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TREATY ASPECTS AND INFORMATION EXCHANGE*

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I will address issues presented by the treatment of information transfers under income tax treaties and the exchange of tax information under such treaties.

I. THE TREATMENT OF INFORMATION TRANSFERS UNDER TAX TREATIES

The tax treatment of information transfers under treaties depends on whether the transfer is viewed as the use of property (which would cause the payment to be taxed as a royalty or a rent), a sale of property (which would cause the payment to be taxed as business profits), or a performance of a service.

Under article 12 of the United States and Organization for Economic Co-operation and Development (OECD) Model Treaties, a royalty is taxed only in the contracting state of which the beneficial owner is a resident, unless the payment is attributable to a permanent establishment or fixed base of the owner in the other state.¹ Under article 12 of the United Nations Model Treaty, royalties may also be taxed in the contracting state in which they arise and on a gross basis.² Under any of the model treaties, royalties are taxed in the source state as business profits where attributable to a permanent establishment through which the owner carries on a business or as services where attributable to a fixed base through which the owner performs cer-

* This Article is a transcript of Ms. Fisher's speech delivered at Borough Hall, Brooklyn, New York on December 5, 1990. The views expressed in this Article are Ms. Fisher's alone and do not necessarily represent the views of the United States Treasury Department or the United States Government.

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1. Treasury Department's Model Income Tax Treaty, art. 12, Tax Treaties (CCH) ¶ 211 (1981) [hereinafter United States Model Treaty]; ORGANIZATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT (OECD) MODEL CONVENTION FOR THE AVOIDANCE OF DOUBLE TAXATION, art. 12, Tax Treaties (CCH) ¶ 201 (1977) [hereinafter OECD MODEL TREATY].

2. U.N. MODEL DOUBLE TAXATION CONVENTION BETWEEN DEVELOPED AND DEVELOPING COUNTRIES, art. 12(2), Tax Treaties (CCH) ¶ 206 [hereinafter U.N. MODEL TREATY].

tain services. A number of United States treaties with OECD countries and developing countries permit the source state to impose a gross-basis withholding tax on royalties not attributable to a permanent establishment or fixed base of the owner there.³

The definition of a royalty in all three model treaties includes payments for "information concerning industrial, commercial or scientific experience."⁴ The OECD's Commentaries on the Articles of the Model Convention (Commentaries)⁵ define the type of information transfer considered to generate a royalty as a transfer of know-how.⁶ In a know-how transfer, the grantor imparts "his special knowledge and experience, which remain unrevealed to the public."⁷ The Commentaries distinguish a know-how transfer from the performance of a service. In a know-how transfer, the grantor is not required to apply the "formulae granted to the licensee and he does not guarantee the result thereof."⁸ In a services contract, "one of the parties undertakes to use the customary skills of his calling to execute work himself for the other party."⁹

The Commentaries note that, in practice, contracts may cover both know-how and technical assistance services.¹⁰ In these cases, the Commentaries recommend determining the consideration for each category and taxing each appropriately, while allowing for the possibility of applying to all consideration under a contract the treatment applicable to the principal part.¹¹

3. See, e.g., Income Tax Treaty, July 28, 1968, United States-France, 1968-2 C.B. 691, 19 U.S.T. 5280, T.I.A.S. No. 6518, Tax Treaties (CCH) ¶ 3003.23 [hereinafter United States-France Income Tax Treaty]; Income Tax Treaty, Jan. 1, 1947, United States-Netherlands, art. IX(1)(3), 1949-1 C.B. 92, 17 U.S.T. 4183, T.I.A.S. No. 2563, Tax Treaties (CCH) ¶ 6203; Income Tax Treaty, Apr. 30, 1984, United States-People's Republic of China, art. 11(1), Tax Treaties (CCH) ¶ 2103.12; Income Tax Treaty, Sept. 12, 1989, United States-India, Tax Treaties (CCH) ¶ 4203.25 [hereinafter United States-India Income Tax Treaty].

