United Nations E/C.18/2014/3

Economic and Social Council

Distr.: General
14 August 2014

Original: English

Committee of Experts on International Cooperation in Tax Matters
Tenth session
Geneva, 27-31 October 2014
Item 3 (a) (vi) of the provisional agenda*
Discussion of substantive issues related to international cooperation in tax matters: article 12: general consideration, including equipment-related issues

Differences between article 12 of the United Nations Model Double Taxation Convention between Developed and Developing Countries and article 12 of the Organization for Economic Cooperation and Development Model Tax Convention on Income and Capital

Note by the Secretariat

Introduction

1. The present note sets out the main differences between the United Nations Model Double Taxation Convention between Developed and Developing Countries (United Nations Model Convention) and the Organization for Economic Cooperation and Development (OECD) Model Tax Convention on Income and Capital (OECD Model Convention) (see table below). In addition, it reflects some of the differing views of the members of the Committee of Experts on International Cooperation in Tax Matters with regard to the relevance of paragraphs 14, 14.1, 14.2, 14.4, 15, 16, 17.2 and 17.3 of the OECD commentary, which arose in discussions at the 2011 session of the Committee and which the Committee may wish to consider in more detail.

* E/C.18/2014/1.

14-59125 (E) 030914

Differences between the Model Conventions in respect of article 12

Article 12 (Royalties)		
United Nations Model Double Taxation Convention between Developed and Developing Countries	*Organization for Economic Cooperation and Development Model Tax Convention on Income and Capital*	*Differences*[a]
1. Royalties arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other State. 2. However, such royalties may also be taxed in the Contracting State in which they arise and according to the laws of that State, but if the beneficial owner of the royalties is a resident of the other Contracting State, the tax so charged shall not exceed __ per cent (the percentage is to be established through bilateral negotiations) of the gross amount of the royalties. The competent authorities of the Contracting State shall by mutual agreement settle the mode of application of this limitation.	1. Royalties arising in a Contracting State and beneficially owned by a resident of the other Contracting State shall be taxable only in that other State.	The United Nations Model Convention omits the word “only”, which means that royalties may be taxable in the source country as well as the residence country, resulting in departure from the principle of an exclusive residence State’s right to tax provided by the Organization for Economic Cooperation and Development (OECD) Model Convention (although the OECD commentary provides an option to tax royalties and many OECD countries have reservations to the OECD Model Convention on this point and include such a provision in treaties). Paragraph 2 of the United Nations Model Convention is an addition flowing logically from the premise of allowable source State taxation. In combination with article 23, article 12 gives the primary right to tax to the source State. The United Nations Model Convention does not present a consensus on a particular rate for the withholding tax to be charged on royalties on a gross basis and thus leaves the rate to be established through bilateral negotiation. The commentary (para. 8ff) notes some of the relevant factors in determining an appropriate rate in the situation of particular countries. The United Nations Model Convention does not reflect the 2003 changes to the OECD Model Convention to introduce the concept of “beneficial” ownership because that concept is included in paragraph 2, which is not in the OECD Model Convention.

Article 12 (Royalties)		
United Nations Model Double Taxation Convention between Developed and Developing Countries	*Organization for Economic Cooperation and Development Model Tax Convention on Income and Capital*	*Differences*[a]
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[b] 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.	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 the industrial, commercial or scientific experience.	The United Nations Model Convention includes so-called “equipment rental”, which was deleted from the OECD Model Convention in 1992 (although several OECD countries have reservations on this point). The OECD commentary indicates that this was done to clarify that such income should be taxed as business income under articles 5 and 7. According to the commentary to the OECD Model Convention, the article does not apply to payments for new information obtained as a result of performing services at the request of the payer since it is intended to be limited. Some members of the Committee of Experts on International Cooperation in Tax Matters have taken the view that there is no base for limiting the scope of the industrial, commercial or scientific experience to that arising from previous experience. Some members of the Committee of Experts have expressed the view that the payments referred to in paragraphs 14, 14.1, 14.2, 14.4, 15, 16, 17.2 and 17.3 (dealing with software contracts in particular) of the OECD commentary may, in fact, constitute royalties (see commentary below para. 17.4 (p. 220) of the United Nations Model Convention). These include software-related royalties, such as software transmitted electronically and certain forms of transfer of the full ownership of the rights in the copyright.

