and the Subcommittee on Royalties (Subcommittee) was formed to further investigate those issues.

The Mandate

The mandate given to the Subcommittee is as follows:

> "The Subcommittee is to consider and report on possible improvements to the commentary on Article 12 (Royalties) of the Model, and if required, the text of that Article. It is mandated to initially report to the Committee at the October session of the Committee in 2016, addressing as its initial priority such improvements to the commentary discussion on industrial, commercial and scientific equipment and software related payments as are most likely to be accepted by the Committee for its inclusion in the next version of the UN model."

Subcommittee Membership

The Subcommittee was created at the eleventh session of the Committee of Experts. The Subcommittee is comprised of Members from tax administrations as well as Members from academia and advisers. Membership is assumed on a personal capacity. The Members are:

Members of the UN Tax Committee who are also Subcommittee Members

Ms. Pragya Saksena, coordinator (India)
Mr. Andrew Dawson (UK)
Ms. Carmel Peters (New Zealand)
Mr. Cezary Krysiak (Poland)
Mr. Christoph Schelling (Switzerland)
Mr. Henry Louie (USA)
Mr. Eric Mensah (Ghana)
Ms. Noor Azian Abdul Hamid (Malaysia)
Mr. Armando Lara Yaffar (Chevez Ruiz Zamarripa, Mexico)
Mr. Jorge Rachid (Brazil)
Mr. Al Khalifa (Qatar)
Mr. El Hadji Ibrahima Diop (Senegal)
Mr. Johan de la Rey (South Africa)
Ms. Xiaoyue Wang (China)
Mr. Ignatius Mvula (Zambia)
Mr. Mohammed Baina (Morocco)

Other Members:
Ms. Anna Binder (Vienna University of Economics and Business, Austria)
Mr. Scott Wilkie (Osgoode Hall Law School, Canada)
Mr. Claudio Souza (Brazil)

Possible Amendments

Possible amendments to the Model's Commentary are attached, and are divided into two parts:

> Part I deals with issues in relation with the characterization of consideration derived from leasing of rent of "industrial, commercial and scientific equipment" (hereby referenced as **Annex I**); and
>
> Part II deals with issues related to software payments (hereby referenced as **Annex II**).

The attached proposals do not purport to represent consensus positions of the Subcommittee at this stage. The Subcommittee proposes an initial discussion by the Committee, at its twelfth session, of possible amendments to Article 12 of the UN Model's Commentary on Article 12. The Subcommittee will then seek to meet and further discuss the issues and to propose revisions for consideration and approval at the Committee's thirteenth session.

Commentary on Article 12 *(Royalties) of the Model, and if required, the text of that Article. It is mandated to initially report to the Committee at the October session of the Committee in 2016, addressing as its initial priority such improvements to the commentary discussion on industrial, commercial and scientific equipment and software related payments as are most likely to be accepted by the Committee for its inclusion in the next version of the UN model."*

3. Accordingly, these papers as well as other relevant materials including the references in these papers and the inputs given by the Sub-committee members and the members of the civil society were examined, and their recommendations ar

retain taxing rights over income arising from activities that involve a meaningful engagement of a non-resident with the source country in many of the same ways that would prompt and sustain taxation contemplated by Articles 5 and 7.

6. The UN Model preserves the interests of developing countries as “source” countries in a number of respects, allowing those countries to tax income earned by non-residents who make substantial use of source countries’ infrastructure, resources and labour etc., that is, the non-residents are commercially active in the “source” country in the same way

9. Article 12 of the UN Model is more cautious about any justification for allowing the potential loss of source country taxing rights. In this regard, the UN Model serves o8(i)4(g)nJ5

e. Taxation would in any case occur in those States that considered the residence of the payer as the source of the royalty even if the equipment was not situated in that State.

11. The OECD Model generally does not provide for source based taxation of royalties. ICS equipment was intended to remain untaxed in the source country unless there was a Permanent Establishment or a fixed base (CRP 6 note prepared by Mr. Scott Wilkie). However, many member countries had entered reservations against this provision and had also concluded treaties which provided for source based taxation of royalties, leading to source based taxation of rental income from ICS equipment even in cases where there was no PE or fixed base in the source country. This result was not intended by the OECD and resulted in, among other reasons, deletion of “industrial, commercial or scientific equipment” from the OECD Model. This argumentation, however, cannot be applied to the UN Model, since the UN Model aimed at source based taxation of royalties including ICS equipment rental from the very beginning.

12. The inclusion of ICS equipment rental was perceived to be problematic by the OECD, on the ground that it leads to taxation on a gross basis of income which, in the event of a PE or fixed base in the source country, would otherwise be taxed on a net basis. While this holds generally true for withholding taxes at source, the Commentary on article 12 of the UN Model acknowledges this issue and contains instructions for the calculation of the withholding tax rate so as to avoid the result of excessive gross taxation (refer to paragraphs 2 and 8-9 on article 12).

