The Tax Treatment of Software

(adopted by the OECD Council on 23 July 1992)

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I. INTRODUCTION

1. In recent years computerisation has become increasingly common in business and industry and one of the main issues arising from this technological explosion relates to the development and transfer of "software" across national borders. This is a major concern of the OECD, principally because trade in software is a substantial part of the total work on "trade in services". A report entitled "Software: An Emerging Industry" was published by the OECD in 1985. The report was prepared for the Committee for Information, Computer and Communications Policy by an *ad hoc* group of experts from member countries. The report discussed developments and trends in the field of software. A discussion of the cross-border taxation problems arising from this modern day phenomenon is of considerable importance. The tax issues are relatively unsettled, and for this reason the Committee felt it would be useful to analyse these questions with a view to reaching agreement on the appropriate tax treatment and in particular whether these questions can be resolved under existing provisions in double taxation conventions.

2. The major issues which this report considers are

- the commercial law and practice of member countries in relation to software rights;
- the nature of payments for software;
- the taxation treatment of software payments by member countries under their domestic law and double taxation treaties;
- the application of the Model Convention and the need for any clarification or amendment of its provisions.

II. CHARACTERISTICS OF SOFTWARE

3. Software can best be described as a programme or series of programmes containing instructions for a computer. In a technical sense, there are two kinds of software. System software is aimed at the operational process of the computer itself (*i.e.* operational software), while application software consists of programmes for using a computer to accomplish specific tasks. These purposes may be specified by a single client/user, a group of client/users, or may result from a marketing effort by the software developer.

4. In general, software is the result of ideas and concepts arising out of research and development efforts. The result is generally a programme which can be described, can be written on paper, or can be carried on a magnetic medium (tape or disc) or an optical medium (a laser disc). The transfer of software may happen through the transfer of the carrier itself or by cable or satellite.

5. Application software may consist of standard software with a wide range of applications or may be special software (tailor-made for single users or to be applied by the developer itself).

6. Both system software and application software can be an integral part of a tangible asset, *i.e.* the hardware. Examples are system software as a part of production equipment and application software for the specific use of equipment such as a word processor.

7. On the other hand, software can have an independent form – often referred to as "canned software" – which can be used by a variety of hardware (with some minor modifications for the different types of computers) and may be applied as information systems for management, consulting and administration.

III. DEVELOPMENT OF SOFTWARE

8. Software is generated by research and development with the result that R & D costs are a major part of the cost of software. The production of software can be generally described along the following lines. The first stage (R&D) constitutes planning, designing, coding and testing the concept for its adaptability into a programme. When the technical feasibility of the programme is established, a master programme is designed. In order to make the product available for release to a specific customer/user, to a specific group of users or to the market generally, the master will be customised to the extent necessary and depending on whether the programme is standard or specific, then made ready for copying and transfer.

9. Software may be developed for internal use, for use by related (foreign) companies or for sale to third parties as part of equipment, as a master copy or as copied and canned software.

10. The results of research and development projects can vary widely from development of software products with a sizeable profit potential to development of software products which either produce losses or are abandoned without any commercial exploitation. Generally one profitable product will have to compensate for the economic failures on many unproductive research efforts. Thus the royalty rates on software (as a percentage of product sales) are often higher than other, more traditional royalty arrangements (*e.g.* patents). For example a royalty rate of 25% of sales is not unusual and may even be on the low side. It is also of relevance that technical obsolescence is very rapid.

IV. TRANSFER OF SOFTWARE

11. Transfer of software can take a variety of commercial forms. Software can be transferred as a separate identifiable product ("unbundled") or transferred as a component in a hardware/software package ("bundled"). It clearly contains elements of intellectual property, and the question thus arises as to whether in conveying software, the transferor is also conveying a licence both to use and to reproduce for sale the ideas contained in the software. Arm's length commercial contracts normally cover this point by spelling out the rights conveyed and the limitations on such rights. Such limitations can have implications for income tax as well as for customs duty and sales tax.

12. Commercial contracts often involve the use of intermediaries as distributors of a finished product, or as assemblers of the elements of a finished product, with software acquired separately from the hardware. Such intermediaries can be economically independent or related.

13. Transaction involving software often grant buyers the right to subsequent improvements in the software or the right to request installation, maintenance and performance review services. Payments for these services may be separately identified, included in a gross price or form part of instalment payments. Additionally, the consideration in contracts covering software can take the form of a front-end lump sum payment, a front-end lump sum plus subsequent periodic payments based on sales (or some other measure of use) or exclusively periodic payments with no front-end payments. The fundamental economic characteristics of the arrangements may represent a transaction in goods, in services, in intellectual property, or in a combination of all three.

14. Another aspect of the subject concerns so-called service centres which are operated by independent firms, on a contract basis, to provide full-line hardware and software services to their clientele, or run payrolls, maintain inventory records, prepare financial statements, prepare plans, draft engineering drawings, monitor operations etc. These centres can also perform independent telecommunications services. Service centres can be solely operational (*i.e.*, perform services using software produced by a related or independent "software house") or they can have a considerable in-house capability for programming (*i.e.* developing their own software). They can be large or small. Large MNEs typically have their own computers and accordingly their own service centres serving a number of their constituent members. An enormous range of experiences and situations must be expected. Software driven communications and computer services are linked through service centres. They can for part of an MNE's centrally-shared services.

V. MULTINATIONAL ENTERPRISES AND SOFTWARE USE

15. MNE groups use software to control specified activities such as inventory, purchases, sales, manufacture orders, billing and payroll; to prepare financial accounts; to control day-to-day plant operations; to monitor repair and replacement of physical assets; to handle engineering and design functions; to prepare financial and market estimates etc. Many MNEs have their own computer operations including software development capability. Alternatively they can purchase software for use by their in-house computers. To produce software an MNE can buy a basic "package" and modify it with internal staff programmers to meet local conditions in each country in which the package will be used. More often, because an MNE's requirements are unique, it must develop internally the basic software package and provide adaptations of local conditions in various countries in which it operates and intends to use the software.

