalties

4. The definition of the term "royalties" in paragraph 3 of Article 12 of UN Model would be amended as follows (the proposed addition appears in ***bold italics***):

> 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.

5. Appropriate changes to the Commentary on Article 12 of the UN Model would accompany that change.

2. Reasons for the proposal

6. The members of the Committee who support the proposed change have first referred to paragraph 12.1 of OECD Commentary, which is quoted in paragraph 12 of the Commentary on Article 12 of the UN Model and which reads 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.

7. These members have argued that with the advancements in means of communication and information technology, computer programs or other software constitute a key tool in the conduct of most businesses. Computer programs and other software allow enterprises that use them to reduce the time needed to perform their tasks, improve efficiency and cut costs. In consequence, it cannot be denied that there is an increasing level of engagement of computer programs and other software in the economic life of States where they are used. That increasing engagement with the State where the software is used justifies the allocation of taxing rights to that State. Without prejudice, these members are of the view that it is a matter of allocation of taxing rights to source countries more than anything else for an item, payments in respect of which are already mostly within ambit of source State taxation as far as it involves use of copyright protecting the software. Proposed change would remove the blurred distinction between payments towards use of copyright in software or copyrighted software and would thus promote tax certainty and reduction of disputes.

8. According to these members, commercial exploitation by the owner or creator of software is heavily dependent on the laws on the protection of intellectual property rights in the territory of exploitation, i.e. where the user is. Non-residents nevertheless benefit from the source country's legal system inasmuch as they rely upon it to protect and 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 and the need for protection of these rights arises. In addition, suitable telecommunication infrastructure in the source country may have a role in promoting the use of software. Also, population's competence in computers will be a relevant factor. Given that reproduction is so cheap and easy for computer software, 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 computer software itself is all the more justified when reproduction is easy and downloading inexpensive. The definition of royalties should thus be broadened to apply to payments for the use or right to use software itself to adapt to the realities of the digital age.

9. These members have also noted that the definition of royalties included in the UN Model applies to payments for the use of, or the entitlement to use, elements of intellectual property, on the one hand, and payments for the use or the right to use industrial, commercial

or scientific equipment, on the other hand. In this latter case, as stated in paragraph 13.1 of UN Model Commentary on Article 12:

> …the owner of the equipment earns profits from letting another person use that equipment, without having the owner establish any presence in the state where it is used, or where the user resides, which would satisfy the requirements of Article 5 for the existence of a permanent establishment. For this kind of business, the equipment itself, when used by another person, is treated in the United Nations Model Convention as having significance similar to that of a permanent establishment.

10. For these members, software payments are "payments for use or right to use" software (e.g. the acquisition of "shrink-wrap" software involves a license for the use of the software itself) and are not payments for the sale of property. One must distinguish payments for the acquisition of the intangible itself from payments for the acquisition of a single copy or for the acquisition of the right to download the software, the latter two cases being payments for the use of the software and not the acquisition of property.The comparison with transactions for the sale or import of goods, including natural resources, is therefore inappropriate. Also, in the case of industrial, commercial or scientific equipment affected by the lessee to its own activities, there is enough engagement of the State where such equipment is used, justifying taxation, in that State, of the income derived by the lessor from such lease. A similar logic applies with respect to the use of computer software.

11. These members have also observed that many countries already treat payments to non-residents in consideration for the use or right to use computer software as royalties under their domestic law. A number of existing bilateral tax treaties also cover payments for use or right to use software itself under the definition of "royalties" in Article 12. The treaties being referred to here are not the ones where explicit reference to "software" has been made in the definition of "royalties" to clarify that "software" is a literary work thus protected by copyright.

12. For these members, while it may be argued that source taxation on gross payments for software would not take account of the costs of developing and distributing the software and would carry the risk that the tax levied by the State of source would be passed on to the residents of that State who acquire software, the same applies to all payments for intangible property referred to in the definition of royalties and there are no reasons to treat software differently from such other property. The same also applies to interest payments, which may be subjected to source taxation under Article 11 of the UN Model.

13. According to these members, the existing Commentary on Article 12 already addresses a number of technical issues that could arise from the proposal, including how to address mixed contracts which cover the acquisition of software together with the acquisition of goods and services. Also, additional guidance could be developed to address issues such as the collection of tax where payments for software are made by individuals.

