



## SOUTH CENTRE TAX INITIATIVE

### **Comments on Discussion Draft: Taxation of Software Payments as Royalties**

#### **Background**

The South Centre<sup>1</sup>, 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.

The South Centre is pleased to submit the present comments to support the work of the UN Tax Committee on the 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.

#### **Overview**

There has been lack of clarity over whether payments for the use or the right to use "computer software" should be taxable as royalties. The term is not explicitly mentioned in the UN Model Tax Convention but a large number of bilateral tax treaties, more than 600<sup>2</sup>, include the term. Developing countries have sought to remove this ambiguity through amending Article 12(3).

The South Centre supports the proposed changes to Art. 12(3) of the UN Model Double Taxation Convention Between Developed and Developing Countries which insert the phrase "computer software" and clarify that payments for the use or right to use computer software (including to reproduce, distribute, prepare derivatives, etc.) constitute royalties. Accordingly, subpara (c) should be deleted, because it would unfairly and illogically deny developing countries the right to tax royalty payments by distribution intermediaries. Subject to the doubtful arguments in the minority view in para 15, the changes to the Commentary are also welcome.

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<sup>1</sup> <http://southcentre.int/>

<sup>2</sup> <https://www.bepsmonitoringgroup.org/news/2020/10/6/inclusion-of-software-payments-in-the-royalties-article-of-the-un-model-convention>

**Below are responses to the three questions outlined in the discussion draft**

*Is the description of “software” in paragraph 12.1 of the Commentary on Article 12 of the OECD Model (extracted in paragraph 12 of the proposed UN Commentary) (a) consistent with current business practice and (b) appropriate for use as a definition in this context, perhaps by adding the definition to Article 3?*

The description of software in the Commentary is adequate. Software by its very nature is dynamic and subject to constant evolution. Placing it in a definition would be restrictive. The scope should be as wide as possible so source countries are able to maximise the revenue potential from software payments. Further, tax treaties have a long shelf life and are not frequently renegotiated. Outdated and/or inappropriate definitions may give rise to complex and unnecessary disputes. These would be especially detrimental for developing countries.

There is also no universally accepted definition of ‘software’ and this has not prevented progress in international rule-making. It is not essential to the resolution of the issue of tax treatment of software-related royalties. It is therefore best that software not be added as a definition to Article 3 and remain only in the Commentary. This should not become a distraction and side-track from the larger need of a quick resolution of this long-pending issue.

*Do paragraphs 16 and 17 of the proposed UN Commentary adequately distinguish between goods that constitute “computers” and those that are not “computers” notwithstanding that they incorporate software to execute their functions or provide some degree of connectivity? What additional language or examples would help to clarify the distinction?*

The tax treatment of software payments as royalties should not be contingent upon the software being installed on what is traditionally understood as a “computer” (desktop, laptop). This is a moot point. A wide variety of devices today are similar in function to these computers such as smartphones, tablets, smartwatches, etc. Trying to shortlist what constitutes a computer would be an exercise similar to trying to nail down software in a definition, i.e one that may become outdated very soon and be harmful for practical purposes. The key aspect is whether the payment is for the right to use or the use of software, for a purchase of the rights over the software; or for hardware that incorporates software (for which a separate payment for the latter is not made). The issue here is the characterisation of the transaction, which is a matter of domestic law. By this yardstick para 17 is adequate, however para 16 may be modified as follows:

*16. Subdivision (a)(iv) is intended to apply to direct payments for computer software, whether installed on **devices such as a smartphone, tablet**, mainframe computer, desktop or laptop or accessed over the internet or an intranet through such computers. As noted in paragraph 14.1 of the Commentary on Article 12 of the 2017 OECD Model set out above, the method by which the computer software is transferred to the transferee is not relevant to the categorization for purposes of Article 12. Therefore, it should not matter whether a user downloads a copy of computer software pursuant to what is legally a “license” under domestic law, or “purchases” a copy of computer software. In the latter case, any CD-ROM or other medium containing the computer software that is purchased is the means by which the user can access the computer software, which is the object of the transaction. Because the domestic law can vary in how it treats these economically equivalent transactions, and to provide a consistent treatment of these transactions, subparagraph (c) was added to paragraph 3.*

*The proposed Commentary continues to adopt paragraph 14.4 of the Commentary on Article 12 of the 2017 OECD Model on distribution intermediaries. Some participants in the Subcommittee do not agree with the analysis in that paragraph for the reasons set out in the Annex to this Discussion Draft. Do you agree with the position set out in paragraph 19 of the proposed Commentary or with the analysis in the annex? If the latter, do you agree that the appropriate approach is to delete the words ‘for the purposes of using it’ at the end of subparagraph (c)?*

The analysis in the annex is endorsed and it correctly states that copyright is a bundle of rights, of which the right to distribute is a part. Hence, payments made by a distributor to a software copyright holder are for the right to distribute and are in essence a payment for a copyright license. As per 12(3)(a)(i), all payments for the use or the right to use copyrights are royalties, and hence such payments by distributors should also be taxable as royalties. Accordingly, 3(c) illogically and unfairly tries to deny developing countries the right to tax payments by distributor intermediaries and should be deleted.

### **The South Centre would also like to share two additional points**

*Software contributes to the economic life of the source country*

The view of the majority of the Committee Members in para 14 rightly states that the addition of subdivision (a)(iv) is “justified because Article 12 is intended to cover payments with respect to the “letting” of property.” Computer software, like industrial, commercial or scientific equipment, contributes to the economic life of the source country. It is used for business activities and is an essential aspect of enabling modern living. In that sense it is quite unlike a book and hence the taxing right must be provided to the source state.

*Gross basis taxation by itself no ground for dismissal*

The view of the minority of the Committee Members in para 15 also claims that categorising software payments as business profits is appropriate as it will result in net basis taxation. The preceding section examined how it is conceptually flawed to categorise software payments as business profits. Here we examine why even the net basis taxation approach is problematic.

First, net basis taxation under Article 7 can happen only if there is a Permanent Establishment (PE) under Article 5. The proliferation of the digitalized economy has meant that often a software payment can happen without a corresponding PE. This would make the application of Article 7 very difficult, with the result that countries, especially developing ones, would effectively lose the taxing right.

Second, even if there is a PE, there is the reality of finding out costs and expenses. It is difficult for tax administrations to determine this for non-residents whose business relies mainly on intangibles. It is especially difficult for developing countries. Concerns of implementation cannot be divorced from concerns of policy. That is the reason why historically for all items of income for which cost or expenses are difficult to determine because there is no PE, there is the approach of gross basis taxation for items of income such as interest, dividends and Fees for Technical Services (FTS). For the same reasons, it should also apply to payments for computer software.

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