The **BEPS** Monitoring Group

INCLUSION OF SOFTWARE PAYMENTS IN THE ROYALTIES ARTICLE OF THE UN MODEL TAX CONVENTION

This submission to the UN Committee of Experts on International Cooperation in Tax Matters has been prepared by the BEPS Monitoring Group (BMG). The BMG is a network of experts on various aspects of international tax, set up by a number of civil society organizations which research and campaign for tax justice including the Global Alliance for Tax Justice, Red de Justicia Fiscal de America Latina y el Caribe, Tax Justice Network, Christian Aid, Action Aid, Oxfam, and Tax Research UK. This report has not been approved in advance by these organizations, which do not necessarily accept every detail or specific point made here, but they support the work of the BMG and endorse its general perspectives. It is based on our previous reports, and has been drafted by Sol Picciotto, Abdul Muheet Chowdhary and Jeffery Kadet, and comments from Attiya Waris.

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SUMMARY

We support this proposal to clarify that taxation of royalties under article 12 should apply to rights to use computer programs or software, which are generally protected under copyright and sometimes also patent law. Uncertainty was created when the OECD in 1992 revised its model convention's commentary to exclude such rights to use. Regrettably extracts of these revisions were included also in the UN model's commentary, although it also noted that some members disagreed with that interpretation. In fact, explicit inclusion of payments for software in the royalties article has already been accepted in over 600 treaties, including many by OECD countries. It is clearly desirable for the UN model to include a standardised provision, and inappropriate that some have opposed this.

It is also important to clarify which payments can be considered to be 'in consideration for' such rights. We strongly suggest this should include all payments received from any users resulting from use of the software. A more restrictive interpretation would make the provision easy to avoid by claiming that rights to software are granted free although substantial income results from use of the software. A potential overlap with the proposed article 12B, which would grant source states the right to tax income from automated digital services, could easily be dealt with by clarifying in the commentary that 12B would not apply to any income that is taxed under article 12. Attention should also be given when drafting the commentary to proposed article 12B to clarifying the interaction between the gross and net bases of taxation that it proposes.

1. GENERAL COMMENTS

We welcome this opportunity to comment on the proposal to amend Article 12 of the UN Model Tax Convention between Developed and Developing countries and its Commentary, to clarify its application to payments for the use of computer programs or software.

1.1 The characteristics of income from the use of software

Software programs, including those used commercially as well as applications commonly referred to as 'apps' used on consumer devices, have become ubiquitous around the world. They are used for a wide variety of business functions, such as enterprise accounting and operational controls, word processing and computations, as well as personal activities, such as gaming, entertainment and access to a range of consumer services. Unlike a sale of goods, such programs are not purchased outright but are licensed to allow use of the software under stated conditions. Users are granted limited rights to the software, not usually extending to any rights to adapt or emulate it, or to resell or relicense. Revenue may derive from payment of a fixed 'purchase' price, but more frequently a continuing subscription, particularly for business software, often supplied to enterprises for use by their employees. Alternatively, especially in relation to consumers, the application itself may be provided free to users, while revenues derive from either purchases they make when using the software, or the sale of advertising targeted at them, or of data obtained from them. In most cases this provides a continuous revenue stream, rather than the single payments made for purchases of discrete goods. Even when software is 'bundled' in the sale of goods delivered in a physical form such as a CD or DVD, the software itself is licensed rather than sold as an unrestricted product to the user (though this physical form of distribution has become less common).

Software programs create a close and often a continuing relationship between the provider and recipient. Software providers obtain a continuing stream of data from users, which can be used to improve the program itself and develop spin-offs, and can also be commercialised, and used for data-mining; in return, users receive updates of the software, and offers of new services. No matter the form of the remuneration (i.e. fixed 'purchase' price, subscription, or other revenues resulting from the free operation of the software by users), there is a good case that income from payments for access to software should be taxed in the country where the rights are exploited.

It will be necessary to clarify also when a payment by a user to a software supplier can be considered to be 'in consideration for … the right to use' the software. Commonly, granting the right to use software is accompanied by the supply of services facilitated by its use. In some cases, such as software enabling interaction between users who are customers for and providers of services, the customers have free access to the software, and pay only for the services delivered by the third-party service providers (who also use the software). It is these third-party service providers who make payments to the software supplier. In other cases, the users of the software make no payments, the income derives from sales to third parties, who do not need to use the software, of services such as advertising, or of data collected from users. It is important to ensure that treaty models can easily be negotiated, where the treaty partners desire it, to allow all of these forms of remuneration to be taxed by the country from which the income derives.

