Republic of the Philippines
DEPARTMENT OF FINANCE
Roxas Boulevard Corner Pablo Ocampo, Sr. Street
Manila 1004

DOF OPINION No. 001-2022

ATTY. RODEL C. UNCIANO
DU-BALADAD AND ASSOCIATES
20TH Floor, Chatham House, Rufino Cor. Valero Sts.
Salcedo Village, 1227, Makati City

SUBJECT: **REQUEST FOR REVIEW OF BUREAU OF INTERNAL REVENUE INTERNATIONAL TAX AFFAIRS DIVISION RULING NO. ITAD 009-21 DATED 17 MAY 2021**

Dear Atty. Unciano:

This refers to the Request for Review that your Office filed on behalf of your client, Bank of the Philippine Islands (BPI), of Bureau of Internal Revenue International Tax Affairs Division (BIR-ITAD) Ruling No. ITAD 009-21 dated May 17, 2021, ruling that the license fees paid by BPI to Welcome Real-Time (ASPAC) Pte. Ltd. (Welcome) are considered royalties subject to income tax rate of 25% pursuant to paragraph 2(c) of Article 12 of the Philippines-Singapore Tax Treaty (PH-SG Tax Treaty).

BACKGROUND:

BPI is a universal banking corporation organized and existing under the laws of the Philippines, while Welcome is a limited foreign company organized and existing under the laws of Singapore. Welcome has not been licensed to do business in the Philippines, as confirmed by a Certificate of Non-Registration issued by the Securities and Exchange Commission.

On March 3, 2004, BPI and Welcome entered into an XLS License and Services Agreement (XLS Agreement),[1] which governs all orders for products and services available from Welcome. Under the XLS Agreement, Welcome granted BPI a non-exclusive and non-transferable license to use an XLS Loyalty Host System (to be referred hereto as "software"), and agreed to provide related services, including but not limited to, training, project management, support and maintenance. The software, considered as "Welcome Confidential Information", shall remain proprietary to Welcome and is furnished to BPI exclusively on a

[1] Attached as Annex A to the Request for Review.

In view of the foregoing, this Office partially grants the Request for Review. This ruling is being issued on the basis of the foregoing facts as represented. However, if upon investigation, it will be disclosed that the facts are different, then this ruling shall be considered as null and void.

Thank you.

Very truly yours,

Digitally signed by
Carlos G. Dominguez
Date: 2022.01.25
22:52:19 +08'00'

CARLOS G. DOMINGUEZ
Secretary

DEPARTMENT OF FINANCE
Republic of the Philippines

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CC: **CAESAR R. DULAY**
Commissioner
Bureau of Internal Revenue

BANK OF THE PHILIPPINE ISLANDS
BPI Head Office
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license to use basis, for which BPI is obligated to pay license fees and related charges applicable to the software.

BPI filed a tax treaty relief application (TTRA) with the BIR International Tax Affairs Divisions (ITAD) and contested that all payments made to Welcome are considered business profits hence, exempt from income taxes under the Philippines-Singapore Tax Treaty (PH-SG Tax Treaty).

The BIR ruled that Welcome is not deemed to have a permanent establishment in the Philippines under paragraphs 1 and 2, Article 5 of the PH-SG Tax Treaty. Thus, the service fees paid by BPI to Welcome in relation to the XLS Agreement are exempt from income tax pursuant to paragraph 1, Article 7 of the treaty. However, the BIR held that the license fees paid by BPI to Welcome are considered royalties, being payments for the use, or the right to use, copyright of literary, artistic or scientific work, subject to income tax at the rate of 25% pursuant to paragraph 2(c), Article 12 of the PH-SG Tax Treaty. The pertinent portion of the BIR Ruling states:

