E/C.18/2015/CRP.6

Distr.: General
13 October 2015

Original: English

Committee of Experts on International Cooperation in Tax Matters
Eleventh Session

Geneva, 19-23 October 2015
Agenda item 3 (a) (v)

Article 12 (Royalties)

a.) The meaning of "industrial, commercial and scientific equipment"
b.) Software payment-related issues

Outline

1. The current version of the United Nations *Model Double Taxation Convention between Developed and Developing Countries* was adopted in its present form most recently in 2011 (the "Model").

2. The Model and the Commentaries on its Articles reflect the parallel Articles and Commentaries of the Organisation for Economic Cooperation and Development's (the "OECD") *Model Tax Convention on Income and Capital* which most recently was updated in July 2014 (the "OECD Model"). The Articles and Commentaries are not identical, reflecting different influences on their development commonly attributed to the balance between the interests of "developing" and "developed" countries. For present purposes, it is convenient, though not meant to be restrictive or judgmental, to refer to salient OECD Model experience as the adopted experience of the UN unless there are clear reasons to qualify that apparent adoption. *It should be said at the outset that references to the OECD Model and its Commentaries, and its historical development in the relevant regard, are meant only to provide an objective framework for the present discussion, and are specifically not meant to suggest that the course of the Model should follow that of the OECD Model or that the influences that bear on the Model are the same as those that have animated the development of the OECD Model.*

bear a royalty characterization under private law. Ultimately it is for a taxing jurisdiction to determine whether and how its charges to tax are configured, including whether they follow and build on, or alternatively overcome limitations of, the private law to which tax law and tax treaties are accessory. It may be important for this discussion about the significance of Article 12 that the Model would treat as "royalties" payments which intrinsically, as a legal matter, do not have or bear that character.

15. The design of Article 12 in relation to "industrial, commercial and scientific equipment" was sensitive to the avoidance of double taxation as a general objective of a tax treaty. In that regard, defining "royalties" to include payments for the use of such property can be seen as not solely to allow for the assertion of (withholding) taxation rights, but also to set limits on the taxation of "business profits" consistent with those found in Articles 5 and 7. At the same time Article 12 defers to those other Articles where a

1963 and 1977 OECD Models addresses, are payments for the use of property, i.e., equipment, to recipients resident in what would now be considered to be intermediate or conduit jurisdictions (with favorable treaties with "source" countries), the capital of which was owned by residents of third countries; in short, there has been a persistent "treaty shopping" awareness and concern inchoate in Article 12 and its development, and in the difference in Model and OECD Model versions.

23. With these concerns in mind, which evidently were in the view of the Fiscal Committees of both the OEEC and the OECD, to achieve identifiable objectives that arise naturally from those concerns, the Model still, and the OECD Model formerly did define "royalties," a term that may or may not depending on applicable private law of treaty partners have this connotation, to encompass payments for the use of business property other than intellectual and cultural property, and to include payments for the use of "industrial, commercial and scientific property". That is, as does any deeming or like rule, the Model declares payments and underlying property interests to be something that otherwise they otherwise are not or, to hedge, may not be. This Note, for the time being, does not explore the notion of "royalties" further, although depending

41.

58. Are there further inferences to draw? Perhaps. Despite the somewhat awkward construction of Article IV in the Mexico Model, Articles IV(2) and (3) could be seen as reflecting the presumption that a taxpayer would, at least, have a permanent establishment where it resides, in its home country where it is what amounts to a tax citizen. But, even so, if the taxpayer was able to carry on business in the source country without establishing a permanent establishment there, Article IV(1) would confine taxation to the source country, without recourse to the multiple permanent establishment allocation rule in Article IV(3), if dealings "in" the source country, which might in the circumstances be or even only be dealings "with" source country residents, would be considered to be "carried out" in the source country. Alternatively, there may be an implied assumption that at least in the commercial circumstances of the day, it was more likely than not that carrying on activities would entail having a business presence where those activities are carried on, i.e., a permanent establishment for any meaningful business activities touching a source country. All of this reflects pressure on what "carried out" means, a persistent question that manifests itself in different guises in international tax matters, for example, in connection with determining corporate residence and where broadcasting and catalogue (the modern analogue is internet) sales businesses are conducted, and even at present, in connection with digital transfers and digital products as they are being studied by the OECD in the BEPS project. This is a question that has caused some countries to adopt extended statutory definitions of carrying on business for which commercial contacts alone with residents of a source country are sufficient to establish the existence of business dealings there.

