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Committee of Experts on International Cooperation in Tax Matters
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Agenda item 3 (a) (v)
Article 12 (Royalties):
a.) The meaning of "industrial, commercial and scientific equipment"
b.) Software payment-related issues

Introduction

1. At the 7th session of the Committee in 2011, when the 2011 Update to the Model was finalized, the Committee acknowledged that article 12 (Royalties) would need further consideration. It was agreed that article 12 would be included in the catalogue of issues for future discussions (E/2011/45-E/C.18/2011/6, para. 47). In the 9th session of the Committee in 2013, the Committee took up the issue and requested the Secretariat to draft a paper covering specific relevant aspects, including equipment-related issues as well as issues that could have an impact on technical services provisions (n article 12),

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3. This note by the Secretariat was prepared following the request of the Committee to propose a text aimed at clarifying the meaning of the term "industrial, commercial or scientific equipment" and to look at software-related payments. The note is not intended

[1] The work of Anna Binder, an intern from the Institute of Austrian and International Tax Law, WU Vienna, in preparing this note is especially acknowledged.

Convention" adopted by the Council of the OECD on 23 July 1992. However, a number of OECD member countries have entered reservations on this point.

Definition of the term "equipment"

7. Article 12(3) of the UN Models states what is covered by the term "royalties". According to this provision, "[t]he 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, trademark, design or model, plan, secret formula or process, or for the use of, or the right to use, industrial, commercial or scientific equipment or for information concerning industrial, commercial or scientific experience". There is no guidance in the Commentary on article 12(3) with respect to the meaning of the terms "industrial, commercial or scientific equipment" and Contracting States may interpret these terms in different ways. Therefore, a definition of "industrial, commercial or scientific equipment" could be included in the Commentary.

8. There was no sample of a specific definition of "industrial, commercial or scientific equipment" found in an existing treaty. However, the following definition is found in the Oxford Dictionaries, whereas equipment is understood as "the necessary items for a particular purpose"[2]. For the sake of a definition, it is suggested to focus on three different characteristics of equipment, whereas equipment needs to be (1) tangible, (2) movable and/or (3) used to perform a task.

9. Except for equipment, all items listed in article 12(3) will be typically referred to as intangibles. Therein lays a major difference between equipment and the rest of the items listed in article 12(3). It might be useful to explicitly mention this difference by clarifying that equipment does indeed denote a tangible item.

10. It is further submitted that only a movable item – as opposed to immovable property which is taxable according to article 6 – falls within the understanding of "equipment".

11. It might be considered useful to include a non-exhaustive and exemplary catalogue of items which the Committee considers to be equipment. While there is no sample of an abstract definition of "industrial, commercial or scientific equipment" in an existing treaty, the question of whether a specific item constitutes "industrial, commercial or scientific equipment" has already been subject to court decisions in many countries. The following items have been qualified as "industrial, commercial or scientific equipment" and the use thereof as yielding income from -20ide(s)1(c)6(ie)6(n)2(tif)5(ic)n(y)22(i)-1 rs ha

c. ships[5] (the relation between article 8 and article 12 will be covered in a separate section of this note, however, letting aside this issue, ships do generally fall within the definition of "equipment").

12. In one instance, the Mexican Federal Judicial Court defined ICS equipment as "items used for the transformation of goods or for providing of services". Furthermore, the Court found that helicopters would not fall within this definition and consequently, payments for the lease of helicopters did not constitute royalties.[6]

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containers;
satellites (see paragraph 13.3 for further details); or
ships.

15. The Committee might wish to consider: (1) whether the above-mentioned way of giving further meaning to the term – or any other more specific "definition" – of "industrial, commercial or scientific equipment" might be useful to include in the Commentary, (2) whether such a definition should also include a catalogue of items such as the catalogue suggested above and (3) which of the above-mentioned items (or other items not mentioned above) should finally be included in such a catalogue.

The deletion of ICS equipment rental from the OECD Model and its relevance or otherwise for the UN Model

Reasons for the deletion of ICS equipment rental from the OECD Model

16. In the 1977 version of the OECD Model, the definition of "royalti6 migurn9twhetgthe t 4(

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23. One reason behind source country taxation of ICS equipment rental is to give the country where the equipment is put to use the right to taxation. However, according to article 12(5) “[r] oyaltiesshall be deemed to arise in a Contracting State when the payer is a resident of that State”. Consequently, thecoknevlg tthtbat whhe eycu taon be(I)13(h)3.7(e)4(r)-7((
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normal case to the rentals paid by the hirer, including all rentals paid by him up to the date he exercises any right to purchase.