> xxx [T]he license fees for the software are considered royalties, being payments for the use, or the right to use, copyright of literary, artistic or scientific work. Under the Agreement, all programs, specifications, works of authorship, inventions, techniques, concepts and ideas developed, provided or disclosed to BPI by Welcome pursuant to the provision of services shall remain the property of Welcome. BPI owns the media on which the software is recorded, but acquires no ownership or other rights to the software except those expressly granted in the Agreement.
>
> xxx
>
> The royalties are subject to 15% withholding tax if they are paid by an enterprise registered with the Board of Investments and engaged in preferred areas of activities, or are paid in respect of cinematographic films or tapes for television or broadcasting. In all other cases, the royalties are subject to 25% withholding tax.
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> Accordingly, since BPI is not registered with the Board of Investments, and the license fees for the software are not paid in respect of cinematographic films or tapes for television or broadcasting, the license fees paid by BPI to Welcome are subject to income tax at the rate of 25% pursuant to paragraph 2(c), Article 12 of the tax treaty.

Aggrieved, BPI, through counsel filed this instant Request for Review requesting that the Secretary of Finance reverse the ruling of the BIR that the payments for license fees are subject to income tax.

BPI maintains that the license fees for the software are not royalties but they are in the nature of business profits, taxable as such, if the licensee is merely granted access to and use of the corresponding software and not readily the right to market or exploit the software. BPI opines that it acquired only the "copy of the copyrighted articles" without acquiring any of the copyright rights, making the income payment of BPI to Welcome as business profits for income tax purposes.

ISSUE:

The pivotal issue in this case is whether the license fees paid by BPI to Welcome for the access and use of the software are royalties subject to income tax at the rate of 25% pursuant to paragraph 2(c), Article 12 of the PH-SG Tax Treaty.

RULING:

The PH-SG Tax Treaty defines the term **"royalties"** to mean 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 cinematographic films or tapes for television or 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.[2]

As regards **"business profits"**, the PH-SG Tax Treaty provides that profits of an enterprise of a Contracting State is taxable only in that State, unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein.[3] The treaty defines the term "permanent establishment" to mean a fixed place of business in which the business of the enterprise is wholly or partly carried on.[4] The treaty enumerates the circumstances by which an entity may be considered to have established a permanent establishment.[5]

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[2] Paragraph 3, Article 12, PH-SG Tax Treaty
[3] Paragraph 1, Article 7, PH-SG Tax Treaty
[4] Paragraph 1, Article 5, PH-SG Tax Treaty
[5] Paragraph 2 of Article 5 enumerates what constitutes "permanent establishment": (2) The term "permanent establishment" includes specially but is not limited to: (a) a seat of management; (b) a branch; (c) an office; (d) a store or other sales outlet; (e) a factory; (f) a workshop; (g) a warehouse, in relation to a person providing storage facilities for others; (h) a mine, quarry, or other place of extraction of natural resources; (i) a building site or construction or assembly project or installation project or supervisory activities in connection therewith, provided such site, project or activity continues for a period more than 183 days; and (j) the

Under the subject BIR Ruling, it was established that Welcome is not deemed to have a permanent establishment in the Philippines, as contemplated under the PH-SG Tax Treaty. It is not engaged in trade or business in the Philippines, as it does not have branch, an office or other fixed place of business in the Philippines, neither did it furnish services in the country for more than 183 days, but performed them outside the Philippines. Business profits of Welcome, if any, from license fees paid by BPI for the software use shall be exempt from income tax pursuant to paragraph 1 of Article 7 of the PH-SG Tax Treaty.

However, in determining whether the license fees paid by BPI to Welcome are business profits or royalties, we look into the provisions of Revenue Memorandum Circular (RMC)[6] No. 44-2005 dated September 1, 2005 providing for guidelines for the taxation of computer software payments,[7] amending for the purpose RMC No. 77-2003 dated 18 November 2003.[8]

The RMC defined the term "royalties" to include payments for the use of copyright over a software as 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.[9]

Section 5 of RMC No. 44-2005 provides that 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. Under said RMC, there are two (2) transfers distinguished, namely: transfer of copyright rights and transfer of copyrighted articles. The nature of the transaction out of which such payments are made will determine whether such payments should be treated as royalties, business income, rental income, or capital gains.