59. All of that said, what is considered important for the present inquiry in this Note is that there is an evident sense in the Mexico Model, which is most closely identified with the Model in its attention to source country taxation, that a taxable connection to a source country may and even should exist merely because commercial activities occur there and, more generally, commercial opportunity arises and is enjoyed because of those contacts. In short, merely carrying out activities in a source country may be sufficient to sustain source country taxation. Possibly more pointed was the expressed concern that imposing a permanent establishment limitation on source country taxation might allow business profits that should be taxable by the source

compass of the "royalties" article and providing for exclusive residence country taxation.

64. The commentary to the Mexico Model Convention is recalled. Despite the specific and seemingly exclusive reference to particular intellectual property and cultural royalties, a broader compass of "scientific, industrial and commercial property" from a jurisdictional perspective in relation to business income earned vicariously through the use by others of an owner's property (giving rise to business income for the owner in the only way in which it could be earned) still may have been in the institutional mind of the Fiscal Committee. In view of the commercial dealings of the day it is not hard to imagine this possibility notwithstanding that the most common manifestation of property for which royalties were paid may have been intangible. The point of this observation is to suggest that at least directionally the underlying perception and conception of royalties around the time of the Mexico and London Model Conventions may have been broader than the Conventions' language suggest, regardless of the different and seemingly more limited approaches to allocating taxing rights.

65. The debate concerning this development of the royalties article, which presaged the formulation and adoption of 1963 OECD Model with these two features in Article 12 was conducted with an explicit awareness of source country interests in relation to the taxation of business income.[24] "Royalties" for the use of "industrial, commercial or scientific equipment" apparently were seen as business profits. Two concerns pervaded the discussion. The first was whether business profits from conducting commercial enterprise in a source country otherwise would go untaxed by the source country, or perhaps any other country, in the absence of a source country permanent establishment. The second was whether the delivery of user rights without the need for a taxable business presence in the source country allowed non-residents to organize their affairs so as to direct payments for those rights to low tax jurisdictions, particular where the recipients of those amounts would not be considered, possibly, to be what modern treaty practice describes as their beneficial owners.

66. Accordingly, aniJ -0.004 d922()-2(i)-2(ng c)42(he)4(di)-2(s)-1(c)4(us)-1(s)-1(i)-2(on. T i)-2f T

similar questions with which Article 12 contends and which persist concerning software. Broadly, within the residence orientation of Article 12, the container analysis was consistent with that for “equipment” more generally.

72. All of this may be seen as reinforcing a restatement or interpretation of the Committee’s question according to the approach taken in this Note. This may help to illuminate and understand why the precise nature or kind of “equipment” or software may be less important than whether it is the object of a letting or use transfer,

73. In effect, the question raised by the two species of property addressed by this Note is whether a non-resident owner of this property who makes it available for use by a source country resident should be considered, vicariously or possibly collaboratively as if in partnership with the source country resident, to carry on business where the source country resident resides (and, possibly, if different where the property is actually used).

74. From this perspective, Article 12 may be seen as a surrogate or covert manifestation of Articles 5 and 7, with ulterior anti-tax avoidance elements.

75. This commentary has focused on “equipment” because that has been actively considered in the evolution of Article 12. Conceptually, however, equipment can be considered to comprise any implement, even possibly a virtual implement that is provided by one to another for use subject to reversion intact. In so far as “software” is concerned, either it includes intellectual property that is addressed by Article 12, in which case the allocation of taxing rights contemplated by Article 12 applies, or it is seen as a composite in the nature, perhaps, of equipment to which Article 12 applies (in the case of the Model) or not (under the OECD Model).

