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RE: Submission re: Commentary on Article 12 of the Model Convention Regarding the Definition of Royalties

Dear Mr. Owens:

We are writing on behalf of the Software Coalition, an industry association representing many of the world's leading computer software companies, to discuss the draft 2008 update to the OECD Model Tax Convention and Commentary (the "Draft Update"). We direct our comments to the newly released changes regarding the clarification of certain aspects of the Article 12 definition of royalties and to the clarification of the characterization of payments made by software distributors.

We appreciate and welcome the work of the OECD to update the Commentary to take into account developing business models. Business and tax administrations alike benefit from the additional clarifications that regular updates provide.

The scope of the term "royalty" is an important issue with considerable significance in the global knowledge-based economy in which the Software Coalition members participate. We welcome the work that the OECD has done in this area to provide greater certainty with respect to the characterization and treatment of transactions in intangible property, and believe that the recently released clarifications of the Article 12 definition of royalties represent useful progress in this area. In an effort to promote further useful guidance to taxpayers and tax administrators, we respectfully submit the following comments regarding the proposed changes.

I. Payments in Consideration for the Transfer of the Full Ownership of an Element of Intangible Property – Paragraph 8.2

Part 1, paragraph 11 of the Draft Update proposes the addition of a paragraph 8.2 to the Commentary on Article 12 addressing payments made in consideration for the transfer of the full ownership of an element of intangible property. Under the proposed paragraph 8.2, payments received for the transfer of full ownership of an intangible property right, or the "alienation" of such property right, are not royalties. Paragraph 8.2 applies this characterization to alienations of rights in cases where the alienated rights constitute

“distinct and specific property.” We agree with the general approach and conclusions of proposed paragraph 8.2, but believe that certain of its specific provisions would benefit from further clarification.

In particular, we believe that further clarification would be useful as to when a set of rights would constitute “distinct and separate property,” and what transaction forms would result in a transfer which is “presented as an alienation” or “structured as a sale.”

A. The Characterization Proposed under Paragraph 8.2 is Consistent with Characterization under U.S. Tax Law

As a preliminary matter, it is our sense that the proposed treatment of the payments described in paragraph 8.2 is generally consistent with the treatment of such payments under U.S. tax law. Under U.S. tax law, a complete transfer of patent rights limited to a single field of use generally is characterized for tax purposes as a sale of those rights, resulting in the characterization of the consideration as business profits or capital gain. Similarly, patent rights that are geographically limited, such as the transfer of the exclusive right to make, use, or sell a patented item in a specific geographic territory, constitutes a sale for tax purposes, even where the transferor retains all patent rights with respect to other regions. This seems to be consistent with the treatment of payments for a grant in a limited geographical area as discussed in proposed paragraph 8.2.

In the context of copyrights, a transaction may be treated as a sale for tax purposes where the copyright owner transfers rights in a single method of expression. For example, under U.S. tax law, the holder of a literary copyright may transfer only the motion picture rights and still have the transfer regarded as a sale, even though these rights clearly represent less than the entirety of the copyright.

We interpret the “distinct and specific property” concept expressed in proposed paragraph 8.2 to be consistent with these examples of patent and copyright right transfers. It would be useful if the Commentary could clarify that the concept of “distinct and specific property” indeed is analogous to these examples of patent and copyright right transactions.

To achieve sale treatment, U.S. tax law does not require the parties to document the transaction as a “sale.” Where a license conveys the exclusive and perpetual license of the relevant rights, sale treatment results for tax purposes, even though not described as such in form. Furthermore, U.S. tax law does not look to the form of consideration to determine the character of the transfer, including if the consideration is payable in installments or subject to a contingency. We agree with the OECD’s adoption of this point in proposed paragraph 8.2.

B. Certain Points Contained in Paragraph 8.2 May Require Further Clarification

As noted above, the issues explored in proposed paragraph 8.2 are important and the general approach seems correct. Specific provisions of the proposed language, however, contain certain ambiguities which may require further clarification to achieve the OECD's goals, either in this new version of the Commentary, or in subsequent updates. We believe that on balance, the current text provides sufficient useful guidance to taxpayers and tax administrators so that it could proceed to publication in the 2008 Update, but we do believe that in short order these additional clarifications will be necessary. In particular, we suggest that additional guidance be given regarding the transaction terms which are required to achieve an "alienation," the appropriate influence of national intellectual property law rules, and the nature of "distinct and separate property."

1. Effect of the Form of the Transaction

Under the language of proposed paragraph 8.2, it is unclear what effect the form of a transaction has on its characterization. The proposed language describes certain rights transfers that are "presented as an alienation" or "structured as a sale" as those which are likely to produce commercial income or capital gains rather than royalties. The types of transactions described in proposed paragraph 8.2, however, in many (if not most) cases will be documented as licenses, not sales, for purposes of intellectual property law. For instance, the grant of exclusive rights to use a patent or a copyright in a limited geographical area or a limited period of time as described in proposed paragraph 8.2 normally would be documented as a license. The transaction would take this form even though the transferor would retain no substantial economic rights in the intellectual property for the territory or period covered by the grant, since the grantor would not be alienating the entire patent or copyright. As such, the Commentary should be clear that the analysis should address the actual substantive economic parameters of the transaction, *i.e.*, whether the transferor retains any substantial economic rights in the territory or for the time period granted, rather than the form which describes the transaction.