27. It is submitted that a lease of equipment is within the scope of article 12 while a sale of equipment is not covered by article 12. The distinction between a lease and a sale is therefore relevant for the correct application of the article. This can be difficult, as the aim behind many leasing agreements is rather the transfer of ownership ("finance leases") than the rental of property ("operating leases"), with only the latter being covered by article 12. If the Committee shares this view, it might wish to add a paragraph regarding this issue (possibly paragraph 13.2).

28. It is suggested, if such a discussion is seen as desirable, to take the former paragraph 9 of the OECD Commentary as a model, but to depart from it in the following points which are underlined in the proposed text:

a. The former paragraph 9 of the OECD Commentary on article 12 made the qualification of a mixed agreement as lease or sale agreement dependent on the "true legal import". This was criticized in literature as being a too narrow, formalistic approach which would not contain a full economic perspective (see M. Valta, in Reimer, E., & Rust, A. [eds] Klaus Vogel on Double Taxation Conventions [4th ed, 2015] Art 12 at m.n. 95). The Committee might wish to consider replacing "true legal import" with "economic substance".
b. The terms "financial lease" and "operating lease" are introduced to the text.
c. In addition, the Committee might wish to include indications of when an agreement is deemed to be a sale rather than a lease. A suggested list of examples, taken from various academic papers on that matter[7], is therefore included in the draft for the new paragraph 13.2. The Committee might wish to include some or all of the criteria included below and also other criteria. However, the Committee might alternatively decide not to include this list so to leave leeway for the contracting states in determining which criteria need to be met to for an arrangement to constitute an operating lease.

29. The result is the following paragraph, which the Committee might wish to consider adding to the Commentary on article 12:

13.2 A clear distinction must be made between royalties paid for the use of equipment, which fall under Article 12, and payments constituting consideration for the sale of equipment, which may, depending on the case, fall under Articles 7, 13, 14 or 21. Some contracts combine the lease element and the sale element, so that it sometimes proves difficult to determine their <u>true legal import / economic substance</u>. In the case of credit sale agreements, hire purchase agreements <u>and other forms of</u> <u>finance leases</u>, it seems clear that the sale element is the paramount use, because the parties have from the outset agreed that the ownership of the property in question shall be transferred from

[7] 24. Valta, in Reimer, E., & Rust, A. (eds) Klaus Vogel on Double Taxation Conventions (4th ed, 2015) Art 12 at m.nos 97 et seq who refers upon a US: Revenue Ruling 55-540 of 1995; Villar Ezcurra, M., State Aid and Tax Lease Regimes in the Shipbuilding Industry:Lessons Learned from a Spanish Case, ET 2014, 439 at 440; Tan A., Tan J., Wan, E., Cross-Border Leasing, Asia-Pacific Tax Bulletin 2014, 150 at 150 et seq.; Ponniah, A., Taxation of Income from Equipment Leases, Asia-Pacific Tax Bulletin 2002, 130 at 130 et seq.

one to the other, although they have made this dependent upon the payment of the last instalment. Consequently, the instalments paid by the purchaser/hirer do not, in principle, constitute royalties. In the case, however, of a lend-lease or operating lease, the sole, or at least the principal, purpose of the contract is normally that of lease, even of the lessee has the right thereunder to opt during its term to purchase the equipment in question outright. Article 12 therefore applies in the normal case to the rentals paid by the lessee, including all rentals paid by him up to the date he exercises any right to purchase. Indications for a finance lease rather than an operating lease might include, for example:

the lease is long term and non-cancellable;
the term of the lease is likely to cover a substantial part (or all) of the equipment's useful life;
there is no other user of the equipment, or it is not feasible for the equipment to be leased to another lessee;
the lessor of the equipment behaves as owner;
the lessor carries positive and/or negative residual value risk in respect of the equipment;
the leasing rates are so high at the beginning that they constitute an inordinately large proportion of the amount needed to secure the acquisition;
payments materially exceed the current fair rental value and thus compensate for more than just the use of property; and
some portion of the payments is specifically designated as interest or is otherwise readily recognizable as the equivalent of interest.

