UNITED STATES COUNCIL FOR INTERNATIONAL BUSINESS

October 2, 2020

To: Subcommittee on the United Nations Model Tax Convention between Developed and Developing Countries

Re: Comments on the discussion draft on the inclusion of software in definition of royalties

USCIB appreciates the opportunity to provide comments on the proposed changes to Article 12 and its Commentary.

Overview

USCIB believes that the current guidance provided by Article 12 and the Commentary to Article 12 of the UN Model[1] is generally correct and does not need to be updated. USCIB, therefore, believes the proposals in the discussion draft should be rejected. If, however, the UN decides to proceed, then the work of the OECD Inclusive Framework on the taxation of the digitalizing economy should be completed and considered before proposing changes with respect to the definition and the taxation of software payments within the context of the royalties article. The OECD's work is expected to have an impact on the current tax treatment of digital transactions and intangibles of all types, including the role of withholding taxes on royalties. Any updates to the royalties article would, therefore, be premature before this work is completed.

Software distribution and usage has changed dramatically, minimizing the need for, and the ability of, the vast majority of software users to make a copy of the computer program to use the software. 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 treaty guidance, and domestic law in many jurisdictions. Input from industry to understand current and continually evolving software business and distribution models should be sought and considered.

The draft report overestimates the ability of companies to achieve market penetration in their significant markets for sales or licensing of software without a local presence. In order to develop a market, business needs a local presence including local marketing, sales support, and customer 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, and install, configure and optimize software programs, in the absence of local presence and support.

[1] UN Model Commentary on Article 12, paragraphs 12 through 17.4.

Gross basis withholding taxes take no account of the costs of developing, selling, distributing, updating the software, and providing customer support. Even though this important consideration was mentioned in the discussion draft, it bears repeating that, these costs are significant, often resulting in tax losses in the early years of development in the country where development occurs and where other unsuccessful software projects may be undertaken. In order to recoup such losses, it is essential that income from the selling and/or licensing of software is taxed on a net basis in the state where it is developed. As taxation on a gross basis does not take into account expenses incurred by the taxpayer in earning the payments for use of that software, it may not be possible to get full credit for taxes paid in the country where the software was developed (which taxes on a net basis). Taking this into account, imposition of withholding taxes may cause vendors to pass such taxes on to customers through price increases adversely impacting source country economic growth. Gross basis withholding taxes may also "cascade" if that software is used to create other software (e.g. developer tools), digital content, or end-products incorporating software (e.g. imbedded software). This would be more likely if the value-chain is split among multiple jurisdictions. Passing on the cost of the withholding tax may be more likely or even essential if the tax "cascades" as the cost of the tax could easily exceed profit, especially for software start-ups.

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. Now is not the time for tax increases (whether borne by companies or consumers) which will act as a barrier to the economic growth which is needed to pull economies out of post COVID-19 recession and restore country tax bases. The ability of technology companies to efficiently distribute their software and other products will be key drivers of economic recovery.

The current UN Model Convention generally achieves correct administrable results

As stated above, USCIB believes that the current guidance provided by Article 12 and the Commentary to Article 12 of the UN Model[2] is generally correct and does not need to be updated. USCIB also generally supports the arguments against the proposal (beginning on page 6). Article 12 of the current Model includes within its scope royalties as defined under Article 12(3) which provides:

> The term "royalties" as used in this Article means payments of any kind received as a **consideration for the use of, or the right to use, any copy-right of literary, artistic or scientific work** including cinematograph films, or films or tapes used for radio or television broadcasting, any patent, trademark, design or model, plan, secret formula or process, or for the use of, or the right to use, industrial, commercial or scientific equipment or for information concerning industrial, commercial or scientific experience. (Emphasis added.)

[2] UN Model Commentary on Article 12, paragraphs 12 through 17.4.

Copyright rights exist to protect the copyright owner and prohibit others from exercising copyright rights with respect to the copyrighted work (such as a computer program). Copyright protection applies to the software source code. Copyright rights are protected by the national copyright laws of the country in which the author seeks protection, regardless of where the author lives or where a work was first published.