2. Effect of National Intellectual Property Law

Proposed paragraph 8.2 suggests that the characterization of each transaction will depend upon a review of "national intellectual property law" as applicable to the type of property involved and the national law rules (we assume here intellectual property rules rather than tax rules) as regards "what constitutes an alienation." The draft Commentary thus suggests that this law would determine or at least influence whether the transaction involves an "alienation" of rights giving rise to commercial income or capital gains. We respectfully submit that there should be limits on any reference to "national intellectual property law" to determine the characterization of a transaction for tax purposes. For example, as noted above, even the perpetual and exclusive grant of rights to a field of use, a

certain geographic territory, and the like, normally would be documented as a license. We would normally interpret the term “alienation” or a transaction “structured as a sale” to refer to assignments of title. Any reference to “intellectual property law” in proposed paragraph 8.2 therefore is likely to be of limited utility and may even be counterproductive, as most of the transactions described in this paragraph would be documented as “licenses” under non-tax law. If the terms “alienation” and “structured as a sale” are, instead, not meant to refer to intellectual property law concepts, but rather to the economic realities of the transaction, then that point should be clarified. Allowing national intellectual property law to determine the character of the transaction also does not achieve the purpose of the Model Convention to eliminate inconsistencies between countries on the characterization of cross-border transactions.

Rather, we believe that it should be possible for the OECD to formulate a description of the nature of transactions that should be treated as giving rise to business income or capital gains by reference to the economic nature of such transactions. Proper guidance should be given in the Commentary as to how those transactions may be commonly documented under applicable intellectual law principles, but the principal determinants of what payments constitute business profits or capital gains in this area should depend primarily on economic factors.

This point is illustrated by the Commentary’s treatment of site and enterprise licenses in the context of software payments. Under all applicable copyright law principles, such transactions are regarded as licenses and not alienations, but the Commentary properly classifies such payments as business profits based on the economic reality of such transactions.

3. Rights that Constitute “Distinct and Specific Property”

Under proposed paragraph 8.2, payments in consideration for “the alienation of rights that constitute distinct and specific property” are likely to be commercial income or capital gain. The phrase “distinct and specific property” is a key concept. It is not clear, however, whether the key elements are that the rights involved constitute recognized property interests (as opposed to, for example, rights to use confidential information), whether the transaction terms play a role in defining when a grant of rights creates “distinct” property, and the like. It therefore would be helpful if specific examples of what would constitute distinct and specific property could be included in the Commentary.

II. Payments for Exclusive Distribution Rights – Paragraph 10.1

Part 1, paragraph 12 of the Draft Update proposes the addition of a paragraph 10.1 to the Commentary to address payments for territory-specific, exclusive distribution rights. Under the proposed Commentary, payments made solely in consideration for obtaining exclusive distribution rights in a given territory should not be classified as royalties. The

Software Coalition supports this addition to the Commentary and endorses the conclusion that these payments are best viewed as amounts paid to increase sales receipts, thereby requiring commercial income treatment. The Coalition would like to suggest that the rationale behind this conclusion does not change when the territory-specific distribution rights are not exclusive. The exclusivity element is not germane to whether or not the payment is made to increase sales receipts. We do note, however, that a distributor is more likely to make a payment for exclusive than nonexclusive distribution rights, so the example provided in the proposed Commentary is the more plausible actual case.

Furthermore, the OECD may wish to expand the example in paragraph 10.1 to address certain other common business practices. It is typical in distribution agreements, such as the one described in paragraph 10.1, for the distributor to receive a royalty-free trademark license to allow the distributor to use the trademark for marketing purposes. While no royalties are charged for these marketing rights, under intellectual property law this is respected as a license. A license is necessary because the distributor must possess certain rights in the trademark to create marketing collateral and other advertising materials. The distributor, however, is not given the more economically meaningful right to affix the trademark onto the property being sold. To address this common business practice, the section 10.1 example could include additional language indicating that commercial income treatment should result even if the distributor is granted rights to use the trademark for purposes of marketing the product.

III. Payments for Designs, Models or Plans – Paragraph 10.2

Part 1, paragraph 12 of the Draft Update proposes the addition of a paragraph 10.2 to the Commentary on Article 12 to address certain payments for designs, models or plans. Under the proposed paragraph 10.2, payments in consideration for the development of a new design, model or plan, even where the developer retains all copyright rights in the design, model or plan, should not be royalties. The Software Coalition agrees with the proposed conclusion that payments under these circumstances should be considered payments made in consideration for services falling under Article 7, not royalties. This is an important clarification, and is a useful addition to the Commentary.

