



TAX TREATY CHARACTERISATION ISSUES ARISING FROM E-COMMERCE

REPORT TO WORKING PARTY NO. 1 OF THE OECD COMMITTEE ON FISCAL AFFAIRS

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**By the Technical Advisory Group on
Treaty Characterisation of Electronic Commerce Payments**

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TAG ON TREATY CHARACTERISATION ISSUES ARISING FROM E-COMMERCE:

REPORT TO WORKING PARTY No. 1

1. INTRODUCTION

1. The Technical Advisory Group (TAG) on Treaty Characterisation Issues arising from E-Commerce was set up by the OECD Committee on Fiscal Affairs in January 1999 with the general mandate "to examine the characterisation of various types of electronic commerce payments under tax conventions with a view to providing the necessary clarifications in the Commentary."¹

2. The TAG met four times on 22-24 September 1999, 17-18 February 2000, 3-4 July 2000 and 7-8 November 2000. During its first two meetings, it identified a number of typical e-commerce transactions and analysed the various treaty characterisation issues that could arise from these. The result of that work was a document which described 26 categories of transactions together with the analysis and preliminary conclusions of the Group. That document was released for comments on 24 March 2000.

3. At its meeting of 3-4 July, the TAG continued its work on the basis of these comments. This allowed the TAG to narrow down areas of disagreement between its members, to revise its list of transactions and to draft some general conclusions on treaty characterisation issues. The results of that work were included in a document which was released for comments on 1 September 2000. That document described the various treaty characterisation issues that were identified by the Group and presented the views of the Group concerning these issues; it also included a revised analysis of the various categories of typical e-commerce transactions identified in the previous draft.

4. After further analysis, and having regard to the comments received, the Group, at its last meeting, was able to reach a consensus and to finalise this report to the Working Party.

5. This report is divided as follows:

- section 2 includes the overall recommendation that the TAG makes to Working Party No. 1;
- section 3 constitutes the main part of the report and includes a description of the various treaty characterisation issues identified by the Group, together with the conclusions of the Group on how to address each such issue and, where appropriate, suggestions for changes to the Commentaries on the Model Tax Convention;
- annex 1 reproduces all the suggestions for changes to the Commentaries on the Model Tax Convention which are found throughout section 3;

1. The detailed mandate and composition of the TAG appear in annex 3.

- annex 2 is a revised version of the document first released on 24 March, which now includes the Group's analysis of 28 categories of typical e-commerce transactions;²
- annex 3 reproduces the mandate given to the Group by the OECD Committee on Fiscal Affairs and includes the list of persons who participated in its meetings.

2. RECOMMENDATION TO WORKING PARTY NO. 1

6. During its work, the Group has examined characterisation issues that are relevant to the OECD Model Tax Convention as currently drafted and also some issues that relate to alternative treaty provisions not found in the Model Tax Convention. Its recommendation covers both sets of issues.

7. The TAG recommends to Working Party No. 1 to issue a document clarifying, along the lines of section 3 of this report, how the various tax treaty characterisation issues arising from e-commerce should be solved. In doing so, and since the mandate of the TAG invited it to examine these characterisation issues "with a view to providing the necessary clarifications in the Commentary", the Working Party is invited to take account of the suggestions for changes to the Commentary of the OECD Model Tax Convention which are included in this report (these suggestions are all reproduced in Annex 1). The Working Party is also invited to take account of the conclusions of this report concerning various provisions which are not part of the OECD Model Tax Convention but are found in some bilateral conventions.

3. TREATY CHARACTERISATION ISSUES ARISING FROM E-COMMERCE TRANSACTIONS

8. This section describes the various treaty characterisation issues that were identified by the Group in the course of its work and presents the views of the Group concerning these issues.

9. Throughout its work, the Group has assumed that all payments made in connection with the typical e-commerce transactions that it identified were received in the course of carrying on a business, whether or not the payers were themselves carrying on business. It follows that all these payments are capable of falling within Article 7 of the OECD Model Tax Convention, which deals with business profits. Some payments, however, may be taken out of Article 7 by the rule of paragraph 7 of Article 7, which gives priority to any other Article that expressly deals with the specific type of income concerned. One such Article is Article 12, dealing with royalties. On the basis of its analysis, the Group does not consider that any of the payments that it has examined fall within Article 21, which deals with other income.

Business profits and royalties

10. The definition of royalties currently found in paragraph 2 of Article 12 of the OECD Model Tax Convention reads as follows:

"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

2. The Group did not attempt to cover all categories of current and future e-commerce transactions. Instead, it sought to identify the principles to be applied in analysing the various treaty characterisation issues so that they can be applied to the existing and emerging transactions as required.

cinematograph films, any patent, trade mark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience."

11. In the 1977 Double Taxation Convention, that definition also included "payments [...] for the use, or the right to use, industrial, commercial or scientific equipment" and some bilateral conventions still include this previous definition of royalties.

12. This section analyses classification issues arising from the possible application of various elements of these two definitions to payments made in e-commerce transactions. It also examines classification issues arising from alternative treaty provisions which deal with the provision of services or technical fees.

Business profits and payments for the use of, or the right to use, a copyright

Analysis and conclusions

13. The Group found that one of the most important characterisation issues arising from e-commerce was the distinction between business profits and the part of the treaty definition of "royalties" that deals with payments for the use of, or the right to use, a copyright. Whilst differing views were originally expressed within the Group as regards this issue (as reflected in the March and September 2000 drafts for comments), further discussion in light of the comments received allowed the Group to reach the unanimous conclusions below. These are fully consistent with the views, which the Group has unanimously endorsed, that are expressed in paragraphs 14 to 14.2 of the Commentary on Article 12 as regards software payments.

14. Since the definition of royalties applies to "payments for" any of the various items listed in that definition, the Group has concluded that, in any given transaction, the main question to be addressed is the identification of the consideration for the payment. Under the relevant legislation of some countries, transactions which permit the customer to electronically download computer programs or other digital content may give rise to use of copyright by the customer, *e.g.* because a right to make one or more copies of the digital content is granted under the contract. Where the essential consideration is for something other than the use of, or right to use, rights in the copyright (such as to acquire other types of contractual rights, data or services), and the use of copyright is limited to such rights as are required to enable downloading, storage and operation on the customer's computer, network or other storage, performance or display device, such use of copyright should be disregarded in the analysis of the character of the payment for treaty purposes. This would be the case, for instance, where a payment is made by a person for the downloading and the operation of a copy of a computer program. Whilst electronic downloading of the program may or may not constitute the use of a copyright by the user (as opposed to by the provider) depending on the relevant copyright law and contractual arrangements, the essential consideration for the payment is not that possible use of a copyright.

15. In the case of transactions that permit the customer to electronically download digital products (such as software, images, sounds or text), the payment is made to acquire data transmitted in the form of a digital signal for the own use or enjoyment of the acquirer.³ This constitutes the essential consideration for the payment. To the extent that the act of copying the digital signal onto the customer's hard disk or other non-temporary media (including transfers to other storage, performance or display devices) constitutes the

3. The same result would apply regardless of whether the payment was made as regards the downloading of one specific product or in the form of a subscription fee for the right to access a web site where that digital product may be downloaded.

use of a copyright by the customer under the relevant law and contractual arrangements, this is merely an incidental part of the process of capturing and storing the digital signal. This incidental part is not important for classification purposes because it does not correspond to the essential consideration for the payment (*i.e.*, to acquire data transmitted in the form of a digital signal), which is the determining factor for the purposes of the treaty definition of royalties.

Suggested changes to the Commentary

16. Based on the following, the Group suggests that the following changes be made to the Commentary on Article 12 of the OECD Model Tax Convention:

Add the following paragraphs 17.1 to 17.4 immediately after paragraph 17 of the Commentary on Article 12:

17.1 The principles expressed above as regards software payments are also applicable as regards transactions concerning other types of digital products such as images, sounds or text. The development of electronic commerce has multiplied the number of such transactions. In deciding whether or not payments arising in these transactions constitute royalties, the main question to be addressed is the identification of the consideration for the payment.