Section 5 of RMC No. 44-2005 provides:

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furnishing of services, including consultancy services, by a resident of one of the Contracting States through employees or other personnel, provided activities of that nature continue (for the same or a connected project) within the other Contracting State for a period or periods aggregating more than 183 days.

[6] **Revenue Memorandum Circular (RMCs)** are issuances that publish pertinent and applicable portions, as well as amplifications, of laws, rules, regulations and precedents issued by the BIR and other agencies/offices. Accessed from https://www.bir.gov.ph/index.php/revenue-issuances/revenue-memorandum-circulars.html.

[7] Revenue Memorandum Circular (RMC) No. 44-2005, Subject: Taxation of Payments for Software. Issued on 1 September 2005

[8] Subject: Classification of Payments for Software for Income Tax Purposes

[9] Section 3(b). Revenue Memorandum Circular (RMC) No. 44-2005, Subject: Taxation of Payments for Software. Issued on 1 September 2005

a. **Transfer of copyright rights.** A transfer of software is classified as 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 of 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 programs; 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. xxx

   If a person acquires a copy of the 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 into a software is a 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.

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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 purpose is not permitted under the license. Payments under such arrangements will generally be dealt with as business income.

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In determining the nature of the software license fees, this Office finds helpful the following statement in the commentaries of the Organisation for Economic Cooperation and Development (OECD) Committee on Fiscal Affairs (OECD Commentaries)[10] on payments for software, which provide:

12.2 The character of payments received in transactions 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. The rights in computer programs are a form of intellectual property. xxx Transfers of rights in relation to software occur in many different ways ranging from the alienation of the entire rights in the copyright in a program to the sale of a product which is subject to restrictions on the use to which it is put. The consideration paid can also take numerous forms. These factors make it difficult to determine where the boundary lies between software payments that are properly to be regarded as royalties and other types of payment. The difficulty of determination is compounded by the ease of reproduction of computer software, and by the fact that acquisition of software frequently entails the making of a copy by the acquirer in order to make possible the operation of the software (underscoring supplied)

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13. The transferee's rights will in most cases consist of partial rights or complete rights in the underlying copyright, or they may be (or equivalent to) partial or complete rights in a copy of the program (the "program copy"), whether or not such copy is embodied in a material medium or provided electronically. In unusual cases, the transaction may represent a transfer of "know-how" or secret formula.

13.1 Payments made for the acquisition of partial rights in the copyright (without the transferor fully alienating the copyright rights) will represent a royalty where the consideration is for granting of rights to use the program in a manner that would, without such license, constitute an infringement of copyright. Examples of such arrangements include licenses to reproduce and distribute to the public software incorporating the copyrighted program, or to

[10] OECD (2019), Model Tax Convention on Income and Capital 2017 (Full Version), OECD Publishing. As also cited in *Commissioner of Internal Revenue v. Fluor Daniel, Inc.-Philippines,* C.T.A. EB Case No. 1555 (C.T.A. Case No. 8444), February 12, 2018

modify and publicly display the program. In these circumstances, the payments are for the right to use the copyright in the program (i.e., to exploit the rights that would otherwise be the sole prerogative of the copyright holder). xxx (underscoring supplied)

14. In other types of transactions, the rights acquired in relation to the copyright are limited to those necessary to enable the user to operate the program, for example, where the transferee is granted limited rights to reproduce the program. This would be the common situation in transactions for the acquisition of a program copy. The rights transferred in these cases are specific to the nature of computer programs. They allow the user to copy the program, for example, onto the user's computer hard drive or for archival purposes. xxx Regardless of whether this right is granted under law or under a license agreement with the copyright holder, copying the program onto the computer's hard drive or random access memory or making an archival copy is an essential step in utilizing the program. Therefore, rights in relation to these acts of copying, where they do no more than enable the effective operation of the program by the user, should be disregarded in analyzing the character of the transaction for tax purposes. Payments in these types of transactions would be dealt with as commercial [(business)] income in accordance with Article 7. (underscoring supplied)

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14.2 The ease of reproducing computer programs has resulted in distribution arrangements in which the transferee obtains rights to make multiple copies of the program for operation only within its own business. Such arrangements are commonly referred to as "site licenses", "enterprise licenses", or "network licenses". 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 in most cases be dealt with as business profits in accordance with Article 7.