16. For MNEs providing a greater degree of local autonomy, local members satisfy their software needs out of local resources (internal and external) but are mindful of the need to ensure that results are compatible with the software of the other group members. Where autonomy within the MNE is less extensive, it is more common to develop and provide software from the central unit (*i.e.* the parent or service centre) of the group to the operating units in the field. The operating units may require a substantial amount of local programming to adapt software obtained from central units or from third parties.

17. Consequently, within an MNE group as a whole – and within the individual component entities – the following pattern of activities may be involved in the acquisition and exploitation of software:

1. Purchase or licence of software from a third party:
   a) resident;
   b) non-resident.
2. Creation *ab initio* or modification of acquired software by:
   a) internal staff;
   b) external service bureau or software house;
   c) individuals retained on contracts for short periods or per project.
3. Transfer of software within the group and across borders:
   a) as internal services involving
      – no charge,
      – a cost charge,
      – a specific transaction with a mark-up;

b) as capital assets with specific territorial rights and subsequent service rights;

c) by identifiable licence.

4. Maintenance and follow-up services to keep software current, which are provided:

a) cost free;

b) at cost;

c) at market price.

5. Operational services which are provided:

a) cost free;

b) at cost;

c) at market price.

18. Since software used for internal purposes frequently requires substantial time and expense to adapt to local needs, and common basic programmes have substantial "group" value (as contrasted to "individual entity" value), access to group software resources is often at low (or no) cost rather than at a "fair" cost charge that can be difficult to calculate. Additional direct costs are of course borne by the user.

19. Where MNEs utilise software as an internal control of production feature and not as a product, the transfer of software to affiliates is perceived by the business community as a service rather than as a transfer of a right to use a piece of intangible property.

VI. PRACTICE OF MEMBER COUNTRIES

20. In order to establish the taxation practices of member countries in dealing with software payments the Committee used a questionnaire which is reproduced as Annex 1. It sought information on the legal classification of software under their domestic laws, their tax practices as the country of residence of the recipient of software payments, the status of software payments in relation to their double taxation treaties and their views on whether the Model Convention required clarification or amendment. The responses to the questionnaire are summarised in Annex 2.

Legal classification

21. All OECD member countries give legal protection under domestic legislation to the intellectual property in software. In all countries except *Switzerland*, the protection is given under copyright law. In some countries protection is regarded as implicit in copyright law but there is a notable trend

for countries to make the protection statutorily explicit. There is significant variation in the extent of protection. Protection may be limited to authors producing significant or unique work. It may be extended to adaptations of existing work and sometime to adaptations by persons other than the original author.

22. For income tax purposes, member countries see no legal distinction between system software and application software nor whether software is "bundled" or "unbundled". Such distinctions may be of significance in certain countries for the purposes of turnover tax, VAT or custom duties.

Tax classification – source country

23. The purpose of this part of the questionnaire was to determine

- in which circumstances payments relating to software are classified under domestic law as a capital gains matter;
- when they are not classified as such, in which circumstances under domestic law they are treated as payments for goods or services, or royalties.

The analysis of the replies shows the following trends.

Capital payments

24. Most of the countries which replied on this point consider that it is a capital gains matter where there is an outright transfer of software implying the transfer of all rights which are attached to it. Some consider that it is also a capital gains matter where:

- hardware is acquired with built-in software;
- the payment is in the form of a lump sum and in consideration of the right to use software for a significant period (three years is most often referred to).

Royalties or payments for goods or services

25. All countries except *Switzerland*, *Norway* and the *Netherlands* have powers to impose tax at source on royalty payments. Six countries also tax payments for goods and services at source. Certain countries draw no distinction between whether a software payment is for goods or services or represents a royalty payment; some because they do not tax payments in either category, the others because they exercise rights to withholding tax in respect of both. If a distinction has to be made for example because a country has taxing rights in respect of royalties only, then the total consideration is broken down on a reasonable basis having regard to the terms of the contract which defines what is provided in return for the payments in question.

Tax classification – country of residence

26. When a resident receives a payment as consideration for transfer or all or part of the rights attached to software, the tax treatment of the receipt reflects the underlying nature of the transaction in most countries. The receipt is treated as business revenue if the rights transferred are comparable to inventory. Receipts are generally treated as a capital gains matter where the rights transferred are in the nature of fixed assets. Some countries also regard as a capital gains matter lump sum receipts or receipts in return for the grant of an exclusive right of use or of a right of use for a specific number of years (for example three years).

27. For many countries the question of whether income relates to goods and services or represents a royalty is of no relevance to its tax treatment. For countries where a distinction is necessary the income is broken down on a reasonable basis having regard to the particular terms of the contract.

28. When the payments have been taxed in the source country, the country of residence applies its domestic laws which may or may not prevent double taxation. No country has special provisions for software.

Double taxation conventions

29. There are differences between member countries regarding the classification of "capital" payments relating to software. Some are of the opinion that these payments come under Article 12, for example when they relate to the use of software; others think that Articles 7, 13 or 14 might apply depending on the facts of the particular case. In most countries, software payments that are not regarded as a capital gains matter may fall to be dealt with under Article 12 or Articles 7 or 14, depending on the facts.

30. Where payments comprise elements for both goods and services and for royalties, a majority are in favour of applying Article 12 of the Model Convention solely to the royalties element. *Greece* and *Australia* consider that Article 12 normally applies to the whole of the payment.

31. In their bilateral negotiations, few countries aim to adopt Article 12 of the Model Convention in its entirety. Variations mainly consist in introducing additional items in the definition of royalties or in providing for the application of withholding tax. Only *France* has specifically referred to software in recent conventions.

32. In cases where a party to a convention has exercised rights of taxation in respect of software payments, classifying them in a different way from the domestic law of the recipient's country, the latter country will generally grant double taxation relief or seek a mutual agreement with the source country in accordance with Article 25.

33. Three countries are of the opinion that the text of Article 12 of the Model Convention ought to be amended. *Italy* and *Luxembourg* propose that the term software should be specifically mentioned in the text. *France* suggests that software should be dealt with in the same way as cinematograph films, namely by referring to the "product" (the software) and not the rights attached to the "product", whether these rights are copyrights or rights of another kind. Other countries think either that no amendments should be made to the Model Convention or that it would be sufficient to include clarification in the Commentary on Article 12 (and if necessary on Articles 7, 13 and 14) regarding the tax treatment of software.