17.2 Under the relevant legislation of some countries, transactions which permit the customer to electronically download digital products may give rise to use of copyright by the customer, *e.g.* because a right to make one or more copies of the digital content is granted under the contract. Where the essential consideration is for something other than for the use of, or right to use, rights in the copyright (such as to acquire other types of contractual rights, data or services), and the use of copyright is limited to such rights as are required to enable downloading, storage and operation on the customer's computer, network or other storage, performance or display device, such use of copyright should be disregarded in the analysis of the character of the payment for purposes of applying the definition of "royalties".

17.3 This is the case for transactions that permit the customer (which may be an enterprise) to electronically download digital products (such as software, images, sounds or text) for that customer's own use or enjoyment. In these transactions, the payment is made to acquire data transmitted in the form of a digital signal for the acquiror's own use or enjoyment. This constitutes the essential consideration for the payment, which therefore does not constitute royalties but falls within Article 7 or Article 13, as the case may be. To the extent that the act of copying the digital signal onto the customer's hard disk or other non-temporary media constitutes the use of a copyright by the customer under the relevant law and contractual arrangements, this is merely an incidental part of the process of capturing and storing the digital signal. This incidental part is not important for classification purposes because it does not correspond to the essential consideration for the payment (*i.e.*, to acquire data transmitted in the form of a digital signal), which is the determining factor for the purposes of the definition of royalties. There also would be no basis to classify such transactions as "royalties" if, under the relevant law and contractual arrangements, the creation of a copy is regarded as a use of copyright by the provider rather than by the customer.

17.4 By contrast, transactions where the essential consideration for the payment is the granting of the right to use a copyright in a digital product that is electronically downloaded for that purpose will give rise to royalties. This would be the case, for example, of a book publisher who would pay to acquire the right to reproduce a copyrighted picture that it would electronically download for the purposes of including it on the cover of a book that it is producing. In this transaction, the essential

consideration for the payment is the acquisition of rights to use the copyright in the digital product, *i.e.* the right to reproduce and distribute the picture, and not merely for the acquisition of the digital content.”

Business profits and payments for know-how

Analysis and conclusions

17. Whilst e-commerce transactions resulting in know-how payments are relatively rare, In some transactions, it is necessary to distinguish whether the consideration for a payment is the provision of services or the provision of know-how (*i.e.* information concerning industrial, commercial or scientific experience).

18. The Group noted that paragraph 11 of the Commentary on Article 12 refers to the following key elements to identify transactions for the provision of know-how:

- according to the ANBPPI [*Association des Bureaux pour la Protection de la Propriété Industrielle*], know-how is “undivulged technical information that is necessary for the industrial reproduction of a product or process, directly and under the same conditions; inasmuch as it is derived from experience, know-how represents what a manufacturer cannot know from mere examination of the product and mere knowledge of the progress of technique”;
- “In the know-how contract, one of the parties agrees to impart to the other, so that he can use them for his own account, his special knowledge and experience which remain unrevealed to the public”;
- in the know-how contract “the grantor is not required to play any part himself in the application of the formula ... and ... does not guarantee the results thereof”;
- the provision of know-how must be distinguished from the “provision of services, in which one of the parties undertakes to use the customary skills of his calling to execute work himself for the other party”.

19. The paragraph also includes the following examples of payments which should not be considered to be received as consideration for the provision of know-how but rather, for the provision of services:

- payments obtained as consideration for after-sales service,
- payments for services rendered by a seller to the purchaser under a guarantee,
- payments for pure technical assistance, and
- payments for an opinion given by an engineer, an advocate or an accountant,

20. Applying these criteria and examples to e-commerce transactions, the Group agrees that, for instance, online advice, communications with technicians and using the trouble-shooting database, would clearly involve actual services being performed on demand rather than the provision of know-how.

21. The Group recognises that the distinction between payments for services rendered and payments for the supply of know-how may sometimes raise practical difficulties. It considers that the following criteria, developed in a ruling by the Australian Tax Office, may be useful in that respect.

- under a contract for the supply of know-how:
 - (a) a "product" (*i.e.* knowledge, information, technique, formula, skills, process, plan, etc.) which has already been created or developed or is already in existence is transferred;
 - (b) the product which is the subject of the contract is transferred for use by the buyer (*i.e.* it is supplied); and
 - (c) except in the case of a disposition where the seller divests himself completely of any further interest in the product, the property in the product remains with the seller. All that is obtained by the buyer is the right to use the product. Subject to the terms of the contract, the seller retains the right to use the product himself and to transfer it to others.
- by contrast, in a contract involving the performance of services:
 - (d) the contractor undertakes to perform services which will result in the creation, development or the bringing into existence of a product (which may or may not be know-how);
 - (e) in the course of developing a product, the contractor would apply existing knowledge, skill and expertise - there is not a transfer (*i.e.* supply) of know-how from the contractor to the buyer as such but a use by the contractor of his knowledge for his own purposes; and
 - (f) the product created as a result of the services belongs to the buyer for him to use without having to obtain any further rights in respect of the product. However, in the course of rendering services the contractor would, in most cases, also produce as a by-product a work (*e.g.* plan, design, specification, report, etc., - which could contain knowledge, etc. not otherwise known to the buyer and which may or may not be protected by patents, etc.) in which copyright would subsist. Unless specifically agreed otherwise, the contractor is the owner of such copyright and the buyer or any other person is, by law, precluded from using the property in which the copyright subsists for any purpose other than the purpose for which it was originally designed without first obtaining the approval of the contractor. This would not alter the nature of the contract which would remain one for the performance of services.
- another very important factor is the incidence of cost, *i.e.*, both the level and the nature of the expenditure incurred by the seller:
 - (g) in most cases involving the supply of know-how which is already in existence there would appear to be very little more which needs to be done by the supplier other than to copy existing material [...] On the other hand, a contract for the performance of services would, in the majority of cases, involve a very much greater level of expenditure.

- (h) a contract for the performance of services would, depending on the nature of the services to be rendered, involve the contractor in such items of expenditure as salaries and wages to employees engaged in researching, designing, testing, drawing and other associated activities, payments to sub-contractors for the performance of similar services, etc
- these factors all point to the one main distinctive feature of know-how - that it is an asset and, as such, it is something which is already in existence and is not something brought into being in pursuance of the particular contract.⁴

22. The Group also considers that the following excerpt of the "software regulations", which U.S. IRS and Treasury issued in 1998 regarding the characterisation of income from cross-border transactions involving computer programs, provides useful criteria to distinguish payments for services and payments for know-how as regards e-commerce transactions related to computer programs. Those regulations deal with the distinction between the provision of services (for the development or modification of the computer program) and the provision of know-how (relating to computer programming techniques) in the following words:

"Provision of services. The determination of whether a transaction involving a newly developed or modified computer program is treated as either the provision of services or another transaction described [above] is based on all the facts and circumstances of the transaction, including, as appropriate, the intent of the parties (as evidenced by their agreement and conduct) as to which party is to own the copyright rights in the computer program and how the risks of loss are allocated between the parties.

Provision of know-how. The provision of information with respect to a computer program will be treated as the provision of know-how. .. only if the information is

- (1) Information relating to computer programming techniques;
- (2) Furnished under conditions preventing unauthorised disclosure, specifically contracted for between the parties; and
- (3) Considered property subject to trade secret protection. "

Example. . . .

(i) Facts. Corp A, a U.S. corporation, and Corp I, a Country Z corporation, agree that a development engineer employed by Corp A will travel to Country Z to provide know-how relating to certain techniques not generally known to computer programmers, which will enable Corp I to more efficiently create computer programs. These techniques represent the product of experience gained by Corp A from working on many computer programming projects, and are furnished to Corp I under nondisclosure conditions. Such information is property subject to trade secret protection.

(ii) Analysis. This transaction contains the elements of know-how specified [above]. Therefore, this transaction will be treated as the provision of know-how."

4. The wording of the preceding criteria corresponds, with some adaptations, to paragraphs 28 to 33 of the Australian Tax Office's Taxation Ruling IT 2660, "Income Tax: Definition of Royalties" available at <http://law.at0.gov.au/atolaw/view.htm?basic=know-how&&docid=ITR/IT2660/NAT/ATO/00001>.