4. UNITED STATES MODEL TREATY, *supra* note 1, at art. 12; OECD MODEL TREATY, *supra* note 1, at art. 12; U.N. MODEL TREATY, *supra* note 2, at art. 12.

5. Commentaries on the Articles of the Model Convention, Model Double Taxation Convention on Income and on Capital, Report of the OECD Committee on Fiscal Affairs, Organization for Economic Co-operation and Development (1977) [hereinafter Commentaries].

6. Commentaries, *supra* note 5, at art. 12, para. 12.

7. Commentaries, *supra* note 5, at art. 12, para. 12.

8. Commentaries, *supra* note 5, at art. 12, para. 12.

9. Commentaries, *supra* note 5, at art. 12, para. 12.

10. Commentaries, *supra* note 5, at art. 12, para. 12.

11. Commentaries, *supra* note 5, at art. 12, para. 12.

While the distinction between technical services and royalties provided in the Commentaries is useful, there will be cases where applying the distinction made in the Commentaries is difficult, as when the service both engages the service provider in performing his customary service and results in the recipient's acquisition of similar expertise.

Some countries, especially developing countries, tax certain service fees under their domestic law as they would tax royalties, applying a gross-basis withholding tax to service payments made to foreign persons. In India, for example, a thirty percent withholding tax is imposed on fees paid to foreign persons for technical, advisory, and consultancy services, wherever performed.¹² In Brazil, a twenty-five percent withholding tax is imposed on all services payments to foreign persons with a limited exception for payments for services intended to further Brazilian exports.¹³ To the extent another country imposes a tax on a service performed in the United States, a United States service provider is potentially subject to double taxation.

The tax convention between the United States and India, expected to go into effect on January 1, 1991 for the United States and on April 1, 1991 for India,¹⁴ permits the imposition of a gross-basis withholding tax under the royalty provision on a narrow category of services, called "included services."¹⁵ Included services are services of a technical type. The term "technical" was not used, however, in order to avoid any implication that Indian law would apply to define the scope of the category. In general, included services consist of services that (1) are ancillary and subsidiary to the use of property giving rise to a royalty or rent or (2) make available technical knowledge, experience, skill, know-how, or process, or consist of the development and transfer of a technical plan or technical design.¹⁶

The "ancillary and subsidiary" class of included services includes only services related to the application or enjoyment of that right, property, or information for which a royalty is received, if the clearly predominant purpose of the arrangement is

12. Taxes and Investment in Asia and the Pacific, Part II, Volume 2, Supplement No. 71, India-83, § 20.7, BULL. FOR INT'L FISCAL DOCUMENTATION (July 1990).

13. Taxation in Latin America, Supplement No. 78, Brazil-45, 46-52, §§ 6.09-6.10, BULL. FOR INT'L FISCAL DOCUMENTATION (Dec. 1989).

14. United States-India Income Tax Treaty, *supra* note 3.

15. United States-India Income Tax Treaty, *supra* note 3, at art. 12(2).

16. United States-India Income Tax Treaty, *supra* note 3, at art. 12(4)(a)(b).

the application or enjoyment of that right, property, or information.¹⁷ The "technical knowledge" class of services is a very narrow category that excludes any service that does not make technology available to the person acquiring the service.¹⁸ Generally, technology is considered to be made available when the person acquiring the service is able to apply the technology. The fact that a service provider must have substantial technical skill does not mean that technology is made available through the service.¹⁹

To reduce double taxation of included services, the United States agreed that fees for included services would be sourced in the residence state of the payor. The treatment of even a narrow category of services as royalties and the resourcing provision were major concessions for the United States. The agreement was a major concession for India as well because of the limited category of services covered by the reduction in the maximum tax rate from thirty to twenty percent for private sector payments during the first five years and, with this exception, to fifteen percent. Because of most-favored-nation provisions in their tax treaties with certain other OECD countries, such as the Netherlands, India will have to provide the same benefit to others. This unique services provision is unlikely to be viewed by the United States as an appropriate starting point in future negotiations with other developing countries. It is the furthest that the United States was able to go in reaching an agreement with a major developing country where the conclusion of a treaty had unusually strong support within the business community.