Article 12 (Royalties)		
United Nations Model Double Taxation Convention between Developed and Developing Countries	*Organization for Economic Cooperation and Development Model Tax Convention on Income and Capital*	*Differences*[a]
		One member of the Committee of Experts specifically doubted the words in parenthesis in paragraph 16, which relate to geographically based and time-limited rights with regard to the use of the software.
4. The provisions of paragraph 1 and 2 shall not apply if the beneficial owner of the royalties, being a resident of a Contracting State, carries on business in the other Contracting State in which the royalties arise, through a permanent establishment situated therein, or performs in that other State independent personal services from a fixed base situated therein, and the right or property in respect of which the royalties are paid is effectively connected with (a) such permanent establishment or fixed base, or with (b) business activities referred to in (c) of paragraph 1 of Article 7. In such cases the provisions of Article 7 or Article 14, as the case may be, shall apply.	3. The provisions of paragraph 1 shall not apply if the beneficial owner of the royalties, being a resident of a Contracting State, carries on business in the other Contracting State in which the royalties arise through a permanent establishment situated therein and the right or property in respect of which the royalties are paid is effectively connected with such permanent establishment. In such case the provisions of Article 7 shall apply.	The United Nations Model Convention contains a limited force-of-attraction principle. Moreover, the United Nations Model Convention excludes royalties that are received in connection with the business activities described in article 7, paragraph 1 (c) (business activities of the same or similar kind as those of the permanent establishment in the source country). The reference to subparagraph (c) would only be required in a bilateral treaty enshrining the limited force-of-attraction rule — most treaties do not. The United Nations Model Convention refers to paragraph 2 in addition to paragraph 1 because of the source State taxation expressly allowed in that paragraph.
5. Royalties shall be deemed to arise in a Contracting State when the payer is a resident of that State. Where, however, the person paying the royalties, whether he is a resident of a Contracting State or not, has in a Contracting State a permanent establishment or a fixed base in connection with which the liability to pay the royalties was incurred, and such royalties are borne by such permanent establishment or fixed base, then such royalties shall be deemed to arise in the State in which the permanent establishment or fixed base is situated.		This paragraph is not found in the OECD Model Convention. It clarifies that royalties are deemed to arise (be sourced) in the State of residence of the payor (except in some fixed-base or permanent establishment cases).

Article 12 (Royalties)		
United Nations Model Double Taxation Convention between Developed and Developing Countries	*Organization for Economic Cooperation and Development Model Tax Convention on Income and Capital*	*Differences*[a]
6. Where by reason of a special relationship between the payer and the beneficial owner or between both of them and some other person, the amount of the royalties, having regard to the use, right or information for which they are paid, exceeds the amount which would have been agreed upon by the payer and the beneficial owner in the absence of such relationship, the provision of this Article shall apply only to the last-mentioned amount. In such case, the excess part of the payments shall remain taxable according to the laws of each Contracting State, due regard being had to the other provisions of this Convention.	4. Where by reason of a special relationship between the payer and the beneficial owner or between both of them and some other person, the amount of the royalties, having regard to the use, right or information for which they are paid, exceeds the amount which would have been agreed upon by the payer and the beneficial owner in the absence of such relationship, the provisions of this Article shall apply only to the last-mentioned amount. In such case, the excess part of the payments shall remain taxable according to the laws of each Contracting State, due regard being had to the other provisions of this Convention.	There are no differences between the two Model Conventions.

[a] Differences may also include differences in interpretation as noted in the respective commentaries, which for reasons of brevity are not reproduced in the present annex.

[b] The reference to films or tapes for radio or television was removed from the OECD Model in 2000 so that article 7 or 9 would apply to them.

Additional notes on article 12

Industrial, commercial or scientific equipment and the definition of royalties

2. In the 1977 OECD Model Tax Convention on Income and Capital, the definition of "royalties" included consideration for the use of or the right to use industrial, commercial or scientific equipment. In paragraph 23 of its 1983 report entitled "The taxation of income derived from the leasing of industrial, commercial or scientific equipment",[1] however, OECD concluded that the inclusion of income from the leasing of industrial, commercial or scientific equipment in the royalty definition would not be advisable, could lead to misinterpretation of the objectives of the OECD Model Convention and might even create difficulties in the negotiation of bilateral tax treaties. Subsequently, in the 1992 revision of the OECD Model Convention, consideration for the use of or the right to use equipment was deleted from the definition of "royalties".

