TAXATION OF ROYALTIES: AN EXAMINATION OF THE TAX TREATMENT OF ROYALTY PAYMENTS UNDER THE TAX CODE AND INTERNATIONAL TAX TREATIES

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business activity and transaction entered into between a domestic corporation and a foreign business entity. Proper income characterization of payments received under such transactions is crucial, as this determines their appropriate tax treatment.

This paper presents the treatment of royalties under the existing tax regime of the country and under select bilateral tax treaties entered into by the Philippines. It shall also highlight the various definitions and treatments under the National Internal Revenue Code, Tax Code for short, and these treaties. It shall also present the classification of certain payments as service fees or royalties through an assessment of important BIR rulings and court decisions. Finally, it also devotes a section to distinguishing between active and passive income.

I. DEFINITION

A. UNDER THE NATIONAL INTERNAL REVENUE CODE

Royalties are generally conceived to mean "compensation for the use of property, usually copyrighted material or natural resources, expressed as a percentage of receipts from using the property or as an account per unit produced."[3] Royalty payments are more ubiquitous than ever, due to the increasing number of franchising opportunities offered by large corporate enterprises.

The foregoing definition of royalties is the limited definition of royalties, the one employed in the 1939 Tax Code. Specifically, section 37(4) defined royalties as payments made "for the use of or for the privilege of using in the Philippines patents, copyrights, secret processes and formulas, goodwill, trademarks, trade brands, franchise, and other like property."

The present Code, however, defines royalties as payments made for the following:

> (a) the use or the right or privilege to use in the Philippines any copyright, patent, design or model, plan, secret formula or process, goodwill, trademark, trade brand, or other like property or right;

[3] BLACK'S LAW DICTIONARY 1330 (6th ed. 1990).

(b) the use or the right to use in the Philippines any industrial, commercial or scientific equipment;

(c) the supply of scientific, technical, industrial, or commercial knowledge or information;

(d) the supply of any assistance that is ancillary and subsidiary to, and is furnished as a means of enabling the application or enjoyment of, any such property, or right as is mentioned in paragraph (a), any such equipment as is mentioned in paragraph (b) or any such knowledge or information as is mentioned in paragraph (c);

(e) the supply of services by a non-resident person or his employee in connection with the use of property or rights belonging to, or the installation or operation of any brand, machinery, or other apparatus purchased from, such non-resident person;

(f) any other amounts paid in consideration of technical advice, assistance or services rendered in connection with technical management or administration of any scientific, industrial, or commercial undertaking, venture, project or scheme; and

(g) the use of or the right to use –

i. motion picture films;

ii. films or video tapes for use in connection with television; or

iii. tapes for use in connection with radio broadcasting."[4]

This is the expanded definition of royalties; it is referred to as expanded because it includes payments not conventionally considered as royalties, as used in the 1977, 1993, and the present Tax Codes. The present definition now includes *inter alia* payments for "the use or the right to use any industrial, commercial or scientific equipment" and those for "the supply of scientific, technical, industrial or commercial knowledge or information." Thus, royalties are no longer limited to registered intellectual property. It now covers even technical or professional advice given to another.

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[4] TAX CODE, § 42(A)(4). The National Internal Revenue Code is Rep. Act No. 8424 (1997).

This modern definition appears to be the generally accepted definition for tax purposes. For example, the International Bureau of Fiscal Documentation (IBFD) defines royalties as:

> [P]ayments of any kind received as consideration for the use of, or the right to use, a copyright of literary, artistic or scientific work including cinematographic films, a patent, trademark, design or model, plan, secret formula or process, or for the use of or the right to use, industrial, commercial or scientific experience. Royalties consist mainly of periodic payments based on certain conditions such as the output of merchandise for the production of which the invention is used, the number of books sold, etc., but lump-sum consideration also falls within the definition.[5]

Further, several countries also use the expanded definition for income tax purposes.[6] A good example of which is Australia, which defines royalties as:

> a. the use of, or the right to use, any copyright patent, design or model, plan, secret formula or process, trademark, or other like property or right;
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> b. the use of, or the right to use, any industrial, commercial or scientific equipment;
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> c. the supply of scientific, technical, industrial or commercial knowledge or information (such as know-how payments);
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> d. the supply of any assistance that is ancillary and subsidiary to, and is furnished as a means of enabling the application or enjoyment of, any such property or right as is mentioned in paragraph (a), any such equipment as is mentioned in paragraph (b), or any such knowledge or information as is mentioned in paragraph (c);
>
> e. the use of, or the right to use, motion picture films, films or video tapes for use in connection with television, or tapes for use in connection with radio broadcasting; or
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> f. a total or partial forbearance in respect of the use of, or the granting of the right to use property of any of the kinds referred to in paragraphs (a), (b) or (e), or the supply of knowledge,

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[5] INTERNATIONAL BUREAU OF FISCAL DOCUMENTATION (hereinafter "IBFD"), INTERNATIONAL TAX GLOSSARY (1998).