Treatment of transmission capacity

30. In the 10th session of the Meeting of Experts on International Cooperation in Tax Matters the issue of satellites was raised: Satellite operators frequently enter into agreements with their customers under which the satellite operator allows the customer to utilize the transmission capacity of the satellite but the customers do not gain physical possession or control over the satellite itself. It is subject to debate whether or not payments for such agreements qualify as payments for the "use, or right to use industrial, commercial or scientific equipment". The same issue arises in connection with cables, pipelines and any other items whose physical possession is not a prerequisite for using their capacity and functions and whose capacity and functions can be subject to contracts of their own.

31. For the OECD, such transactions do not yield royalties according to article 12, because payments for the use of transmission capacity were neither payments for the use, or the right to use of property, nor payments for information or for the use of, or right to use a secret process. Furthermore, payments for the use of transmission capacity would not constitute payments for the use, or right to use ICS equipment, because the customer would not gain physical possession over the equipment. In the same manner, the OECD deals with the issue of roaming and the use of a radio frequency spectrum. The relevant paragraphs of the OECD Commentary on article 12 reads as follows:

9.1 Satellite operators and their customers (including broadcasting and telecommunication enterprises) frequently enter into "transponder leasing" agreements under which the satellite operator allows the customer to utilise the capacity of a satellite transponder to transmit over large geographical areas. Payments made by customers under typical "transponder leasing" agreements are made for the use of the transponder transmitting capacity and will not constitute royalties under the definition of paragraph 2: these payments are not made in consideration for the use of, or right to use, property, or for information, that is referred to in the definition (they cannot be viewed, for instance, as payments for information or for the use of, or right to use, a secret process since the satellite technology is not transferred to the customer). As regards treaties that include the leasing of industrial, commercial or scientific (ICS) equipment in the definition of royalties, the characterisation of the payment will depend to a large extent on the relevant contractual arrangements. Whilst the relevant contracts often refer to the "lease" of a transponder, in most cases the customer does not acquire the physical possession of the transponder but simply its transmission capacity: the satellite is operated by the lessor and the lessee has no access to the transponder that has been assigned to it. In such cases, the payments made by the customers would therefore be in the nature of payments for services, to which Article 7 applies, rather than payments for the use, or right to use, ICS equipment. A different, but much less frequent, transaction would be where the owner of the satellite leases it to another party so that the latter may operate it and either use it for its own purposes or offer its data transmission capacity to third parties. In such a case, the payment made by the satellite operator to the satellite owner could well be considered as a payment for the leasing of industrial, commercial or scientific equipment. Similar considerations apply to payments made to lease or purchase the capacity of cables for the transmission of electrical power or communications (e.g. through a contract granting an indefeasible right of use of such capacity) or pipelines (e.g. for the transportation of gas or oil).

9.2 Also, payments made by a telecommunications network operator to another network operator under a typical "roaming" agreement (see paragraph 9.1 of the Commentary on Article 5) will not constitute royalties under the definition of paragraph 2 since these payments are not made in consideration for the use of, or

paragraph 2. This conclusion holds true even in the case of treaties that include the leasing of industrial, commercial or scientific (ICS) equipment in the definition of royalties since the payment is not for the use, or the right to use, any equipment. (Added on 22 July 2010; see HISTORY)

32. It is understood that not all countries share the approach put forth in the OECD Commentary. Of the OECD countries, at least Greece and Germany take a different view. Greece has reserved "the right to include the payments referred to in paragraphs 9.1, 9.2 and 9.3 in the definition of royalties" (see paragraph 38 of the OECD Commentary on article 12). Germany has made an observation concerning the aforementioned paragraph 9.1 of the OECD Commentary. According to paragraph 31.1 of the OECD Commentary on article 12, "Germany reserves its position on whether and under which circumstances payments made for the acquisition of the right of disposal over the transport capacity of pipelines or the capacity of technical installations, lines or cables for the transmission of electrical power or communications (including the distribution of radio and television programs) could be regarded as payments made for the leasing of industrial, commercial or scientific equipment."

