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ICC Comments on UN Tax Committee 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

The International Chamber of Commerce (ICC), as the institutional representative of over 45 million businesses in more than 100 countries and in its capacity as Permanent Observer to the United Nations (UN) General Assembly, appreciates the opportunity to provide comments on the UN Model Convention Double Taxation Between Developed and Developing Countries (UN Model Convention) concerning the inclusion of software payments in the definition of royalties.

ICC advocates for a consistent global tax system, founded on the premise that stability, certainty and consistency in global tax principles are essential for business and will foster cross-border trade and investment; which is important for the economic development of all UN member countries.

GENERAL COMMENTS

ICC notes that the work of the Organisation for Economic Co-operation and Development (OECD) Inclusive Framework on the taxation of the digitalising economy (which includes many of the members of the UN Tax Committee of Experts) will have an impact on the current tax treatment of digital transactions and intangibles of all types, and therefore believes that this work should be completed and the results considered before any separate decisions are made with respect to proposed changes to the definition and the taxation of royalties in the UN Model Convention.

Software distribution and usage has changed dramatically in the last 10 years minimising the need for most software users to make a copy to use the software. ICC holds that these changes should be carefully considered in deciding the appropriate tax treatment of payments for software particularly when the proposal represents such a fundamental change from the existing law and practice in many countries. ICC suggests that input from industry to understand current and evolving software business and distribution models should be sought and considered in this respect. For example, digital services do not involve the transfer of technology; they are simply technology-enabled services and, as such, fall under Article 7 (Business Profits) of the UN Model Convention.

ICC notes that the current proposal does not reflect the consensus views of the UN Sub-committee members, which is especially important when considering such a relevant change to the UN Model Convention. A more thorough analysis and consideration of all the issues by the full committee, to attempt to achieve consensus, is required.

ICC believes that there are no principled grounds for altering the division of taxing rights for computer software payments and holds that the existing Article 7 treatment is sufficient in applying a principled division of taxing rights between source and residence states.

ICC considers that the proposal will likely result in a higher tax burden due to the generally higher withholding tax rate in source jurisdictions compared to the average corporate income tax rate in developed countries. ICC suggests that it is not timely for tax increases which could hamper economic growth, which is essential to rebuilding economies ensuing post-COVID recession.

ICC notes that gross withholding taxes do not take account of the costs of developing, distributing and updating the software, which are significant and often result in losses which must be recouped before a taxpayer can turn any profit. The imposition of withholding taxes in this context will require taxpayers to pass these costs on to customers, often local SMEs in their growth phase, through price increases which could adversely impact source country economic growth and disincentivise investment.

ICC fully supports a harmonised approach to ensure that international tax rules remain relevant and applicable in an increasingly digitalised global economy. In this respect, ICC believes that a departure from the existing UN, OECD or EU approach could lead to confusion, the likelihood of double taxation, tax disputes and increased compliance costs.

ICC, therefore, does not support the proposed inclusion of software payments in the definition of royalties and considers that the proposal does not justify the broadening of the scope of Article 12 and the re-allocation of taxing rights given that the proposal has not sufficiently taken into consideration the proliferation of research and tax policy review undertaken over the last few decades on this topic, the economic impacts on countries or companies, the interaction of the existing legal framework taxing such transactions or the fact that such a proposal will increase tax uncertainty and the potential for double taxation – which is contrary to a fundamental intended desire of the consultation.

ICC highlights below some of the additional risks in pursuing this proposal as follows:

a. **The proposed change to Article 12 broadens the scope of the royalty article beyond commercial exploitation of copyrights and creates taxing rights without sufficient factors to justify a reallocation of taxing rights from residence to source taxation.**
b. **Potential overlap with the OECD Pillar I work could lead to increased risk of payments for computer software being taxed twice in the source/ market jurisdiction.**
c. **Definition of computer software payments is not adequately defined within this discussion draft.**
d. **Taxation of payments on a gross basis can lead to double taxation / over-taxation and lead to misallocation of taxation rights.**
e. **Depending on the precise design and rate, taxation on a gross basis can put a foreign provider at a competitive disadvantage and increase costs for customers.**
f. **Additional confusion, double taxation, compliance costs and disputes will likely result in trying to address how these changes will apply to new business models.**

These points are elaborated on in further detail below.