There are four copyright rights relevant to the analysis under Article 12(3) for software:

i. The right to reproduce the copyrighted work
ii. The right to distribute copies of the work to others
iii. The right to make derivative works based on the copyrighted work
iv. The right to perform or display the work publicly

If the software copyright owner permits the payor to exploit the copyright in the market by exercising one or more of the owner's copyright rights with respect to the work in exchange for a payment, the payment for the use of the copyright right would be a royalty under Article 12(3). This is the conclusion reached under the Commentary to Article 12(3). Whether such a right has been granted would be determined under the contract between the copyright owner and the payor. The discussion draft indicates that this distinction is "blurred." We do not believe that is the case. The customer license agreement (e.g. End User License Agreement or EULA, OEM License Agreement, etc.), which is generally more restrictive than copyright law, will either restrict the use of the computer program to internal purposes or allow the further commercialization of the copyright on the market by reproduction and distribution. The purchaser of a software copy does not require a copyright license to use the software, because personal use of a software program does not constitute copyright infringement under copyright law. The "user" of a copyrighted article (e.g. the individual copy of a computer program, book, song, movie) does not exploit the copyright rights in the market, any more than the purchaser and reader of a book exploits the copyright or the purchaser and user of a machine incorporating patented inventions exploits the patent.

A copyright owner may, by contract, transfer or assign all or a portion of its exclusive copyright rights to another party. In which case, the income from the transaction would be treated either as the sale of a copyright or as a royalty.

USCIB acknowledges that software copyright licenses permitting the copying of computer programs for sale to the public do exist, are characterized as royalties, and subject to withholding taxes depending on the treaty agreements (e.g. OEM licenses to computer manufacturers permitting them to load software onto computers).

A copyright owner may also give another party permission to use (or "license") a copyrighted work without transferring its copyright rights. When a copyrighted work is used under this type of license, the payor is not obtaining a copyright right, but a contractual right to use a copyrighted article. Today's technology does not require the payor/user to copy the software in order to use it. In this case the income from the transaction would be treated as business profits.

Software is generally provided under a license agreement that provides additional, contractually based protections for the copyright owner not available in copyright law. Nevertheless, the use of the word "license" and not "sale" does not convert a permission to use the copyrighted work into a transfer of copyright rights.

There should, therefore, be no difference in tax treatment between the acquisition for internal use of a copyrighted software article and the acquisition for internal use of a copyrighted literary article (e.g., a book) or a copyrighted artistic work (e.g., a photograph).

Similarly, the character of payments for the exercise of the right to reproduce the copyrighted article and distribute copies on the market is a royalty, regardless of whether the copyrighted article is a software copy, a literary work or an artistic work. There should be no difference in tax treatment between the different types of copyrighted works.

Application of Article 12 to all software creates boundary issues

USCIB believes that the proposed definition would create far more issues concerning the application of Article 12 than it solves.

Applying Article 12 to all software would bring an extraordinarily large class of goods and services within scope of royalties withholding taxes. The definition of software for this purpose is as follows:

> 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.

In a digital world, software is ubiquitous and, in most transactions, does not require or result in any payment. Given the proliferation of digital technology, an ever-increasing number of goods (and potentially services) will incorporate some form of operational software, driver software (which allows products to interact with each other) or application software. This extends beyond personal computers, phones and tablets. It may also include goods as broad and varied as home electronics (e.g. televisions, gaming consoles and printers), electric appliances (e.g. fridges), smart utilities (such as smart meters for electricity and gas), vehicles (e.g. cars, planes and boats), industrial equipment (automated production equipment, generators) , medical devices (monitors, surgical equipment), and all manner of personal electronics, which might include device drivers to allow them to work with a computer (e.g. electronic headphones). This list only skims the surface of in-scope goods given the wide range of tools businesses might use that come with an in-built CPU, interface or function that relies on software (e.g. a barcode scanner or

bank/credit card reader). In the case of goods or services that rely on or have in-built software, all of these transactions should be treated as transactions in physical goods, not software.

Payments for development, improvement, or maintenance of software should not be within scope of the proposal as such payments are not made to obtain copies of software (copyrighted articles) or for the right to use software. Inclusion of payments for such services would subject an even broader class of payments to withholding tax (e.g. payments for IT support).

Rationale for the proposal does not justify the special rules for software

There are no principled grounds for altering the current division of taxing rights. Article 7 treatment today is sufficient and applies a principled division of taxing rights between source and residence states.

Many of the arguments set out in section 2 of the document are equally applicable to tools, machines, appliances, and devices, especially in the age of IoT, automated features, and smart devices. Accordingly, 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).