[6] ROY ROHATGI, BASIC INTERNATIONAL TAXATION 200 (2002).

> information or assistance of any of the kinds referred to in paragraphs (c) or (d).[7]

Australian Tax Office Income Tax Ruling IT 26/60 concisely discusses these categories of royalties, and provides clearer insight into the expanded definition. Paragraph (a) generally covers all forms of exploitation of a right or property short of outright sale of the right or property. The reference made to "other like property or right" refers to property similar to any of the properties enumerated.[8] Paragraph (b) refers to "equipment," as interpreted expansively.[9] It would generally include all types of equipment and apparatuses. Paragraph (c) refers to scientific, technical, industrial or commercial knowledge or information. This should be understood in the context of "know-how" or undivulged technical knowledge, information, experience or technique that is necessary for the industrial reproduction of a product or process.[10] Paragraph (d) relates to payments under contracts covering ancillary assistance to enable the application or enjoyment of the property or know-how. They are considered royalties irrespective of the relative value of such payments in relation to the "pure" property or know-how payment.[11] Paragraph (e) includes works both copyrighted and non-copyrighted, the former being also covered by Paragraph (a). Lastly, Paragraph (f) relates to contracts entered into by parties to prevent the holder of a right from granting the same to another person. Without Paragraph (f), transactions could be structured so that payments may not being regarded as royalties under the other paragraphs because the payments are made for forbearance rather than for the use of the relevant property.[12]

On the other hand, some countries still use the limited definition. Section 861(a)(4) of the United States Internal Revenue Code, for example, defines royalties as payment "for the use of or for the privilege of using in the United States patents, copyrights, secret processes and formulas, good will, trade-marks, trade brands, franchises, and other like property."

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[7] Australian Taxation Office, Income Tax Ruling IT 26/60, ¶ 12, *available at* http://www.austlii.edu.au/au/other/ato/itr/it2660.html (Jan. 25, 2004).

[8] *Id.*, ¶ 17.

[9] *Id.*, ¶ 18.

[10] *Id.*, ¶ 19-21.

[11] *Id.*, ¶ 22.

[12] *Id.*, ¶ 23-24.

B. UNDER INTERNATIONAL TAX TREATIES

As of December 31, 2003, the Philippines had 31 effective bilateral tax treaties with major trading partners such as the United States, Japan, and the Association of Southeast Asian Nations members.

All these treaties not only provide a definition of royalties for international tax purposes, but unfortunately, they also collectively create a problematic scenario for both tax authorities and practitioners. Given a specific type of income, say for example, income from the lease of industrial equipment, the income characterization may change depending on the state of residence of the payee.

The OECD Model Tax Treaty (2003) defines royalties as:

> [P]ayments 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, 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 above definition has generally been incorporated in most of the tax treaties entered into by the Philippines, since it conforms to the OECD Model Convention. However, in some tax treaties entered into by the Philippine Government, it can be observed that this definition has not been strictly adhered to, rather it can be observed that the definition has either been expanded or restricted.

1. Payments for the use of any copyright of literary, artistic or scientific work, any patent, trade mark, design or model, plan, secret formula or process

The OECD Commentaries consider royalties as generally relating to the payments for the use of, or the entitlement to use, rights of the kind mentioned, whether or not they have been, or are required to be registered in a public register.[13] This therefore includes intellectual property generally registrable in the Philippines such as patents, trademarks, copyrights, utility models and industrial designs. It also includes non-registrable or non-patentable items such as business method patents, discoveries, scientific

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[13] *Model Double Taxation Convention on Income and on Capital*, *in* REPORT OF THE OECD COMMITTEE ON FISCAL AFFAIRS 116 (Edward Kerr ed. 1977).

theories and mathematical methods, methods for treatment of the human or animal body by surgery or therapy and diagnostic methods practiced on the human or animal body, plant varieties or animal breeds or essentially biological process for the production of plants or animals.[14] This expands the definition of royalties to include the "rent" of most types of intangibles.