76. Similar issues concerning “mixed” or “bundled” contracts encountered in examining services are also present here. The Commentary to Article 12 of the Model and to Article 12 of the OECD Model, as well as the Committee’s ongoing work to understand how services should be addressed by the Model including to consider a specific services Article, are sufficient to explain the issue of “mixed” or “bundled” contracts and how, if a particular aspect is primary and not incidental or ancillary, that aspect would be categorized among possibly competing Articles. This Draft Note, at least for the time being, will not address this issue.

The BEPS Inquiry – Directionally Consistent Perceptions

77.

78.

83. In both cases, but possibly more acutely with respect to “software” rights to use property or assets that are in the nature of “equipment” and “software” co-exist with rights to obtain or use other “things” through “mixed” or “bundled” contracts that in addition m

87. This is another situation in which, apart from narrow or non-contextual definitions of "equipment" or software, contract characterization may be important to determine whether and to what extent Article 12 does or should apply, anticipating as in the case of other "mixed" or "bundled" whether comparing "operating" versus "financing" leases payments are exclusively or primarily for the "use" of property or whether they combine or aggregate payments of other kinds such as a purchase price or principal and interest notwithstanding that the property is used in the same manner as if acquired by way of a user arrangement such as a lease.

88. Article 12 is seen, with Articles 10 and 11, as one of a trio of distributive rules mostly concerned with withholding tax and closely identified with earning income passively rather than actively.

89. There is, however, a material distinction, subtle though it may be, between financial capital addressed by Articles 10 and 11, and property that is "let" to others for compensation. This is reflected in Article 12, which provides no protocol or rate limitations applicable to source taxation, but simply preserves the application of source country taxing rights where they otherwise exist.

90. Financial capital has an inchoate return potential that exists apart from what the capital is used for. The use of the capital by its owner, for example by lending money, is the trigger for that return even if the user of that capital does nothing with it. The lender is paid the time value of that capital, which could, presumably be realized to the same extent by providing it to others. In other words, there is no special connection or allegiance between an investor in shares or interest bearing debt, and the investee to whom the capital is transferred for limited or indefinite use. That is the case even if it is the business of the provider of the financial capital to make it available and it does that in a business-like way. It lies in the nature of money and its value set by external markets what the return is or should be for its use.

91. By contrast, "equipment" and software embed no inchoate return of this nature. Despite parallels, and acknowledging that there is some doubt, the capacity of let property that is not financial property lies in its specific utility to perform a function. The return only arises from the use of this property; an inherent return in the property is not being released in the same way as for financial property. Rather, it is the utility and use – the particular use and the manner of use – that creates a return that otherwise did not and would not exist. The possibility of generating such a return arises from the use of the property in particular circumstances, assuming credit worthiness of the use from the circumstances of use rather than from a mere release of value inherent in the property which could be captured in a host of alternative settings where money capital could be used.

92. This distinction makes it more plausible to perceive what amounts to a *functional* partnership or co-venture between the provider of "industrial, commercial or scientific equipment" and software, and the user, with the user being, in effect, the means by which the owner of the property uses the property in a business setting to create a return – a flow of revenue - that otherwise would not exist, through external use of the

specific references to various manifestations of intangible property, it is reasonable to conclude, regardless of any particular other features, that "equipment" is any tangible property that is capable of being used without being depleted by another, as a device or tool, for a utilitarian purpose. The same is the case for software, except that it, or the valuable aspect of it, is not tangible and may already, to some extent, be captured by the specific kinds of intellectual property to which Article 12 in any case applies.

f. A source country could mitigate "slippage" in the taxation of business profits by adopting, possibly through bilateral negotiations, particular definitions of "industrial, commercial or scientific equipment" (and each component of that phrase, i.e., "industrial," "commercial," "scientific" and "equipment") and / or software, to preserve or expand taxation of business profits that otherwise might escape both Articles 5 and 7 and Article 12 and, otherwise, to identify particular elements of "mixed" or "bundled" contracts that do fall within Article 12's reach. However, it is not clear why that would be necessary. The connotations of "industrial," "commercial" and "scientific" seem clear enough when understood as devices to allocate taxing jurisdiction over business profits and otherwise there would be indifference, for Article 12, in their meaning, i.e., these are unlikely to be associated with portfolio returns, but even if they were it is not likely that Article 12 would not apply.

i.