REPUBLIKA NG PILIPINAS
KAGAWARAN NG PANANALAPI
KAWANIHAN NG RENTAS INTERNAS

September 1, 2005

REVENUE MEMORANDUM CIRCULAR NO. 44 – 2005

SUBJECT : Taxation of Payments for Software

TO : All Internal Revenue Officers and Other Concerned

Section 1. SCOPE – This Circular shall provide for the guidelines for the taxation of computer software payments.

Section 2. DEFINITION OF SOFTWARE – "Software" is 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 standardized with a wide range of application or be customized for specific users. It can be transferred as an integral part of the computer hardware or in an independent form available fro use on a variety of hardware.

Section 3. PAYMENTS FOR THE USE OF SOFTWARE AS ROYALTIES

a. ***Definition of ROYALTIES*** – The tern "royalties", as generally used, means payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work including cinematograph films, or films or tapes used for radio or television broadcasting, any patent, trade mark, design or model, plan, secret formula or process, or for use of, or the right to use, industrial, commercial, or scientific equipment, or for information concerning industrial, commercial or scientific experience.

The definition covers both payments made under a license and compensation which a person would be obliged to pay for fraudulently copying or infringing the right.

b. ***Definition of royalties includes payments for the use of copyright over software*** – Software is generally assimilated as a literary, artistic or scientific work protected by the copyright laws of various countries. Thus, payments in consideration for the use of or the right to use a copyright relating to software are generally royalties.

Section 4. CATEGORIES OF TRANSACTIONS – Transactions involving software may take any one or more of the following categories:

a. A (full or partial) transfer of a copyright right in software;
b. A transfer of a copy of the software (a copyrighted article);
c. The provision of services for the development or modification of the software; or
d. The provision of know-how relating to software programming techniques.

Any transaction involving software which consists of more than one of the transactions above shall be treated as a separate transaction, with the appropriate provisions of this Circular being applied to each such transaction. However, any transaction that is *de minimis*, taking into account the overall transaction and the surrounding facts and circumstances, shall not be treated as a separate transaction, but merely as a part of another transaction.

Section 5. CHARACTERIZATION OF TRANSACTIONS – The character of payments received in a transaction involving the transfer of computer software depends on the nature of the rights that the transferee acquires under the particular arrangement regarding the use and exploitation of the program.

a. ***Transfers of copyright rights.*** A transfer of software is classified as a transfer of a copyright right if, as a result of the transaction, a person acquires any one or more of the rights described below:

i. The right to make copies of the software for purposes of distribution to the public by sale or other transfer of ownership, or by rental, lease or lending;
ii. The right to prepare derivative computer programs based upon the copyrighted software;
iii. The right to make a public performance of the software;
iv. The right to publicly display the computer program; or
v. Any other rights of the copyright owner, the exercise of which by another without his authority shall constitute infringement of said copyright.

The determination of whether a transfer of a copyright right in a software is a sale or exchange of property is made on the basis of whether, taking into account all facts and circumstances, there has been a transfer of *all* substantial rights in the

copyright. A transaction that does not constitute a sale or exchange because not all substantial rights have been transferred will be classified as a license generating **royalty income.**

When only copyright *rights* are transferred, payments made in consideration therefore are **royalties.** On the other hand, when copyright *ownership* is transferred, payments made in consideration therefore are **business income.**

b. Transfer of copyrighted articles. A **copyrighted article** incorporating a software includes a copy of a software from which the work can be perceived, reproduced, or otherwise communicated, either directly or with the aid of a machine or device. The copy of the software may be fixed in the magnetic medium of a floppy disk or a CD – ROM, or in the main memory or hard drive of a computer, or in any other medium.

If a person acquires a copy of a software *but* does not acquire any of the rights described above (or only acquires a *de minimis* grant of such rights), and the transaction does not involve the provision of services or of know-how, the transfer of the copy of the software is classified solely as a transfer of a copyrighted article and payments for which constitute **business income.**

The determination of whether a transfer of a copyrighted article or right in a software is sale or exchange of property is made on the basis of whether, taking into account all facts and circumstances, the benefits and burdens of ownership have been transferred. A transaction that does not constitute a sale or exchange because insufficient benefits and burdens of ownership of the copyrighted article have been transferred, such that a person other than the transferee is properly treated as the owner of the copyrighted article, will be classified as a lease generating **rental income.**

c. After-Sales Service. Contracts for the use of software are often accompanied with the provision of services (e.g., installation, maintenance, and customization of the software) by personnel of the relevant foreign licensor/owner or of the relevant local subsidiary, reseller, and distributor. Payments as consideration for after-sales service in a mixed contract are *not royalties* alone, but will include *income from services.* The appropriate course to take with such a 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 payments 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. Thus, the part of the payments representing the use of the software will be treated as **royalties** and taxable as such and the other part of the payments representing the provision of services will be treated as **income from services** and taxable as such.