14. Finally, given the current uncertainly surrounding ongoing work related to taxation and the digitalisation of economy, these members consider that it is important to address the

taxation of software payments, which has been on the agenda of the UN Tax Committee for many years. They also note that in the event of proposed changes in definition of royalty in Article 12 being accepted, the overlap between the Article 12B recently released for public comments and Article 12 can be addressed by suitably clarifying inter-se operation of the two and the interaction of the two proposals would not create problems.

3. Arguments against the proposal

15. The members who oppose the proposal have raised a number of arguments, including the following:

- It is not clear why payments for software should be treated differently from payments for other goods. For example, shrink-wrap software that is not customized for a particular customer, but are the same standardized products sold to all potential customers alike, are essentially a sale of a good that would give rise to business profits that fall under Article 7.
- The Committee should be mindful of the challenges of coordinating work on the taxation of software payments and other work related to taxation and the digitalisation of the economy.
- It is unclear on which on policy principle the proposal is based. The argument that source taxing rights on payments can be based on the fact that services or goods delivered by the payee create "an increasing level of engagement in the economic life of States where they are used" is problematic. What would this mean for countries exporting (rare) natural resources, like the rare metals used in cell phones, or oil, on which the world's economy relies? Do these goods not have a "significant level of engagement in other State's economy" and does that justify taxation in consumer States?
- An appropriate allocation of taxing rights is something countries must always consider. However, the allocation of taxing rights to the country of source is in of itself not justification for such a change. The underlying principles, and consistency with approaches taken elsewhere, must underpin such a change.
- Neither the prevalence of the use of a product software in a given country, the fact that producers of software rely upon the legal infrastructure in that country for the protection of intellectual property rights, the reliance on the telecommunication network of the country for the delivery of software, the ease of reproduction and cost of downloading software in that country nor the education or computer proficiency of the population of that country justify a taxing right for that country with respect to payments for the acquisition of software.
- The use of software should not be compared to the use of industrial, commercial or scientific equipment ("the leasing provision"), as included in Article 12(3) of the UN Model. Paragraph 13.2 of the commentary to Article 12 of the UN Model is explicit that intellectual property cannot be "equipment", confirming the underlying principle that the leasing provision is based on physical presence. Software by its nature means

there is no physical presence in the source state and as such the considerations that underpin the leasing provision do not apply to computer software. Also, the business of selling software is fundamentally different from the business of leasing industrial, commercial or scientific equipment.

- While it is correct that some existing treaties allow the source taxation of software payments, it is important to note that other treaties (not referred to in paragraph 11 above) include a reference to software payments that does do not grant source taxation rights to the state of source on payments for acquiring copies of software for business or personal use but simply clarify that payments for the use of copyright in software is covered by the definition of royalties or clarify that copyright in software is included in the definition's reference to copyright of literary work.
- Payments for the acquisition of copies of software to be used for the personal or business use of the acquiror are not payments "for the use or right to use" the software but, rather, are payments for the acquisition of these copies. The definition of royalties should exclude such payments to the same extent that the part of the definition of royalty that refers to payments "for the use or right to use of industrial, commercial or scientific equipment" does not apply to payments for the acquisition of such equipment.
- Gross taxation of payments for software will likely mean the additional (tax) cost is passed on to end users. This increases the cost of software in the state where the software is used, potentially in a way that makes it too expensive for end users.
- The development of software is often expensive and may result in tax losses in the country where it is developed in the early years of development and where other unsuccessful software projects may be undertaken. This makes it particularly important that income from the licensing of software is taxed on a net basis in the state where it is developed, as it is currently. As taxation on a gross basis ignores expenses incurred by the payee in earning the payments for use of that software, it may not be possible to get full credit for that suffered in the state of residence (which taxes on a net basis). This increases the likelihood that the software provider will either cease to sell its software into that other state, or that it increases the price for end users.
- The source taxation of software payments raises a number of practical difficulties, such as:
    - How would such a rule work when individuals purchase software?
    - How would the rule deal with software embedded in other products (e.g. the purchase of a computer or mobile phone with pre-installed software)?
    - How would the rule deal with software licenses that are centrally procured but where the software is used in a number of states?

16. Some of these members have also stressed that it would be important to review the Commentary changes that would be required to interpret the proposed changes (e.g. to

understand the interaction between the proposed change and the other provisions of the UN Model and to address issues such as the definition of software and whether software embedded in a product will be covered by the change). It would also be important to seek public comments on any such Commentary changes.