SPECIFIC COMMENTS ON THE PROPOSAL

a. The proposed change to Article 12 broadens the scope of the royalty article beyond commercial exploitation of copyrights and creates taxing rights without sufficient factors to justify a reallocation of taxing rights from residence to source taxation.

Under the current rules, payments for the use of computer software do not generally qualify as royalties per se, only some of these payments can be classified as royalties if they are made primarily for the use or the right to use and economically exploit the copyright embedded in the computer software.

The OECD Commentary on Art. 12, for instance, refers to the right to use a copyright on computer software for commercial exploitation. The commercial exploitation of the copyright rights can be considered a key factor in determining when a license leads to royalties. Copyright rights include, for example, the right to reproduce the program for distribution to the public and the rights to modify the original program in a substantial and significant way.[1]

If the modification is just ancillary and unimportant, the license does not involve a right for tax purposes, i.e. a tax right. In other words, if there is no commercial exploitation, there is no transaction in copyright rights for tax purposes, and the license cannot give rise to royalties. Payments in these types of transactions, where there is not an exploitation of the protected right, are business profits in accordance with Article 7.

The UN commentary mirrors this approach in paras 13.1 ("exploit the rights that would otherwise be the sole prerogative of the copyright holder"[2]) and 14.4 ("exploit any right in the software copyrights").[3] Also here, payments in these types of transactions are business profits in accordance with Article 7.

Section 2 of the current UN Discussion Draft lists the reasons put forward by the members of the Committee who support the proposed change, and would like to include this type of payment within the remit of Art. 12, even in the absence of commercial exploitation. Para 8 clarifies that:

"*The commercial exploitation by the owner or creator of software is heavily dependent on the laws on the protection of intellectual property rights in the territory of exploitation, i.e. where the user is. Non-residents nevertheless benefit from the source country's legal system inasmuch as they rely upon it to protect and uphold intellectual property rights and enforce payment for transactions*."

In response it can be noted that the proposal is to include payments within the remit of Art. 12, even in the absence of commercial exploitation. The proposed change would therefore not only remove the distinction between payments for the use of copyright in software versus payments for the right to use the copyrighted article (a copy of the software program) (as noted by the members in Section 2), but also the important distinction between payments towards use of copyright in computer software with commercial exploitation (currently taxed under Art. 12) and towards use of the copyrighted article (without commercial exploitation - currently taxed under Art. 7).

The latter regards (i.a.) situations where there are no rights to reproduce the program for distribution to the public or rights to modify the original program in a substantial and significant way. On this basis, it is difficult to understand why - without commercial exploitation- non-residents would nevertheless benefit from the source country's legal system protecting copyright rights, since the license agreement clearly restricts the user's rights even beyond the restrictions under copyright law, there is no transaction in copyright rights to protect and uphold – apart from the (less likely) situation where there is a breach of the license agreement (protected by more general contract law).

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[1] The protected rights are exclusive rights of the copyright owner which typically includes the rights such as those to copy (excluding for own use, back-ups or necessary functioning of the computer software for its ordinary intended purpose), modify the original source code of the program or reproduce the program in a substantial and significant way, and exclusive distribution rights. The existing guidance, for instance, makes it clear that the distribution of standard computer software is not the exploitation of the underlying protected right, but is a regular commercial activity.

[2] 13.1 Payments made for the acquisition of partial rights in the copyright (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 licenses to reproduce and distribute to the public software incorporating the copyrighted program, or to modify and publicly display the program. In these circumstances, the payments are for the right to use the copyright in the program (i.e. to exploit the rights that would otherwise be the sole prerogative of the copyright holder).

[3] 14.4 Arrangements between a software copyright holder and a distribution intermediary frequently will grant to the distribution intermediary the right to distribute copies of the program without the right to reproduce that program. In these transactions, the rights acquired in relation to the copyright are limited to those necessary for the commercial intermediary to distribute copies of the software program. In such transactions, distributors are paying only for the acquisition of the software copies and not to exploit any right in the software copyrights. Thus, in a transaction where a distributor makes payments to acquire and distribute software copies (without the right to reproduce the software), the rights in relation to these acts of distribution should be disregarded in analysing the character of the transaction for tax purposes. Payments in these types of transactions would be dealt with as business profits in accordance with Article 7. This would be the case regardless of whether the copies being distributed are delivered on tangible media or are distributed electronically (without the distributor having the right to reproduce the software), or whether the software is subject to minor customisation for the purposes of its installation.