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equipment is understood as "the necessary items for a particular purpose"[1]. However, it would be appropriate to use the word 'property' instead of 'item' as the term 'property' is consistent with other provisions of the model. Thus equipment would mean a tangible property.

15. With an exception for equipment, all other items listed in article 12(3) are in nature of intangibles. Therein a major difference between equipment and the rest of the properties which are covered in article 12(3). Therefore, it would be appropriate to explicitly mention this difference by clarifying that equipment denotes a tangible property.

16. Further, since the immovable property is taxable according to article 6 – only the moveable property falls within the meaning of "equipment".

17. It has been suggested in the Secretariat Paper (E/c.18/2015/CRP.7) that 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 have been qualified as "industrial, commercial or scientific equipment" and the use thereof as yielding income from royalties:

a. aircraft[2];
b. cranes[3]; and
c. ships[4]

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[1] E/C.18/2015/CRP.7.page 3.

[2] See for example Turkey: Supreme Administrative Court of 10 April 2013, E.2011/1367, K.2013/1281 re DTC Turkey/USA, as cited in Yalit, B., *Turkey: Leasing of Aircraft Characterization of Leasing Payments as Royalties*, in Lang, M. et al. (eds) *Tax Treaty Case Law Around the Globe 2014* (2014) at 161 et seq.

[3] The respective case was cited in Teck, H. & Oei, J., *Singapore Applicability of the Domestic General Anti-Avoidance Rule to 0 1 271.877[(in)-8( )10(T)11(e)4(c)-8(k)7(245 0 0 T1 0 0 [(W*n /P /MCID 12/Lang (en-US)>>BDC/F1 6 Tf1 g10.3 145.17Al.)-4( )n4( )00-4(i)11(a*

scientific" appear to have a very wide scope. As highlighted in Paragraphs 6 and 7 that this determination has resulted in court decisions in many countries and hence, there is a need to give a proper meaning.

21. The broad purpose of the Model and Article 12 is to distribute taxing rights between two countries. There does not appear to be any specific reason why the distribution rule should be restricted to only the income arising from that equipment which qualify as "industrial, commercial and scientific" equipment. Assuming that some compelling reason existed in the past to restrict the distributive role only to such equipment, there does not appear to be any compelling reason presently for which this distributive role should not be applied to all tangible movable assets.

Accordingly, the following approach may also be evaluated by the Committee:

Amend the text of Article 12(3) to replace the words "industrial, commercial or scientific equipment".

This will result in desired distribution of taxing rights in respect of all tangible movable assets, as against only certain categories of assets.

Amendment to the Commentary would provide immediate guidance.

Situs of payer vs. situs of equipment

22. As per article 12(5), 'royalties' shall be deemed to arise in a contracting state where the payer is a resident of that State. However, in the case of taxation of rental income from ICS equipment, the country of the payer may not necessarily be the country of situs of the equipment. However, this issue has been dealt with in paragraph 19 of the Commentary on Article 12 which is reproduced below:-

> "19. As in the case of interest, some members suggested that some countries may wish to substitute a rule that would identify the source of a royalty as the State in which the property or right giving rise to the royalty (the patent etc.) is used. Where, in bilateral negotiations, the two parties differ on the appropriate rule, a possible solution would be a rule which, in general, would accept the payer's place of residence as the source of royalty; but where the right or property for which the royalty was paid was used in the

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 read as follows]

9.1Satellite operators and their customers (including broadcasting and

customer to utilize the capacity of a satellite transponder to transmit over large geographical areas. Payments made by customers under typical

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 characterization of the payment will depend to a large extent on the relevant contractual arrangements. Whilst the relevant contracts often

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, (er fof, s ofofofe((e)8(r)4( )-3(e)8(r)4( )os749(t)

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).

9.2Also, payments made by a telecommunications network operator to

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)*

a. The former paragraph 9 of the OECD Commentary on article 12 made the qualification of a mixed agreement as lease or sale

43. Mr. Scott Wilkie has raised another issue in his paper that payments for the use of, or right to use, an equipment are basically attributive business profits which are getting taxed under Article 12 on gross basis. The rent from the use of an equipment being business income should, therefore, be taxed on net basis, though in the absence of a Permanent Establishment, under Article 12. An equipment is basically eligible for depreciation. It is felt that this issue can be addressed by the countries bilaterally while calibrating the rate of tax on equipment royalty on gross basis in the source country.