1.2 The role of the model conventions and of the Committee

It should also be stressed that the allocation of taxing rights is a matter for negotiation between countries. The role of the model convention is to facilitate these negotiations by providing a template that can act as a basis for these negotiations, as well as an international

standard to help to provide a degree of uniformity in interpretation and application. If a significant number of states, especially developing countries, consider a particular allocation of taxing rights is desirable for them, then an appropriate provision should be made available in the model, as a basis for negotiation of actual treaties. This would benefit all states by avoiding a proliferation of ad hoc variations in actual treaties.

The primary issue here is clarification of the terms of the UN Model. As currently drafted, article 12 has a very wide scope, covering 'the use of, or the right to use' (i) copyright works, (ii) patents or other industrial property, (iii) industrial or scientific equipment, and (iv) 'information concerning industrial, commercial or scientific experience' (i.e. 'know-how'). The characterisation of software has caused legal difficulties historically, but it has become protected in most countries under either copyright or patent law, sometimes both. Indeed, copyright protection of computer programs is an obligation on states members of the World Trade Organisation, under article 10 of its agreement on Trade Related Intellectual Property Rights (TRIPS) of 1995. A further area of ambiguity is the extent of protection, but generally protection includes any acts necessary to run or operate the software. In view of the wide scope of article 12, a good argument can be made that payments for software are already within the scope of the article under one or another aspect of the definition.[1]

However, in 1992 the OECD introduced in the Commentary to article 12 of its model a distinction for tax purposes between the rights necessary for a user to operate or run software, and the more extensive rights needed for example to modify it, or distribute copies.[2] The revised Commentary accepted the view that payments for allowing users only to run software programs should be treated as business income, taxable under article 7.[3] This involves restricting the scope of the phrase 'the right to use [a] copyright' in article 12, based on the view that that allowing users to operate a software program does not entail granting a 'right to use' the copyright in the software. However, some OECD members continue to dissent from this view, and have entered reservations on this interpretation in the Commentary to article 12.[4]

Although the relevant paragraphs from the OECD Commentary on article 12 were included in the UN Model's commentary, it also stated that some members considered that these payments may constitute royalties.[5] This created an ambiguity in the interpretation of the UN Model, which for the sake of tax certainty it is important to resolve. There is clearly a division of opinion among countries as to whether allowing a user to run a software program could be regarded as granting 'the right to use … copyright of a work'. Many countries take the view that it does, and have applied their domestic laws to tax payments to non-residents for the grant of such rights. A reference to computer programs or software has been included in article 12 of a significant number of treaties.[6] It is clear that many states wish to safeguard

[1] See discussion paper by Scott Wilkie on 'The character and purpose of Article 12 with reference to "industrial, commercial and scientific equipment" and software-payment related issues', Document E/C18/2015/CRP.6, submitted to the 11th session of the Tax Committee, para. 75.
[2] OECD Convention 2017, Commentary to article 12, paras. 12-14. These were introduced following the report on 'The Tax Treatment of Software' of 1992, now available in Part II of the Full Version of the OECD Model Convention.
[3] Commentary on article 12 of the OECD Model, para. 14.
[4] Differing reservations were made on this point by (i) Mexico, Portugal and Spain, (ii) the Slovak Republic, and (iii) Greece: see OECD Model Convention 2014 (Full Version) C(12) 20-21.
[5] UN Model Convention 2017, p. 315.
[6] A search in Tax Analysts' database *Worldwide Tax Treaties* identifies 669 bilateral agreements (including protocols) which refer to computer programs or computer software in a paragraph referring to royalties. The treaties usually involve a capital-importing country, although it is notable that OECD countries have often

their right to tax this type of income in treaties, so the option should be available in the UN model, even if the OECD model has excluded it. Treaty negotiators would then have a choice of formulations, each accompanied by its own commentary. Providing such an option is the direct responsibility of the UN Committee of Experts, indeed the very reason for which it was created.

1.3 Relationship of the royalties article to other treaty provisions

In the absence of inclusion of software in article 12, such income would only be taxable under article 7 as business profits. If the provider of the program is a non-resident, taxation under article 7 would of course depend on whether it has a permanent establishment as defined in article 5. Under the OECD model this article requires a physical place of business for 12 months, so it would rarely apply to income from software programs. The limitations in the OECD model on taxation of business income at source have greatly contributed to the problems, exacerbated by digitalisation of the economy, that led to the current attempts at reform of international tax rules through the OECD/G20 project on base erosion and profit shifting (BEPS).