Proposed paragraph 10.2 creates a distinction between payments to develop a new design, model or plan and payments for the right to modify or reproduce previously developed plans. In the latter case, proposed paragraph 10.2 would treat such payments as royalties. We would respectfully suggest that the paragraph 10.2 language be clarified to ensure that royalty characterization results only if the payor is making the payment for the purpose of obtaining market exploitation rights with respect to such modifications or reproductions. For example, an individual may purchase a plan for a home from an architect. Whether or not that individual receives the right to modify that plan to his or her own requirements should not determine characterization of the architect's income. The

relevant right under these circumstances would be whether or not the purchaser could exploit any modifications of such plan through reproduction and resale on the market.

IV. Know-how – Paragraph 11

The Draft Update proposes a modification of the paragraph 11 interpretation of the phrase “industrial, commercial or scientific experience” as used in Article 12, Paragraph 2. Paragraph 11 defines industrial, commercial or scientific experience as “know-how,” the payments for the use of which are royalties. Proposed paragraph 11 distinguishes between payments for know-how and payments for “new information obtained as a result of performing services at the request of the payor.”

The Software Coalition endorses this change. We believe that it provides a useful distinction between transactions which transfer know-how in exchange for a royalty, and those in which industrial, commercial or scientific experience is used by the vendor to provide technical or other services in exchange for a service fee. This distinction is becoming increasingly important in the knowledge economy. We suspect that there will be good reason to enhance this Commentary with further examples in the future, as particular cases arise which raise difficult interpretative issues.

V. Payments for Customer Lists – Paragraph 11.4

Paragraph 11.4 of the Commentary provides a list of payments which are not “received as consideration for the provision of know-how.” Instead, the payments listed in paragraph 11.4 are characterized as consideration for the provision of services. The Draft Update proposes the addition of certain payments for customer lists to the list of transactions not involving know-how. Under the proposed language in paragraph 11.4, a payment for a customer list is services income when the list is developed specifically for the payor out of generally available information. In contrast, the payee would receive royalty income for granting the right to use a pre-existing list developed through commercial experience.

First, we note that the addition of the parenthetical discussion of a payment for a confidential list of customers seems out of place in the context of the other elements of paragraph 11.4, as in none of the other cases is a distinguishable know-how transaction described (although one could be presented in many of the other cases).

Second, the parenthetical hypothetical would need to be modified by reference to the rule in new paragraph 10.2, that royalty characterization would be appropriate only if no additional work was required to customize the information for the purchaser. Royalty treatment should be limited to cases of rentals of proprietary customer lists where the vendor does nothing more than provide the relevant information.

VI. Alienation of Copyrights – Paragraphs 15 and 16

The revisions to proposed paragraphs 15 and 16 of the Commentary on Article 12 incorporate the concept of distinct and specific property with respect to copyrights, as is discussed above with respect to paragraph 8.2. The Software Coalition endorses the conclusion that sale treatment may be appropriate even for transfers of rights limited by geography and time. As discussed in the context of paragraph 8.2, however, more clarity would be helpful to indicate specifically where an alienation or assignment of the right has taken place, in particular where title to the copyright has not been alienated or assigned (*e.g.*, where a transferee receives geographically limited rights in a copyright transaction documented as a license for intellectual property law purposes).

Also, the references in paragraph 15 to “difficulties” arising in the case of additional consideration related to usage and consideration in the form of a substantial lump sum payment seem to be inconsistent with the statement in paragraph 16 that the form of consideration does not alter the essential character of a transaction. It seems that these paragraphs as well could benefit from a further elaboration of the parameters of the concept of a transfer of “distinct and specific property,” with the attendant analysis of whether form of consideration should ever play a role in the characterization analysis.

VII. Software Distribution

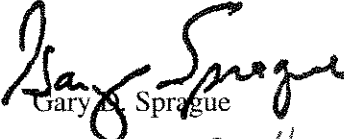
We are pleased with the clarifications provided in paragraph 14.4 with respect to software distribution. This is a useful clarification to the Commentary dealing with software transactions, and we very much appreciate the continuing work of the OECD in the area of software revenue characterization.

With the CFA’s expected endorsement of the proposed paragraph 14.4, the Software Coalition is hopeful that all OECD member states now will conform their treaty interpretations of payments with respect to software transactions to the guidance contained in the Commentary. Because many of the observations to various aspects of the Commentary on software transactions, including payments by distributors, arose some years ago, and because there now appears to be a firm international consensus among both OECD members and non-members that the OECD Commentary on software payments correctly characterizes such payments, it may be useful at this time for the OECD to encourage any members which have expressed observations on elements of the software Commentary to revisit such conclusions, in light of the further work which has been done by the OECD on this issue in the past few years.

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Thank you for this opportunity to submit our comments on these issues. Please feel free to contact us if you would like further elaboration on these points.

Respectfully submitted,


Gary A. Sprague


Nancy E. Hacker

cc: Software Coalition Members

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