44 Based on the discussion in foregoing paragraphs, amendments in the commentary have been suggested below:

Suggested amendments in commentary of Article 12

13.1 Equipment is any tangible, movable property used to perform a task. Examples of industrial, commercial and scientific equipment may include, for example:

aircraft;
cranes;
cars;
containers;
satellites (see paragraph 13.3 for further details); q729(s)4(i)-411(3[( )] i8(i)4(t)-3

Annex II

Proposal for modification of Article 12 of the UN Model Tax Convention and its Commentary regarding characterization of Software payments as Royalty[6]

Mandate

1.

in the context of the 2016/17 update of the UN Model. In the Eleventh Session of the Committee of Experts on International Cooperation in Tax Matters held in Geneva, 19-23 October 2015, this was taken up as item 3 (a) (v), and a sub-committee was formed to consider the issues and prepare a proposal for the consideration of the Committee. The mandate given to the Sub-committee in the

is important not only for avoiding double taxation, but also for ensuring a fare division of taxing rights and providing greater tax certainty to the stakeholders paying taxes. The various aspects relevant to this issue are summarized in the following paragraphs.

Lack of uniformity of views and positions

the domestic

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the insights into practices of the member countries of OECD that were being followed prior to the insertion of paragraphs 12 to 17.4 of existing commentary on Article 12 of OECD Convention, which in turn are significant indicators of the "context" that would be relevant for those tax treaties that have been signed prior to the development of such guidance. It may also be a significant indicator of "context" for the tax treaties that adopted the text of Article 12 as recommended by the UN Convention prior to the inclusion of reference to this guidance on software payments in the Commentary on Article 12 of UN Convention.

12. Since the existing guidance on characterization of payments for software have their genesis in this report, the review of its contents can help in understanding the underlying rationale and justification for the existing guidance in OECD Commentary. Paragraphs 38 to 47 of this report provide the relevant insights in this regard, and hence are worth referring here:

Many bilateral treaties between Member countries maintain a limited rate of tax at source on royalties generally or on particular types of royalties. Twelve countries have indeed entered a reservation against the zero rate provided in Article 12. *As bilateral treaties which provide for tax at source on royalties usually adopt the full definition of royalties in paragraph 2 of Article 12, a number of countries exercise taxing rights at source on many types of software payments on the grounds that they represent royalties.*

39. Source taxation of software payments raises questions of principles and of practical application. As regards the latter, it is necessary to determine which of the various types of payments relating to software represent royalties; how payments effected under mixed contracts are to be dealt with.

Analysis

40. The Committee examined whether it was in principle appropriate to regard software payments as within Article 12. It took into account the following:

a) Article 12 recommends a zero rate of tax on royalties with the ***intention of protecting royalties from taxation in the State of source except to the limited extent provided by paragraph 3*** *of Article 12.*

b) ***Taxation of royalties at source may lead to taxation on a gross basis which disregards the expenses incurred by the payee in earning the royalties****.* ***In some cases this may result in unrelieved double taxation*** *when the State of residence is unable to credit fully the tax withheld at source because it taxes the royalties on a net basis.*

c) Taxation on a gross basis occurs only in the absence of a permanent establishment; if a royalty is effectively connected with a permanent establishment, the effect of Article 7 together t; 1 157.58 tablisgisp-3(b)4(s)o; 1 157.13(r)-3(t)4(

accordance with Article 7 or Article 13 as appropriate. They did not consider it to be relevant that the product was protected by copyright and that there were restrictions on the use to which the purchaser could put it.
In the s

those whose purpose is to transfer the exclusive right to use software during a specific period or in a limited geographical area;

those involving additional consideration related to the usage of the software;

those which comprise substantial lump-sum payments.

47. Countries have differing practices in their treatment of such transactions and it is impossible to draw a clear borderline between payments which are properly to be treated as a capital gains matter and those that are royalties within Article 12 in every situation. Nevertheless there are clear principles to be followed in determining the nature of the transaction. Firstly, regard must be had to the precise terms of the contract under which the software rights were transferred. Secondly, where a transfer of ownership of rights has occurred, payments cannot be for the use of the rights. Finally, the form that the consideration takes, whether payment by instalments or, in the view of most countries, payment related to a contingency, is irrelevant in

13. These observations of the Committee provide detailed insights about the guidance that it recommended for inclusion in the Commentary on Article 12 in OECD Convention. **The report documents that the argument supporting the need for drawing a distinction between software payment for personal or business use of the purchaser and the software payment for commercial development or exploitation was based on the intention of Article 12 in the**

consideration for use of the product, whereas if a definition is adopted, only a payment made for commercial exploitation of such a product would be considered as royalty. The Committee adopted the narrower definition keeping in view the intention of Article 12 in OECD Convention of eliminating source based taxation. **This is an important insight, since it is obvious that those who do not intend to eliminate source taxation of royalty would not be**

15. Since all subsequent reports of OECD that led to further expansion of this guidance went by the recommendations of this report, these insights become significant to this discussion. They also necessitate a review and comparison of the "intent" of Article 12 in the two Conventions.