33. Of the non-OECD countries, India takes a firm position against the treatment of payments as suggested in paragraphs 9.1-9.3 of the OECD Commentary on article 12 (see paragraph 20-22 of the positions to the OECD Commentary on article 12):

> 20. India does not agree with the interpretation in paragraph 9.1 of the Commentary on Article 12 according to which a payment for transponder leasing will not constitute royalty. This notion is contrary to the Indian position that income from transponder leasing constitutes an equipment royalty taxable both under India's domestic law and its treaties with many countries. It is also contrary to India's position that a payment for the use of a transponder is a payment for the use of a process resulting in a royalty under Article 12. India also does not agree with the conclusion included in the paragraph concerning undersea cables and pipelines as it considers that undersea cables and pipelines are industrial, commercial or scientific equipment and that payments made for their use constitute equipment royalties.
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> 21. India does not agree with the interpretation in paragraph 9.2 of the Commentary on Article 12. It considers that a roaming call constitutes the use of a process. Accordingly, the payment made for the use of that process constitutes a royalty for the purposes of Article 12. It is also the position of India that a payment for a roaming call constitutes a royalty since it is a payment for the use of industrial, commercial or scientific equipment.
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> 22. India does not agree with the interpretation in paragraph 9.3 of the Commentary on Article 12. It considers that a payment for spectrum license constitutes a royalty taxable both under India's l3or0.9(t)-2(he)4( )-10(us)-1(e)4(of)3(a)-6( )]T u

constitute neither copyrights, nor patents, trademarks, models, plans, secret formulas or processes nor information or equipment. Second, in order to qualify as payments for the use, or right to use, ICS equipment (where that provision is used), physical possession of the equipment must be obtained. Since the physical possession of transmission capacity cannot be transferred separately, only a transfer of the whole object constitutes ICS equipment use.

35. Also those who support the OECD's view (e.g. Vogel, K., Klaus Vogel on Double Taxation Conventions [3rd ed, 1993] Art 12 at m.n. 71 and M. Valta, in Reimer, E., & Rust, A. [eds] Klaus Vogel on Double Taxation Conventions [4th ed, 2015] Art 12 at m.n. 106) stress that whoever entered into an agreement for the use of transmission capacity does not obtain the control over the equipment as such but that the term "use" suggests that there must be some positive act of utilization (see also Authority for Advance Rulings [New Delhi] of 18 July 2008, Dell International Services India [P.] Ltd., AAR No. 735 of 2006 at m.n. 13.2).

36. There also exist jurisprudence and rulings which support the OECD's view. Regarding the leasing of transponder capacity, there is advance ruling issues by the Authority for Advance Rulings (New Delhi) ("AAR") on ISRO Satellite Centre of 22 October 2008, AAR No. 765 of 2007 where the AAR did not qualify transponder leasing as equipment use, on the grounds that the taxpayer neither received possession or control of the equipment, nor could it use or operate the equipment. In its decision of 31 January 2011 on Asia Satellite Telecommunications Co. Ltd v., DIT ITA No. 131 (2003) with ITA no. 134 (2003) the High Court of Delhi, for example, has explicitly relied on the arguments by Klaus Vogel and on the treatment proposed in paragraph 9.1 of the OECD Commentary on article

Alternative B:

13.3

46. In the 10th session of the Meeting of Experts on International Cooperation in Tax Matters, a subcommittee on Article 8 was formed to evaluate what falls under auxiliary activities to international transport. If the Committee maintains the understanding as currently put forth in paragraph 10 of the Commentary on article 8, so that article 8 is understood to also cover the lease of containers if it is supplementary or incidental to international operations of ships or aircrafts, the relation between article 8 and article 12 needs to be addressed, because containers, being tangible and movable items used to perform a task, also fall -6(e)]TJ 0 40erbebeat2(t)( )-1(r)iqu(s)-1emeionaxperick, ae3(a)4(ph)]2

49. Since there might be cases where both, the application of article 8 and the application of article 12 might be possible, the Committee might wish to consider which provision should prevail.

50. Were article 8 to be given priority, taxation rights would be shifted from the source country to the country of effective management of the enterprise operating the ship or aircraft. However, it must be kept in mind that the country of effective management will only obtain the right to exclusive taxation if the lease is an auxiliary activity to international traffic (unless it is a wet lease and the OECD's view is followed). This requirement in itself restricts the potential for applying article 8 to an agreement for the use of equipment. In this case, the lease would be connected with an "active" business operation and the application of article 8 as opposed to article 12 might be consistent also with the scope of article 12, since article 12 was designed to cover "passive" activities.

51. This approach was chosen in the treaty between the United States and India which includes the following article 12(3):

3.