VII. THE APPLICATION OF THE MODEL CONVENTION

34. The Articles of the OECD Model Double Taxation Convention which may be relevant to the tax treatment of software are:

- Article 7 (Business Profits);
- Article 12 (Royalties);
- Article 13 (Capital Gains);
- Article 14 (Independent Personal Services).

35. The tax treatment applying to payments between residents of two countries poses no problems when those countries have concluded a double taxation convention which conforms in all respects to Article 12 of the Model Convention, which does not allow for withholding tax on royalties in the source State. Suppose that payments are made by an enterprise of State S (the State of source) in favour of an enterprise of State R (the State of residence). State S will only be able to exercise taxing rights in respect of the payments if the enterprise of State R has a permanent establishment in State S and if the software which gives rise to the payments is/was effectively connected with such a permanent establishment. Otherwise taxation is solely a matter for State R.

36. The definition of "royalties" in paragraph 2 of Article 12 includes among others payments of any kind made for:

a) the use of or the right to use any copyright of literary, artistic or scientific work;

b) the use or the right to use industrial, commercial or scientific equipment;

c) information concerning industrial, commercial or scientific experience.

37. The Commentary on Article 12 specifies in particular that

- as regards copyright, the definition applies whether or not that right has been or is required to be registered in a public register;
- as regards equipment, a distinction must be made between royalties paid for the use of equipment (which fall under Article 12) and payments constituting consideration for the sale of equipment (which depending on the case fall under Articles 7, 13, 14 or 21).

However, in the report entitled "The Taxation of Income Derived from the Leasing of Industrial, Commercial or Scientific Equipment" (published in 1985 under the title "Trends in International Taxation") the Committee recommended not including under the definition of "royalties" income derived from the leasing on industrial, commercial or scientific equipment where a convention provides for the taxation of royalties in the source State.

VIII. PROBLEMS RELATING TO SOFTWARE PAYMENTS

Problems described

38. Many bilateral treaties between member countries maintain a limited rate of tax at source on royalties generally or on particular types of royalties. Twelve countries have indeed entered a reservation against the zero rate provided in Article 12. As bilateral treaties which provide for tax at source on royalties usually adopt the full definition of royalties in paragraph 2 of Article 12, a number of countries exercise taxing rights at source on many types of software payments on the grounds that they represent royalties.

39. Source taxation of software payments raises questions of principles and of practical application. As regards the latter, it is necessary to determine

- which of the various types of payments relating to software represent royalties;
- how payments effected under mixed contracts are to be dealt with.

Analysis

40. The Committee examined whether it was in principle appropriate to regard software payments as within Article 12. It took into account the following:

a) Article 12 recommends a zero rate of tax on royalties with the intention of protecting royalties from taxation in the State of source except to the limited extent provided by paragraph 3 of Article 12.

b) Taxation of royalties at source may lead to taxation on a gross basis which disregards the expenses incurred by the payee in earning the royalties. In some cases this may result in unrelieved double taxation

when the State of residence is unable to credit fully the tax withheld at source because it taxes the royalties on a net basis.

c) Taxation on a gross basis occurs only in the absence of a permanent establishment; if a royalty is effectively connected with a permanent establishment, the effect of Article 7 together with paragraph 3 of Article 12 is to ensure taxation on a net basis. Paradoxically the less the connection of the payee with the State of source, the greater his tax burden there.

The Committee noted that nevertheless within OECD there was near unanimity in affording protection to software rights under copyright law. It concluded from this that software payments made for the right to exploit intellectual property in software could not be separated from copyright royalties generally. It was not able to recommend that software payments should be regarded as entirely outside the scope of Article 12. There are, however, difficulties in applying the copyright provisions of Article 12 to software royalties since paragraph 2 of the Article requires that software should be classified as a literary, artistic or scientific work. None of these categories seems entirely apt, but treatment as a scientific work might be the most realistic approach. Countries for which it is not possible to attach software to any of those categories might be justified in adopting in their bilateral treaties an amended version of paragraph 2 of Article 12 which either omits all references to the nature of copyrights or refers specifically to software.

41. The Committee also examined the question of the boundary between software payments in the nature of royalties and software payments of other kinds – a problem which gives rise to considerable difficulties.

First hypothesis: partial transfer of rights

42. The first hypothesis is that of payments made in circumstances where less than the full rights to software are transferred. Some countries argued that payments made in consideration of a partial transfer of intangible rights attached to software were within the broad scope of the definition in Article 12 even when the leasing of equipment is excluded. They considered that it was not appropriate to distinguish according to whether:

- a single payment or payments spread over a period of time are involved;
- the rights of use are transferred for a limited period or otherwise;
- the transferor of the rights is the author of the software or another person downstream in the commercial exploitation of the software.

They accordingly expressed the view that in all of the above circumstances the payments are taxable in the State of source (State S) if the convention between

State S and the State of residence (State R) of the recipient provides for the taxation of royalties at source. The royalties received in State R are also taxable there in accordance with its laws. State R must eliminate double taxation in accordance with the convention for example by giving a tax credit.

43. The contrary view of other countries was that the intention of Article 12 was to eliminate source taxation and that the definition of royalties had to be interpreted more narrowly so as to limit its scope. They considered that an important distinction had to be drawn between:

- the acquisition of software for the personal or business use of the purchaser;
- the acquisition of software for commercial development or exploitation.

In the first situation, they considered that the purchaser had done no more than purchase a product and that the payment fell to be dealt with in accordance with Article 7 or Article 13 as appropriate. They did not consider it to be relevant that the product was protected by copyright and that there were restrictions on the use to which the purchaser could put it. In the second situation, they agreed that the payments were made for rights to exploit intellectual property and accordingly were likely to be royalties. Examples of such exploitation included the reproduction or adaptation of software for onward distribution. In such situations, payments to the owner of the copyright were likely to be royalties especially if they were related to the number of products distributed.