Difference in the intent & purpose of Article 12 of UN and OECD Conventions

16. Article 12 of the UN Convention deviates significantly in the intent and purpose from the Article 12 of the OECD Convention, as evident from the exclusion of the word "*only*" from paragraph 1 and the insertion of source taxation rule in the form of paragraph 2. Thus, while the objective of Article 12 of OECD Convention is to confirm exclusive taxation rights for the residence country in respect of income covered by Article 12, the objective of this Article in UN Convention is exactly the opposite, i.e. to confer source based taxation of income covered by it. This difference also manifests in other areas, such as in the treatment of income derived from leasing of industrial, commercial and scientific equipment as royalty as well as in the inclusion of films or tapes in UN Convention. **The rationale for this distinctive approach is already explained in paragraphs 2 to 9 of the existing Commentary on Article 12 of UN Convention and continues to guide and govern the application of this Article. Unless it is intended to change the approach already detailed in paragraph 2 to 9 of the Commentary on Article 12 and harmonize it with the approach adopted in Article 12 of the OECD Convention, the guidance on interpretation on this issue would need to be in accordance with that approach. Thus, it would appear, that adopting the**

with the intent and purpose of Article 12 in the UN Convention, wherein

consideration of a product protected by copyright or a patent is treated as royalty.

Other Considerations noted by the OECD Committee

17. It would be important to take into account any principles or considerations other than the intent of the Article of eliminating taxation of such payments in the source state, which may have influenced the guidance developed by the OECD Committee.

Protection to software under copyright laws

18. The primary reason OECD Committee, in spite of the intention to eliminate source taxation of royalty, was unable to keep software payments completely outside the definition of 'royalties' was because all member states afforded protection to intellectual properties related to software under their respective copyright laws. This is an important consideration. Since, software can be copied at zero marginal cost, unless such protection is afforded by the Copyright laws of a State, any software would have virtually no market value.[15] Thus, existence of Copyright laws in a State should be an essential consideration for the taxation of royalty arising in that State, a principle that supports the source based taxation of royalty, including that for software.

19. Here it would be useful to examine whether the absence of Copyright protection would affect payments for use of software (for business or personal purposes). While this can be considered a matter fit for greater analysis, it can be safely concluded that it will result in significant adverse impact on such payments, and that the absence of Copyright protection significantly erode the quantum of

copyright, and an implicit recognition of software as scientific work, this approach leads to the same outcome that would be derived without this modification. Thus,

amount of use (as may happen when access to a centralized software in a server under the control of software owner is provided over a network), the payment for software for business or personal use, without any limits or restrictions of use, should be considered as a payment for the ‘right to use’ that software rather than a payment for use of software. Since this payment is made for using this right, i.e.

26.

29. Irrespective of whether one agrees or not with these observations, the concerns raised need further analysis that must include the relationship between Article 7 and Article 12. It may also necessitate the observations made in respect of payments related to the digital economy and taxation of its income, in the Final Report on Action 1 of BEPS. While doing so, it may be appropriate to look at Article 12 (along with Articles 10 and 11) as alternative provisions for taxing business income[19].

Relationship between Article 12 and Article 7

30. The relationship of these articles is clarified in paragraph 6 of Article 7 of UN Convention as under:

other Articles of this Convention, then the provisions of those Articles shall

As also clarified in the paragraphs 59 to 62 of Commentary on paragraph 7 of Article 7 of the 2008 OECD Model Convention (which are also referred to in paragraph 21 of the Commentary on paragraph 6 of Article 7 of the 2011 UN Model Convention), income that constitute royalties may often be taxable as business profits but by application of the priority rule provided in paragraph 7 of OECD Model Convention and paragraph 6 of UN Model Convention, royalties are taxable only under Article 12 and not under Article 7.[20]

31. Thus, the rules provide special treatment to these special categories of income, i.e. interest, dividend and royalty, even if they constitute business profits, by exempting them from the threshold for taxation provided by Article 5

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the patent or similar property, in addition to regular royalty payments.
3. The Commentary on Article 12 of the OECD Model Convention includes the following preliminary remarks:

1. In principle, royalties in respect of licences to use patents and similar property and similar payments are income to the recipient from a letting. The letting may be granted in connection with an enterprise (e.g. the use of literary copyright granted by a publisher or the use of a patent granted by the inventor) or quite independently of any activity of the grantor (e.g. use of a patent gran

2. Certain countries do not allow royalties paid to be deducted for

the same State or is taxable in that State. Otherwise they forbid the deduction. The question whether the deduction should also be allowed in cases where the royalties are paid by a resident of a Contracting State to a resident of the other State is dealt with in paragraph 4 of Article 24.

