‘Royalties’ paid for work done & Software royalties under the OECD and UN Models

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‘Royalties’ paid for work done

Last time: *distinction between:*

A – income from rendering a service

B – royalty income: income from exploitation of existing knowledge and experience (‘EKE’)

> *example:* difference between junior lawyer and senior lawyer

> *extreme case*: retired lawyer sells copies of a top-level opinion he prepared earlier

‘Royalties’ paid for work done

Database

An internationally operating industrial group maintains a central Knowledge & Solution Center (‘KSC’) which provides paid technical support to the group’s operating subsidiaries all over the world. In addition, KSC provides the subsidiaries also with paid access to intra-group technical information.

Before 1995, this information was provided through loose-leaf manuals; thereafter through a database. Like the loose-leaf manuals, the database is continuously updated by a specialized staff of 20 engineers. A small part of the information in the database is IP-protected but most of it is know-how (‘EKE’).

Group companies pay for access to the database. When those payments are cross-border, are they covered by Art. 7 or (also) by Art. 12:

- before 1995 (printed loose-leaf manuals)?
- from 1995 (online database)?

Scope of royalties

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Italian Revenue Agency Ruling No. 493/2020

- An Italian company makes annual payments to a Swiss resident singer as remuneration for the alienation by the singer to the Italian company of his exclusive worldwide right to exploit his studio recordings and the recordings of performances (‘recording rights’).
- The annual payments are a percentage of the amount of royalties received by the Italian company for licenses it issued to third parties for the use of the recordings
- Under Italian IP law a ‘recording right´ is not considered a proper ‘copyright’ but a ‘neighbouring right’.
- issue: is income from ‘neighbouring right’ covered by the royalty definition in the Italy-Switzerland treaty: :

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 copyright of literary, artistic or scientific work including cinematograph films, any patent, trade mark, 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.

Scope of royalties

Italian Revenue Agency Ruling No. 493/2020 *cont'd*

- The Italian company requested treatment of the annual payments as royalty, because in earlier years it believed it was not a treaty royalty and therefore subject to unreduced Italian wht rate (30%) !!
- Italian Revenue Agency: in sec. 18 of OECD Comm on Art. 12 mention is made to a 'copyright in [a] sound recording' and therefore (¿ Art. 3.2: context overriding domestic law meaning ?) Art. 12 should be applied.
- *Bad ruling:*

  -- *annual payments, regardless of contingency, are clearly for alienation of a right: capital gain*

  -- *they are not covered by royalty definition because of absence of reference to 'other rights"*

Scope of royalties

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Italian Revenue Agency Ruling No. 139/2021

- An Italian movie production company enters into an agreement with a Spanish resident movie actress under which she receives payments that reflect for *60% remuneration for her acting* and for *40% for the alienation* by her to the Italian company of her exclusive worldwide image rights.
- Under the Italy-Spain tax treaty income from acting is covered by Art. 17: taxation in the country of performance at ordinary tax rates, whereas under Art. 12 royalty payments may be taxed at 4%. Royalties are defined as 'payments for … the use of, or the right to use, copyright of literary, *dramatic, musical* or artistic work.
- Under earlier Italian case law image rights, in same way as recording rights, are treated for tax purposes as 'neighbouring rights'
- Sec. 9.5 OECD Commentary on Art. 17 (Entertainers & Sportspersons): income from image rights is covered by Art. 17 if closely connected to a person's performance in a given state. Available facts do not show in which countries the movie was marketed
- Italian Revenue Agency: image right component of payment covered not by Art. 12 but by Art. 17.