Suggested changes to the Commentary

23. The Group considers that it would be useful to provide greater guidance in the Commentary, on the basis of the above criteria and factors, on the distinction to be made between payments for the provision of know-how and payments for the provisions of services. It therefore suggests that the following changes be made to the Commentary on Article 12 of the OECD Model Tax Convention:

Replace paragraph 11 of the Commentary on Article 12 by the following paragraphs 11 to 11.5 (additions to the existing text of paragraph 11 appear in bold italics):

“11. In classifying as royalties payments received as consideration for information concerning industrial, commercial or scientific experience, paragraph 2 alludes to the concept of "know-how". Various specialist bodies and authors have formulated definitions of know-how which do not differ intrinsically. One such definition, given by the "*Association des Bureaux pour la Protection de la Propriété Industrielle*" (ANBPPI), states that ‘know-how is all the undivulged technical information, whether capable of being patented or not, that is necessary for the industrial reproduction of a product or process, directly and under the same conditions; inasmuch as it is derived from experience, know-how represents what a manufacturer cannot know from mere examination of the product and mere knowledge of the progress of technique’.

11.1 In the know-how contract, one of the parties agrees to impart to the other, so that he can use them for his own account, his special knowledge and experience which remain unrevealed to the public. It is recognised that the grantor is not required to play any part himself in the application of the formulas granted to the licensee and that he does not guarantee the result thereof.

11.2 This type of contract thus differs from contracts for the provision of services, in which one of the parties undertakes to use the customary skills of his calling to execute work himself for the other party. *Payments made under the latter contracts generally fall under Article 7.*

11.3 The need to distinguish these two types of payments, i.e. payments for the supply of know-how and payments for the provision of services, sometimes gives rise to practical difficulties. The following criteria are relevant for the purpose of making that distinction:

- ***Contracts for the supply of know-how concern information that already exists or concern the supply of information after its development or creation and include provisions concerning the confidentiality of that information.***
- ***In the case of contracts for the provision of services, the supplier undertakes to perform services which may require the use, by that supplier, of special knowledge, skill and expertise but not the transfer of such special knowledge, skill or expertise to the other party.***
- ***In most cases involving the supply of know-how, there would generally be very little more which needs to be done by the supplier under the contract other than to supply existing information or reproduce existing material. On the other hand, a contract for the performance of services would, in the majority of cases, involve a very much greater level of expenditure by the supplier in order to perform his contractual obligations. For instance, the supplier, depending on the nature of the services to be rendered, may have to incur salaries and wages for employees engaged in researching, designing, testing, drawing and other associated activities or payments to sub-contractors for the performance of similar services.***
- ***In the particular case of a contract involving the provision, by the supplier, of information concerning computer programming, as a general rule the payment will***

only be considered to be made in consideration for the provision of such information so as to constitute know-how where it is made to acquire information constituting ideas and principles underlying the program, such as logic, algorithms or programming languages or techniques, where this information is provided under the condition that the customer not disclose it without authorisation and where it is subject to any available trade secret protection.

11.4 *Examples of payments which should therefore not be considered to be received as consideration for the provision of know-how but, rather, for the provision of services, include:*

- payments obtained as consideration for after-sales service,
- payments for services rendered by a seller to the purchaser under a guarantee,
- payments for pure technical assistance,
- payments for an opinion given by an engineer, an advocate or an accountant, and
- *payments for advice provided electronically, for electronic communications with technicians or for accessing, through computer networks, a trouble-shooting database.*

11.5 In business practice, contracts are encountered which cover both know-how and the provision of technical assistance. One example, amongst others, of contracts of this kind is that of franchising, where the franchisor imparts his knowledge and experience to the franchisee and, in addition, provides him with varied technical assistance, which, in certain cases, is backed up with financial assistance and the supply of goods. The appropriate course to take with a mixed contract is, in principle, to break down, on the basis of the information contained in the contract or by means of a reasonable apportionment, the whole amount of the stipulated consideration according to the various parts of what is being provided under the contract, and then to apply to each part of it so determined the taxation treatment proper thereto. If, however, one part of what is being provided constitutes by far the principal purpose of the contract and the other parts stipulated therein are only of an ancillary and largely unimportant character, then it seems possible to apply to the whole amount of the consideration the treatment applicable to the principal part.” [paragraph 49 below includes suggested changes to this last sentence]

Business profits and payments for the use of, or the right to use, industrial, commercial or scientific equipment

Analysis and conclusions

24. As already mentioned, a number of bilateral conventions include a definition of royalties that covers “payments for the use of, or the right to use, industrial, commercial or scientific equipment” even though these words are no longer found in the definition of the current OECD Model Tax Convention.⁵

5. Paragraph 9 of the Commentary on Article 12 indicates that these words were deleted from the definition of royalties in order “to exclude income from ... leasing [of such equipment] from the definition of royalties and, consequently, to remove it from the application of Article 12 in order to make sure that it would fall under the rules for the taxation of business profits...”

a) *Digital products*

25. The Group examined a few transactions where the issue could arise whether the words “payments for the use of, or the right to use, industrial, commercial or scientific equipment” covered payments for time-limited use of a digital product (*e.g.* category 5 dealing with limited duration software and other digital information licenses).

26. The members of the Group all agreed that payments for such use of digital products cannot be considered as payments "for the use of, or the right to use, industrial, commercial or scientific equipment" on the basis of one or more of the following reasons:

- because digital products cannot be considered as “equipment”, either because the word “equipment” can only apply to a tangible product (and the fact that the digital product is provided on a tangible medium would not change the fact that the object of the transaction is the acquisition of rights to use the digital content rather than rights to use the tangible medium) or because the word “equipment”, in the context of the definition of royalties, applies to property that is intended to be an accessory in an industrial, commercial or scientific process and could not therefore apply to property, such as a music or video CD, that is used in and for itself;
- because such products cannot be viewed as “industrial, commercial or scientific”, at least when provided to the private consumer. Based on the nature of these products or the purpose of their acquisition by the users, these members believe that products such as games, music or videos cannot be considered as “industrial, commercial or scientific”; or
- because the payments involved in that type of transaction generally cannot be considered to be “for the use, or the right to use” the product since these words do not apply to a payment made to definitively acquire a property designed to have a short useful life, which is the case for most of these products, *e.g.* where someone acquires a video game CD that is programmed to become unusable after a certain period of time.

b) *Computer equipment*

27. The Group also examined a few transactions where it could be argued that tangible computer equipment (hardware) was being used by a customer so as to allow the relevant payment to be characterised as “payments for the use of, or the right to use, industrial, commercial or scientific equipment” (see categories 7, 8, 9, 11 and 13 in annex 2).

28. The Group examined various factors used to distinguish rental from service contracts for purposes of section 7701(e) of the U.S. Internal Revenue Code and found these factors to be useful for purposes of determining whether payments are for "the use of, or the right to use, industrial, commercial or scientific equipment". Once adapted to the transactions examined by the Group, these factors, which indicate a lease rather than the provision of services, can be formulated as follows:

- (a) the customer is in physical possession of the property,
- (b) the customer controls the property,
- (c) the customer has a significant economic or possessory interest in the property,
- (d) the provider does not bear any risk of substantially diminished receipts or substantially increased expenditures if there is nonperformance under the contract,

- (e) the provider does not use the property concurrently to provide significant services to entities unrelated to the service recipient, and
- (f) the total payment does not substantially exceed the rental value of the computer equipment for the contract period.

29. This is a non-exclusive list of factors, and some of these factors may not be relevant in particular cases. All relevant facts bearing on the substance of the transaction should be taken into account when determining whether the agreement is a service contract or a lease.

30. Applying these factors to application service provider transactions, the Group concluded that these should generally give rise to services income as opposed to rental payments. In a typical transaction, the service provider uses the software to provide services to customers, maintains the software as needed, owns the equipment on which the software is loaded, provides access to many customers to the same equipment, and has the right to update and replace the software at will. The customer may not have possession or control over the software or the equipment, will access the software concurrently with other customers, and may pay a fee based on the volume of transactions processed by the software.