Developing countries have long been aware of these types of problems, particularly taxation of income from services. They have generally considered that such income should be taxed by the country where the services are supplied.[7] When the first UN model convention was published in 1980 it reflected this perspective, by including a wider definition for a 'services PE' in article 5; but this also requires some physical presence of personnel. Many developing countries apply withholding taxes to payments of fees for services. Such taxes are permitted by some tax treaties, which have an article on fees for technical and professional services. Such a provision has now been included in the UN Model of 2017, as article 12A.

However, this article only applies to 'technical services', which is understood to entail some human intervention in the form of skills or knowledge.[8] Hence, it does not apply to services provided digitally by the use of an automated system. For this reason, consideration is now being given by the UN Committee to a complementary article 12B to cover income from automated digital services. The draft of the proposed article 12B published in August defines this term as 'any payment in consideration for any service provided on the internet or an electronic network requiring minimal human involvement from the service provider'. This, however, would not extend to payments for rights to computer programs or software. Hence, even with the addition of both 12A and 12B, there is a need to clarify the scope of article 12 itself.

1.4 Justification for the clarification

Highly digitalised MNEs have been able to exploit the uncertainties in the definitions of 'royalties', and of 'technical services' to avoid source taxation. The lack of a suitable treaty provision allowing source taxation of this type of income has enabled digitalised multinational enterprises (MNEs) to generate substantial revenues through close engagement

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accepted the inclusion of software payments in article 12, e.g. in 24 agreements with the UK, 36 with the US, 23 with France, 27 with the Netherlands.

[7] The so-called Mexico draft of the League of Nations model convention provided that income from any business or gainful activity 'shall be taxable only in the State where the business or activity is carried out', unless there were only 'isolated or occasional transactions'. This was omitted from the London draft, see League of Nations (1946) *London and Mexico Model Tax Conventions Commentary and Text*, pp. 13-14, 60, available at https://biblio-archive.unog.ch/Dateien/CouncilMSD/C-88-M-88-1946-II-A_EN.pdf.

[8] UN Model Convention 2017, commentary to article 12A, para. 62. The commentary also provides an alternative version which covers income from any services (para. 26).

with users without paying tax in those countries. Furthermore, they have been able to route these payments through conduits in jurisdictions with treaties based on the OECD model, and where they are taxed at a low or zero rate. This has generated considerable 'stateless' income.

There is therefore a strong case for plugging this gap, by providing a tax treaty provision which can clearly allow countries that wish to do so to tax these payments. In view of the long-standing uncertainties in the interpretation of the Royalties article, it seems to us essential to clarify its scope. Including the proposed reference to software payments would provide such clarification. Countries negotiating treaties would be provided with a clear alternative to the OECD model, and the choice would depend on the outcome of the negotiation. If the Committee were to agree also on inclusion of an Article 12B as currently proposed, the relationship between these two provisions should of course be clarified in the Commentary.

It seems to us inappropriate that some members of the Committee have opposed this clarification, which would have the effect of making negotiation of such an option more difficult, and perpetuating uncertainty about the interpretation of the article. There is clearly a strong case for taxing payments for rights to use computer programs or software by the source country, which we support. It seems clear to us that the supply of services, including software, creates a close economic relationship with source countries, and this has now been widely accepted in the discussions on tax implications of digitalisation of the economy. The counter example of extractive industries is a false analogy: proposals for an increased allocation of taxing rights to market countries exclude extractive industries, while it should be noted that downstream activities such as sales of refined products are in fact heavily taxed. Source state taxing rights on natural resources are in any case protected under article 6 of the model conventions. States that provide protection of intellectual property rights and allow their exploitation to generate revenues from users should be allowed to tax such income if they wish to do so.

Spurious technical arguments have been used for too long to perpetuate uncertainty, and to prevent countries from asserting their tax rights. This clarification is long overdue, and we urge the Committee to fulfil its responsibilities and adopt a suitable amendment as soon as possible.

The COVID-19 pandemic has provided further impetus for ending the uncertainty and providing clarification. Many software companies and highly digitalised MNEs have seen a rise in demand for their services in the post-COVID world where working from home is becoming increasingly widespread. While some of these changes may be temporary, it can be reasonably assumed that many will be long-lasting. Accordingly, the question of whether these software payments can be taxable as royalties requires urgent resolution and should not be postponed any further.