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BPI did not acquire any of the copyright rights

Examination of the XLS Agreement would reveal that none of the rights enumerated in Section 5 (a) of RMC No. 44-2005 is present in BPI's contract with Welcome.

By BIR's own admission as provided in its Ruling, and as indicated in the XLS Agreement, BPI may use the software in object code form on its designated equipment unit or computers and BPI has to even obtain a separate license for

each computer on which the software will be used.[11] BPI shall not make any copies of the software, except solely for archival backup purposes.[12] BPI shall not sell, transfer or make the software available to third parties without prior express prior written consent of Welcome,[13] neither can BPI reverse assemble or decompile the software in whole or in part except as may be allowed for purposes of interoperability and compatibility of the software with other products but BPI must request technical information from Welcome.[14] Any technical information acquired in the process of reverse engineering, disassembling, or decompiling the software shall not be used by BPI to develop any other software, or any other derivative works which may directly or indirectly compete with the software.[15]

BPI owns the media on which the software is recorded, but acquires no ownership or other rights to the software except those expressly granted in the XLS Agreement,[16] which is furnished to BPI in a license to use basis.[17] All copies of the software provided by Welcome or made by BPI,[18] are and remain the property of Welcome.[19] All programs, specification, works of authorship, interventions, techniques, concepts, and ideas developed, provided or disclosed to BPI by Welcome pursuant to the provision of services shall remain the property of Welcome.[20]

Moreover, there is nothing in the XLS Agreement granting BPI the right to make a public performance of the software, nor to publicly display such software. Such rights should not be presumed to be transferred to BPI. The contract is clear that BPI acquires no ownership or other rights to the software except those expressly granted in the XLS Agreement.[21]

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[11] Section 12.1.A and B of the XLS Agreement. Section 12.1.D provides that if BPI is temporarily unable to use the software on the designated computer, BPI may temporarily use such software on a backup computer, provided that such authorization shall extend only until operation is restored to the designated CPU.
[12] Section 12.1.D of the XLS Agreement
[13] Section 6.2 and 12.2 of the XLS Agreement
[14] Section 12.2 and 12.3 of the XLS Agreement
[15] Section 12.3 of the XLS Agreement
[16] Section 6.2 and 12.5 of the XLS Agreement.
[17] Section 6.2. of the XLS Agreement which provides that all software furnished by Welcome is included as "Welcome Confidential Information". Such information shall remain confidential and proprietary to Welcome and is furnished to BPI on a license to use basis. *See also* Section 11.1 of the XLS Agreement.
[18] Copies made in any form and in accordance with the provision of Section 11.1.D which pertains to making of one copy solely for archival backup purposes.
[19] Section 12.2. of the XLS Agreement
[20] Section 20 of the XLS Agremeent
[21] Section 12.5 of the XLS Agreement

The grant by Welcome to BPI of rights to Welcome's software exclusively on a license to use basis may be classified as a transfer of a copyright right if the acquisition and exercise of such right by the latter without the authority of the former constitutes an infringement of Welcome's copyright. In order to determine if such right can be subject to infringement, Section 177 of the Intellectual Property Code of the Philippines, as amended,[22] enumerates those rights of an author or owner of a literary, artistic or scientific work like software which can be the subject of infringement, to wit:

> **Section 177.** *Copyright or Economic Rights.* - Subject to the provisions of Chapter VIII, copyright or economic rights shall consist of the exclusive right to carry out, authorize or prevent the following acts:
> 177.1. Reproduction of the work or substantial portion of the work;
> 177.2. Dramatization, translation, adaptation, abridgment, arrangement or other transformation of the work;
> 177.3. The first public distribution of the original and each copy of the work by sale or other forms of transfer of ownership;
> 177.4. 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; (n)
> 177.5. Public display of the original or a copy of the work;
> 177.6. Public performance of the work; and
> 177.7. Other communication to the public of the work. (Sec. 5, P. D. No. 49a)

For reasons detailed in the preceding paragraphs, it is this Office's view that there was no transfer of any of the copyright right from Welcome to BPI. If any, BPI under the Agreement is granted the right to make a copy of the software, however, for archival backup purposes only.

