UNITED STATES COUNCIL FOR INTERNATIONAL BUSINESS

November 30, 2016

VIA EMAIL

Pragya Saksena
Coordinator, Subcommittee on Royalties
UN Committee of Tax Experts

Re: Amendments to the Commentary on Article 12 (Royalties)

Dear Pragya,

USCIB appreciates the opportunity to comment on the Subcommittee on Royalties (the "Subcommittee") draft report on possible amendments to the Commentary on Article 12 (Royalties) including both possible amendments to the Commentary with respect to leasing industrial, commercial and scientific equipment and whether payments for software are included in the definition of royalties. Given the short time for commenting, this letter summarizes our concerns. We may provide more detailed comments before the scheduled February meeting of the Subcommittee and, as pointed out below, believe that business representatives should be included on the Subcommittee.

Comments

Procedural Issues

- The draft report on possible amendments to the Commentary on Article 12 (Royalties) raises a number of complex and controversial issues. Based on comments at the meeting of the Committee of Tax Experts in October in Geneva, there have not been any meetings of the Subcommittee and the work does not, at this point, reflect the careful deliberation of the Subcommittee. There is now a meeting of the Subcommittee scheduled for February, but a single meeting may be inadequate given the scope of the work necessary and the fact that this Committee's term will be ending after its final meeting in April. In our view, there simply isn't adequate time to consider and resolve the difficult issues presented by this report before the end of this Committee's term.

- With respect to payments for software, the draft report assumes that technological advances (the internet-of-things) make it possible for businesses to carry on economic activity without a physical presence. The draft report also cites certain changing

business models as a reason to adopt an expansive definition of the term “royalties”. Many of the proposed changes to the Commentary would substitute new descriptions of business practices in the software industry for the previously agreed descriptions of such practices. Many of these technological points are addressed below, but if business models and business practices are to be fully understood, members of the business community should be allowed to participate in the Subcommittee. USCIB has members who are industry experts who have previously volunteered to assist the Subcommittee and continue to be willing and able to participate in the work of the Subcommittee.

Substantive Issues

- The draft report justifies a “broad” interpretation of the term “royalty” based on the premise that the “narrower” view was based, in part, on the premise that the OECD Model Convention recommends a zero rate on royalties[1]. This way of framing the issue is inaccurate. The OECD was not attempting to “narrow” the definition of royalties, but to reach the right interpretation. It is worth noting that the ultimate conclusions of the e-commerce TAG were unanimously supported by members of the TAG.

- The so-called “narrow” interpretation gives little weight to the other reasons for the conclusion of the TAG. The primary reason for the conclusion with respect to software was the distinction between copyrighted articles and copyright rights. This distinction applies to many copyright based articles besides software, and the distinction between selling a good which incorporates intellectual property versus licensing the intellectual property for exploitation would implicate many products. If the draft report were adopted, it would create the possibility that the mere purchase of a product protected by copyright or patent could result in the payment of a royalty for the use of the product (See WSJ article on *Is it a Car or Is It a Computer*).

- The conclusion of the OECD on the definition of the term “royalty” was also based in part on the need to distinguish between the personal use of software and the business use of software. Personal use will not include the use of copyright rights as that term is generally understood. Further, to the extent that base erosion (discussed below) serves as justification for the proposed changes, there is no possibility of base erosion, however construed, with respect to sales of software to individuals for personal use.

- The draft report vastly overstates the ability of companies to achieve market penetration without a local presence (and seems to misunderstand the internet of

[1] Paragraphs 13 through 15.

things).[2] In order to develop a market, business needs a local presence including local marketing and sales support. Without a local presence there will be a natural limit on what can be sold into the market, as all sales will only be to those persons who are able to find the remote vendor in the absence of a local presence.

- The draft report[3] states that "since software can be copied at zero cost, unless such protection is provided by the Copyright laws of a State, any software would have virtually no market value. Thus, existence of Copyright laws in a State should be an essential consideration for the taxation of royalty (sic) arising in that State, a principle that supports the source based taxation of royalty, including software." Critically, this proposal fundamentally misunderstands the use of software in cloud computing or in any context other than software separately purchased in a distribution model.

- In the context of cloud computing, the user has access to software but does not have the ability to copy software that is under the control of the cloud service supplier. There is no value provided by the copyright laws of the source state in this context. This is also the case with respect to e-commerce app stores, online advertising, participative networked platforms and online payment services. These platforms do not rely on the copyright laws of the source state and, thus, again there is no value that is added by the copyright laws of the source state. As such, there is no justification for charging a royalty when there is no value added by the source state.

