TAXING SOFTWARE TRANSACTIONS

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Romeo H Duran of Sapalo Velez Bundang and Bulilan explains how transactions involving software are taxed in the Philippines

The Intellectual Property Code defines the term "copyright or economic rights" as consisting of the exclusive right to carry out, authorise or prevent the following acts:

- Reproduction of the work or a substantial portion of the work;
- Dramatisation, translation, adaptation, abridgment, arrangement or other transformation of the work;
- The first public distribution of the original and each copy of the work by sale or other forms of transfer of ownership;
- Rental of the original or a copy of an audiovisual or cinematographic work, a work embodied in a sound recording, a computer program, a compilation of data and other materials or a musical work in graphic form, irrespective of the ownership of the original or the copy which is the subject of the rental;

- Public display of the original or a copy of the work;
- Public performance of the work; and
- Other communication to the public of the work.

The term "copyright rights" may therefore be understood as pertaining to the inherent right of the copyright owner to derive economic benefit from his copyright or, in general, to prevent others from benefitting or profiting from it without his authority. These are particular attributes of ownership which the copyright owner may allow third parties to utilise, benefit from, or enjoy subject to the payment of an agreed consideration.

The term "software" is defined as:

a program, or a series of programs, containing instructions for a computer required either for the operational processes of the computer itself (operational software) or for the accomplishment of other tasks (application software). It can be transferred through a variety of media, for example in writing or electronically, on a magnetic tape or disk, or on a laser disk or CD-ROM, or it can be downloaded through the internet or through a network. It may be standardised with a wide range of applications or be customised for specific users. It can be transferred as an integral part of the computer hardware or in an independent form available for use on a variety of hardware.

Software is "generally assimilated as a literary, artistic or scientific work protected by the copyright laws of other countries", and that "payments in consideration for the use of or the right to use a copyright relating to software are generally royalties" (Revenue Memorandum Circular [RMC] no 44-2005).

Software (a computer program) is included in the enumeration of "literary and artistic works" which are original and intellectual creations in the literary and artistic domains and are protected at the moment of their creation (Section 172, Intellectual Property Code).

Software-related transactions may fall under any or more of the following categories:

- (full or partial) transfer of a copyright right in software;
- a transfer of a copy of the software (a copyrighted article);
- the provision of services for the development or modification of the software; or
- the provision of know-how relating to software programming techniques (RMC no 44-2005).

Full or partial transfer of copyright in software

The determining factor in characterising the nature of the payments in software-related transactions is whether, taking into account all facts and circumstances, there has been a "transfer of all substantial rights in the copyright". In a transaction where not all substantial rights are transferred, this will be considered as a licence giving rise to royalty income. In cases involving the transfer of copyright (not involving all substantial rights since the rights granted to the transferee/licensee are limited in scope or require the copyright owner's authority or consent to use or exploit), the payment shall be classified as "royalties". If, however, the transaction involves the transfer of ownership over the entire copyright, the payment shall be classified as "business income" (Revenue Memorandum Circular no 44-2005).

In a transfer of copyright rights where not all substantial rights have been transferred, the payment shall be treated as royalty income. Accordingly, if the recipient of the royalty is a

domestic corporation or another reseller/distributor, the royalty payment will be subject to a withholding tax of 20% based on the gross amount. If, however, the copyright is acquired from a non-resident foreign licensor, the royalty will be subject to a 30% final withholding tax based on the gross amount, unless the non-resident foreign licensor is a resident of a country with which the Philippines has an existing tax treaty, in which case, the preferential tax treaty rate shall apply.

Transfer of a copy of the software

A copyrighted article incorporating software includes a copy of the software from which the work can be perceived, reproduced, or otherwise communicated, either directly or with the aid of a machine or device (for example, a laptop computer). The acquisition of the laptop is considered acquisition of a copyrighted article if the purchaser does not acquire any of the copyright rights on the software (or acquires only a *de minimis* grant of such rights), and the same does not involve provision of services, or a transfer of technology or know-how. In this case, payments shall be considered as business income. This is consistent with the rule under the Intellectual Property Code that copyright is distinct from the material object subject to it, and that "the transfer or assignment of the copyright shall not itself constitute a transfer of the material object" (Section 181, Intellectual Property Code of the Philippines).