In this regard, Paragraph 14 of the OECD commentaries on Article 12 is instructive in this wise:

> 14. xxx Regardless of whether this right [reproducing the software for archival purposes] is granted under law or under a license agreement with the copyright holder, copying the program onto the computer's hard drive or random access memory or making an archival copy is an essential step in utilizing the program. Therefore, rights in relation to these acts of copying, where they do no more than enable operation of the program by the user, should be disregarded in analyzing the character of the transaction for tax purposes. Payments in these types of transactions would be dealt with as commercial [(business)] income in accordance with Article 7. (underscoring supplied)

[22] Republic Act (RA) No. 8392, as amended by RA No. 10372

As such, BPI's reproduction of the software for archival backup purposes pursuant to paragraph 12.1.D of the XLS Agreement will not, for tax purposes, be considered as a grant of a copyright right.

BPI's transaction with Welcome is a transfer of a copyrighted article

Moreover, BPI maintains that they merely acquired "copy of the copyrighted articles." In this regard, the second paragraph of Section 5.b of RMC 44-2005 provides that, *"if a person acquires a copy of the software but does not acquire any of the [copyright] rights xxx (or only acquires a de minimis grant of such rights), and the transaction does not involve the provision of services or of a 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."*

As elucidated above, it is our view that BPI did not acquire any of the copyright rights, however, for the transaction to fall as a transfer of a copyrighted article, there is a twin requirement that must be complied with:

1. The person does not acquire any of the copyright rights; and
2. The transaction does not involve the provision of services or of a know-how.

The pertinent provisions of the OECD Commentaries on what constitutes "know-how" provide:

> 11. [The concept of "know-how"] generally corresponds to undivulged information of an industrial, commercial or scientific nature arising from previous experience, which has practical application in the operation of an enterprise and from the disclosure of which an economic benefit can be derived. Since the definition related to information concerning previous experience, the Article does not apply to payments for new information obtained as a result of performing service at the request of the payer.
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> 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. <u>It is recognized 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.</u>

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. Payment made under the latter contracts generally fall under Article 7.

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11.5 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 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 authorization and where it is subject to any available trade secret protection.

It is our opinion that BPI complied with the twin requirement. When BPI was granted the right to the software on a license to use basis, it only acquired the end-product itself, and this does not include the ideas and principles underlying such software, such as the logic, algorithms or programming language, or techniques thereof. In fact, the XLS Agreement prohibits BPI from reverse assembling or decompiling the software in whole or in part, but if warranted by circumstances that the software is reverse assembled or decompiled pursuant to Section 12.3 of the XLS Agreement, any technical information obtained by BPI shall not be used by the latter to develop any software or any derivative works that may directly or indirectly compete with the licensed software.[23]

RMC No. 44-2005 has prospective application

Nonetheless, RMC No. 44-2005 may only be applied prospectively.[24] It is clear under Section 9 of RMC No. 44-2005 that the RMC shall take effect immediately and shall cover software payments paid or payable starting said effectivity date. In fine, only payments made after the effectivity of the RMC shall be covered by its provisions as discussed above.

In fine, this Office is of the view that the business profits of Welcome from license fees paid by BPI for the software use after the effectivity of the RMC are exempt from income tax pursuant to paragraph 1 of Article 7 of the PH-SG Tax Treaty, and as such, the same is exempt from withholding taxes.

[23] *Supra fn.* 7 and 8

[24] Section 9 of RMC No. 44-2005 provides that the RMC shall take effect immediately and shall cover software payments paid or payable starting said effectivity date.