2. Rents in Cinematograph Films

Rents with respect to cinematograph films are also treated as royalties, whether such films are exhibited in cinemas or broadcasted on television. In some Philippine tax treaties, royalties from other media such as tapes, discs and radio or TV broadcast have been explicitly included. However, notwithstanding the non-inclusion of these media types in other treaties, it seems that they should nonetheless be included.

For example, the RP-Finland (1982) and RP-Norway (1997) Tax Treaties omit the phrase "including cinematograph films." However, these treaties still include the phrases "any copyright of literary, artistic or scientific work" and "any copyright," respectively. Items of cinematographic or musical value are considered copyrightable materials,[15] thus, their use falls under the right to use copyrights, thereby subsuming the resulting rents within the term royalties.

Royalties also include payments for the use of or the right to use, industrial, commercial or scientific equipment. Note, however, that this clause is not specifically included in some treaties such as the RP-Belgium (amended 2000), RP-Switzerland (2002) and RP-US (1983) treaties.

3. Lease of Equipment

Lease of equipment is conventionally categorized under rentals or leasing payments and not under royalties. However, royalties paid for the use of equipment and payments constituting the sale of equipment may, depending on the particular case, fall under the Model Convention's article 7 on Business Profits, 13 on Capital Gains, 14 on Independent Personal Services or 21 on Other Income. Income characterization is relatively straightforward in ordinary lease and ordinary sale transactions, where payments are considered royalties and business profits, respectively. Still, a dilemma arises in case of contracts combining the hire element and the sale element, so that it sometimes proves difficult to determine their true legal import. This is true for capital leases and credit sales agreements.

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[14] Rep. Act No. 9150, § 22.
[15] § 172.

Capital leases are leases of property where the risks and rewards of ownership are deemed to have been passed from the lessor to the lessee.[16] An accounting method, similar to a purchase by installment, is used since the underlying transaction is considered to be more akin to a purchase of property than a rental.[17]

Credit sales agreements are either installment sales agreements or deferred sales agreement. Under the Tax Code,[18] sale of personal properties and real properties where the initial payments do not exceed 25% of the selling price are allowed to be reported under the installment basis. All other credit sale arrangements must be reported on deferred payment basis.

Thus, for the foregoing transactions where the sale element is the paramount purpose of the transaction, the transaction will constitute a sale of property rather than royalty payment because the parties have from the outset agreed that the ownership of the property shall be transferred from one to the other, notwithstanding the fact that they have made this dependent upon the payment of the last installment. Consequently, the installments paid by the purchaser or lessor do not, in principle, constitute royalties.

On the other hand, in cases where the lease is the sole or the principal purpose of the contract, even if the lessor has the right or option to purchase the object of the lease at the end of the lease term (as is present in most capital leases), payments pursuant to the contract are considered royalties.[19]

4. Lease or Sale of Information concerning Industrial, Commercial or Scientific experience

Lastly, lease or sale of information concerning industrial, commercial or scientific experience may be considered royalties. Note that in some tax treaties, including the RP-Australia (1980) and RP-Canada (1977) Tax Treaties, the term "information" is used in place of the term "experience." Both refer to the same concept, and is in a sense

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[16] PATRICK DELANEY, WILEY CPA EXAMINATION REVIEW, FINANCIAL ACCOUNTING AND REPORTING 377 (2000).

[17] JAY SMITH ET AL, INTERMEDIATE ACCOUNTING 812 (Comprehensive Volume, 12th ed. 1995).

[18] TAX CODE, § 49(A)-(B).

[19] Model Convention, *supra* note 13.

interchangeable. However, "information" appears to be broader than "experience."

In classifying the foregoing as royalties, article 12(2) of the OECD Model Convention alludes to the concept of "know-how." Various specialist bodies and authors have formulated definitions of know-how which do not differ intrinsically. One such definition, given by the *Association des Bureaux pour la Protection de la Propriete Industrielle* (ANBPPI), states that "know-how is all the undivulged technical information, whether capable of being patented or not, that is necessary for the industrial reproduction of a product or process, directly and under the same conditions; inasmuch as it is derived from experience, know-how represents what a manufacturer cannot know from a mere examination of the product or a mere knowledge of the process or technique."[20]

As earlier discussed, in a know-how contract, one of the parties agrees to impart special knowledge and experience to the other for his own account, such special knowledge remaining unrevealed to the public. The grantor himself is not required to play any part in the application of the formula and does not guarantee its results.[21]