33. **The reference to paragraph 4 of Article 24[22] is related to the obligation of the source state to provide deduction to a payment covered under Article 12 to a resident of the other Contracting State in the same manner as it would provide to a payment of this nature to a resident of that State. This obligation, unless accompanied with the right to tax such payments at source will actually amount to erosion of its tax base, and thus there would be a strong argument in favor of combining it with a right to collect tax on that income, while taking**

[22] Paragraph 4 of Article 24 (Non Discrimination) provides as under:
4. Except where the provisions of paragraph 1 of Article 9, paragraph 6 of Article 11, or paragraph 6 of Article 12

care of the po

other States without requiring a physical presence. The Report on Action 1 refers to this redundancy of physical presence PE in the digital economy as a proxy threshold test for determining the significant presence oxy

have arisen in application of PE rules that were not conceptualized for the digital economy, and which tend to make the 'nexus' rule inherent in existing definition of PE irrelevant in the digital economy.

39. **From the perspective of the issue of taxation of software payments as royalty, it would be relevant to note from these observations, that the increased ability of enterprises to directly interact with their customers and commercially interact with them, virtually obviates the need for them to**

payments from such rights largely redundant. Even if it some enterprises may still derive income under this category, it can be safely concluded that such payments in respect of software has already receded significantly. With most software developers providing software for use to their customers through the

so, additional options to take care of different concerns and possible deviations in approach would need to be provided.

41. **Even though an alteration in the Article 12 does not appear to be necessary, the Commentary should, include possible options for countries that would like to explicitly provide for source based taxation of software**

i.e. clarificatory approach) or by explicitly providing within the article that payment for use of software will be taxable as royalty in the state from where it arises.

42. **Other possible options for inclusion in the Commentary could be for those countries that may wish to restrict taxation of software payments as royalty only to business-to-business payments that are claimed as deduction and which lead of erosion of their tax base. Another option could for those countries who may wish to subject the taxation of royalty to a minimum revenue threshold, so as to facilitate compliance and administration.**

43. **For countries that wish to look at Article 12 as an alternative to Article 7, a possible option in the Commentary could be to enable taxation on a net**

bilaterally by the Contracting States.

44. **For this purpose, draft amendments replacing ad verbatim references to paragraphs 12 to 17.4 of the Commentary on Article 12 of OECD Convention are suggested in the next part of this note.**

Suggested Amendments in Paragraph 12 of Commentary on Article 12
Paragraph 3

12. This paragraph reproduces Article 12, paragraph 2, of the OECD Model Convention, but does not incorporate the 1992 amendment thereto which

operation of an enterprise and from the disclosure of which an economic benefit can be derived. Since the definition relates to information concerning previous experience, the Article does not apply to payments for new information obtained as a result of performing services at the request of the payer.

Some members of the Committee of Experts are of the view that there is no ground to limit the scope of information of an industrial, commercial or scientific nature to that arising from previous experience. The OECD Commentary then continues:

11.1 In the know-how contract, one of the parties agrees to impart to the other, so that he can use them for his own account, his special knowledge and experience which remain unrevealed to the public. It is recognized that the grantor is not required to play any part himself in the application of the formulae granted to the licensee and that he does not guarantee the result thereof.

11.2 This type of contract thus differs from contracts for the provision of services, in which one of the parties undertakes to use the customary skills of his calling to execute work himself for the other party. Payments made under the latter contracts generally fall under Article 7 or in the case of the United Nations Model Convention

Article 14.

11.3 The need to distinguish these two types of payments, *i.e.* payments for the supply of know-how and payments for the provision of services, sometimes gives rise to practical difficulties. The following criteria are relevant for the purpose of making that distinction:

Contracts for the supply of know-how concern information of the kind

supplier, of special knowledge, skill and expertise but not the transfer of such special knowledge, skill or expertise to the other party.

In most cases involving the supply of know-how, there would generally be very little more which needs to be done by the supplier under the contract other than to supply existing information or reproduce existing material. On the other majority of cases, involve a very much greater level of expenditure by the supplier in order to perform his contractual obligations. For instance, the supplier, depending on the nature of the services to be rendered, may have to incur salaries and wages for employees engaged in researching, designing, testing, drawing and other associated activities or payments to sub-contractors for the performance of similar services.

11.4 Examples of payments which should therefore not be considered to be received as consideration for the provision of know-how but, rather, for the provision of services, include:

payments obtained as consideration for after-sales service,

payments for services rendered by a seller to the purchaser under a warranty,

payments for pure technical assistance,

payments for a list of potential customers, when such a list is developed specifically for the payer out of generally available information (a payment for the confidential list of customers to which the payee has provided a particular product or service would, however, constitute a payment for know-how as it would relate to the commercial experience of the payee in dealing with these customers),

payment

only be considered to be made in consideration for the provision of such information so as to constitute knowhow where it is made to acquire information constituting ideas and principles underlying the program, such as logic, algorithms or programming languages or techniques, where this information is provided under the condition that the customer not disclose it without authorization and where it is subject to any available trade secret protection.