44. The solution to these crucial differences of view must lie in the definition of royalties in paragraph 2 of Article 12: "The term "oyaltie" 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 [...] any patent [...]". On the broad interpretation, the mere purchase of a product protected by copyright or a patent is likely to result in the payment of a royalty as consideration for use of the product. The narrower interpretation is that "use" as referred to in the Model Convention is limited to use by an acquirer who seeks to exploit commercially the intellectual property of another. A substantial majority of the Committee took the firm view that the narrower interpretation was correct. They felt that paragraph 1 of the Commentary on Article 12 which describes royalties in principle as "income to the recipient from a letting" made the position clear. As the outright acquisition of a product (*e.g.* a computer programme) for simple use by the purchaser could not represent any form of letting it clearly could not give rise to a royalty within the meaning of Article 12.

Second hypothesis: transfer of all rights

45. In the second hypothesis, the payments are effected as consideration for the final transfer of all the rights attached to the software. In this case there was general agreement that the payments were in consideration for the acquisition of the software without involving questions on rights to use it. The provisions of Article 12 were not applicable.

46. A further question is whether it is appropriate to classify certain other transactions as a transfer of software such as:

- those whose purpose is to transfer the exclusive right to use software during a specific period or in a limited geographical area;
- those involving additional consideration related to the usage of the software;
- those which comprise substantial lump-sum payments.

47. Countries have differing practices in their treatment of such transactions and it is impossible to draw a clear borderline between payments which are properly to be treated as a capital gains matter and those that are royalties within Article 12 in every situation. Nevertheless there are clear principles to be followed in determining the nature of the transaction. Firstly, regard must be had to the precise terms of the contract under which the software rights were transferred. Secondly, where a transfer of ownership of rights has occurred, payments cannot be for the use of the rights. Finally, the form that the consideration takes, whether payment by instalments or, in the view of most countries, payment related to a contingency, is irrelevant in determining the character of a transaction.

Mixed contracts

48. The Committee finally considered payments under mixed contracts. Examples of such contracts include:

- sales of hardware with built-in software;
- concessions of the right to use software combined with the provision of services.

49. The problem of mixed contracts also arises in other fields, for example in respect of patent royalties and know-how. The Commentary on Article 12 discusses the problem at paragraph 12. It recommends breaking down the total amount of the consideration which is payable under the contract on the basis of the information contained in the contract or by means of a reasonable apportionment and then applying to each apportioned part the appropriate tax treatment. When, however, some of the parts are of an ancillary character compared to the principal part, the treatment applicable to the latter part may be extended to the entire consideration. Mixed contracts relating to software

do not therefore pose any problem of principle since the approach in the Commentary for other types of mixed contracts is appropriate.

Specific example

50. An enterprise purchases a computerised machine tool. If a single payment were made, some countries would regard it as paid solely for the acquisition of an asset. If, however, further payments were required to be made, related for example to the number of times the machine was used or the number of products manufactured on it, then they would recognise the additional payments as royalties within Article 12. Other countries would regard the payment as partially for the acquisition of the asset and partially for the right to use the operating software. They would accordingly apportion the payment and treat the latter part as representing a royalty. Unless the latter part were minor or ancillary, they would apply source taxation.

IX. CONCLUSIONS

51. The subject of software payments is of undoubted importance in view of the rapidity of technological developments in recent years. The subject does not, however, raise new issues of principle. Rather it highlights in a new form long-standing difficulties especially regarding source taxation and the scope of Article 12 of the Model Convention. The Committee considered nevertheless that it was a useful subject of study and that it would be helpful to set out how the Model Convention is to be interpreted specifically in relation to software payments.

52. The conclusions of the Committee are that:

a) Payments made in connection with software represent royalties within the meaning of Article 12 only in circumstances where there is a limited grant of rights (not amounting to a change in ownership) for the commercial development or exploitation of the software. Payments for software, whether "bundled" or not, which is acquired for the personal or business use of the purchaser do not represent royalties.

b) Payments made for the alienation of all rights attached to software do not represent royalties. The characterisation of payments made for more limited alienation of rights (as described in paragraph 46) may depend on the precise terms of the relevant contract but in circumstances where there is alienation of ownership, the consideration paid does not represent a royalty in the view of most countries.

c) Where countries adopt in their bilateral conventions the zero rate of withholding tax recommended in Article 12, problems in connection with software payments cannot arise since the taxation of such payments is solely a matter for the State of residence of the recipient except to the extent that the payments are effectively connected with a permanent establishment in the State of source.

d) Where a double taxation convention provides for source taxation in respect of some but not all royalties, it is expected that software payments that properly have the characteristics of royalties will normally be classified as paid in respect of copyright.

e) It is the responsibility of the State of residence to relieve any resulting double taxation where the terms of a bilateral convention with a State of source permits the latter to exercise rights of taxation in respect of software payments. Any difficulties in the application of the convention should be resolved under the mutual agreement procedure of Article 25.

f) The terms on which technology is transferred across national borders within multinational enterprises should conform with the arm's length principle underlying Article 9.

g) No changes to the text of the Model Convention are required but it is recommended that clarification of the treatment of software should be included in the Commentary on Article 12 (with cross-references to Articles 7 and 14) in accordance with Annex 3 to this Report.

APPENDIX 1

QUESTIONNAIRE ON TAX TREATMENT OF SOFTWARE

1. Legal Classification

   1.1 Is protection provided under your domestic legislation for the intellectual property in software?

   1.2 If it is protected, is it under the copyright legislation, patent legislation or other form of legislation?

   1.3 If it is protected, does it apply only to the author or does it also cover those who may adapt or transform the software?

   1.4 Are the following distinctions of significance in your internal law?

      1.4.1 System or operational software and application software,

      1.4.2 Software as an integral part of hardware or canned software,

      1.4.3 Bundled or unbundled software product, and

      1.4.4 Other distinctions?

   1.5 Please add any remark which may facilitate understanding the legal classification of rights related to software.

2. Tax Classification as the country of source

Assume that payments for the use of software are made by a resident of your State to a resident of another State with which you do not have a tax treaty.

