

REPUBLIC OF THE PHILIPPINES
DEPARTMENT OF FINANCE
BUREAU OF INTERNAL REVENUE

November 18, 2003

REVENUE MEMORANDUM CIRCULAR NO. 77-2003

SUBJECT: Classification of Payments for Software for Income Tax Purposes

TO : All Internal Revenue Officers and Others Concerned.

Introduction:

Classification of payments received as consideration for computer software is, for taxation purposes, a matter of considerable importance in view of the rapid development of computer technology in recent years and the extent of transfers of such technology across national borders.

"Software" is a program, or 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, diskette, or compact disks, 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 computer hardware or in an independent form available for use on a variety of hardware.

Definition of Royalties Includes Payments for the Use of Software:

The term "royalties" as generally used means *payment 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 the use of, or the right to use, industrial, commercial or scientific equipment, or for information concerning industrial, commercial or scientific experience.* The term "use" as contained herein shall include the reselling or distribution of software.

Software is generally assimilated as a literary, artistic or scientific work protected by the copyright laws of various countries including the Philippines, thus, payments in consideration for the use of, or the right to use, a copyright or a copyrighted article relating to software are generally royalties.

Modes of Acquiring Software and the Relevant Tax Treatment Thereof:

1. *From local subsidiaries, resellers, and distributors.* - A local end-user may acquire license to use software from local subsidiaries, resellers, or distributors, authorized by the foreign licensor/owner of the software to distribute its products in the Philippines. Payments made by the end-user to the local subsidiaries, resellers, or distributors as *royalties* are treated as *business income* subject to thirty two percent (32%) income tax as that imposed on the net taxable income of a domestic corporation if they are derived from the ordinary conduct or in the active pursuit of business of the subsidiaries, resellers, or distributors (Section 27[A], National Internal Revenue Code of 1997 [NIRC]). When making payments to the local subsidiaries, resellers, or distributors, the end-user shall withhold two percent (2%) income tax of the gross amount of the payments, which shall be creditable against the tax due on the taxable income of the local subsidiaries, resellers, or distributors (Section 2.57.2[E][4][m], Revenue Regulations [RR]2-98, as amended by Section 2 of RR 14-020, *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 RR14-02) 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 government-owned and controlled corporation, a provincial, city, or municipal government, and a barangay.

If the payments made by the end-user to the local subsidiaries, resellers, or distributors will not result in an income derived from the ordinary conduct or in the active pursuit of business of the subsidiaries, resellers, distributors to which payments are made, such payments as *royalties* are treated as passive income which shall be subject to twenty percent (20%) final income tax based on the gross amount thereof as that imposed on royalties derived by a domestic corporation (Section 27[D][1], NIRC), and said amount shall be withheld and collected by the end-user making such payments (Section 2.57-1[G][2], RR 2-98).

On the other hand, payments made by the local subsidiaries, resellers, or distributors to the foreign licensor/owner of the software as *royalties* are

subject to thirty two percent (32%) income tax based on the gross amount thereof as that imposed on royalties derived by a nonresident foreign corporation (Section 28[B][1], NIRC), withheld and collected by the subsidiaries, resellers, or distributors 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 conditions prescribed therein are complied with by the licensor/owner.

2. *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 as *royalties* are subject to thirty two percent (32%) income tax based on the gross amount thereof as that imposed on royalties derived by a nonresident foreign corporation (Section 28[B] {1}, NIRC), 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 conditions prescribed therein are complied with by the licensor/owner.

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 the personnel of the relevant foreign licensor/owner or of the relevant local subsidiary, reseller, and/or 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 the proper tax treatment therefore. Thus, the part of the payments representing use of, or the right to use, copyright relating to software will be treated as royalties and taxable as such. The other part of the payments representing the provisions of services will be treated as income from services and taxed as such.

Computer Hardware Bundled with Software:

Payments for the software, or that portion of the payments apportioned for the software bundled with computer hardware, where the bundling are done in the Philippines, shall taxed in the manner provided under this Circular. Payments for

software where the software are bundled with computer hardware outside the Philippines shall be dealt with in a separate revenue issuance.

All internal revenue officers, employees and others concerned are enjoined to give this Circular the widest publicity possible.

(Original Signed)
GUILLERMO L. PARAYNO, JR.
Commissioner of Internal Revenue