11.6 In business practice, contracts are encountered which cover both know-how and the provision of technical assistance. One example, amongst others, of contracts of this kind is that of franchising, where the franchisor imparts his knowledge and experience to the franchisee and, in addition, provides him with varied technical assistance, which, in certain cases, is backed up with financial assistance and the supply of goods. The appropriate course to take with a mixed contract is, in principle, to break down, on the basis of the information contained in the contract or by means of a reasonable apportionment, the whole amount of the stipulated consideration according to the various parts of what is being provided under the contract, and then to apply to each part of it so determined the taxation treatment proper thereto. If, however, one part of what is being provided constitutes by far the principal purpose of the contract and the other parts stipulated therein are only of an ancillary and largely unimportant character, then the treatment applicable to the principal part should generally be applied to the whole amount of the consideration.

[up to this point the Commentary can remain unchanged. Thereafter new paragraphs in the UN Commentary beginning with paragraph 12.1 may be inserted by modifying the existing OECD Commentary as under:]

12.1 ~~***12.***~~ Whether payments received as consideration for computer software may be classified as royalties poses difficult problems but is a matter of considerable importance in view of the rapid development of computer technology in recent years and the extent of transfers of such technology across national borders. ~~***In 1992, the Commentary was amended to describe the principles by which such***~~

~~classification should be made. Paragraphs 12 to 17 were further amended in 2000 to refine the analysis by which business profits are distinguished from royalties in computer software transactions. In most cases, the revised analysis will not result in a different outcome~~. In particular, with the increasing use of software in all aspects of business and personal life, these payments often constitute an increasing proportion of overall economy, including for developing countries, requiring that a clear view may be taken by countries in respect of their taxation.

12.2 ***~~12.1~~*** Software, ***also known as Computer Program,*** 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 standardized 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.

12.3 ***12.2*** The character of payments reymeym3(t)4(i)4(n)-(t)ed

~~*subject to*~~ ***usually with*** restrictions ***made under a licensing agreement*** on the use to which it is put***, which would make such transfer of rights equivalent to renting of the software for use***. The consideration paid can also take numerous forms. ~~***These factors may make it difficult to determine where the boundary lies between software payments that are properly to be regarded as royalties and other types of payment. The difficulty of determination is compounded by the ease of reproduction of computer software, and by the fact that acquisition of software frequently entails the making of a copy by the acquirer in order to make possible the operation of the software.***~~

~~***13. The transferee's rights will in most cases consist of partial rights or complete rights in the underlying copyright (see paragraphs 13.1 and 15 below), or they may be (or be equivalent to) partial or complete rights in a copy of the program (the "program copy"), whether or not such copy is embodied in a material***~~

other countries treatment as a scientific work might be the most ***~~realistic~~*** ***appropriate*** approach. ***Countries that may wish to provide greater clarity in this regard may explicitly include software in the category of literary or scientific***

12.6 With respect to the position adopted by the OECD in paragraph 14 of its Commentary on Article 12, the Committee of Experts noted that inherent differences exist in the purpose and intent of the Article 12 in the two Conventions. Whereas the purpose and intent of Article 12 in OECD Convection is to eliminate source taxation of royalty, the purpose and intent of Article 12 in the UN Convection is to grant partial rights of taxing royalty to the source state. The Committee also noted that its view on payments for granting right to use intellectual property that is protected by Copyright laws or similar protections, such as in case of patent is to provide source state partial taxation rights on such payments under paragraph 2 of Article 12. A similar view has also been taken by it in respect of payments received for rental payments for use of Cinematographic films, as explained in paragraph 9 above. It also noted that in view of the widespread digital networks today enable copyright owners of software to directly grant license for use to the public, without necessitating grant of copying or distribution to intermediaries, treating grant of license to use software differently from other transactions involving transfer of partial rights in a software will practically eliminate the source taxation of such payment. As this would not be in accordance with the purpose and intent of the UN Convention, the Committee decided not to accept the narrower interpretation adopted by the OECD in applying the definition of royalty in case of software payments, and instead opted for the broader interpretation according to which, any payments for grant of any rights in the software, irrespective of whether they are in respect of use of the software or to reproduce, distribute or modify it, would constitute royalty as defined in paragraph 3.

~~14. In other types of transactions, the rights acquired in relation to the copyright are limited to those necessary to enable the user to operate the program, for example, where the transferee is granted limited rights to reproduce the program. This would be the common situation in transactions for the acquisition of a program copy. The rights transferred in these cases are specific to the nature of computer programs. They allow the user to copy the program, for example onto the user's computer hard drive or for archival purposes. In this context, it is important to note that the protection afforded in relation to~~

~~*computer programs under copyright law may differ from country to country. In some countries the act of copying the program onto the hard drive or random access memory of a computer would, without a license, constitute a breach of*~~ *copyright. However, the copyright laws of many countries automatically grant*

relation to patent royalties and know-how are equally applicable to computer software. Where necessary the total amount of the consideration payable under a contract should be broken down on the basis of the information contained in the contract or by means of a reasonable apportionment with the appropriate tax treatment being applied to each apportioned part.