Furthermore, without commercial exploitation, it is also unlikely that there is any specific value being generated by the payor in the market into which computer software is being remotely sold.

Particularly in the absence of an active and/or sustained participation of a business in the economy of a market jurisdiction, it seems difficult to understand that the presence of a suitable telecommunication infrastructure in the source country[4] and population's competence in computers (alone) can be seen as sufficient factors to justify a reallocation of taxing rights from residence to source taxation.

Many of the arguments set out in section 2 of the document, are equally applicable to tools, machines, appliances, and devices, particularly in the age of the Internet of Things (IoT), automated features, smart devices, etc. Accordingly, ICC believes that they do not represent valid distinguishing characteristics to justify different tax treatment for software payments. In many of these examples, performance features are heavily dependent on software code, internet connectivity, data collection and transmission (e.g. cars, phones, jet engines, generators, locomotives, medical devices, robotic manufacturing, appliances, etc).

Paragraph 7 argues that with the advancements in means of communication and information technology, computer programs or other software constitute a key tool in the conduct of most businesses. As noted in para 7, "*Computer programs and other software allow enterprises that use them to reduce the time needed to perform their tasks, improve efficiency and cut costs*". Therefore, according to the text there is increased engagement in the economic life of states which justifies increased allocation of taxing rights to the state. In addition to the arguments outlined under section 3 of the document, it should be noted that source country tax revenues will benefit from the use of software. Such economic efficiencies and cost reductions allow local businesses to increase profitability, competitiveness, job creation leading to increases in business taxes on profits and wage taxes from employees. More generally, businesses purchase all products and services to increase their productivity, increase customer revenue, and reduce costs. Software products and services are tools purchased for the same reasons; therefore, the payment for standard computer software for personal or operational business use should not be treated, or taxed, differently than any other business input.

Paragraph 8 argues that commercial exploitation of the software is heavily dependent on the IP protection laws in the source state. In addition, the telecom infrastructure in the source state may also have a role in promoting the use of the software. This in itself does not justify a reallocation of taxing rights. This is particularly true where the infrastructure in question has been created and funded by significant investment by private businesses. Software developers (and/or the IP owner) rely significantly primarily on end user license agreements to limit customer use and protect their rights. These licenses can be more restrictive than copyright laws. IP protection laws and telecom infrastructure benefit a broad array of companies selling protected products and services into the source country, so this rationale does not justify different source country taxation for computer software payments.

Paragraph 8 also states *"Given that reproduction is so cheap and easy for computer software, there is greater dependence on source state protection."* ICC considers that this proposal within the UN discussion draft fundamentally misunderstands the use of software in any context other than software licensed for copy and distribution to the public. In the context of software services, the user has access to the functional output of the software but is unlikely to have access to any of the protected rights over the software, such as the ability to copy the service provider's software. As the transaction is not for copyright rights, there is minimal, or 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

[4] In case software is delivered over the Internet, it is likely to also involve telecommunication infrastructure in third jurisdictions - outside the residence and source country.

there is minimal or no value that is added by the copyright laws of the source state. Due to significant improvements in network bandwidth (funded by software developers) software users increasingly download their computer software program directly from the software developer, or rent software directly from the ‘cloud’, giving the software developer greater control, based on license keys, to prevent unauthorised copying. As such, ICC states that there is no justification for royalty characterisation of any payment when there is minimal, or no value added by the source state.

Paragraph 10 states that software payments are *“payments for use or right to use” software (e.g. the acquisition of “shrink-wrap” software involves a license for the use of the software itself) and are not payments for the sale of property”.* It is a well-settled matter of law and/or rule in many jurisdictions that the payment for a standard copy of a computer program is a transaction for a copyrighted article and treated equivalent to the purchase of a product.

However, in today’s digitalised economy, payments for many software services do not involve any transfer of a copy of the computer software from one party to the other (nor the provision of services by a technical expert). Albeit there is a transaction involving software, these are technology-enabled services rather than the transfer of technology. Therefore, ICC holds that such payments should be covered solely by Article 7 (business profits article) of the UN model convention. As copies of standardised software (i.e., shrink-wrap software) do not differ from other goods, they too are covered by Article 7, and the delivery format for the standard software should not delineate the tax treatment thereof.