3. Profits of an enterprise of a Contracting State described in paragraph 1 from the use, maintenance, or rental of containers (including trailers, barges, and related equipment for the transport of containers) used in connection with the operation of

b.) Article 12: Software payment-related issues

Issues in Dispute

58. Regarding the treatment of payments for software, the UN Commentary largely reproduces the OECD Commentary. However, there are some paragraphs in the OECD Commentary which have not met with unanimous agreement among the Committee Members. A paragraph was included in the UN Commentary on article 12 owing to this disagreement (see paragraph 12 of the UN Commentary on article 12):

> 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 royam Tw 0. 0.038 Tw 0..

automatically royalties. The notion is that for these transactions, there are just enough rights in the copy of a program transferred to enable the operation of the program (such as the right to copy a program onto a hard drive or the right to make copies for one's

62. The view expressed by the OECD aims at limiting the scope for application of article 12 to software. It has not been unanimously shared by the Committee. Voices opposing this view might say that the distinction between the use of copyright underlying software (royalties) and the use of just enough copyright to operate the software (no royalties) is not straightforward and difficult to draw and may unfavorably impose on source state taxing rights. In addition, the need for this distinction must not necessarily be derived from the wording of article 12(3). Furthermore, a limitation of the scope might not be in every country's interest. Due to the dissenting opinions of the Committee, a paragraph was added, stating that "[s]ome members of the Committee of Experts are of the view that the payments referred to in paragraphs 14, 14.1, 14.2, […] of the OECD Commentary extracted above may constitute royalties.

63. In view of the above, the application of article 12 and the Commentary thereto on software in their current state is not self-explanatory. A further limitation of the scope seems not within reach, given the opposition already manifested in the Commentary. Another – and radically different – option to facilitate the application of article 12 in relation to software would be to explicitly include payments for software in article 12.

66. Hence, the Committee might wish to discuss including payments for the use of or the right to

Distinction between the use of, or the right to use copyright and the transfer of ownership

70. Paragraphs 15 and 16 of the OECD Commentary regard the differentiation between the transfer of a copyright and the transfer of ownership:

> 15. Where consideration is paid for the transfer of the full ownership of the rights in the copyright, the payment cannot represent a royalty and the prov -4.95 -1.2i0ast
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Digital products

73. Paragraphs 17.2 and 17.3 of the OECD Commentary address the treatment of digital products:

> 17.2 Under the relevant legislation of some countries, transactions which permit the customer to electronically download digital products may give rise to use of copyright by the customer, e.g. because a right to make one or more copies of the digital content is granted under the contract. Where the consideration is essentially for something other than for the use of, or right to use, rights in the copyright (such as to acquire other types of contractual rights, data or services), and the use of copyright is limited to such rights as are required to enable downloading, storage and operation on the customer's computer, network or other storage, performance or display device, such use of copyright should not affect the analysis of the character of the payment for purposes of applying the definition of "royalties".
>
> 17.3 This is the case for transactions that permit the customer (which may be an enterprise) to electronically download digital products (such as software, images, sounds or text) for that customer's own use or enjoyment. In these transactions, the payment is essentially for the acquisition of data transmitted in the form of a digital signal and therefore does not constitute royalties but falls within Article 7 or Article 13, as the case may be. To the extent that the act of copying the digital signal onto the customer's hard disk or other non-temporary media involves the use of a copyright by the customer under the relevant law and contractual arrangements, such copying is merely the means by which the digital signal is captured and stored. This use of copyright is not important for classification purposes because it does not correspond to what the payment is essentially in consideration for (i.e. to acquire data transmitted in the form of a digital signal), which is the determining factor for the purposes of the definition of royalties. There also would be no basis to classify such transactions as "royalties" if, under the relevant law and contractual arrangements, the creation of a copy is regarded as a use of copyright by the provider rather than by the customer.

74. The suggested treatment of digital products, which is put forth in paragraphs 17.2-17.3 of the OECD Commentary on article 12, follows the same pattern as the treatment of software. So any changes in the Committee's view on the treatment of software will and must affect the view on the treatment of digital products.

General Comments

75. Some of the changes proposed in the note would – if adopted – lead to a substantial broadening of the scope of article 12 and thus, source country taxation. In order to reach

profits rule or alternatively a constructive PE rule and might wish to consider adopting a modified net basis taxation. This might be preferable than to further broadening the scope of article 12 and thus further adding to the complexity of its application.

76. Furthermore, it is expected that there will remain areas of disagreement on the application of article 12. However, explanations of the differences might be useful – not framed in a way that might be seen as implication that reaction to the OECD's view is always necessary but in order to better comprehend and anticipate the application of article 12 in different countries.

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