31. Likewise, data warehousing transactions should be treated as services transactions. The vendor uses computer equipment to provide data warehousing services to customers, owns and maintains the equipment on which the data is stored, provides access to many customers to the same equipment, and has the right to remove and replace equipment at will. The customer will not have possession or control over the equipment and will utilise the equipment concurrently with other customers.

Provision of services

Analysis and conclusions

32. Whilst the OECD Model Tax Convention does not deal separately with payments for the provision of services, the distinction between these payments and payments made as consideration for the acquisition of property is relevant for certain bilateral conventions as well as for some domestic tax law purposes. The Group therefore considered it useful to discuss the distinction between the provision of services and transactions resulting in the acquisition of property, noting that the preceding subsection already dealt with the particular question of the distinction between a rental of property and the provision of services.

33. The basic distinction between, on the one hand, a transaction resulting in the acquisition of property and, on the other hand, a transaction in services is whether the consideration for the payment is the acquisition of property from the provider. In this regard, a transaction resulting in the acquisition of property should be understood to include a transaction where a digital product (such as a copy of electronic data, a software program, digitised music or video images, and other forms of digital information and content), whether provided on a tangible medium or in the form of a digital signal, is acquired by a customer.

34. Generally speaking, if the customer owns the relevant property after the transaction, but the property was not acquired from the provider, then the transaction should be treated as a services transaction. For example, if one party engages another party to create an item of property that the first party will own from the moment of its creation, then no property will have been acquired by the first party from the other and the transaction should be characterised as the provision of services.

35. The Group recognised, however, that if one party acquires property from another party, the transaction should nonetheless be characterised as a services transaction to the extent that the predominant nature of the transaction is the provision of services and the acquisition of property is merely ancillary. This would be the case, for example, where the relevant property itself has little intrinsic value and the provider creates value through the exercise of its particular talents and skills to create a unique result for the acquiror. Online consulting or other professional services is an example of an electronic commerce transaction that typically results in services income. In these transactions, the customer usually does not acquire any form of property from the other party. If the customer does acquire property, such as a report, it most likely will have been created specifically for him and arguably was owned by the customer from the moment of its creation. If, however, the customer acquires a valuable report or other property that was not created specifically for that customer, then the transaction could give rise to income from the sale of property. For example, the sale of the same investment report or other high-value proprietary information to many customers should be treated as a sale of property rather than a service. Even if the customer obtained the report electronically by downloading it from a database of reports maintained on the vendor's server, the essential consideration would still be to acquire data transmitted in the form of a digital signal for the own use or enjoyment of the acquiror rather than to obtain a service.

Technical fees

Analysis and conclusions

36. The Group discussed how various e-commerce payments would be treated under alternative treaty provisions that allow source taxation of "technical fees".

37. Whilst these provisions may be drafted differently, they often include the following definition:

"The term 'technical fees' as used in this Article means payments of any kind to any person, other than to an employee of the person making the payments, in consideration for any service of a technical, managerial or consultancy nature."

38. Alternative formulations of provisions dealing with technical fees typically limit the application of these provisions to some categories of services that could fall within the scope of the definition above.⁶ For these reasons, the Group decided to restrict its analysis to that definition so as to try to clarify the limits of application of these provisions. In doing so, the Group examined separately the three different types of services referred to in the definition, *i.e.* technical services, managerial services and consultancy services.

Technical services

39. For the Group, services are of technical nature when special skills or knowledge related to a technical field are required for the provision of such services. Whilst techniques related to applied science or craftsmanship would generally correspond to such special skills or knowledge, the provision of knowledge acquired in fields such as arts or human sciences would not. As an illustration, whilst the provisions of engineering services would be of a technical nature, the services of a psychologist would not.

40. The fact that technology is used in providing a service is not indicative of whether the service is of a technical nature. Similarly, the delivery of a service via technological means does not make the service technical. This is especially important in the e-commerce environment as the technology underlying the

6. See, for example, the provision of the India-United States tax convention dealing with "included services".

internet is often used to provide services that are not, themselves, technical (*e.g.* offering on-line gambling services through the internet).

41. In that respect, it is crucial to determine at what point the special skill or knowledge is used. Special skill or knowledge may be used in developing or creating inputs to a service business. The fee for the provision of a service will not be a technical fee, however, unless that special skill or knowledge is required when the service is provided to the customer. For example, special skill or knowledge will be required to develop software and data used in a computer game that would subsequently be used in carrying on the business of allowing consumers to play this game on the internet for a fee. Similarly, special skill or knowledge is used to create a troubleshooting database that customers will pay to access over the Internet. In these examples, however, the relevant special skill or knowledge is not used when providing the service for which the fee is paid, *i.e.* allowing the consumer to play the computer game or consult the troubleshooting database.

42. Many categories of e-commerce transactions similarly involve the provision of the use of, or access to, data and software (see, for example, categories 7, 8, 9, 11, 13, 15, 16, 20 and 21 in annex 2). The service of making such data and software, or functionality of that data or software, available for a fee is not, however, a service of a technical nature. The fact that the development of the necessary data and software might itself require substantial technical skills is irrelevant as the service provided to the client is not the development of that data and software (which may well be done by someone other than the supplier) but rather the service of making the data and software available to that client. For example, the mere provision of access to a troubleshooting database would not require more than having available such a database and the necessary software to access it. A payment relating to the provision of such access would not, therefore, relate to a service of a technical nature.

Managerial services

43. The Group considers that services of a managerial nature are services rendered in performing management functions. The Group did not attempt to give a definition of management for that purpose but noted that this term should receive its normal business meaning. Thus, it would involve functions related to how a business is run as opposed to functions involved in carrying on that business. As an illustration, whilst the functions of hiring and training commercial agents would relate to management, the functions performed by these agents (*i.e.* selling) would not.

44. The comments in paragraphs 40 to 42 above are also relevant for the purposes of distinguishing managerial services from the service of making data and software (even if related to management), or functionality of that data or software, available for a fee. The fact that this data and software could be used by the customer in performing management functions or that the development of the necessary data and software, and the management of the business of providing it to customers, might itself require substantial management expertise is irrelevant as the service provided to the client is neither managing the client's business, managing the supplier's business nor developing that data and software (which may well be done by someone other than the supplier) but rather making the software and data available to that client. The mere provision of access to such data and software does not require more than having available such a database and the necessary software. A payment relating to the provision of such access would not, therefore, relate to a service of a managerial nature.

Consultancy services

45. For the Group, “consultancy services” refer to services constituting in the provision of advice by someone, such as a professional, who has special qualifications allowing him to do so. It was recognised that this type of services overlapped the categories of technical and managerial services to the extent that the latter types of services could well be provided by a consultant.

Mixed payments

Analysis and conclusions

46. The Group identified a number of e-commerce transactions where the consideration of the payment could be considered to cover various elements (e.g. the software maintenance transactions described in category 12). It noted the principles for dealing with mixed contracts which are set out in paragraph 11 of the Commentary on Article 12.

47. It also noted, however, that the last sentence of the paragraph provides that "it seems possible to apply to the whole amount of the consideration the treatment applicable to the principal part" where "the other parts [...] are only of an ancillary and largely unimportant character". The Group considers that it would be more practical, as well as more consistent with the conclusions put forward in the recently approved changes to the Commentary on Article 12, to provide that, in such circumstances, the treatment applicable to the principal part should generally be applied to the whole consideration.

48. Some members of the Group took the view that, in most e-commerce transactions, the treaty classification applicable to the predominant element of the payment involved should be applied to the whole of that payment. These members noted that where as a commercial matter the transaction is regarded as a single transaction, an obligation to break down the payments involved in these transactions would impose an unreasonable compliance burden on taxpayers, especially for consumer transactions that involve relatively small amounts of money. Whilst the Group invited comments on that issue, no such comments were received. The conclusion was therefore that only the change suggested in the preceding paragraph should be recommended by the Group.

Suggested changes to the Commentary.