Paragraph 11 states that “*that many countries already treat payments to non-residents in consideration for the use or right to use computer software as royalties under their domestic law”.* Whilst it is a sovereign right for jurisdictions to determine the treatment of software payments under their domestic law, ICC believes that this does not justify any changes to the UN Model Convention. Many countries do not treat these payments as royalties under their domestic law.

ICC maintains that the proposed change to Article 12 therefore broadens the scope of the royalty article beyond commercial exploitation of copyrights and creates taxing rights without sufficient factors to justify such a reallocation of taxing rights from residence to source taxation.

b. Potential overlap with the OECD Pillar I work could lead to increased risk of payments for computer software being taxed twice in the source/ market jurisdiction.

The sale of computer software was enumerated as a consumer-facing business (CFB) in the January OECD Inclusive Framework Outline on addressing the tax challenges of digitalisation. The draft Pillar I Blueprint clarifies that certain computer software that may be delivered online will be in-scope as Automated Digital Services (‘ADS’) and the same material delivered by a multinational enterprise (MNE) on a physical medium will be in scope as CFBs.

On this basis there is potential overlap of the proposal with Pillar I work leading to increased risk of computer software being taxed twice in the source/ market jurisdiction.

Given the potential impact and advanced stage of the Pillar I and II discussions, ICC recommends postponing discussions on revisions to the royalty definition until the conclusion of the Inclusive Framework Pillar I and II discussions in order to avoid duplicities and inconsistencies.

c. Definition of computer software payments is not adequately defined within this discussion draft

The term “computer software” as used in the Article is not adequately defined, and basically refers to the interpretation at the level of parties’ domestic legislation. As a consequence, there is a concern that the application of Article 12 will result in increased uncertainty, inconsistent treatment, and lengthy disputes between taxpayers and tax authorities.

The UN discussion draft also refers to the OECD commentary section 12.1 description of Software as: *"Software 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 standardised 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."*

The UN discussion draft reaches the assertion that "*increasing engagement with the State where the software is used justifies the allocation of taxing rights to that State*" and "*proposed change would remove the blurred distinction between payments towards use of copyright in software or copyrighted software and would thus promote tax certainty and reduction of disputes.*"

Separate to the issues arising from amending the taxing rights, as noted within this paper, the concern around the definition is that the proposal also fails to take into consideration the range of items that include computer software, nor the ways in which computer software is procured and used by businesses and end-users. Each of these points needs to be fully considered, as simply treating all the transactions that contain 'computer software' as royalties will create a perverse and distortive taxation result in different countries which also likely capture significant amounts of unintended transactions.

There are already appropriate rules and legal structures in place to deal with the delineation between cross border transactions which should and should not be contained within the definition of a royalty. Many jurisdictions have been able to establish and administer distinctions between payments for the use of copyrights and payments for copyrighted articles.

There are double-tax treaties (DTTs) around the world which do contain the word 'computer software' or 'computer programs' within the definition of 'royalties' and also a majority of countries where such definitions are excluded. Where the terms are included (e.g. in several of the US DTTs), there is also guidance (e.g. Technical Interpretation notes / Protocol's) which set out that the distribution of standard commercial off the shelf (COTS) software would not be within the definition of a royalty. Consequentially, simply including the word 'computer software' within the definition of a royalty will not eliminate uncertainty but will add to the potential amount of variable approaches taken by different countries.

The topic has been considered by multiple working parties previously within the United Nations, as well as detailed considerations by the OECD (for example, their report to the working party No.1 on the OECD Committee of Fiscal Affairs in February 2001 where they considered the tax treaty characterisation of 28 different categories of typical e-commerce transactions ('2001 report')). It is worth noting that the 2001 report identified different computer software related transactions which fell within the definition of royalties, as well as those which did not. The Technical Advisory Group for the 2001 report whose conclusions included the identification of multiple computer software transactions which should not be royalties included Ministries of Finance from Australia, Chile, China, Germany, India, Israel, Japan, Norway, United Kingdom and United States, as well as business representatives. Many of these countries (also being UN members) have detailed tax certainty positions (via law, practice and case law) which would be at opposition to the discussion draft from the United Nations and consequentially at fundamental risk of increasing tax uncertainty for countries as well as taxpayers.

d. Taxation of payments on a gross basis can lead to double taxation / over-taxation and lead to misallocation of taxation rights.

The imposition of a tax on a gross basis denies the taxpayer the ability to take into account expenses that were incurred in connection with the development and provision of computer software, which would be deductible if taxes were imposed on a net basis.