2. SPECIFIC COMMENTS

2.1 Relationship of article 12 to article 12A and proposed article 12B

It should be noted that even after the clarification is made, article 12 would not apply to all revenue resulting from granting the right to use software. Article 12.3 defines royalties as 'payments of any kind received as a consideration for the use of, or the right to use, any copyright…'. Hence, it will be very important to clarify in the Commentary to article 12 what income can be considered to constitute 'consideration for the right to use' software.

Three broad types of business models are relevant:

(i) users pay for rights to run software as well as for the supply of additional services, such as access to content, customer support, software updates, etc (e.g. video games, MS Office);

(ii) a software application grants users access to a platform enabling customers to obtain services from third-party providers, payments for which are made through the software application, from which the software provider takes a commission before transmitting the balance to the third-party service providers (e.g. Uber);[9]

(iii) users make no payment but the software provider earns income from others by the sale of services such as advertising or of user data (e.g. WhatsApp).

In our view, all the income accruing to the software provider in the first two of these situations should be covered by article 12. A narrow view of the wording of article 12.3 would require a distinction to be made between payments strictly attributable to the grant of rights to the software, and those for other related services. This would be difficult to administer, and create uncertainty and opportunities for avoidance. For example, contracts could easily be devised so that no charge is made for use of the software, while the payments are for customer support or other services - indeed this is common. Any income accruing to the supplier of the software from any users resulting from operating the software should be regarded as falling within the ambit of article 12. It should also be made clear in the commentary that this would be the case even if the payments are made to a related entity of the supplier of the software, if both are part of the same MNE group (i.e. under common ownership and control).

In the third situation, since the income is not received from a user it could not be regarded as being a consideration for the rights to use the software. As the supporters of the proposal for clarification of article 12 suggest in the consultation document, the Commentary should make clear the relationship between this article and other relevant provisions. The Committee is also considering a proposal to add a new article 12B to the model, which would be particularly relevant. This proposal, as published in August 2020, would allow the source country to tax 'income from automated digital services', defined as 'any payment in consideration for any service provided on the internet or an electronic network requiring minimal human involvement from the service provider'.

Proposed article 12B would supplement article 12 (as clarified by the proposed amendment under consideration here). It would cover income derived from software other than from users, described in category (iii) above, which could not be regarded as coming under article 12. At the same time, 12B might not be considered to cover income from the grant of rights to use software, which reinforces the arguments for clarifying that such income does come within article 12.

However, a potential overlap would be created between the two provisions if the Committee adopts the broad interpretation that we suggest of payments that could be regarded as consideration for rights to software. We suggest that the best and simplest way to deal with such potential overlap would be to make clear in the Commentary to article 12B that any income taxable under article 12 should not also be taxed under 12B. Hence, source countries could, and in our view should, ensure that both provisions are included in their treaties.

MNEs would still have the ability to structure especially their internal contractual arrangements and payments so as to characterise them in the most tax efficient manner. To

[9] See for example the analysis of Uber by N. Cicin-Šain: 'Taxing Uber. In: Marin J, Petrović S, Mudrić M, et al. (eds) *Uber—Brave New Service or Unfair Competition Legal Analysis of the Nature of Uber Services*. Springer 2020, pp.181-198.

discourage such tax-motivated structuring, it will be important to ensure that the treaty articles are aligned as to coverage and rates. Articles 12 and 12B both permit a withholding tax on the gross payment, leaving it to states to agree the maximum rate, which as we believe should be aligned. The proposed article 12B (August 2020 draft) in addition would offer the company the alternative of a taxation of net profits, defined as 30% of the amount resulting from applying the MNE's global profit rate to the relevant local revenues. This alternative creates a play between tax bases and rates that could encourage MNEs to structure payments to be under one or the other of articles 12 and 12B. We suggest that applicable commentary include discussion and one or more examples focused on this issue. Thus, where an MNE group has structured its arrangements to mis-characterise a payment, tax authorities should have the flexibility to apply the appropriate article to the applicable portion of such a payment.

In view of the way that articles 12, 12A and 12B are linked, we suggest that the Committee should consider combining them in a free-standing multilateral convention similar to the 'Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS'. This could provide a more rapid as well as a more orderly way to ensure that existing tax treaties are amended, to block the loopholes created by the omissions and ambiguities of the model treaties. In this way the Committee could make its own contribution to the international efforts to respond to the tax challenges of digitalisation of the economy, complementing proposals under consideration in other forums.