49. Based on the following, the Group suggests that the following changes be made to the Commentary on Article 12 of the OECD Model Tax Convention:

Replace the last sentence of paragraph 11 of the Commentary on Article 12 by the following (changes to the existing text appear in strike-through and bold italics):

“If, however, one part of what is being provided constitutes by far the principal purpose of the contract and the other parts stipulated therein are only of an ancillary and largely unimportant character, ***then the treatment applicable to the principal part should generally be applied to the whole amount of the consideration.*** ~~then it seems possible to apply to the whole amount of the consideration the treatment applicable to the principal part.~~”

ANNEX 1

SUGGESTIONS FOR CHANGES TO THE COMMENTARY TO THE OECD MODEL TAX CONVENTION

[Changes to the existing text of the Commentary appear in bold italics for additions and for deletions]

1. Replace paragraph 11 of the Commentary on Article 12 by the following paragraphs 11 to 11.5:

Replace the last sentence of paragraph 11 of the Commentary on Article 12 by the following (changes to the existing text appear in strike-through and bold italics):

“11. In classifying as royalties payments received as consideration for information concerning industrial, commercial or scientific experience, paragraph 2 alludes to the concept of "know-how". Various specialist bodies and authors have formulated definitions of know-how which do not differ intrinsically. One such definition, given by the *"Association des Bureaux pour la Protection de la Propriété Industrielle"* (ANBPPI), states that know-how is all the undivulged technical information, whether capable of being patented or not, that is necessary for the industrial reproduction of a product or process, directly and under the same conditions; inasmuch as it is derived from experience, know-how represents what a manufacturer cannot know from mere examination of the product and mere knowledge of the progress of technique.

11.1 In the know-how contract, one of the parties agrees to impart to the other, so that he can use them for his own account, his special knowledge and experience which remain unrevealed to the public. It is recognised that the grantor is not required to play any part himself in the application of the formulas granted to the licensee and that he does not guarantee the result thereof.

11.2 This type of contract thus differs from contracts for the provision of services, in which one of the parties undertakes to use the customary skills of his calling to execute work himself for the other party. ***Payments made under the latter contracts generally fall under Article 7.***

11.3 ***The need to distinguish these two types of payments, i.e. payments for the supply of know-how and payments for the provision of services, sometimes gives rise to practical difficulties. The following criteria are relevant for the purpose of making that distinction:***

- ***Contracts for the supply of know-how concern information that already exists or concern the supply of information after its development or creation and include provisions concerning the confidentiality of that information.***
- ***In the case of contracts for the provision of services, the supplier undertakes to perform services which may require the use, by that supplier, of special knowledge, skill and expertise but not the transfer of such special knowledge, skill or expertise to the other party.***
- ***In most cases involving the supply of know-how, there would generally be very little more which needs to be done by the supplier under the contract other than to supply existing information or reproduce existing material. On the other hand, a contract for the performance of services would, in the majority of cases, involve a very much***

greater level of expenditure by the supplier in order to perform his contractual obligations. For instance, the supplier, depending on the nature of the services to be rendered, may have to incur salaries and wages for employees engaged in researching, designing, testing, drawing and other associated activities or payments to sub-contractors for the performance of similar services.

- *In the particular case of a contract involving the provision, by the supplier, of information concerning computer programming, as a general rule the payment will only be considered to be made in consideration for the provision of such information so as to constitute know-how where it is made to acquire information constituting ideas and principles underlying the program, such as logic, algorithms or programming languages or techniques, where this information is provided under the condition that the customer not disclose it without authorisation and where it is subject to any available trade secret protection.*

11.4 *Examples of payments which should therefore not be considered to be received as consideration for the provision of know-how but, rather, for the provision of services, include:*

- payments obtained as consideration for after-sales service,
- payments for services rendered by a seller to the purchaser under a guarantee,
- payments for pure technical assistance,
- payments for an opinion given by an engineer, an advocate or an accountant, and
- *payments for advice provided electronically, for electronic communications with technicians or for accessing, through computer networks, a trouble-shooting database.*

11.5 In business practice, contracts are encountered which cover both know-how and the provision of technical assistance. One example, amongst others, of contracts of this kind is that of franchising, where the franchisor imparts his knowledge and experience to the franchisee and, in addition, provides him with varied technical assistance, which, in certain cases, is backed up with financial assistance and the supply of goods. The appropriate course to take with a mixed contract is, in principle, to break down, on the basis of the information contained in the contract or by means of a reasonable apportionment, the whole amount of the stipulated consideration according to the various parts of what is being provided under the contract, and then to apply to each part of it so determined the taxation treatment proper thereto. If, however, one part of what is being provided constitutes by far the principal purpose of the contract and the other parts stipulated therein are only of an ancillary and largely unimportant character, ***then the treatment applicable to the principal part should generally be applied to the whole amount of the consideration.*** ~~then it seems possible to apply to the whole amount of the consideration the treatment applicable to the principal part."~~

2. Add the following paragraphs 17.1 to 17.4 immediately after paragraph 17 of the Commentary on Article 12:

"17.1 The principles expressed above as regards software payments are also applicable as regards transactions concerning other types of digital products such as images, sounds or text. The development of electronic commerce has multiplied the number of such transactions. In deciding whether or not payments arising in these transactions constitute royalties, the main question to be addressed is the identification of the consideration for the payment.

17.2 Under the relevant legislation of some countries, transactions which permit the customer to electronically download digital products may give rise to use of copyright by the customer, e.g. because a right to make one or more copies of the digital content is granted under the contract. Where the essential consideration is for something other than for the use of, or right to use, rights in the copyright (such as to acquire other types of contractual rights, data or services), and the use of copyright is limited to such rights as are required to enable downloading, storage and operation on the customer's computer, network or other storage, performance or display device, such use of copyright should be disregarded in the analysis of the character of the payment for purposes of applying the definition of "royalties".

17.3 This is the case for transactions that permit the customer (which may be an enterprise) to electronically download digital products (such as software, images, sounds or text) for that customer's own use or enjoyment. In these transactions, the payment is made to acquire data transmitted in the form of a digital signal for the acquiror's own use or enjoyment. This constitutes the essential consideration for the payment, which therefore does not constitute royalties but falls within Article 7 or Article 13, as the case may be. To the extent that the act of copying the digital signal onto the customer's hard disk or other non-temporary media constitutes the use of a copyright by the customer under the relevant law and contractual arrangements, this is merely an incidental part of the process of capturing and storing the digital signal. This incidental part is not important for classification purposes because it does not correspond to the essential consideration for the payment (i.e. to acquire data transmitted in the form of a digital signal), which is the determining factor for the purposes of the definition of royalties. There also would be no basis to classify such transactions as "royalties" if, under the relevant law and contractual arrangements, the creation of a copy is regarded as a use of copyright by the provider rather than by the customer.

17.4 By contrast, transactions where the essential consideration for the payment is the granting of the right to use a copyright in a digital product that is electronically downloaded for that purpose will give rise to royalties.. This would be the case, for example, of a book publisher who would pay to acquire the right to reproduce a copyrighted picture that it would electronically download for the purposes of including it on the cover of a book that it is producing. In this transaction, the essential consideration for the payment is the acquisition of rights to use the copyright in the digital product, i.e. the right to reproduce and distribute the picture, and not merely for the acquisition of the digital content."

ANNEX 2

ANALYSIS OF VARIOUS CATEGORIES OF TYPICAL E-COMMERCE TRANSACTIONS

1. This annex is an updated version of the draft released by the TAG on 24 March 2000 and first revised on 1 September 2000. This last version reflects the conclusions reached by the Group on the various characterisation issues identified in section 2 of the report.

Category 1: Electronic order processing of tangible products

Definition

The customer selects an item from an online catalogue of tangible goods and orders the item electronically directly from a commercial provider. There is no separate charge to the customer for using the online catalogue. The product is physically delivered to the customer by a common carrier.

Analysis and conclusions

2. Whilst the Group considers that category of transaction as a useful starting point, it does not see it as raising any treaty characterisation issue. In this type of transaction, the payment made by the customer constitutes consideration that clearly falls within Article 7 (Business Profits) rather than Article 12 (Royalties), because it does not involve a use of copyright.

Category 2: Electronic ordering and downloading of digital products

Definition

The customer selects an item from an online catalogue of software or other digital products and orders the product electronically directly from a commercial provider. There is no separate charge to the customer for using the online catalogue. The digital product is downloaded onto the customer's hard disk or other non-temporary media.