12.12 ***~~17.1~~*** The principles expressed above as regards software payments are also applicable as regards transactions concerning other types of digital products such as images, sounds or text. The development of electronic commerce has multiplied the number of such transactions. ***The changing business models adopted by enterprises have also given rise to new challenges, which are being examined and may lead to evolution or adoption of additional options. However, greater analysis of such options and detailed guidance for their application may be required before they can be recommended by the Committee of Experts.*** ***~~In deciding whether or not payments arising in these transactions constitute royalties, the main question to be addressed is the identification of that for which the payment is essentially made.~~***

~~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~~

~~*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.*~~

~~*17.4 By contrast, transactions where the essential consideration for the payment is the granting of the right to use a copyright in a digital product that is electronically downloaded for that purpose will give rise to royalties. This would be the case, for example, of a book publisher who would pay to acquire the right to reproduce a copyrighted picture that it would electronically download for the purposes of including it on the cover of a book that it is producing. In this transaction, the essential consideration for the payment is the acquisition of rights to use the copyright in the digital product, i.e. the right to reproduce and distribute the picture, and not merely for the acquisition of the digital content.*~~

~~*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 royalties. The OECD Commentary then continues:*~~

12.13 Paragraph 2 of Article 12 provides for taxation of the gross payment made for grant of rights in respect of software. This could give rise to concerns similar to those examined and discussed in paragraph 8 and 9. In such cases, Contracting States can either agree to a maximum rate of tax in the source state taking into account these concerns. Alternatively, Contracting States that so desire may also opt to amend the paragraph 2 by providing a specified deduction for the expenses. In order to prevent escalation of compliance burden and keeping in view the

constraints often faced by the developing countries, one possible option could to provide fixed deduction on a pro rata basis, on account of depreciation of the software, the specifics of which can be bilaterally agreed by the Contracting States.
12.14 For Contracting States that may wish not to tax software payments made for personal use, and instead may want to limit it to those payments that are claimed as business expenditure leading to erosion of tax base, an option could be to amend paragraph 2 of Article 12 by limiting payments therein to those that are claimed as deduction by an enterprise for the purpose of computing its income. Another possible option for those Contracting State that may not wish to extend the application of Article 12 to smaller payments, with the purpose to limit compliance burden, could be to provide a minimum revenue threshold in respect of payments covered under paragraph 2.

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Clean version of suggested paragraph 12 of Commentary on Article 12

Paragraph 3

Some members of the Committee of Experts are of the view that there is no ground to limit the scope of information of an industrial, commercial or scientific nature to that arising from previous experience. The OECD Commentary then continues:

11.1 In the know-how contract, one of the parties agrees to impart to the other, so that he can use them for his own account, his special knowledge and experience which remain unrevealed to the public. It is recognized that the grantor is not required to play any part himself in the application of the formulae granted to the licensee and that he does not guarantee the result thereof.

11.2 This type of contract thus differs from contracts for the provision of services, in which one of the parties undertakes to use the customary skills of his calling to execute work himself for the other party. Payments made under the latter contracts generally fall under Article 7 or in the case of the United Nations Model Convention

Article 14.

11.3 The need to distinguish these two types of payments, *i.e.* payments for the supply of know-how and payments for the provision of services, sometimes gives rise to practical difficulties. The following criteria are relevant for the purpose of making that distinction:

> Contracts for the supply of know-how concern information of the kind described in paragraph 11 that already exists or concern the supply of that type of information after its development or creation and include specific provisions concerning the confidentiality of that information.
>
> In the case of contracts for the provision of services, the supplier undertakes to perform services which may require the use, by that supplier, of special knowledge, skill and expertise but not the transfer of such special knowledge, skill or expertise to the other party.
>
> In most cases involving the supply of know-how, there would generally be very little more which needs to be done by the supplier under the contract other than to supply existing information or

reproduce existing material. On the other majority of cases, involve a very much greater level of expenditure by the supplier in order to perform his contractual obligations. For instance, the supplier, depending on the nature of the services to be rendered, may have to incur salaries and wages for employees engaged in researching, designing, testing, drawing and other associated activities or payments to sub-contractors for the performance of similar services.

11.4 Examples of payments which should therefore not be considered to be received as consideration for the provision of know-how but, rather, for the provision of services, include:

the condition that the customer not disclose it without authorization and where it is subject to any available trade secret protection.