The included services provision in the United States-India Income Tax Treaty²⁰ is far more extensive than the provision in the United States-Tunisia Income Tax Treaty.²¹ Under the royalty article of the Tunisian treaty, a maximum fifteen percent

17. United States-India Income Tax Treaty, *supra* note 3, at art. 12(4)(a).

18. United States-India Income Tax Treaty, *supra* note 3, at art. 12(4)(b).

19. This explanation is drawn from the Memorandum of Understanding, which was developed by the negotiators and which was accepted by both governments as representing their current views, subject to the later development of amendments and further understandings by the competent authorities of the United States and India. Memorandum of Understanding, Sept. 12, 1989, United States-India, Tax Treaties (CCH) ¶ 4215 [hereinafter United States-India 1989 MOU].

20. United States-India Income Tax Treaty, *supra* note 3, at art. 12(4).

21. Income Tax Treaty, June 17, 1985, United States-Tunisia, Tax Treaties (CCH) ¶ 10,003.25 [hereinafter United States-Tunisia Income Tax Treaty]. Supplementary Protocol signed on October 4, 1989, brought into force on December 26, 1990.

gross-basis withholding tax is permitted to be imposed on (1) fees for technical or economic studies, wherever prepared, that are paid for out of public funds and (2) fees for the performance of accessory technical assistance for the use of property or rights described in the royalty article, to the extent that the assistance is performed where the payment, property, or right is sourced.²²

The difficult questions in the application of tax treaties to information transfers are not limited to distinguishing between services and royalties. Various treaties apply different tax rates to royalties for the transfer of different types of information. For example, the transfer of cultural information is sometimes eligible for a lower maximum withholding rate. This may mean that copyright payments are eligible for the lower rate, regardless of the subject matter of the work.

For example, under the United States treaty with France, a gross-basis tax on royalties is permitted up to a maximum of five percent, except that no tax is imposed on royalties derived from copyrights of literary, artistic, or scientific works.²³ In practice, the French apply the zero rate only to certain copyright payments — those considered to be for authors' rights (the rights of a creator, including a composer, sculptor, or author). Under French law, authors' rights are distinguished from "neighboring rights" (the rights of a performer or producer). The United States does not distinguish between the two.

Under the new Spanish treaty, a maximum five percent gross-basis tax may be imposed on payments for the use of copyrights of literary, dramatic, musical, or artistic work; an eight percent gross-basis tax on payments may be imposed for the use of film, and industrial, commercial, or scientific equipment, and for any copyright of a scientific work; and a ten percent gross-basis tax may be imposed on any other royalty.²⁴

Under the Finnish treaty, a maximum five percent gross-basis withholding tax may be imposed on payments for the use of any patent, trademark, design or model, plan, secret formula or process, or like property or on information concerning industrial, commercial, or scientific experience.²⁵ A zero rate applies to pay-

22. United States-Tunisia Income Tax Treaty, *supra* note 21, at art. 12(2).

23. United States-France Income Tax Treaty, *supra* note 3, at art. 11(2).

24. Income Tax Treaty, and Protocol, Feb. 22, 1990, United States-Spain, art. 12(2)(a), Tax Treaties (CCH) ¶ 8403.25.

25. Income Tax Treaty, Sept. 21, 1989, United States-Finland, art. 12(2), Tax Treaties (CCH) ¶ 2845.23 [hereinafter United States-Finland Income Tax Treaty].

ments for the use of any copyright of literary, artistic, or scientific work, including films or tapes.²⁶

Tax treaty distinctions between different types of royalties are breaking down. A major factor in the breakdown is the payment of "bundled royalties," payments both for favored and unfavored rights. For example, a turn-key contract for the development of a manufacturing facility could include the use of trademarks, formulas, copyrights, and the furnishing of know-how and technical assistance. In some cases, a reasonable allocation of a payment to each different item provided based on their relative values is too difficult; in such cases, the entire payment will be characterized by its predominant component.