Analysis and conclusions

3. The Group found that this category of transaction raised the fundamental characterisation issue discussed in paragraphs 13 to 15 of section 3 above, *i.e.* the distinction between business profits and the part of the treaty definition of "royalties" dealing with payments for the use of, or the right to use, a copyright. It concluded that in the case of transactions that permit the customer to electronically download digitised products (such as software, images, sounds or text) for the customer's own use or enjoyment, the

payment is made to acquire data transmitted in the form of a digital signal. Since this constitutes the essential consideration for the payment, that payment cannot be considered as royalties as a payment made for the use or the right to use a copyright so as to constitute a royalty. To the extent that the act of copying the digital signal onto the customer's hard disk or other non-temporary media (including transfers to other storage, performance or display devices) constitutes the use of a copyright under the relevant law and contractual arrangements, this is merely an incidental part of the process of capturing and storing the digital signal. This incidental part is not important for classification purposes because it does not correspond to the essential consideration for the payment (*i.e.* to acquire data transmitted in the form of a digital signal), which is the determining factor for the purposes of the treaty definition of royalties.

Category 3: Electronic ordering and downloading of digital products for purposes of commercial exploitation of the copyright

Definition

The customer selects an item from an online catalogue of software or other digital products and orders the product electronically directly from a commercial provider. There is no separate charge to the customer for using the online catalogue. The digital product is downloaded into the customer's hard disk or other non-temporary media. The customer acquires the right to commercially exploit the copyright in the digital product (e.g. a book publisher acquires a copyrighted picture to be included on the cover of a book that it is producing).

Analysis and conclusions

4. The Group considered it useful to refer to this category of transaction in order to illustrate a case where all its members agree that the payment qualifies as a royalty. Indeed, in that case, the payment is made as consideration for the right to use the copyright in the digital product. In the example given, that use takes the form of the reproduction and sale, for commercial purpose, of the copyrighted picture.

Category 4: Updates and add-ons

Definition

The provider of software or other digital product agrees to provide the customer with updates and add-ons to the digital product. There is no agreement to produce updates or add-ons specifically for a given customer.

Analysis and conclusions

5. The Group agrees that this category of transaction should be treated

- like the transactions described in category 1 above if the updates and adds-on are delivered on a tangible medium;

- like the transactions described in category 2 above if the updates and adds-on are delivered electronically.

6. Since both categories 1 and 2 would give rise to payments falling under Article 7, payments made by the customer in this category of transaction should therefore be treated similarly.

Category 5: Limited duration software and other digital information licenses

Definition

The customer receives the right to use software or other digital products for a period of time that is less than the useful life of the product. The product is either downloaded electronically or delivered on a tangible medium such as a CD. All copies of the digital product are deleted or become unusable upon termination of the license.

Analysis and conclusions

7. The Group unanimously concluded that, under the OECD Model as currently worded, that transaction should be treated exactly as transactions falling under categories 1 or 2 so that the payment to the commercial provider of the limited duration digital product would fall under Article 7 (Business Profits).

8. Also, if a particular convention includes a definition of royalties that covers “payments for the use of, or the right to use, industrial, commercial or scientific equipment”, the Group concluded that such payments cannot be considered as payments "for the use of, or the right to use, industrial, commercial or scientific equipment" for the reasons set out in paragraphs 25 and 26 of section 3 above.

Category 6: Single-use software or other digital product

Definition

The customer receives the right to use software or other digital products one time. The product may be either downloaded or used remotely (e.g. use of software stored on a remote server). The customer does not receive the right to make copies of the digital product other than as required to use the digital product for its intended use.

Analysis and conclusions

9. Whilst some members view this type of transaction as contracts for services and others view them as being similar to the transactions referred to in categories 2 and 5, the Group unanimously agreed that payments made in these transactions fall under Article 7 as business profits.

Category 7: Application Hosting - Separate License

Definition

A user has a perpetual license to use a software product. The user enters into a contract with a host entity whereby the host entity loads the software copy on servers owned and operated by the host. The host provides technical support to protect against failures of the system. The user can access, execute and operate the software application remotely. The application is executed either at a customer's computer after it is downloaded into RAM or remotely on the host's server. This type of arrangement could apply, for example, for financial management, inventory control, human resource management or other enterprise resource management software applications.

Analysis and conclusions

10. The Group agrees that, under the current wording of the OECD Model, this type of transaction gives rise to business profits falling under Article 7.

11. Where, however, a particular convention includes a definition of royalties that covers “payments for the use of, or the right to use, industrial, commercial or scientific equipment”, the issue arises whether these words can be applied to all or part of the payments arising from these transactions.

12. As discussed in paragraphs 27 to 31 of section 3 above, the Group concluded that these transactions should generally give rise to services income as opposed to rental payments. In a typical transaction, the vendor uses computer equipment to provide data warehousing services to customers, owns and maintains the equipment on which the data is stored, provides access to many customers to the same equipment, and has the right to remove and replace equipment at will. The customer will not have possession or control over the equipment and will utilise the equipment concurrently with other customers.

13. The Group also discussed whether payments arising in this type of transaction could be treated as payments for services of a “technical nature” under alternative treaty provisions that allow source taxation of “technical fees”. To the extent that main service being provided is merely that of storing the data and software of customers, this service is akin to mere warehousing and the performance of that function does not require the direct exercise of any special technical skill or knowledge.

Category 8: Application Hosting - Bundled Contract

Definition

For a single, bundled fee, the user enters into a contract whereby the provider, who is also the copyright owner, allows access to one or more software applications, hosts the software applications on a server owned and operated by the host, and provides technical support for the hardware and software. The user can access, execute and operate the software application remotely. The application is executed either at a customer's computer after it is downloaded into RAM or remotely on the host's server. The contract is renewable annually for an additional fee.

Analysis and conclusions

14. The Group agrees that, under the current wording of the OECD Model, there would be no need to separate the payment described in this example as all of it would constitute business profits falling under Article 7.

15. Pursuant to the existing paragraph 11 of the Commentary on Article 12, however, the need to separate the payment into various components could arise when applying bilateral conventions that include the alternative provisions referred to in the previous category (see paragraphs 46 to 49 of section 3 above). This would be the case to the extent that part of the payment relates to the provision of technical support for the software that would constitute services of a technical nature. In that case, that part would be treated differently from the parts relating to allowing access to one or more software applications and hosting such software applications as such functions do not require the application of special skills or knowledge (they essentially require owning the relevant equipment and software rights that are made available).

Category 9: Application Service Provider ("ASP")

Definition

The provider obtains a license to use a software application in the provider's business of being an application service provider. The provider makes available to the customer access to a software application hosted on computer servers owned and operated by the provider. The software automates a particular back-office business function for the customer. For example, the software might automate sourcing, ordering, payment, and delivery of goods or services used in the customer's business, such as office supplies or travel arrangements. The provider does not provide the goods or services. It merely provides the customer with the means to automate and manage its interaction with third-party providers of these goods and services. The customer has no right to copy the software or to use the software other than on the provider's server, and does not have possession or control of a software copy.

Analysis and conclusions

16. As regards the payment made by the customer, the Group agrees that the issues arising are similar to those discussed under the preceding category.

Category 10: ASP License Fees

Definition

In the example above, the ASP pays the provider of the software application a fee which is a percentage of the revenue collected from customers. The contract is for a one year term.

Analysis and conclusions

17. The Group agrees that this type of transaction, being essentially for the provision of a software product to be used in the business of the transferee, falls within Article 7. The Group acknowledged that

the fact that the ASP's customer will have access to the software copy hosted on servers owned and operated by the provider may technically involve the ASP displaying to the customers some copyrighted information (e.g. forms for data input). The Group agreed, however, that if providing such access constituted the use of a copyright right by the ASP (for example a display or other right), such use of copyright would be such a minimal part of the consideration for the payment made by the ASP to the software provider that it should not be relevant for the treaty characterisation of that payment.

Category 11: Web site hosting

Definition

The provider offers space on its server to host web sites. The provider obtains no rights in the copyrights created by the developer of the web site content. The owner of the copyrighted material on the site may remotely manipulate the site, including modifying the content on the site. The provider is compensated by a fee based on the passage of time.