2.2 Implications of the clarification for existing treaties

As noted above, this revision would resolve the uncertainty resulting from the inclusion of extracts from the OECD Commentary in the Commentary to article 12 of the UN Model. This would also acknowledge the statement by some members that they consider that software payments can constitute royalties. This raises the question of whether the clarification would apply only prospectively, or could be applied to existing treaties by those countries which did not accept the OECD interpretation. This should be clarified in the Commentary.

In our view, countries that made clear their view that the royalties article might cover software should be allowed to apply that interpretation in their existing treaties. Since many treaties have already included a reference to software this may not be a significant issue.

Further justification for treating payments for the use of computer software as royalties from intellectual property rights is provided by the treatment of these payments for international economic purposes by the World Bank and the IMF. The IMF's Balance of Payments Manual measures royalties and license fees payments as follows:[10]

> Receipts are between residents and nonresidents for the authorized use of intangible, nonproduced, nonfinancial assets and proprietary rights (such as patents, copyrights, trademarks, industrial processes, and franchises) and for the use, through licensing agreements, of produced originals of prototypes (such as films and manuscripts).

A related, broader indicator that measures 'Charges for the use of intellectual property, receipts (BoP, current US$)' specifically mentions computer software in the definition:[11]

> Charges for the use of intellectual property are payments and receipts between residents and nonresidents for the authorized use of proprietary rights (such as

[10] https://tcdata360.worldbank.org/indicators/h6b089e58?country=BRA&indicator=40521&viz=bar_chart&years=2015

[11] https://data.worldbank.org/indicator/BX.GSR.ROYL.CD

patents, trademarks, copyrights, industrial processes and designs including trade secrets, and franchises) and for the use, through licensing agreements, of produced originals or prototypes (such as copyrights on books and manuscripts, computer software, cinematographic works, and sound recordings) and related rights (such as for live performances and television, cable, or satellite broadcast). Data are in current U.S. dollars.

Hence, it is clear that payments for rights to use computer software can validly be considered as royalties from intellectual property rights. Including a specific mention as now proposed would be for the sake of certainty, and a welcome clarification.

This recognition by the IMF and World Bank of the nature of software payments also addresses any objection raised that payments for software are akin to payments for other goods sold as standardized products to customers that are taxable under article 7. Such objections overlook the fact that software payments are for the 'use or the right to use' software and not the software itself *per se*. The analogy with sale of goods is accordingly invalid. Whether a product is standardized or customised is also irrelevant as, again, the payment is for the 'use or the right to use', and hence like other payments involving intellectual property rights should be taxable as royalties.

2.3 Withholding taxes on gross basis

Critics understandably raise concerns that imposing withholding taxes on gross payments could cause difficulties for software companies as it ignores expenses incurred by the payee in earning the payments for the use of that software. They argue it is compounded by the inability of the taxpayer to obtain full credit in certain states of residence where the taxation would be on a net basis.

The imposition of taxes on gross payments is driven in part by the limits of existing international tax rules that make it difficult to allocate joint costs incurred in an MNE group. This could be seen as the reasoning behind the Digital Service Taxes (DSTs) which are also on a gross basis. Nevertheless, paragraphs 8-10 of the Commentary on Article 12 clarify that the withholding tax rate on gross royalty should be set recognising both current expenses allocable to the royalty and expenditure incurred in the development of the property whose use gave rise to the royalty. This could also address the underlying concerns made with reference to software.

Paragraph 9 of the Commentary in particular highlights important factors influencing the determination of the withholding tax rate on gross royalties including *inter alia* the developing countries' need to earn revenue and conserve foreign exchange, the fact that royalty payments flow almost entirely from developing to developed countries, which are equally true in the case of software payments.

The concern on the inability of taxpayers to obtain full credit in certain residence jurisdictions in fact strengthens the case for more countries to adopt this method of elimination of double taxation. It is disconcerting that there are arguments being made in the opposite direction, *i.e.,* that the option of full credit in the state of residence should be removed altogether from the UN Model Convention. The opposite in fact is what should happen especially as more and more countries are seeking to ensure that highly digitalized MNEs pay tax in line with their global profits.

The discussion draft also mentions the practical difficulties arising from source taxation of software payments. These are not insurmountable and can be left to further elaboration in the Commentary if need be. For instance, financial intermediaries such as banks can be made to

withhold and remit taxes when individuals are involved. They do not distract from the essential policy question of the need for clarifying whether software payments should be taxable as royalties.