   2.1 Under your tax legislation would you classify any payment from the use of software as a capital payment?

      2.1.1 Only if it was for the outright acquisition of all rights relating to the software.

      2.1.2 In other circumstances and, if so, what?

      2.1.3 No.

   2.2 Under your tax legislation, under what circumstances would you classify a payment, other than a capital payment, as either:

      2.2.1 A payment for goods and services?

      2.2.2 A royalty payment?

   2.3 Where payments are for a right to use and for services under a contract requiring advice and information to be provided without any separately stated consideration, would you, in any circumstances, break down the total consideration into the separate elements of payment for services and royalty payment respectively?

2.3.1 If no, is this because there is no power in your legislation to enable this to be done?

2.3.2 If yes, on what basis is the split calculated?

2.4 Does your country provide for taxation at source on the following payments:

2.4.1 A capital payment?

2.4.2 A payment for goods and services?

2.4.3 A royalty payment?

2.5 In each case referred to in 2.4 is this because they are:

2.5.1 Classified as royalties?

2.5.2 For some other reasons?

2.6 If they are classified as royalties subject to tax at source, does the definition of royalties in your tax legislation coincide with the definition in Article 12 of the Model Convention and, if not, how does it differ?

3. Tax classification as the country of residence

Assume that payments for the use of software are made by a resident of another country with which you do not have a tax treaty to a resident of your country.

3.1 Under your tax legislation would you classify any receipt for the use of software as a capital payment

3.1.1 Only if it was for the outright disposal of all rights relating to the software.

3.1.2 In other circumstances and, if so, what?

3.1.3 No.

3.2. Under your tax legislation, under what circumstances would you classify a receipt, other than a capital receipt, either as:

3.2.1 A receipt for goods and services?

3.2.2 A receipt for royalty?

3.3 Where payments are for a right to use and for services under a contract requiring advice and information to be provided without any separately stated consideration, would you, in any circumstances, break down the total consideration into the separate elements of receipt for services and receipt for royalty respectively?

3.3.1 If no, is this because there is no power in your legislation to enable this to be done?

3.3.2 If yes, on what basis is the split calculated?

3.4 Are there any provisions in your tax legislation that would prevent you from giving a credit for the tax due to the country of source (or from exempting the receipt) that do not apply to income received from residents of other countries generally?

4. Are the distinctions referred to in 1.4 above relevant for any of the answers in paragraphs 2 and 3 above and, if so, how and in what ways?

5. Double taxation conventions

5.1 Do you consider that the payments and receipts referred to in 2.1 and 3.1 come under Article 12 of the Model Convention? If not, under which Article would you consider them to fall?

5.2 Do you consider that the payments and receipts referred to in 2.2.1, 2.2.2 and 3.2.1, 3.2.2 come under Article 12 of the Model Convention? If not, under which Article would you consider them to fall?

5.3 In the cases described in 2.3 and 3.3 would you apply Article 12 to none, part only or all of the payment/receipt?

5.4 Do you generally adopt Article 12 of the Model Convention in your tax treaties with other member countries? If not, please describe the main deviations?

5.5 When a right to tax royalties at source is provided, do you take the definition of "royalties" found in Article 12 as is or do you modify it (and if the latter, please specify)?

5.6 If you consider that Articles other than Article 12 apply to software payments, do you make any special provision in your treaties for software?

5.7 Where you have a treaty with the country of source which has exerted taxing rights having classified the income differently from your internal law, would you give double taxation relief and if so how and upon what measure of income?

5.8 Do you consider that the Model Convention and its Commentary need to be revised to deal in a clearer way with software payments and, if so, what suggestions would you make?

5.9 Any other comments?

APPENDIX 2

REPLIES TO QUESTIONNAIRE ON TAX TREATMENT OF SOFTWARE

1. Legal classification

	1.1 Does domestic legislation protect?	1.2 Is this Copyright or other?	1.3 Does protection apply only to author, are adoptions covered?	1.4 Are certain distinctions significant? (See full Questionnaire)	1.5 Other Remarks
Netherlands	Yes	Copyright by case law	Includes licencees who adopt or transform	No	Legislation pending to include software
Australia	Yes	Copyright	Adaptations by owners and others	No	Inquiry into aspects of copyright protection
Greece	Indirectly	Copyright by case law possible	Others may be protected depending on contract	No	–
Ireland	Yes	Copyright	Only author	No	Not specifically included in copyright yet
Sweden	Yes	Copyright	Some adaptations	No	Software considered as literary work
Switzerland	Only partial	No copyright but some other protections	Where protected can include adaptations	1 & 2 Yes 3 & 4 No	–
United States	Yes	Copyright and some others	Owner of copyright, adaptation not usually covered	No	Definition of computer program included in copyright act
Germany	Yes	Copyright and possible patent	Author, some rare additions	Protection may apply only to sophisticated programs	See 1.4 high standards needed to gain protection
Austria	Yes	Copyright	Includes adaptations	No	Single program may not qualify as literary work. No specific mention in legislation

1. Legal classification *(cont.)*

	1.1 Does domestic legislation protect?	1.2 Is this Copyright or other?	1.3 Does protection apply only to author, are adoptions covered?	1.4 Are certain distinctions significant? (See full Questionnaire)	1.5 Other Remarks
Spain	Yes	Copyright	Includes subsequent versions	3 may be of significance	Computer software specifically included
Japan	Yes	Copyright	Some adaptations	No	Software included specifically in copyright law
United Kingdom	Yes	Copyright	Some adaptations	No	Specifically included as copyright
Norway	Yes	Copyright	Some adaptations and transformations	No	Regarded as literary work not specifically included in legislation
France	Yes	Copyright	Yes, adaptations and transformations	Bundling effects accountancy treatment	–
Luxembourg	Yes	Copyright	Extends to adaptations	–	–
Italy	Yes	Copyright	–	Copyright if software independent. If integral then follow treatment of hardware	–
Portugal	Yes	Copyright	–	–	No specific legislation
Denmark	Yes	Copyright plus others	Extends to adaptations	–	Computer programs usually copyright. User manuals literary works
Canada	Yes	Copyright	Extends to adaptations	No	–
New Zealand	Probably	Copyright	Some adaptations	Not for tax, but may affect patent law	Copyright protection is unsettled but believed to exist
Belgium	Not directly	Copyright by case law	–	Yes, if integral part of hardware then treat as hardware. Others may be intangible property	Probable that protection will be introduced