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A transfer involving a copyrighted article is commonly considered a sale or exchange (hence, the payments considered as business income). A point to note in this regard is whether, taking into account all facts and circumstances, the benefits and burdens of ownership have been transferred. In the above example of a laptop, where a person other than the transferee continues to be treated as the owner of the laptop, the transaction will not be considered a sale or exchange of the copyright on the software, and will be classified as a lease giving rise to rental income.

Payments for copyrighted articles received by a local reseller or distributor from a local end-user shall constitute business income and be taxed at the regular 30% corporate tax rate (if the transferor is a corporation) or graduated income tax rates of 5% to 32% (if the transferor is an individual citizen or resident alien). If the end-user has been designated as a withholding agent, the payment will be subject to a 2% creditable withholding tax.

The characterisation of software payments as royalties will depend on which party owns the proprietary rights over the programs. This was the decision of the Supreme Court in a case involving payments by Smart Communications, a Philippine company, to Prism Transactive, a non-resident foreign corporation based in Malaysia. Prism rendered programming and consultancy services in favour of Smart for the installation of the service download manager and the channel manager, and for the installation and implementation of smart money and mobile banking service SIM Applications and a private text platform. In determining whether the software payments should be considered royalties, the Court looked into which party owned the IP. The Court noted that the IP over the service download manager would be retained by Prism, while Smart owns the IP for all components of the channel manager and the IP for the specifications and the source code of the SIM applications. Accordingly, the Court ruled that only the payment

for the service download manager program is a royalty (*Commissioner of Internal Revenue vs Smart Communications, Inc*, GR Nos 179045-46, August 5 2010).

Value-Added Tax

Payments for software transactions are subject to VAT since intangible objects capable of pecuniary estimation, such as copyright, are among the goods subject to VAT. Moreover, the sale or exchange of services subject to VAT include lease or the use of or the right or privilege to use any copyright, the supply of scientific, technical, industrial or commercial knowledge or information, and the supply of ancillary and subsidiary services.

Accordingly, the following software payments are subject to VAT:

- royalty payments for the use of a copyright over a software;
- payments made to resellers/distributors or retailers who are engaged in the trade or business of distributing or selling software;
- payments for services rendered in the Philippines in connection with purchased software.

If the payments are made to a non-resident licensor, the person in control of the payment shall withhold the VAT on these payments by filing a separate VAT return for and on behalf of the non-resident licensor. The licensee may claim the VAT withheld as its input tax upon filing its VAT return. In case the licensee is a non-VAT taxpayer, the VAT shall form part of the cost of services purchased, which may be treated either as an "asset" or "expense" of the licensee.

Companies in the Philippine Economic Zone

Companies registered with the Philippine Economic Zone Authority (PEZA) are granted fiscal and non-fiscal incentives, including a special tax rate of 5% on gross income earned (GIE) after the lapse of the four-year income tax holiday (ITH) incentive. Since the 5% GIE is imposed on gross income, a question raised in relation to royalty payments is whether these are deductible from gross income in computing gross income earned. The tax authorities had consistently held that:

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[T]he treatment of royalties depends of the consideration for which such fees were paid. When the royalties relate to a system or license, royalties are treated as general and administrative expenses, which are not inventoriable costs. When, however, royalties are connected with a product design, logo, formula or process, the payment is capitalised as part of inventories. Therefore, payment of royalties related to the transfer of technical information and manufacturing know-how (for example, on the use of software) should be considered as part of the cost of manufacturing the products.

Royalty payments under the second category were allowed as deductions in computing GIE since these are considered as direct costs forming part of inventory cost or cost of finished goods manufactured. I believe that this is the correct interpretation of the PEZA Law and its implementing regulations. Although royalty payments are not expressly included in the enumeration of direct costs deductible from gross income, the Philippine Tax Court held that

enumeration in the PEZA regulations is not meant to be all-inclusive. Citing a Philippine Supreme Court decision, the Tax Court held that the word "includes" necessarily conveys the very idea of non-exclusivity of the enumeration. The principle of *expressio unius est exclusio alterius* (the expression of one thing is the exclusion of the other) does not apply where other circumstances indicate that the enumeration was not intended to be exclusive, or where the enumeration is by way of example only" (*East Asia Utilities Corporation vs Commissioner of Internal Revenue*, CTA Case no 8179, August 6 2014). This was reiterated in the subsequent case of *Medtex Corporation vs Commissioner of Internal Revenue*, CTA Case no 8508, September 1 2014.

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