Analysis and conclusions

18. The Group agrees that, under the current wording of the OECD Model, this type of transaction gives rise to business profits falling under Article 7. The Group also notes that where a particular convention includes a definition of royalties that covers "payments for the use of, or the right to use, industrial, commercial or scientific equipment" or alternative treaty provisions that allow source taxation of "technical fees", this type of transaction would not give rise to these two types of income under the circumstances and for the reasons presented under category 7, which deals with application hosting.

Category 12: Software maintenance

Definition

Software maintenance contracts typically bundle software updates together with technical support. A single annual fee is charged for both updates and technical support. In most cases, the principal object of the contract is the software updates.

Analysis and conclusions

19. The Group concluded that the remarks expressed in paragraphs 46 to 48 of section 3 above as regards mixed contracts, which refer to the principles set out in paragraph 11 of the Commentary on Article 12, apply to such transactions. Where, under those principles, part of the payment is regarded to be for the provision of technical support, the issues described in category 14 below as regards alternative treaty provisions that allow source taxation of "technical fees" will arise.

Category 13: Data warehousing

Definition

The customer stores its computer data on computer servers owned and operated by the provider. The customer can access, upload, retrieve and manipulate data remotely. No software is licensed to the customer under this transaction. An example would be a retailer who stores its inventory records on the provider's hardware and persons on the customer's order desk remotely access this information to allow them to determine whether orders could be filled from current stock.

Analysis and conclusions

20. The Group agrees that, under the current wording of the OECD Model, this type of transaction gives rise to business profits falling under Article 7. The Group also notes that where a particular convention includes a definition of royalties that covers "payments for the use of, or the right to use, industrial, commercial or scientific equipment" or alternative treaty provisions that allow source taxation of "technical fees", this type of transaction would not give rise to these two types of income under the circumstances and for the reasons presented under category 7, which deals with application hosting.

Category 14: Customer support over a computer network

Definition

The provider provides the customer with online technical support, including installation advice and trouble-shooting information. This support can take the form of online technical documentation, a trouble-shooting database, and communications (e.g. by e-mail) with human technicians.

Analysis and conclusions

21. The Group agreed that, based on this description and under the wording of the OECD Model Convention, the payment arising in this type of transaction would fall within Article 7. In reaching its conclusion, the Group discussed the extent to which the payment could be considered as a payment for "information concerning industrial, commercial or scientific experience" (know-how) so as to constitute royalties.

22. Based on paragraphs 17 to 23 of section 3 above and, in particular, the factors listed in paragraphs 18 and 19, the Group agrees that online advice, communications with technicians and using the trouble-shooting database, would clearly involve actual services being performed on demand rather than the provision of know-how.

23. Whilst the provision of technical documentation could, depending on the circumstances, constitute the provision of know-how, this would require that the information be "undivulged technical information" as described in paragraph 11 of the Commentary on Article 12. Also, as mentioned in the same paragraph, know-how "is necessary for the industrial reproduction of a product or process". To the extent that know-how must be technical information relating to industrial reproduction of a product or

process, the Group considers that information that merely relates to the operation or use of products as opposed to their development or production would not fall under the definition of know-how.

24. The Group notes that the remarks in paragraphs 46 to 48 of section 3 above, which deal with mixed contracts, would be relevant if the contract were considered to cover the provision of both services and know-how.

25. The Group finally discussed how the payment arising in this type of transaction would be treated under alternative treaty provisions that allow source taxation of "technical fees".

26. Whilst the provision of online advice through communications with technicians may require the application of special skill and knowledge and might therefore constitute services of a technical nature, the mere provision of access to a troubleshooting database would not require more than having available such a database and the necessary software to access it. The part of the payment relating to the provision of such access would not, therefore, relate to a service of a technical nature.

Category 15: Data retrieval

Definition

The provider makes a repository of information available for customers to search and retrieve. The principal value to customers is the ability to search and extract a specific item of data from amongst a vast collection of widely available data.

Analysis and conclusions

27. All members of the Group consider that the payment arising from this type of transaction would fall under Article 7. Some of them reach that conclusion because, given that the principal value of such a database would be the ability to search and extract the documents, these members view the contract as a contract for services. Others consider that, in this transaction, the customer pays in order to ultimately obtain the data that he will search for. They therefore view the transaction as being similar to those described in category 2 and will accordingly treat the payment as business profits.

28. The Group also addressed the issue of whether these could be considered as services "of a technical nature" under the alternative provisions on technical fees previously referred to. The Group agreed that providing a client with the use of search and retrieval software and with access to a database does not involve the exercise of special skill or knowledge when the software and database is delivered to the client. The fact that the development of the necessary software and database would itself require substantial technical skills was found to be irrelevant as the service provided to the client was not the development of the software and database (which may well be done by someone other than the supplier) but rather making the completed software and database available to that client.

Category 16: Delivery of exclusive or other high-value data

Definition

As in the previous example, the provider makes a repository of information available to customers. In this case, however, the data is of greater value to the customer than the means of finding and retrieving it. The provider adds significant value in terms of content (e.g. by adding analysis of raw data) but the resulting product is not prepared for a specific customer and no obligation to keep its contents confidential is imposed on customers. Examples of such products might include special industry or investment reports. Such reports are either sent electronically to subscribers or are made available for purchase and download from an online catalogue or index.

Analysis and conclusions

29. The Group agrees that these transactions involve the same characterisation issues as those described in the previous category. It therefore believes that the payment arising from this type of transaction would fall under Article 7 and is not a technical fee for the same reason.

Category 17: Advertising

Definition

Advertisers pay to have their advertisements disseminated to users of a given web site. So-called “banner ads” are small graphic images embedded in a web page, which when clicked by the user will load the web page specified by the advertiser. Advertising rates are most commonly specified in terms of a cost per thousand “impressions” (number of times the ad is displayed to a user), though rates might also be based on the number of “click-throughs” (number of times the ad is clicked by a user).

Analysis and conclusions

30. All members of the Group agreed that the payments arising from these transactions would constitute business profits falling under Article 7 rather than royalties, even under alternative definitions of royalties that cover payments “for the use, or the right to use, industrial, commercial or scientific equipment”.

Category 18: Electronic access to professional advice (e.g. consultancy)

Definition

A consultant, lawyer, doctor or other professional service provider advises customers through email, video conferencing, or other remote means of communication.

Analysis and conclusions

31. Again, all members of the Group agreed that the payments arising from these transactions would constitute business profits falling under Article 7 rather than royalties. As already stated, the provision of on-demand advice is a service and not the supply of know-how.

32. As these transactions involve the provision of technical, managerial or consultancy services, the Group also addressed the issue of whether these could be considered as services “of a technical nature” under the alternative provisions on technical fees that have been previously referred to. The Group concluded that to the extent that the services were rendered by someone acting as a consultant, they would constitute services of a consultancy nature so as to fall within the definition quoted in paragraph 37 of section 3.

Category 19: Technical information

Definition

The customer is provided with undivulged technical information concerning a product or process (e.g. narrative description and diagrams of a secret manufacturing process).

Analysis and conclusions

33. The Group agrees that payments arising from this category of transactions constitute royalties as they are made for the supply of know-how, *i.e.* “for information concerning industrial, commercial or scientific experience.”

Category 20: Information delivery

Definition

The provider electronically delivers data to subscribers periodically in accordance with their personal preferences. The principal value to customers is the convenience of receiving widely available information in a custom-packaged format tailored to their specific needs.

Analysis and conclusions

34. The Group agrees that this type of transaction raises basically the same issues as those described under category 15 above. The members of the Group therefore consider that the payments arising from these transactions constitute business profits falling under Article 7 and are not technical fees for the same reason.

Category 21: Access to an interactive web site

Definition

The provider makes available to subscribers a web site featuring digital content, including information, music, video, games, and activities (whether or not developed or owned by the provider). Subscribers pay a fixed periodic fee for access to the site. The principal value of the site to subscribers is interacting with the site while online as opposed to getting a product or services from the site.