Paragraph 7 of the discussion draft 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, and 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 so software 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. Software revenue is not heavily dependent on copyright protection. Software developers rely primarily on end user license agreements to limit customer use and protect their rights. These licenses are more restrictive than copyright laws. To the extent that governments do provide protection for investors relating to the enforcement of contracts, this is no different than other industries. If the contract is governed by the law of the supplier's state, then it is not the market country state which provides the forum for the supplier and

customer to protect each of their commercial rights. Paragraph 8 of the discussion draft also argues that, 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, particularly when, as is often the case, the infrastructure in question has been created and funded by significant investment by private businesses.

Paragraph 8 of the discussion draft also states: *"Given that reproduction is so cheap and easy for computer software, there is greater dependence on source state protection".* Entitlement to common legal protections that are afforded by most countries to all forms of intellectual property cannot serve as a rationale for shifting taxation rights on software to the destination state. Additionally, the assertion of greater dependence on copyright protections fundamentally misunderstands the technological evolution in the way software to delivered to users and customers. With the online platforms, app stores, and other modern software distribution and delivery models, there typically is less reliance on the copyright laws of the "source" state. Due to significant improvements in network bandwidth (funded by software developers) software users are generally prohibited from copying the software and instead download their computer software program directly from the software developer, giving the software developer greater control, based on license keys, to prevent unauthorized copying. As such, there is no justification for allocating a taxation right to the market state when there is minimal or no value added by the market state.

Paragraph 10 states 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 computer program copy is a purchase of a copyrighted article, equivalent to the purchase of a product. As standardized software does not differ from other goods it too should be covered by Article 7.

The justifications advanced by proponents applied on an equal basis to other sectors would require WHT on cross-border payments for many other services, including software consulting. It is further noted that analogous arguments could be made for other, common goods, including, for example, cars, which rely on the user jurisdiction to have:

i. infrastructure such as roads, traffic lights and road signs;

ii. a legal framework for the enforcement of road rules;

iii. proficiency with vehicles within the driver population; and

iv. further, the design or certain parts of the car may be protected by patent in the user jurisdiction.

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".* It is a sovereign right for jurisdictions to determine the treatment of software payments under their domestic law, but that does not justify any changes to the UN Model Convention. There are

also many countries which do not treat payments for the use of computer program copies (copyrighted articles) as royalties under their domestic law.

Other concerns

Many types of software are either built-in or free to download and use. The companies that develop the software do not charge a fee for the software; they may instead earn revenue via related or unrelated goods and services. Sometimes this may be charged through an app or it could be charged separately. Such application of software can arise in a variety of industries, including financial services, food delivery, home electronics and electronic games. It is noted that in many cases the provision of software may be purely incidental to the delivery of the service itself. As noted above, it is entirely unclear whether the provision of application software without a fee is subject to a withholding tax and, if a withholding tax were to be levied, the base upon which that withholding tax would be calculated. If a withholding tax is not chargeable where an identifiable payment is not made for the software, companies would be incentivised to adopt indirect fee models simply to avoid a withholding tax. In some cases, such as in-app purchases for computer games, such models result in greater costs for consumers when compared to one-off payments. On the other hand, if fees not directly related to software are subject to withholding tax simply because software is used in the delivery or preparation of a good or service, that would subject an impractically large class of payments to withholding tax.

It is unclear how individuals or small businesses would be able to efficiently deduct and pay withholding tax when they purchase software nor how governments would obtain the expertise to allow them to consider boundary definitional issues and whether to grant relief under double tax agreements. In the case of individuals, USCIB is concerned that the discussion draft may attempt to shift the burden for withholding to financial intermediaries that would not be in a position to know what is being purchased and are unlikely to have access to funds to collect any tax due.

Conclusion

As stated above, USCIB believes that existing Article 12 and its Commentary generally reach the correct conclusion and, therefore, the changes proposed by the discussion draft should be rejected. The discussion draft is not a consensus document and in fact members of the Sub-committee have raised significant objections which we generally support. If these changes are not rejected, differing views indicate a more thorough analysis and consideration of all the issues by the full committee is required. The Committee should also consider the potential impact of a departure from the existing UN and OECD approach. An uncoordinated change will lead to confusion, disputes and increased compliance costs. Because this topic is within the scope of the ongoing Inclusive Framework project on digitalization, which project includes many of the Committee members in their official capacities, we believe it should not be prioritized to burden the limited resources of the Committee.

USCIB has many members that are familiar with the software industry and we would be pleased to provide additional background or explanations if that would be helpful to the Committee.

Sincerely,

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