3. According to the 1983 OECD report, the Committee on Fiscal Affairs examined whether it seemed appropriate to subject income from the leasing of the use of industrial, commercial or scientific equipment to taxation at source and found that:

(a) Income from the leasing of industrial, commercial or scientific equipment was usually of a different nature than royalties proper for which article 12 had been designed;

(b) Article 12 of the OECD Model Convention provided for a zero-rate of tax for industrial, commercial or scientific equipment at source to protect it from source taxation. The inclusion of industrial, commercial or scientific equipment in the definition of royalties was therefore not meant to imply that where there was a tax on royalties at source it should extend to industrial, commercial or scientific equipment;

(c) When extending taxation at source of royalties proper to income from the leasing of industrial, commercial or scientific equipment, such income would be subject to taxation on a gross basis, which might lead to an excessive tax at the expense of the lessor. Additionally, the tax at source might not be fully credited in the residence country;

(d) Given that taxation on a gross basis would occur only in the absence of a permanent establishment, taxation where a permanent establishment did not exist might be far more burdensome than where it did;

(e) Taxation would in any case occur in those States that considered the residence of the payor as the source of the royalty even if the equipment was not situated in that State.

Link to a provision on taxation of technical services

4. In a paper entitled "Note on a new article of the United Nations Model Convention dealing with the taxation of fees for technical and other services",[2]

[1] Available from www.oecd-ilibrary.org/taxation/model-tax-convention-on-income-and-on-capital-2010/r-2-the-taxation-of-income-derived-from-the-leasing-of-industrial-commercial-or-scientific-equipment_9789264175181-95-en.

[2] Available from www.un.org/esa/ffd/tax/ninthsession/CRP5_Services.pdf.

which he prepared for the ninth session of the Committee of Experts, Brian Arnold addressed the taxation of fees for technical services and concluded that a possible way of dealing with income from technical services would be to allow the source country to tax all payments made by residents of the source country (and non-residents with a permanent establishment or fixed-base in the source country) to the residents of the other country for technical services. Such a treatment is similar to the treatment of royalties under article 12. The source country would be entitled to tax payments for technical services on a gross basis at a rate to be agreed upon through bilateral negotiations by the contracting States. One possible option presented was to amend article 12 to treat fees for technical services as royalties. Another option, and in fact the one chosen by the Committee, was to have a separate article specifically on fees for technical services.

5. A subcommittee on tax treatment of services, coordinated by Liselott Kana, was created and given the following mandate:

> The subcommittee is mandated to address the issue of the taxation treatment of services in general in a broad way. The particular issue of taxation of fees for technical services will be addressed by presenting wording, including different options, for the text of the Article on Technical Services at the tenth session in 2014.[3]

6. In view of the services-related work, it will be necessary to include a definition of "technical services" in the proposed new article on fees for technical services and/or to provide sufficient discussion in the commentary of what constitutes "technical services" and how that relates to the definition of "royalties" in article 12. It may also be necessary to specifically indicate which article takes precedence in the event that, prima facie, both articles apply. This would only be necessary if the taxation results, such as rates, varied between the two articles.

Meaning of the term "industrial, commercial or scientific equipment"

7. During discussions on the update of the United Nations Model Convention held at the 2011 session of the Committee, one member of the Committee noted the lack of any detailed discussion on the meaning of "industrial, commercial or scientific equipment" in the commentary to article 12 and suggested that if the provision were to be retained more guidance would be needed, including what would be covered by the provision and what would be covered by other articles of the United Nations Model Convention.

8. The Coordinator of the Subcommittee on the United Nations Model Tax Convention Update responded by noting that drafting such an explanation was not part of the mandate of the Subcommittee dealing with the update, but that is should considered as an important issue for further consideration by the Committee.

9. The Committee might now wish to consider whether to begin drafting further guidance on the meaning of the term.

---

[3] See www.un.org/esa/ffd/tax/subcommittee/TTS.htm.