Analysis and conclusions

35. The Group agrees that the subscription fee paid in this type of transactions would constitute a payment for services. As that payment is mainly for the interaction with the site for purposes of the personal enjoyment of the user and not for the provision of any service of a technical, managerial or consultancy nature, it would not, under the previously quoted definition of “technical fees”, fall under the alternative provisions covering these types of payments. The Group also agreed any payment to the owner of the copyright in the digital content that would be made by the provider for the right to display that content to its subscribers would constitute royalties.

Category 22: Online shopping portals

Definition

A web site operator hosts electronic catalogues of multiple merchants on its computer servers. Users of the web site can select products from these catalogues and place orders online. The web site operator has no contractual relationship with shoppers. It merely transmits orders to the merchants, who are responsible for accepting and fulfilling orders. The merchants pay the web site operator a commission equal to a percentage of the orders placed through the site.

Analysis and conclusions

36. The Group agrees that these payments are revenues from advertising or similar services that constitute business profits falling under Article 7.

Category 23: Online auctions

Definition

The provider displays many items for purchase by auction. The user purchases the items directly from the owner of the items, rather than from the enterprise operating the site. The vendor compensates the provider with a percentage of the sales price or a flat fee.

Analysis and conclusions

37. The Group agrees that these payments are revenues similar to those of an auction house and constitute business profits falling under Article 7.

Category 24: Sales referral programs

Definition

An online provider pays a sales commission to the operator of a web site that refers sales leads to the provider. The web site operator will list one or more of the provider's products on the operator's web site. If a user clicks on one of these products, the user will retrieve a web page from the provider's site from which the product can be purchased. When the link on the operator's web page is used, the provider can identify the source of the sales lead and will pay the operator a percentage commission if the user buys the product.

Analysis and conclusions

38. The Group agrees that these payments constitute business profits falling under Article 7.

Category 25: Content acquisition transactions

Definition

A web site operator pays various content providers for news stories, information, and other online content in order to attract users to the site. Alternatively, the web site operator might hire a content provider to create new content specifically for the web site.

Analysis and conclusions

39. The Group agrees that the two alternatives described above need to be distinguished. Where the site operator pays a content provider for the right to display copyrighted material, the payment would fall under the definition of royalties to the extent that the public display of the content constitutes a right covered by the copyright of the owner of the content. Where, however, the operator pays for the creation of new content and, as a result of the relevant contractual arrangements, becomes the owner of the copyright in the content so created, the payment cannot be for royalties and falls under Article 7.

Category 26: Streamed (real time) web based broadcasting

Definition

The user accesses a content database of copyrighted audio and/or visual material. The broadcaster receives subscription or advertising revenues.

Analysis and conclusions

40. The Group agrees that the subscription or advertising fees that would be received in these transactions would constitute business profits falling under Article 7.

Category 27: Carriage fees

Definition

A content provider pays a particular web site or network operator in order to have its content displayed by the web site or network operator.

Analysis and conclusions

41. The Group agrees that in that type of transactions, the web site or network operator is providing a commercial service for a fee and its income should be characterised as business profits under Article 7. In these transactions, unlike in those described in category 25, it is the owner of the copyrighted material who makes the payment, which makes it clear that Article 12 is not applicable.

Category 28: Subscription to a web site allowing the downloading of digital products

Definition

The provider makes available to subscribers a web site featuring copyrighted digital content (e.g. music). Subscribers pay a fixed periodic fee for access to the site. Unlike category 21, the principal value of the site to subscribers is the possibility to download these digital products.

Analysis and conclusions

42. The Group agrees that the subscription fee paid in this type of transaction would fall under Article 7. As explained in paragraph 3 above, transactions that permit the customer to electronically download digitised products (*i.e.* music in this case) for the customer's own use or enjoyment do not give rise to royalties. The Group also agreed that this category of transaction is closer to category 2 than to category 21 since the essential consideration for the payment is not the temporary interaction with the site but, rather, the acquisition of the music data transmitted in the form of a digital signal.

ANNEX 3

MANDATE AND COMPOSITION OF THE TAG

[The following is the mandate that the TAG received by the Committee on Fiscal Affairs]

General mandate

The general mandate for the TAG on Treaty Characterisation of Electronic Commerce Payments is as follows:

“To examine the characterisation of various types of electronic commerce payments under tax conventions with a view to providing the necessary clarifications in the Commentary.”

Specific mandate

The work of the TAG on Treaty Characterisation of Electronic Commerce Payments will involve primarily, but not exclusively, a consideration of the application of the definition of royalties in the context of electronic commerce.

It has already been decided to seek comments from interested parties on how the principles that underlie the proposed changes to the Commentary on software payments may be relevant in considering how that definition applies in the case of electronic commerce transactions involving digitised contents. The first responsibility of the TAG will therefore be to examine these comments and to make appropriate suggestions.

In the course of its work, the TAG will be invited to examine and provide comments on the distinction that can be drawn between various types of payments in determining whether a particular electronic commerce payment, *e.g.* a payment made for electronically searching a computer database and downloading a document from it, is made for the sale or lease of property, for the provision of a service or as a royalty. In particular:

- a) the TAG is invited to identify different types of electronic commerce transactions and the particular characteristics of such transactions which might enable distinctions to be drawn between payments for services and income from sales or leasing of property;
- b) the TAG is invited to identify characteristics of electronic commerce transactions which might enable distinctions to be drawn between business profits and royalties and, in particular, the circumstances, if any, in which electronic commerce payments may be considered to be payments for use of copyright or use of know-how;
- c) the TAG is invited to comment on whether there are reasons for preferring one characterisation to another;
- d) the TAG is invited to identify the circumstances in which electronic commerce transactions can be considered to give rise to payments for industrial, commercial or scientific equipment.

Composition of the TAG

The following persons have participated in the activities of the TAG and have attended one or more of its meetings: It should be noted that this report reflects the personal views of the TAG participants at the time it was prepared. These views should not, therefore, be attributed to any government, business or organisation for which these participants work.

AUSTRALIA

Ms. Ariane Pickering (*Co-Chair of the TAG*)
Australian Taxation Office

Ms. HK Holdaway
Australian Taxation Office

CHILE

Ms. Liselott Kana (*Co-Chair of the TAG*)
Ministry of Finance

CHINA

Mr. Wang Yukang
Ministry of Finance

GERMANY

Mr. Helmut Krabbe
Federal Ministry of Finance

Mr. Martin Kreienbaum
Federal Ministry of Finance

INDIA

Mr. Vijay Mathur
Ministry of Finance

ISRAEL

Mr. Yehoshua Sherman
Israel Income Tax and Property Tax Commission
(*Mr. Sherman left the Israel Income Tax and Property Tax Commission before the report was completed*)

Ms. Frida Israeli
Israel Income Tax and Property Tax Commission

Mr. Yuval Cohen
Israel Income Tax and Property Tax Commission

JAPAN

Mr. Hiroyuki Iguchi
Ministry of Finance

Mr. Isao Watanabe
Ministry of Finance

Mr. Akihiko Yoshida
Ministry of Finance

Mr. Katsumi Shinagawa
Ministry of Finance

NORWAY

Mr. Gjert Melsom
Ministry of Finance

UNITED KINGDOM

Mr. Mike Waters
Inland Revenue

UNITED STATES

Mr. Michael Mundaca
Department of Treasury

BUSINESS

Mr. Gary Sprague (*Co-Chair of the TAG*)
Baker & McKenzie
United States

Mr. Frank Steimel
SIEMENS
Germany

Mr. Yasushi Ogasawara
NTT Data
Japan

Mr. M. Onodera
NTT Data
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Mr. David Fuller
REED ELSEVIER plc
United Kingdom

Mr. Charles Fontaine
REED ELSEVIER Inc.
United States

Ms. Anne Buettner
WALT DISNEY Co.
United States

Mr. Mark Williams
WALT DISNEY Co.
United States

Ms. Carol Felepchuk
IBM Canada Ltd.
Canada

Mr. Mark E. Nebergall
SOFTEC
United States

While representatives of the Government of Israel participated in the work of the Group, these representatives wish to indicate that they do not necessarily support some of the conclusions reached by the Group, especially as regards the meaning of the words "payments for the use, or the right to use, industrial, commercial or scientific equipment.