2. Classification as country of source – I

	2.1 Under what circumstances are payments for software capital?	2.2 Are non capital payments classified as goods and services or royalties?	2.3 If payment covers services and right to use is a breakdown necessary?	2.4.1 Is tax deducted at source from payments for capital?
Netherlands	Capital for acquisitions with useful life of at least 1 year	No distinction	No, no tax at source on royalties	No
Australia	Generally revenue, capital if sold with hardware	For all practical purposes as royalty	No, both treated as royalty	No
Greece	No specific provision	As royalty	No	No
Ireland	On facts, outright acquisition: capital	Goods and services if stock, most others royalties	Yes, on a fair and reasonable basis	No
Sweden	Capital if custom made and life more than 3 years	Goods and services if stock, royalty if licence fees periodical	Yes, split according to value	No
Switzerland	No taxation of royalties at source, no distinction	No distinction for tax purposes	No, no tax distinction	No
United States	Acquisitions: capital, payments for use: revenue, look to substance	Question of fact	Yes, depends on facts	Generally no. Some exceptions
Germany	Acquisition or unlimited use: capital	Goods and services if dominant part. Royalties if payment for limited right to use	Yes, if material, on a just and reasonable basis	No, with exceptions
Austria	Capital if valuable asset	Standard software goods or services, if technical experience, then royalty	Yes, if material, on just and reasonable basis	Yes, if for use of technology
Spain	Capital if acquisition or lump sum for several years usage	Royalty if ownership of property remains, so tax significance	Yes, reasonable basis according to contract	Yes
Japan	–	Case by case basis	Yes	Yes if for use
United Kingdom	Acquisitions capital. Lump sum can be capital	Royalty unless bought as stock or for distribution	Yes if material, based on contract	Yes if for use
Norway	Capital if considerable and durable over 3 years life	No distinction necessary	No	If recipient in business in Norway
France	Outright acquisitions	No distinction necessary	No, as tax treatment similar	Yes
Luxembourg	Outright acquisitions	Patent if right to use	Yes, on reasonable basis	No
Italy	Not capital	No distinction necessary	No, as similar tax treatment	Yes

2. Classification as country of source – I *(cont.)*

	2.1 Under what circumstances are payments for software capital?	2.2 Are non capital payments classified as goods and services or royalties?	2.3 If payment covers services and right to use is a breakdown necessary?	2.4.1 Is tax deducted at source from payments for capital?
Portugal	–	Generally taxed as copyright payments	–	–
Belgium	Capital if outright acquisition	Royalties if paid for use without outright acquisition	Yes	No
Denmark	Capital if sizeable and 3 years life	Royalty unless stock	Yes on estimated value	No
Canada	If outright disposal but this is unusual	Royalty unless for distribution	No, usually treat as royalty	No
New Zealand	Outright acquisitions capital	Generally royalty but services if payment unconnected with royalty or know how	Yes, but unusual, normally royalty	No

2. Classification as country of source – II

	2.4.2 Is tax deducted at source from payments for goods and services?	2.4.3 Is tax deducted at source from payments for royalties?	2.5 In 2.4 is this because they are royalties?	2.6 If royalties, if your definition of royalties similar to Article 12?
Netherlands	No	No	No tax on royalties	N/A See 2.5
Australia	No, unless source income	Yes	Yes as royalties	Wider definition of royalty in Australian law
Greece	No	Yes	Yes as royalties	As model with additions
Ireland	No	No	No tax at source on copyright royalties	N/A See 2.5
Sweden	No	Yes	Yes on business profits	No definition of royalty, treated as business profits
Switzerland	No	No	No tax at source	N/A
United States	No. Unless recipient trading in US	Yes	Depends on source of income	No internal definition of royalty
Germany	No	Yes	Yes, with some exceptions	Yes
Austria	Yes	Yes	Yes	Definition is not as wide as Article 12
Spain	Yes	Yes	No, could be taxed at source anyway	Similar but no tax distinction between royalty and goods or services
Japan	Yes	Yes	–	Broader definition than Article 12
United Kingdom	No	Yes	Yes	Taxation at source only on some types of royalties
Norway	As 2.4.1	As 2.4.1	No withholding tax	No definition of royalty
France	Yes	Yes	No, can be taxed at source in both cases	–
Luxembourg	No	Yes	Yes	Yes
Italy	Yes, unless employee services	Yes	No can be taxed at source anyway	As Article 12
Portugal	–	–	–	Tax deduction when beneficiary or payor resident of Portugal
Belgium	Yes	Yes	Could be taxed in any event	No, could be different sources. Capital gains from sale of rights etc. usually business profits

2. Classification as country of source – II *(cont.)*

	2.4.2 Is tax deducted at source from payments for goods and services?	2.4.3 Is tax deducted at source from payments for royalties?	2.5 In 2.4 is this because they are royalties?	2.6 If royalties, if your definition of royalties similar to Article 12?
Denmark	No	Yes	Yes	Definition does not cover many payments for use
Canada	Yes	Yes	Yes but also tax on services	Similar but exceptions for reproductions
New Zealand	No	Yes	Yes	Broader than model Article 12