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. (*De minimis)*

d. "Site license" / "Enterprise License" / "Network License Arrangements" These refer to arrangements in which the transferee obtains rights to make multiple copies of the program for operation only within its own business. Although these arrangements permit the making of multiple copies of the program, such rights are generally limited to those necessary for the purpose of enabling the operation of the program on the licensee's computers or network, and reproduction for any other purpose is not permitted under the license. Payments under such arrangements will generally be dealt with as **business income.**

e. Supply of information. Another type of transaction involving the transfer of computer software is the more unusual case where a software house or computer programmer agrees to supply information about the ideas and principles underlying the program, such as logic, algorithms or programming languages or techniques. In these cases, the payments may be characterized as **royalties** to the extent that they represent consideration for the use of, or right to use, secret formulas or for information concerning industrial, commercial or scientific experience which cannot be separately copyrighted.

f. Transfer of Ownership. Where consideration is paid for the transfer of full or partial *ownership* of the rights in the copyright, the payments made therefore are, in general, not royalties but **business income or capital gains.**

Section 6. COMPUTER HARDWARE BUNDLED WITH SOFTWARE – The tax treatment of payments involving the sale of computer hardware bundled with software, where the software is bundled in the Philippines, are covered by this Circular. On the other hand, computer hardware bundled with software, where the software is bundled abroad will be dealt with another revenue issuance.

Section 7. MODES OF ACQUIRING SOFTWARE AND THE RELEVANT TAX TREATMENT THEREOF

A. Acquisition of ownership over a copyright

1. From a **local owner of a copyright** – Payments made to a copyright owner for a full or partial *transfer* of a copyright shall be subject to Philippine income tax as follows:

    a. Transfer by a resident individual owner of copyright – A resident individual owner of a copyright is subject to the graduated income tax rates (5% - 32%) under Section 24 of the National Internal Revenue Code of 1997 (NIRC). The amount paid in consideration of the copyright or portions

thereof transferred shall form part of the copyright owner's gross income (Section 32, NIRC), from which his taxable income[1] shall be computed.

b. Transfer by a domestic corporation owner – The amount paid in consideration of the copyright or portions thereof transferred shall form part of the copyright owner's gross income (Section 32, NIRC), from which his taxable income, subject to 32% income tax under Section 27 of the BIRC, shall be computed.

2. From a **foreign licensor** – Payments made to a copyright owner for a full or partial *transfer* of a copyright shall be subject to Philippine income tax as follows:

a. Transfer by a nonresident alien individual – A nonresident alien individual engaged in trade or business in the Philippines shall be taxed in the same manner as a resident individual owner of a copyright.

b. Transfer by a foreign corporation – The amount paid in consideration of the copyright or portions thereof transferred by a resident foreign corporation engaged in trade or business within the Philippines shall form part of the copyright's owner gross income (Section 32, NIRC), from which his taxable income, subject to 32% income tax under Section 28 of the NIRC, shall be computed.

The amount paid in consideration of the copyright or portions thereof transferred by a nonresident foreign corporation shall be subject to a final tax of 32%, based on the gross income (Section 28, NIRC).

However, if the foreign owner of the copyright is a resident of a country which has an existing tax treaty with the Philippines, royalties paid to such owner are subject to the reduced tax rates on royalties under the relevant tax treaty, provided the conditions prescribed therein are complied with by the owner.

B. Acquisition of copyright rights

1. By a **Local Subsidiary/Reseller/Distributor/Retailer** –

a. From a *local licensor or reseller/distributor licensee*

[1] Section 31, NIRC provides "The term **'taxable income'** means the pertinent items of gross income specified in this Code, less deduction and/or personal and additional exemption, if any, authorized for such types of income by this Code or other special laws.