A know-how contract must be distinguished from a provision of services, in which one of the parties undertakes to use the customary skills of his calling to execute work for the other party. In the service contract, the contractor undertakes to perform services which will result in the creation, development or the bringing into existence of a product. In the course of developing a product, the contractor would apply existing knowledge, skill and expertise – there is no transfer or supply of know-how from the contractor to the buyer. The contractor uses his knowledge for his own purposes, and the product created belongs to the buyer without his having to obtain any further rights with respect to the product.[22] Thus, payments obtained as consideration for after-sales services rendered by a seller to the purchaser under a guarantee, for pure technical assistance, or for

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[20] *Id.*, at 117.

[21] TAX TREATY CHARACTERISATION ISSUES ARISING FROM E-COMMERCE, ORGANIZATION FOR ECONOMIC COOPERATION AND DEVELOPMENT (hereinafter "OECD") REPORT TO WORKING PARTY NO. 1 OF THE OECD COMMITTEE ON FISCAL AFFAIRS 7 (Oct. 18, 2003), *available at* http://www.law.wayne.edu/mcintyre/text/Treaty_Class/oecd-e-comm_treaty.pdf.

[22] *Id.*

an opinion given by an engineer, an advocate, or an accountant, do not constitute royalties within the meaning of paragraph 2.[23]

However, in most cases, the contractor also produces a byproduct (such as a plan, design, specification, or report which could contain knowledge not otherwise known to the buyer and which may or may not be protected by patents) which is copyrightable. Unless otherwise specifically agreed, the contractor retains the copyright, and the buyer or any other person is, by law, precluded from using the property for any purpose other than that for which it was originally designed without first obtaining the contractor's approval. This will not alter the character of the contract, which remains one for the performance of services.[24]

5. "Additional" items deemed as royalties

Some treaties employ the expanded definition of royalties, such definition not being explicitly included in the other tax treaties. Specifically, the RP-US Tax Treaty considers as royalties "gains derived from the sale, exchange or other disposition of any such right or property," such as patents, trademarks, and copyrights, "which are contingent on the productivity, use, or disposition thereof." Consequently, there is a difference in the income characterization and taxability of such payments compared to the treatment under other treaties. If a taxpayer is covered by the RP-US treaty and the foregoing income accrues to him, then the income is considered as royalties. The taxpayer is thus taxed subject to that treaty's article 13. Otherwise, the said income is taxed subject to the provisions on business profits or capital gains, generally articles 7 and 13 of the OECD Model, respectively.

a) RP-Australia Tax Treaty

Among the tax treaties entered into by the Philippines, the RP-Australia Tax Treaty arguably has the most modifications. Following the Philippine and Australian Tax Codes, the treaty uses the expanded definition of royalties, and extends the concept to include certain payments for "the supply of any assistance that is ancillary and subsidiary to, and is furnished as a means of enabling the application or enjoyment of, any such property or right as is mentioned in paragraph (a), any such equipment as is mentioned in paragraph (b) or any such knowledge or information as is mentioned in paragraph (c)" and "total or partial forbearance in respect of the use of a property or right referred to in this paragraph."

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[23] Model Convention, *supra* note 13, at 117.

[24] TAX TREATY CHARACTERIZATION ISSUES, *supra* note 22, at 14.

i. Ancillary Service Contracts

The provision on the supply of ancillary services as provided in this treaty effectively modifies the "influence or paramount purpose test" used or prescribed in the other tax treaties. As provided in the OECD Commentaries, to determine whether services contracted together with royalty contracts are considered royalties, the paramount purposes of the contract should be determined. If the primary purpose of the contract is the transfer of the right to use in consideration of the royalty payments, then the fees paid in relation to the services are considered royalties. Otherwise, the fees are deemed business profits.

Under the RP-Australia Tax Treaty, all ancillary services are considered royalties, even if the paramount purpose of the contract is the transfer of the right to use. It may however be argued that the "ancillary contract" clause is merely a restatement of the "paramount purpose" test, since there must first be a finding that the service or support aspect of the contract is merely ancillary before the pursuant payment is considered a royalty. The fact that the support or service aspect is merely "ancillary" necessitates the finding that the "paramount purpose" of the contract is for royalties. This issue has yet to be resolved by the Philippine Supreme Court.