Another factor in the breakdown of these distinctions is substantial growth in computer software transfers across national boundaries. Although the protection of intellectual property rights contained in software has usually developed under copyright laws, the determination of the type of property protection available does not always settle the tax classification of the payment for rights to the property. For example, United States federal income tax law treats a software payment as a payment for goods and services or as a payment for a license to use the software intangibles, depending on the substance of the transaction.²⁷ United States law imposes a thirty percent gross-basis withholding tax on a United States source royalty payment to a foreign person if not effectively connected with a United States trade or business.²⁸ Gain on the sale of certain intangibles, including copyrights and patents, is subject to this tax if any gain is contingent on productivity, use, or disposition of the property.²⁹

Similarly, the United States does not automatically assign payments for the outright disposal of all rights relating to software to treatment under article 12 (royalties) of the United States Model Treaty.³⁰ Such payments would be classified as royalties under article 12 if the payments were contingent on productivity, use, or further disposition.³¹ Otherwise, depending on the business of the seller, such payments or receipts would be

26. United States-Finland Income Tax Treaty, *supra* note 25, at art. 12(2)(3)(a).

27. See generally 66-2 U.S.T.C. P9648, 57-1 U.S.T.C. P9419.

28. I.R.C. § 1441(a) (1990).

29. I.R.C. § 881(a)(4) (1990).

30. United States Model Treaty, *supra* note 1, at art. 12.

31. United States Model Treaty, *supra* note 1, at art. 12, para. 12.

business profits or capital gains.³²

To date, little has been said about the treatment of software transfers under United States tax treaties. However, the Memorandum of Understanding accompanying the United States-India Income Tax Treaty provides a hint that some software transfers would be considered sales under that treaty.³³ The Memorandum contains an example analyzing the application of the royalty article (article 12) to services performed under a contract for the sale of a computer and its operating system.³⁴ This example suggests that operating software transferred with the computer is an integral part of the computer sale, which would generate business profits rather than royalties. Installation and initial training services are also considered to generate business profits because they are ancillary and subsidiary to the sale of the computer, as well as inextricably and essentially linked to the sale. Later upgrades to the operating system are not so linked and are not excluded from the category of services that are taxed as royalties. The treatment of system software sold with computer hardware as business profits might be possible under other treaties as well.

A more difficult question is whether gain from a sale of software alone will be treated as business profits or capital gain under treaties. Business profits or capital gain can be justified by paragraph 1 of the OECD Commentary on article 12 of the OECD Model Treaty³⁵ to the effect that royalties are income to the recipient from a letting. A number of countries would treat a sale of software alone as business profits or capital gain under treaties, although this treatment is not universal. Where software is considered to be licensed, countries may have different views about the rate that should apply. Under the United States treaty with France, the French maintain that, although software receives copyright protection, payments under a license are not for the use of the copyright because (a) the payments are considered copyright royalties only when received by an individual and (b) even then, the payments are not derived from copyrights of scientific works, but rather from copyrights of technical works. Because the French do not treat software payments as copyright payments for a scientific work, an exemption from tax

32. United States Model Treaty, *supra* note 1, at arts. 7, 13.

33. See United States-India 1989 MOU, *supra* note 19.

34. United States-India 1989 MOU, *supra* note 19, at ¶ 4215 (example 8).

35. Commentaries, *supra* note 5, at art. 12, para. 1.

at source is not available.

An international consensus has not yet developed on the treatment of computer software transfer payments under tax treaties. I think it safe to predict that, given the magnitude of payments to the United States for computer software rights, specific provisions for the treatment of computer software will begin to appear in some United States tax treaties. I also predict that the treatment of computer software under existing treaties will be an active area of consideration for competent authorities in the future. The American Bar Association's Section of Taxation recently urged the United States and Finnish competent authorities to clarify the treatment of royalties for the use of computer software, and to the distinction between a payment for information concerning industrial, commercial, or scientific experience and business profits from independent personal services connected to the sale of goods or services related to a license.