Payments made by a local subsidiary/reseller/distributor/retailer to a domestic corporation owner of a copyright or a reseller/distributor licensee of a copyright shall be subject to a final income tax of 20%, based on the gross amount of royalties under Section 27(D) of the NIRC, to be withheld by the local subsidiary/reseller/distributor/retailer making the payments.

c. From a *nonresident foreign licensor*

Payments made by the local subsidiaries/resellers/distributors/retailers to a nonresident foreign licensor/owner of the software are **royalties** subject to 32 percent final income tax, based on the gross amount thereof (Section 28[B][1], NIRC), the full amount of which shall be withheld and collected by the subsidiary/reseller/distributor/retailer making the payments (Section 2.57-1[I][1], RR 2-98).

However, if the foreign licensor/owner is a resident of a country which has an existing tax treaty with the Philippines, royalties paid to such licensor/owner are subject to the reduced tax rates on royalties under the relevant tax treaty, provided the conditions prescribed therein are complied with by the licensor/owner.

2. By an **End-user** –

a. From *local subsidiaries, resellers, distributors of resellers* –

Payments made by the end-user to the local subsidiaries, resellers, distributors of resellers for the purchase of copyrighted articles are **business income** subject to 32 percent income tax, based on the net taxable income of a domestic corporation (Section 27[A]), National Internal Revenue Code of 1997 [NIRC]). When making payments to the local subsidiaries, resellers, distributors of resellers, the end-user shall withhold 2 percent income tax of the gross amount of the payments creditable against the taxable income of the local subsidiaries, reseller or distributors (Section 2.57.2[E][4][m], Revenue Regulations [RR] 2-98, as amended by Section 2 of RR 14-02), *provided* the end-user is any of the following persons (under Section 2.57.3 of RR 2-98, as amended by Section 3 of RR 14-02) required to withhold such tax:

(a) A juridical person, whether or not engaged in trade or business;
(b) An individual, with respect to payments made in connection with his trade or business; or
(c) A government office including a government-owned or controlled corporation, a provincial, city, or municipal government.

b. Directly from the *foreign owner and/or licensor of the software.* –

A local end-user may acquire license to use software directly from the foreign licensor/owner of the software. Payments made by the end-user to the licensor/owner are **royalties** subject to 32 percent income tax, based on the gross amount thereof, imposed on royalties derived by a nonresident foreign corporation (Section 28[B][1], NIRC), which amount shall be withheld and collected by the end-user making the payments (Section 2.57-1[I][1], RR 2-98).

However, if the foreign licensor/owner is a resident of a country which has an existing tax treaty with the Philippines, royalties paid thereto are subject to the reduced tax rates on royalties under the relevant tax treaty, provided the condition prescribed therein are complied with by the licensor/owner.

Section 7. VALUE-ADDED TAX –

A. The following payments for software transactions shall be subject to the 10% value-added tax (VAT) pursuant to Sections 106 and 108 of the NIRC:

1. Royalty payments for the use of a copyright over a software;
2. Payments made to resellers/distributors/retailers who are engaged in the trade or business of distributing or selling software; and
3. Payments for services rendered in the Philippine in connection with software purchased.

B. Withholding of the VAT for nonresident payees

The payor in control of the payment of VAT in the software transactions enumerated under (A) above shall be responsible for the withholding of VAT on such fees on behalf of the nonresident payee, by filing a separate VAT return for and on behalf of such payee using BIR Form No. 1600 (Monthly Remittance Return of Value-Added Tax and Other Percentage Taxes Withheld). The duly filed BIR Form No. 1600 and proof of payment thereof shall serve as sufficient basis for the claim of input tax to be applied against the output tax that may be due from the payor. In addition, the payor is required to issue the Certificate of Creditable Tax Withheld at Source (BIR Form No. 2307) in quadruplicate upon the request of the nonresident payee, the first three copies thereof to be given to the payee and the fourth copy to be retained by the payor as its file copy.

Section 8. REPEALING CLAUSE – All existing revenue issuances, including Revenue Memorandum Circular No. 77-2003, or parts thereof which are inconsistent with the provisions of this Circular are hereby revoked or amended accordingly

Section 9. EFFECTIVITY – This Circular shall take effect immediately and shall cover software payments paid or payable starting said effectivity date.

(Original Signed)
JOSE MARIO C. BUÑAG
OIC-Commissioner of Internal Revenue