- Further, in the context of the internet-of-things (IOT), customers who purchase a "thing" generally do not have the capacity to copy the software embedded in the "thing", nor is there a market for the embedded software separate from the physical thing. The software exists to enable better use of the "thing" itself. In many cases, the embedded software is more for the benefit of the manufacturer of the device (e.g., supporting their data analytics business). In neither case, however, is there any value that is added by the copyright laws of the source state.

- The draft report justifies an expansive reading of both lease payments and software payments on the grounds that permitting a deduction without applying a withholding tax results in base erosion. This misconstrues base erosion. Base erosion should not be defined based on whether the tax loop is closed in any one jurisdiction. The principle of coherence that has been articulated as part of the Base Erosion and Profits Shifting project (which has been approved by the OECD and G20 countries) is that deductible payments in one jurisdiction should generate a corresponding inclusion either in that

[2] Paragraph 37 "With the global reach of internet-of-things (IOT), it is possible for software developers to distribute it directly to the users, without requiring an intermediate entity, thereby allowing enterprise of a State to derive substantial income from other States without requiring a physical presence."

[3] Paragraph 18, page 37.

jurisdiction or in another jurisdiction. If deductible payments are not excessive and generate a corresponding inclusion in another jurisdiction where the recipient is subject to tax, then there is no base erosion even though taxable income in the country from which the payment originated is reduced. That country's tax base has been appropriately reduced because the value was created in another jurisdiction. If an appropriate payment is not made and taxable in the jurisdiction where value is created, then it is the jurisdiction where the value was created that is being inappropriately "eroded". In addition, business payments for software should enable that business to earn additional profits in the local jurisdiction, increasing the source country tax base.

- Article 12 of the UN Model contains a source rule that looks to the residence of the payer of the royalty (although paragraph 19 of current the Commentary provides that some countries may wish to substitute a place of use rule) and the draft report does not suggest any changes to these rules. The UN Commentary with respect to Article 12 justifies gross basis taxation in part (paragraph 6) on the fact that patent and processes might be licensed to developing countries after they had been fully exploited elsewhere and expenses relating to their development had been largely recouped. While this may not be true generally (see paragraph 7 of the Commentary), it is clearly not true in the case of software. Software is constantly updated for no additional compensation and the expenses of these updates cannot be said to be recouped from other transactions. Further, the expenses incurred with respect to products with embedded software (the internet-of-things) the particular "thing" containing embedded sensors and software will be unique and expenses associated with producing that "thing" will be not recovered from other transactions. Returning to the car example, if the development of the technology embedded in the car and the manufacture of the car occur outside of the residence of the payer, would the residence of the payer source rule be appropriate? There is no possibility that the expenses associated with producing this car have been previously recovered. Even if withholding is limited to the value of the software (and patents?), the valuation issues involved in determining what is attributable to software and what is attributable to the physical car, will be difficult, if not impossible to sort out. Further, all of the value related to the car would be created outside of that jurisdiction and taxation ought to follow value creation. Thus, an expansive reading of software that would impose tax in such a case ought to be rejected.

- The car example undercuts the basic premise of the draft report. That basic premise of the draft report is that there should be no distinction between a payment that represents mere purchase of a product protected by a copyright or patent and a payment that is made in return for the ability to commercially exploit the intellectual property of another. USCIB believes that this distinction, which was the fundamental

premise for the existing definition of the term "royalty", remains appropriate and meaningful, and ignoring it will create inappropriate results and lead to significant disputes.

- The likelihood of disputes is increased because the draft report is recommending changes to the Commentary, as opposed to Article 12 itself. The draft report is of the view that the definition of royalties – including the terms used to define a royalty -- should be ambulatory. The draft report cites paragraph 2 of Article 3 of both the OECD and UN Model Conventions. That paragraph provides:

  > "2. As regards the application of the Convention at any time by a Contracting State, any term not defined therein shall, unless the context otherwise requires, have the meaning that it has at that time under the law of that State for the purposes of the taxes to which the Convention applies, any meaning under the applicable tax laws of that State prevailing over a meaning given to the term under other laws of that State."

  Paragraph 6 of the draft report then provides:

  > 6. The Commentary on Article 3 on both Conventions specifically clarifies that the domestic legislation at the time of application of the treaty, rather than the legislation at the time of the signing, will be applicable and that a specific legislation in respect of taxes will prevail. Thus, the definition of "royalty" in the domestic tax laws of the Contracting States as well as the definition and meaning of the term "copyright" under domestic laws of the Contracting State applying it become relevant in characterization of software payment.