II. EXCHANGE OF TAX INFORMATION UNDER TAX TREATIES

I would like to briefly cover another tax treaty topic relating to information — the exchange of tax information under tax treaties. The exchange of tax information between the competent authorities of a contracting state is provided for in every tax treaty to which the United States is a party with the exception of our treaty with the Soviet Union. In a few treaties, such as the Swiss Treaty, information exchange is very limited. The scope of tax information exchange under our treaties varies, depending usually on the age of the treaty.

Under United States tax treaties that are consistent with the United States Model Treaty provision, tax information exchange is provided for to carry out the United States Model Treaty or the domestic tax laws of the contracting states, regardless of whether the tax case is civil or criminal and regardless of where the subject of the information exchange resides.³⁶ Under treaties consistent with the United States model, the contracting state requested to provide the information is required to obtain it as if the information were needed for the enforcement of its own tax. The information provided is required to be kept secret in accordance with the confidentiality laws of the state

36. United States Model Treaty, *supra* note 1, at art. 26.

receiving the information under the treaty. However, information exchanged may be disclosed in public court proceedings or in judicial decisions.

Taxpayer protections are incorporated into every treaty, including the provision that a contracting state is not required to disclose any trade, business, industrial, commercial, or professional secret or trade process, or information the disclosure of which would be contrary to public policy or to the laws or administrative procedures of either contracting state.

The most interesting new development in tax information exchange is the development of the OECD Council of Europe Multilateral Convention for Mutual Administrative Assistance in Tax Matters (Multilateral).³⁷ The Multilateral is similar to the information exchange provision of the United States Model Treaty. The biggest differences between them are that, in an exchange between two countries, the stricter secrecy law applies³⁸ and that the treaty does not apply once criminal judicial proceedings have begun.³⁹ Our position is that criminal judicial proceedings begin at a criminal indictment.⁴⁰

On June 28, 1989, the United States signed the Multilateral, expressing the intention to reserve as to assistance in the collection of tax claims and in the service of documents.⁴¹ On February 13, 1991, the United States presented the OECD with the instrument of ratification signed by President Bush on January 30, 1991.⁴² The United States was the third signatory (after Sweden and Norway) and will be the third country to ratify it, as the Senate gave its advice and consent to ratification last September. Finland and the Netherlands have also signed the Multilateral and will proceed to ratification procedures in 1991.

After the Multilateral enters into effect because at least five signatories have agreed to be bound by it, the United States will issue a procedure providing, in general, for notification by the United States to United States citizens and residents concerning whom information has been requested and is proposed to be

37. See Explanatory Report on the Convention on Mutual Administrative Assistance in Tax Matters, Council of Europe, Strasbourg 1989.

38. Commentaries, *supra* note 5, at ch. III, § 1, art. 4(1), para. 50.

39. Commentaries, *supra* note 5, at ch. III, § 1, art. 4(2), para. 56.

40. SENATE COMM. ON FOREIGN RELATIONS, COUNCIL OF EUROPE-OECD CONVENTION ON MUTUAL ADMINISTRATIVE ASSISTANCE IN TAX MATTERS, 101ST CONG., 1ST SESS. 6 (1990).

41. See Treasury News Release NB-353, June 28, 1989.

42. See Treasury News Release NB-1144, Feb. 20, 1991.

provided. The Internal Revenue Service will offer such a person the opportunity for administrative appeal of a proposed exchange of information over a taxpayer's objections.

The scrutiny given to the United States information exchange program in the context of our consideration of the Multilateral was a good development. Overall, the United States private sector (lawyers and academics) made useful and constructive suggestions for implementing and improving information exchange under the Multilateral. I think that the most important challenge in future years will be to expand the network of tax treaty partners with whom we have comprehensive information exchange provisions, to increase the bilateral flow of information between the United States and our treaty partners, and to develop a workable program for computerized exchange of information on payments of fixed or determinable annual and periodical income to treaty country residents.