Thus, as noted also by the members in Section 2, it is possible that the Residence State's remedies for relieving double taxation may not be adequate to fully relieve the gross-basis taxation imposed by the other State. Consequently, taxation of computer software payments on a gross basis can lead to situations of double taxation.

In addition, there is a risk of over-taxation since revenue bears no necessary relationship to profit. For instance, selling shrink-wrap software can be considered a low margin business so that even a withholding tax set at a modest level could represent a significant percentage of taxable income of the seller.

Furthermore, withholding tax on computer software payments potentially imposes a higher tax burden (i.e. tax on gross receipts) on a company with no activities in-country (and hence no permanent establishment (PE)) than on a company that furnished those services through a local PE with significant substance in-country (and hence would be taxed only on net profits).

This again highlights the inconsistency of the proposed Article 12 with the established 'source' concept. Depending on the provisions for relief from double taxation agreed in a particular treaty, it also means that a potentially significant difference in the scope of double tax relief could emerge between treaty and non-treaty situations.

e. Depending on the precise design and rate, taxation on a gross basis can put a foreign provider at a competitive disadvantage and increase costs for customers.

A business' net economic returns for the activities in a country should be linked to the value functions within that location, and not solely linked to the popularity of an industry or to the ease of reproduction of computer software. If computer software is sold within a country, there are already alternate appropriate mechanisms in place to ensure that the value creating activities are appropriately captured within the tax system.

Placing additional taxation obligations into low-value-add and low-risk areas of this value chain undermines the principles of a fair return attributable to the relevant jurisdictions. There is no direct correlation between the amount of risk and investment a company makes in developing computer software and the economic viability of the product. Solely because this is intellectual property, it would be flawed to assume that the taxing right and process should be similar to interest.

The blanket approach of imposition of a withholding tax for all foreign computer software vendors on a gross basis may increase the costs of doing business in that territory and put the business at a competitive disadvantage, effectively foreclosing access to the market and restricting a legitimate choice of suppliers.

It is foreseeable that a computer software provider may seek to include a 'gross-up' clause within the customer contracts, to pass on the impact of withholding tax to the customer, in return increasing the net computer software cost in that territory. Essentially the increased cost which would be higher than that in other countries, could have a negative impact on cross-border trade productivity, and economic growth.

Further, with some countries imposing withholding tax and others not on comparable transactions, this could lead to distortive market places and in addition could lead to the inadvertent use of tax rule differences to favour competitive growth in some countries over others.

f. Additional confusion, double taxation, compliance costs and disputes will likely result in trying to address how these changes will apply to new business models.

The proposal to include computer software within the definition of royalties fails to consider the continuing evolution of different business models, and risks arbitrarily and artificially creating a new class of taxing rights for transactions which were not intended within the remit of the withholding tax rules.

As computer software becomes more integrated into a wider array of business models, adding 'computer software' to the royalty definition makes it increasingly challenging for all parties to apply the correct tax treatment to 'royalties', 'services or other commercial transactions subject to business profits', etc..

This uncertainty could lead to taxing the same income twice, additional compliance costs and disputes for companies and tax administrations as they seek to understand and apply consistency. Currently, there are clear examples of where different services are provided which do not fall within the definition of know-how (royalties) or technical services or other similar categories under which tax is withheld. For such transactions, there is considerable research and support for such service transactions to be treated as a business profit and taxed within Article 7 (business profits).

The royalty clause can apply without explicitly mentioning computer software, such as the commercial exploitation of any copyright right (e.g. books, music, movies). However, there are many instances where payments for computer software are not royalties. Making it unclear if a transaction, which may have been typically the domain of a business profit (for example payment for services), is now a royalty risks fundamental negative change if services-based payments are captured within the definition of a royalty because they contain an element of computer software.

Introducing such uncertainty within the UN proposal also increases the risks of unilateral approaches by tax authorities as they seek to reach a national position, which itself may be contrary to that of treaty partners. Unilateral measures in cross-border transactions usually leads to an increase in tax litigation and the likelihood of double taxation.

Overall, ICC considers that the proposals within the UN discussion draft are not justified by the facts and would fundamentally lead to uncertainty in the way that such transactions are taxed in different countries, and lead to additional compliance burdens for tax payers and tax authorities, as well as increasing uncompetitive practices between countries.

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