Scope of royalties

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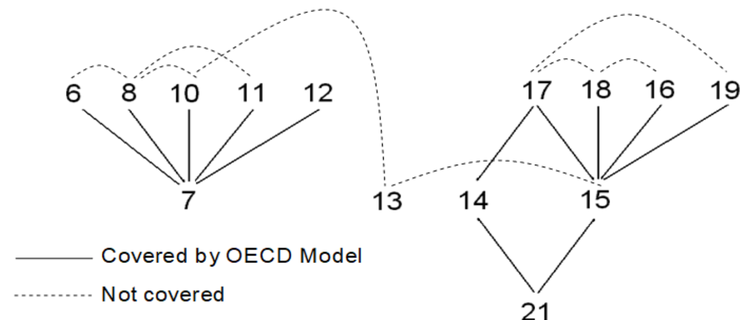
Italian Revenue Agency Ruling No. 139/2021 *cont'd*

- See below: overlap between distributive rules often not dealt with in OECD Model
- What to do in case of overlap:
  - >> *lex specialis* overrides *lex generalis:* often does not work in these cases as both rules are special
  - >> simultaneous application (treaties restrict)

4. The scopes of the distributive rules

b. Scope with regard to the nature of the income -- overlap among articles



Hierarchy of articles within the OECD Model

Payments for software

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Preliminary

Which OECD / UN Model distributive rules could be applicable to payments involving intellectual property rights ?

Residence State [RS]

Other State [OS]

Art. 7: RS only (unless through PE in OS)

Art. 12.1: OS may (UN) or may not (OECD) apply wht

Art. 13.2: gains from alienation of movable property (*incl. intangible property: Comm. 13/24-3d: 'incorporeal property'):* RS (unless effectively connected with OS-PE)

Art.s 12 + 13: priority over Art. 7 (see Art. 7.4)

Payments for software

Thus: if no PE:

– if income: is Art. 12 applicable? (if not: Art. 7: generally no OS taxation)

– if capital gain: Art. 13: generally no OS taxation

Difference between income and capital gain

more difficult issue with *intangible* property than with (movable and immovable) *tangible* property:

ownership:

- title: to dispose of the property (bare property)
- right to use (usufruct) & to grant use to others

gain (avoiding terms 'income' and 'capital gain') from granting to others *use of property*: *e.g.*, renting out building for 10-y period:

\>> disposal of a *partial* ownership right in the building
(2x 'partial': only right to use, only during 10 y)

Payments for software

Sec. 8.2 OECD Commentary on Art. 12:

“In case of payments made in consideration for the alienation of rights that constitute *distinct and specific property* (which is more likely in the case of geographically-limited than time-limited rights), such payments are likely to be commercial income within Article 7 or a capital gain matter within Article 13 rather than royalties within Article 12.

That follows from the fact that where the ownership of rights has been alienated, the consideration cannot be for the use of the rights. The essential character of the transaction as an alienation nation cannot be altered by the form of the consideration, the payment of the consideration in installments or, in view of most countries, by the fact that the payments are related to a contingency.

Further on issue whether the disposition of a limited right gives rise to capital gain rather than income: perhaps relevant whether the transfer reduces the value of the remaining ownership:

>> if reduction: alienation of property: capital gain; if not: income.

Art. 12: The definition of royalty

OECD Model -- current

2. 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 copyright of literary, artistic or scientific work including cinematograph films, any patent, trade mark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience.

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 **copyright** of literary, artistic or scientific work including cinematograph films,
  - > any **patent, trade mark, design or model, plan, secret formula or process**, or
– for **information** concerning industrial, commercial or scientific experience.

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Art. 12: The definition of royalty

UN Model -- current

3. 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 copyright of literary, artistic or scientific work including cinematograph films, *or films or tapes used for radio or television broadcasting*,

> any patent, trade mark, 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.

Payments for software

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How to fit in software payments in Art. 12.2 definition of royalties ?

Are they for use of 'literary, artistic or scientific' work:

- ☐ yes, if so covered by national copyright law
- ☐ otherwise: addition in definition 'computer software'

Payments for software

Art. 12: The definition of royalty

UN Model -- proposed

3. The term “royalties” as used in this Article means payments of any kind received as a consideration

a. for the use of, or the right to use,

i. any copyright of literary, artistic or scientific work including cinematograph films, or films or tapes used for radio or television broadcasting,

ii. any patent, trade mark, design or model, plan, secret formula or process, ~~or~~

iii. ~~for the use of, or the right to use~~ industrial, commercial, or scientific equipment, or

iv. computer software;

b. for information concerning industrial, commercial or scientific experience*, or*

c. for the acquisition of any copy of computer software for the purposes of using it.