3. Tax Classification as country of residence

	3.1 Under what circumstances are receipts classified as capital?	3.2 Are non capital receipts classified as goods and services or as royalties?	3.3 If receipts cover services and right to use is a breakdown necessary?	3.4 Any special treaty provisions restricting credit for software but not other income?	4 Are the distinctions (*e.g.* bundled etc.) referred to in 1.4 relevant for question 2 and 3?
Netherlands	Capital if ownership sold and durable	Goods and services if trade, royalty if for design	Yes, prorata split	No	No
Australia	Capital if not business income	Royalty, can be goods if sold with hardware	No both within definition of royalty	No	Relevant to 2.2 and 3.2
Greece	No specific provision	As royalty but no specific provision	No	–	No
Ireland	Outright disposals except where stock	Goods and services if trade, otherwise royalty	If different elements specified split on fair and reasonable basis	No	No
Sweden	Capital for outright disposal unless stock	No distinction for tax purposes	No, no distinction in tax treatment	No	No
Switzerland	No distinction relevant	No distinction relevant	No, no distinction in tax treatment	No	–
United States	Capital if for exclusive use and durable unless stock	Royalty if services only auxillary, reflect substance	Yes based on relative value	No	No
Germany	Capital if for unlimited use or if payment is a lump sum	Depends on contract	Yes if amounts material, on a just and reasonable basis	No	No
Austria	If fixed asset then disposal follows	Standard software sales receipts, right to use royalty	Yes if material split on just and reasonable basis	Relief can be granted if necessary	Possibly
Spain	Capital unless trading in software	No significance of distinction	No, as no tax distinction	No	Yes, customs duty on a bundled package precludes income tax
Japan	Business income if incorporated. If individual can vary	No difference in treatment	No, as no tax distinction	–	No
United Kingdom	Outright disposal: capital and in certain other cases	Can be distinguished but no internal tax differences	No, as no tax distinction	No	Yes bundled software usually follows treatment of hardware

3. Tax Classification as country of residence *(cont.)*

	3.1 Under what circumstances are receipts classified as capital?	3.2 Are non capital receipts classified as goods and services or as royalties?	3.3 If receipts cover services and right to use is a breakdown necessary?	3.4 Any special treaty provisions restricting credit for software but not other income?	4 Are the distinctions (*e.g.* bundled etc.) referred to in 1.4 relevant for question 2 and 3?
Norway	Capital if for use of software	No difference both business income	No	No	No
France	Capital if disposal of all rights	No difference in treatment except for sale of goods	No	No	Bundled software effects accountancy treatment
Luxembourg	Capital for outright disposal	No difference in treatment except for sale of goods	No	No	No
Italy	Not capital	No difference in treatment	No, treatment same as sales price	No	Yes whether software is part of hardware
Portugal	–	No difference in treatment	No	No	–
Denmark	Capital unless trading	No difference in treatment	No	No	No
Canada	If outright disposal of fixed asset	No difference in treatment	No	No	No
New Zealand	Outright disposals capital unless by way of trade	Normally royalties unless payments for services not connected	Yes but not usual	No	Generally no, bundled software follows treatment of hardware
Belgium	Capital for outright disposal	No difference unless received by individual and not a business activity	Only if individual	No	Yes distinguish between sale of equipment and other payment

4. Double Taxation Conventions – I

	5.1 Are payments in 2.1 and 3.1 within Article 12 if not which article?	5.2 Are payments in 2.2.1 and 3.2.1 within Article 12 if not which article?	5.3 If payment in 2.3 or 3.3. do you apply Article 12 to none, all or part?	5.4 Do you adopt Article 12 in your treaties?
Netherlands	No, 7 and 14 and possibly 13	Yes but also 7 and 14	In part	Aim for Article 12 but half treaties include withholding
Australia	Yes, but may be 12, 13 or 7	Yes but also 7 and 14	Normally all	No, wider definition of royalty and tax at source
Greece	Yes	Yes	All	Approximately but allow for tax at source in most treaties
Ireland	Yes but if capital then 13, 7 or 14	Yes but also 7 and 14	In part	Yes only 4 exceptions
Sweden	Yes but also 7, 13 and 14	As for 5.1	To royalty part	Yes
Switzerland	Not if acquisition then 7 or 14	Yes	Part only	Yes, but only incorporated in half of treaties
United States	Could also be 7 or 13	No	Part only	Yes generally, some treaties allow for reduced withholding tax
Germany	Only if for use otherwise, 13, 7 or 14	Yes for use but also 13, 7 and 14	To royalties part	Yes generally, but half treaties have reduced withholding tax
Austria	Only if for use otherwise 7	Yes	To royalty part	With a 10% tax at source
Spain	Yes but also 13, 7 or 14	Yes	To royalty element	No, reserve right to deduct tax at source
Japan	If for use, also 7, 13 and 14	Also 7, 13 and 14	To royalty part	No levy tax at source
United Kingdom	If for use, also 7, 13 and 14	Yes	To royalty part	Yes but half treaties include tax at source
Norway	7, 13 or 14 as case may be	Also 7, 13, 14	To royalty part	Yes
France	Also 7, 13 or 14	Yes	To royalty part	Treaties often include withholding tax, sometimes only certain royalties
Luxembourg	7, 13 or 14	Goods and services 7 and 14	To royalty part	Some treaties allow withholding tax
Italy	Also 7, 13 or 14	Yes	Yes except for employee services	Yes
Portugal	–	–	–	–
Denmark	Also 7, 13 or 14	Also 7, 13, 14	To royalty part	As far as possible

4. Double Taxation Conventions – I *(cont.)*

	5.1 Are payments in 2.1 and 3.1 within Article 12 if not which article?	5.2 Are payments in 2.2.1 and 3.2.1 within Article 12 if not which article?	5.3 If payment in 2.3 or 3.3. do you apply Article 12 to none, all or part?	5.4 Do you adopt Article 12 in your treaties?
Canada	Yes but others possible 7		To royalty part	Yes but with some withholding rights
New Zealand	Also 7, 13 or 14	Yes	To royalty part	No, wider definition, tax at source
Belgium	Yes but also 7, 13 or 14	7 or 14	To royalty part	Yes with some exceptions

