SOUTH CENTRE TAX INITIATIVE

Comments on Discussion Draft:
Possible Changes to the United Nations Model Double Taxation Convention Between Developed and Developing Countries Concerning Inclusion of software payments in the definition of royalties

Background

The South Centre, an intergovernmental organisation of, by and for the Global South in 2016 launched the South Centre Tax Initiative (SCTI) (https://taxinitiative.southcentre.int). This is the organisation's flagship program for promoting cooperation among developing countries on international tax matters. The program aims at the important need to increase collaboration among developing countries on international tax issues and reform processes.

With a focus on network building, the SCTI is centered on activities to promote and support intensified, better coordinated, and more institutionalized approaches to South-South cooperation in tax matters, so as to enable developing countries to become full participants for substantive norm-setting in international taxation matters.

Overview

The SCTI offers its comments on the discussion draft on inclusion of software payments in the definition of royalties. As is well known, this is an important issue that developing countries have been fighting for, for a while now. **The SCTI supports the proposed change which seeks to insert the phrase "computer software" in article 12(3) of the UN Model Double Taxation Convention Between Developed and Developing Countries.** The COVID-19 pandemic adds special urgency to resolving this long-pending issue as revenue from software payments made from developing countries continues to increase.

Arguments to strengthen reasons for the proposal

The SCTI supports the reasons for the proposal mentioned in the discussion draft and provides additional arguments in favor as provided below.[1]

[1] Acknowledgements are due to the BEPS Monitoring Group for sharing their draft which has helped in preparing this submission.

Payments for computer software already accounted for as royalties by international institutions

The IMF and the World Bank's definition of royalties makes it clear that payments for computer software comes under this category. The IMF's Balance of Payments Manual measures royalties and license fees payments as follows:[2]

> 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:[3]

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

Thus, payments for rights to use computer software can validly be considered as royalties from intellectual property rights.

Source state contributions must be accounted for

The discussion draft rightly highlights the source state's contributions by enforcing intellectual property rights, facilitating payments, providing telecommunications infrastructure and population competence in computers, all of which are important factors. However in the reasons against the proposal, critics have dismissed these factors without providing any explanation why. Till such explanation is forthcoming the argument can be seen to continue remaining valid.

False analogy with sale of goods

Critics of the proposal state that payments for software are the same as payments for goods and hence should be taxable under article 7. This overlooks 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

---

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

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

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.

Large number of treaties allow for software payments to be taxed as royalties

As mentioned by the BEPS Monitoring Group, the 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. These usually involve a capital-importing country (which are mostly developing countries), although it is notable that OECD countries have often 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. Hence state practice of some major developed countries too supports this position.

Practical difficulties are not insurmountable

Critics say the proposal gives rise to practical difficulties such as how would it work when individuals purchase software, etc. These can be dealt with in the commentary and are not insurmountable. For example financial intermediaries such as banks can be made to withhold and remit taxes when individuals are involved.

Contributions to clarifying the relationship between article 12 and 12B

A simple way to deal with potential overlap between the two articles would be to make clear in the Commentary to article 12B[4] that any income taxable under article 12 should not also be taxed under 12B.

Source taxing rights can be based on increasing engagement in economic life

Critics of this proposal say it is problematic to argue that services or goods delivered by the payee create "an increasing level of engagement in the economic life of States where they are used". An analogy is drawn with the extractives industry and the rhetorical (unsaid) implication is that commodity exporting countries would lose their source taxing rights if this train of thought is taken to its logical conclusion.

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 misleading as proposals for an increased allocation of taxing rights to

[4] http://us5.campaign-archive.com/?u=fa9cf38799136b5660f367ba6&id=f330625ffc

market countries exclude extractive industries. Source state taxing rights on natural resources are in any case protected under article 6 of the model conventions.

Issue of gross taxation already dealt with in commentary

Critics raise concerns that imposing withholding taxes on gross payments could cause difficulties for software companies as it ignores expenses incurred by the payee. 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.

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 addresses the underlying concerns made with reference to software.

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 problematic 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.