  This analysis is selective. Paragraph 6 ignores the portion of the Commentary that examines the context; applies the principle of reciprocity; and requires balance between the need to ensure permanency of commitments entered into by States and the need to be able to apply the Convention in a convenient and practical way. Before adopting a new interpretation in the Commentary, these other concerns should be examined. While the draft report looks at some of the history of the development of the rules on software and notes divergent views, any examination of context and the intention of the parties would need to take place within the framework of an individual bilateral treaty. That is, did this country express a view and how was that view reflected in a particular bilateral treaty with another country? If the countries hold contrary views, is it clear that a particular bilateral treaty was intended to reflect one view or another? If a country has conceded an issue in the context of a bilateral convention (in all likelihood in exchange for a concession from the other party to the convention), then that concession should not be undone by new language in the Commentary or a unilateral change in domestic law.

- The draft report is very confusing in its discussion of the interaction of Article 7 and Article 12. The draft report seems to acknowledge that if an enterprise has a permanent establishment and earns a royalty that is attributable to that permanent establishment that the royalty would be subject to net basis taxation under Article 7. This is the standard interpretation of the interaction of Article 7 and Article 12. Nevertheless, the draft creates doubt about this standard interpretation. Paragraph 29 of the paper provides that:

> Irrespective of whether one agrees or not with these observations[4], 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.

- This seems to imply that regardless of whether a royalty is attributable to a permanent establishment that the income should be subject to gross basis withholding tax. Paragraph 30 (page 41) provides:

> [I]ncome 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.

- This is simply incorrect. The plain language of Article 12 states that royalties attributable to permanent establishments should be taxed under Article 7 (or Article 14) as follows:
    - Paragraph 4 of Article 7 of the OECD Model and paragraph 6 of Article 7 of the UN Model contain identical language providing:

[4] "An important consideration noted by the OECD Committee related to taxation of gross payment. It noted that gross basis taxation disregards the expenses incurred by the payee in earning the royalties and in some cases, if the State of residence is unable to credit fully the tax withheld at source because it taxes royalties on net basis. Significantly, it also noted that such gross taxation happens only in the absence of a permanent establishment in the source country and is alleviated if royalty is effectively connected with a permanent establishment, since that makes paragraph 3 (sic) of Article 12 providing for net basis taxation into play." (Draft report paragraph 28, page 41.) These are the observations that paragraph 29 is referring to. The implication of paragraph 29 is that these observations are debatable. It is hard to see how one could disagree with any of these observations; they are all simply facts.

Where profits include items of income which are dealt with separately in other Articles of this Convention, then the provisions of those Articles shall not be affected by the provisions of this Article.

- However, paragraph 3 of Article 12 of the OECD Model and paragraph 4 of Article 12 of the UN Model puts the income back in Article 7 (or Article 14 as the case may be in the case of the UN Model).

- Thus, even though the application of Article 12 is not affected by Article 7, Article 12 itself contains the rule that treats the income as subject to Article 7 (or Article 14).

- Perhaps the draft report is attempting to draw a distinction between passive income and business profits more generally. That is, the notion of royalties is not limited to passive income. Royalties that are subject to Article 12 may be business income in the sense that the business earning the income is actively generating that income. It does not seem, however, that statement at the end of paragraph 30 "royalties are taxable only under Article 12 and not under Article 7" can be aligned with that thinking. Further, as noted above (paragraph 29), the draft report is calling for the rethinking of the relationship between Article 7 and Article 12. This would represent a fundamental shift in the nature of business taxation and is certainly not something that should be considered in haste. While the draft Commentary does not contain any language that would change the standard interpretation, it does provide:

> ***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 may be required before they can be recommended by the Committee of Experts.*** (Proposed para. 12.12, page 61 draft report, emphasis in the original.)

- While this language does not recommend any current changes, the language invites "evolution" and suggests that that greater analysis and detailed guidance only "may be required". This implies that guidance may evolve without such further analysis and detailed guidance. At a minimum, further analysis and detailed guidance "should be" required.

Conclusion

- Adoption of the draft report would result in a fundamental change from existing law on the taxation of royalties. The draft does not reflect the careful discovery of facts pertaining to business models or the careful legal analysis that would be necessary in

order to justify a such a fundamental change. The remaining term of the Committee is insufficient to complete the necessary work. Therefore, the work of the Subcommittee should be continued to the next Committee. Further, it is important to include representatives of business who understand the software industry and who can help the Subcommittee understand how the industry actually operates.

Sincerely,

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