11.6 In business practice, contracts are encountered which cover both know-how and the provision of technical assistance. One example, amongst others, of contracts of this kind is that of franchising, where the franchisor imparts his knowledge and experience to the franchisee and, in addition, provides him with varied technical assistance, which, in certain cases, is backed up with financial assistance and the supply of goods. The appropriate course to take with a mixed contract is, in principle, to break down, on the basis of the information contained in the contract or by means of a reasonable apportionment, the whole amount of the stipulated consideration according to the various parts of what is being provided under the contract, and then to apply to each part of it so determined the taxation treatment proper thereto. If, however, one part of what is being provided constitutes by far the principal purpose of the contract and the other parts stipulated therein are only of an ancillary and largely unimportant character, then the treatment applicable to the principal part should generally be applied to the whole amount of the consideration.

12.1 Whether payments received as consideration for computer software may be classified as royalties poses difficult problems but is a matter of considerable importance in view of the rapid development of computer technology in recent years and the extent of transfers of such technology across national borders. In particular, with the increasing use of software in all aspects of business and personal life, these payments often constitute an increasing proportion of overall economy, including for developing countries, requiring that a clear view may be taken by countries in respect of their taxation.

12.2 Software, also known as Computer Program, may be described as a program, or series of programs, containing instructions for a computer required easisve(a)8( )-168(c)] TJETBinea, maygter c

tape or disk, or on a laser disk or CD-ROM. It may be standardized 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.

12.3 The character of payments received in transactions involving the transfer of computer software depends on the nature of the rights that the transferee acquires under the particular arrangement regarding the use and exploitation of the program. The rights in computer programs are a form of intellectual property. Most countries protect~~s~~ rights in computer programs either explicitly or implicitly under copyright law and their reproduction, copying, modification, sale or rental by a person other than the owner of the copyright or a person authorized by him is usually prohibited by such laws. Transfers of rights in relation to software occur in many different ways ranging from the alienation of the entire rights in the copyright in a program, *which would amount to sale of the copyright,* to limited transfer of right to use that software usually with restrictions made under a licensing agreement on the use to which it is put, which would make such transfer of rights equivalent to renting of the software for use. The consideration paid can also take numerous forms.

12.4 Payments made for the acquisition of partial rights without the transferor fully alienating the copyright rights~~)~~ will represent a royalty where the consideration is for granting of rights to use the program in a manner that would, without such license, constitute an infringement of copyright. Examples of such arrangements include grant of license~~s~~ to reproduce, distribute, modify or for the right to use software Paragraph 3 requires that software be classified as a literary, artistic or scientific work. The copyright laws of many countries deal with this problem by specifically classifying software as a literary or scientific work. For

the software from the payment received for the right to use. The rationale for adoption of this position by the OECD is provided in paragraphs 38 to 47 of the Report titled, “The Tax Treatment of Software”, which documents that the Committee tasked with preparing that Report was faced with two opposing views. One view preferred a broad interpretation of paragraph 2, wherein payments received for transfer of right to use software protected by copyright would be considered royalty. This view was opposed by other countries on the ground that the purpose and intent of Article 12 in the OECD Convention was to eliminate source taxation and that the definition of royalty has to be interpreted more

in respect of payments received for rental payments for use of Cinematographic films, as explained in paragraph 9 above. It also noted that in view of the widespread digital networks today enable copyright owners of software to directly grant license for use to the public, without necessitating grant of copying or distribution to intermediaries, treating grant of license to use software differently from other transactions involvi

royalty. For reasons already detailed in paragraph 12.5 and 12.6 above, the Committee did not agree with this view. Thus, where a distributor is making payment to the owner of the copyright for distributing copies of software to the public, irrespective of whether it prepares these copies from a master copy provided to it by the copyright owner or whether it downloads each copy separately from its website, such payment being a payment in respect of partial rights in respect of the software would constitute royalty under paragraph 3. This will not be the case with a distributor, who without obtaining any rights in the software or making payments in respect of the same, is only facilitating its distribution to the public as a distribution service provider. The income of such distributor would usually be taxed under Article 7.

12.10 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 provisions of the Article are not applicable. Such payments are likely to be business profits within Article 7 or 14 or a capital gain within Article 13 rather than royalties within Article 12. Paragraph 16 of OECD Commentary provides that certain cases of transfer of less than full ownership, as in case of exclusive right of use of the copyright during a specific period or in a limited geographical area, additional consideration related to usage or consideration in the form of a substantial lump sum payment would also not constitute royalty. However, since accepting this distinction would open a world of opportunities for artificial structuring of transfer of rights in software with the objective of disguising royalty payments for the purpose of avoiding source taxation, the Committee did not accept this view, and preferred not to accept such artificial distinction. Payments made for less than full ownership should thus be considered as royalty within the definition of royalty in paragraph