Payments for software

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OECD Commentary Art 12.2 (*definition royalty*) :

1963: 9 lines

1977: expanded but focus on rental fees equipment, and on know-how

1992: addition of some sections on software

2000: many additions on software

2008 & 2017: some further additions & amendments

Commentary on Art. 12: 3 examples of Art. 7 v. Art. 12 applicability:

- Sec. 14: making copy only to 'enable the effective operation of the program': making use of this right to copy: to be disregarded for tax classification of payment: not Art. 12 (income from granting to a person the use of IP) but Art. 7
- Sec. 14.2: same if 'site license': if right granted [a] to *make* copies, and [b] to distribute to others: clear: Art. 12

Query: what if only distribute: see 14.4

- Comm 14.4: distributer only purchases copies for resale (no exploitation of rights in the software); cf. bookseller: Art. 7

Payments for software

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Transfer of rights

- Comm. sec. 16: if the transfer concerns a '***distinct & specific property***': generally ***not Art. 12 but Art. 13 (or: Art. 7***: clear that Art. 13 is not subordinate to 7: see sec. 72 of Comm on Art. 7.4: 'income')

  even if:

  - additional payments for actual use (contingency payments): is simply *form of compensation*
  - restricted to particular area
  - ? if restricted to particular period

  because if ownership is transferred: no possibility charging for use

- Some states disagree: Spain, Portugal, Mexico: Art. 12 in all cases in which less than FULL prop is transferred (sec 28: Obs on Comm
- Also UN disagrees: royalty; arguments: *[a]* use within given state, *[b]* IP protection by that state, *[c]* use of that state's telecom infrastructure, *[d]* obtaining use (= downloading) is simple & inexpensive. >> Therefore: include 'software payments' in Art.12.2 royalty definition

Payments for software

Software: interaction with:

UN (draft) Art. 12B ('Income from automated digital services'):

- para. 5: 'The term "automated digital services" as used in this Article means any service provided on the Internet or another electronic network, in either case requiring minimal human involvement from the service provider.'
- para. 7: Art. 12B does not cover royalties that are covered by Art. 12 (& 12A: *technical service fees*): border lines between 12, 12A, 12B, 7,13.

UN (draft) Commentary on Art 12, sec. 21: *examples:*

– a payment in consideration for the online acquisition of a copy of standardized accounting software for use in a business would be within the scope of Article 12 and therefore would be excluded from Article 12B

– a merchant provides free application software to facilitate the on-line purchase of goods: payment for sales of such goods, incl. the software component, will give rise to business profits which are subject to Article 7

Other payments

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OECD Commentary on Art. 12, sec.s 17.1-17.4

- *[17.1]* Non-software payments: for products like *images, sound, text*: treatment by analogy: identify core purpose for which payment is made:
  - *[17.2]* right to make copies for trading: Art. 12
  - copy only to enable download / storage / operation: Art. 7

- *[17.3]* General: downloading *software, images, sounds, text*:
  - for customer's own use & enjoyment: transfers happens to be in digital format (rather than physical): Art. 7
  - *[17.4]* opposite: downloading by book publisher of images from internet to be used in cover of a book to be published: Art. 12

Payments for software

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Supreme Court of India

2 March 2021 – Engineering Analysis Center of Excellence

- payments to foreign computer software manufacturer / supplier / distributor/ by Indian end-users of the software, or
- payments by Indian end-users for software included in hardware:
  do not create any right to use a copyright: *i.e.* no transfer of copyright

In addition: Indian government had referred to its position on:

- text OECD Art. 12 [Position of non-member countries]: '4.1. INDIA reserves the right to define royalties and fees for technical services particularly by reference to its domestic law' and
- OECD Commentary on Art. 12: '17. INDIA reserves its position on the interpretations provided in paragraphs [many]; it is of the view that some of the payments referred to may constitute royalties'.

- positions taken on the Commentary do not affect [the interpretation of] a tax treaty (unless treaty language amended to reflect that position).
- (*generally:*) taxpayers should be able to rely on the Commentary to understand their positions

Takeaways