5. Double Taxation Conventions - II

	5.5 If royalties are taxed at source are they defined as in 12?	5.6 Is software mentioned in other articles?	5.7 Where a treaty country taxes the income differently, do you give relief and how?	5.8 Amend the Model or its commentary?	5.9 Other comments?
Netherlands	Yes with some modification	No	Yes if in accordance with treaty	No	No
Australia	No	No	Yes if foreign source	N/A	No
Greece	Yes with addition	No	Yes	As for UK	Include discussion in commentary
Ireland	Separate definition	No	Yes	No, not 12, no problem if no withholding tax	No
Sweden	Modified as in "Trends in International Taxation"	No	Yes by mutual agreement	No	Include in commentary that 7, 12, 13 or 14 could apply
Switzerland	Yes but with addition	No	No, but mutual agreement tried	Amend Commentary	No
United States	Modified	None yet, some under discussion	–	No, resolve bilaterally	No
Germany	Yes, one exception	No	Yes	Add to Commentary on Article 12	No
Austria	Yes, normally	No	Yes	No	No
Spain	Yes with addition	No	–	Yes expand Commentary	No
Japan	Yes with addition	No	Yes	–	No
United Kingdom	Yes with addition	No	In accordance with treaty	No deal with bilaterally and expand Commentary	No
Norway	Yes with modification	No	Mutual agreement	Expand Commentary to point out that 7, 12, 13 or 14 could apply	No
France	Yes similar	Yes, in recent treaties	By mutual agreement	Mention in Article 12 and expand Commentary on mixed contracts and when to apportion	–

5. Double Taxation Conventions - II *(cont.)*

	5.5 If royalties are taxed at source are they defined as in 12?	5.6 Is software mentioned in other articles?	5.7 Where a treaty country taxes the income differently, do you give relief and how?	5.8 Amend the Model or its commentary?	5.9 Other comments?
Luxembourg	Yes with additions	No	By mutual agreement	Mention in 12 and expand Commentary on mixed contracts	No
Italy	Yes	No	Yes	Mention software in 12	No
Portugal	–	–	–	–	No
Denmark	Narrower definition	No	Yes	Expand Commentary to say 7, 12, 13 or 14 could apply	No
Canada	Yes	No	Yes, under domestic rules	No	No
New Zealand	Yes, often wider	No	Yes	Expand Commentary to provide greater clarity	No
Belgium	Yes, minor amendments	No	Mutual agreement	Define types of payment in Commentary	No

APPENDIX 3

PROPOSED AMENDMENTS TO THE COMMENTARY ON THE MODEL TAX CONVENTION

1. Add the following at the end of the penultimate sentence of paragraph 34 of the Commentary on Article 7:

> (*cf.* paragraph 13 of the Commentary on Article 12 which discusses the principles governing whether in the particular case of computer software payments should be classified as commercial income within Articles 7 or 14 or as a capital gains matter within Article 13 on the one hand or as royalties within Article 12 on the other.)

2. Add the following paragraphs 13 to 18 immediately after paragraph 12 of the Commentary on Article 12:

> 13. Whether payments received as consideration for computer software may be classified as royalties poses difficult problems but is a matter of considerable importance in view of the rapid development of computer technology in recent years and the extent of transfers of such technology across national borders. Software may be described as a programme, or series of programmes, 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, on a magnetic tape or disc, or on a laser disc. 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 rights in computer software are a form of intellectual property. Research into the practices of OECD member countries has established that all but one protect software rights either explicitly or implicitly under copyright law. Transfers of rights occur in many different ways ranging from the alienation of the entire rights to the sale of a product which is subject to restrictions on the use to which it is put. The consideration paid can also take numerous forms. These factors may make it difficult to determine where the boundary lies between software payments that are properly to be regarded as royalties and other types of payment.
>
> 14. Three situations are considered. The first is of payments made where less than the full rights in software are transferred. In a partial transfer of rights the consideration is likely to represent a royalty only in very limited circumstances. One such case is where the transferor is the author of the software (or has acquired from the author his rights of

distribution and reproduction) and he has placed part of his rights at the disposal of a third party to enable the latter to develop or exploit the software itself commercially, for example by development and distribution of it. It should be noted that even where a software payment is properly to be regarded as a royalty there are difficulties in applying the copyright provisions of Article 12 to software royalties since paragraph 2 of the Article requires that software should be classified as a literary, artistic or scientific work. None of these categories seems entirely apt but treatment as a scientific work might be the most realistic approach. Countries for which it is not possible to attach software to any of those categories might be justified in adopting in their bilateral treaties an amended version of paragraph 2 of Article 12 which either omits all references to the nature of copyrights or refers specifically to software.

15. In other cases, the acquisition of the software will generally be for the personal or business use of the purchaser. The payment will then fall to be dealt with as commercial income in accordance with Articles 7 or 14. It is of no relevance that the software is protected by copyright or that there may be restrictions on the use to which the purchaser can put it.

16. The second situation is where the payments are made as consideration for the alienation of rights attached to the software. It is clear that where consideration is paid for the transfer of the full ownership the payment cannot represent a royalty and the provisions of Article 12 are not applicable. Difficulties can arise where there are extensive but partial alienation of rights involving:

- exclusive right of use during a specific period or in a limited geographical area;
- payment of additional consideration related to usage;
- consideration in the form of a substantial lump sum payment.

17. Each case will depend on its particular facts but in general such payments are likely to be commercial income within Article 7 or 14 or a capital gains matter within Article 13 rather than royalties within Article 12. That follows from the fact that where the ownership of rights has been alienated in full or in part, the consideration cannot be for the use of the rights. The essential character of the transaction as an alienation cannot be altered by the form of the consideration, the payment of the consideration in instalments or, in the view of most countries, by the fact that the payments are related to a contingency.

18. The third situation is where software payments are made under mixed contracts. Examples of such contracts include sales of computer hardware with built-in software and concessions of the right to use

software combined with the provision of services. The methods set out in paragraph 12 above for dealing with similar problems in relation to patent royalties and know-how are equally applicable to computer software. Where necessary the total amount of the consideration payable under a contract should be broken down on the basis of the information contained in the contract or by means of a reasonable apportionment with the appropriate tax treatment being applied to each apportioned part.

[*The following paragraphs of the Commentary on Article 12 are renumbered accordingly.*]

3. Add the following at the end of paragraph 3 of the Commentary on Article 14:

e.g. in determining whether computer software payments should be classified as commercial income within Articles 7 or 14 or as royalties within Article 12.