Specifically on software licenses, there is a different treatment on ancillary services prescribed by RMC 77-2003[25] vis-à-vis that provided in article 12 of the RP-Australia Tax Treaty. As opposed to the treaty which automatically considers payments for ancillary services as royalties, RMC 77-2003 prescribes the following treatment:

> 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 the use of, or the right to use, copyright relating to software will be treated as royalties and taxable as such.

[25] Nov. 18, 2003.

> The other part of the payments representing the provisions of services will be treated as income from services and taxed as such.

Consequently, in a service contract ancillary to a software license involving an Australian resident, a potential conflict in rules arises. What treatment should be applied for ancillary services? Should they be considered as royalties given that these services are considered "ancillary" under the RP-Australia Tax Treaty? Or should a proper theoretical allocation as prescribed by RMC 77-2003 be made?

We believe that the rule prescribed by the treaty prevails over the RMC issued by the CIR. On international treaties, it has been stated by the Supreme Court:

> Equally important is article 26 of the Convention which provides that "Every treaty in force is binding upon the parties to it and must be performed by them in good faith." This is known as the principle of *pacta sunt servanda* which preserves the sanctity of treaties and have been one of the most fundamental principles of positive international law, supported by the jurisprudence of international tribunals.[26]

Provisions of treaties entered into by the Philippines are accorded a status equal to that of domestic legislation.[27] Thus, a treaty provision necessarily prevails over a Bureau of Internal Revenue ("BIR") ruling, which is an administrative issuance and not a legislative act.[28] As such, payments for services ancillary to software license contracts should be considered as royalty contracts pursuant to the RP-Australia Tax Treaty.

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[26] Bayan v. Executive Secretary, G.R. No. 138570, 342 SCRA 449 at 493 (2000). *See* Vienna Convention on the Law of Treaties, art. 26, May 23, 1969, 1155 U.N.T.S. 331.

[27] Santos v. Northwest Orient Airlines, G.R. No. 101538, 210 SCRA 256 at 261 (1992).

[28] Tayug Rural Bank v. Central Bank of the Philippines, G.R. No. 46158, 146 SCRA 120 at 129-30 (1986). Here, the Court stated: "Administrative rules and regulations have the force and effect of law.

There are, however, limitations to the rule-making power of administrative agencies. A rule shaped out by jurisprudence is that when Congress authorizes promulgation of administrative rules and regulations to implement given legislation, all that is required is that the regulation be not in contradiction with it, but conform to the standards that the law prescribes....

In case of discrepancy between the basic law and a rule or regulation issued to implement said law, the basic law prevails because said rule or regulation cannot go beyond the terms and provisions of the basic law. Rules that subvert the statute cannot be sanctioned...." (internal citations omitted) *ii. The "total or partial forbearance clause"*

With regard to the "total or partial forbearance" clause in the RP-Australia Tax Treaty, it is submitted that it merely restates in the negative article 12(a)-(c)[29] of the RP-Australia Tax Treaty. As discussed earlier, the Australian Tax Office has held that this provision refers to contracts for the forbearance of intellectual property, and that in its absence, payments for contracts for the forbearance of intellectual property would not be considered royalties under paragraphs (a), (b), and (c).

However, notwithstanding this "total or partial forbearance" clause, the same results would still follow since a contract for forbearance and a royalty contract have the same legal and economic effect. Note that a contract is classified by its accompanying legal effects and not the name given to it.[30] Contracts for forbearance of intellectual property and royalty contracts both refer to the same thing and have the same legal effect: the grant of permission by the property or right holder to the payor for the use of such property or right. As such, it may be argued that notwithstanding the stipulation of "total or partial forbearance," the contract should still be construed a royalty contract subject to paragraphs (a), (b), and (c).

II. ROYALTIES V. SERVICE FEES

A very troubling question oft raised in our jurisdiction is how to treat certain payments which may be considered as either royalties or service

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[29] Article 12(2) of the RP-Australia Tax Treaty defines royalties as payments for:

(a) the use of, or the right to use, any copyright, patent, design or model, plan, secret formula or process, trademark, or other like property or right;
(b) the use of, or the right to use, any individual, commercial or scientific equipment;
(c) the supply of scientific, technical, industrial or commercial knowledge or information;
(d) the supply of any assistance that is ancillary and subsidiary to, and is furnished as a means of enabling the application or enjoyment of, any such property or right as is mentioned in paragraph (a), any such equipment as is mentioned in paragraph (b) or any such knowledge or information as is mentioned in paragraph (c);
(e) the use of, or the right to use —
  (i) motion picture films;
  (ii) films or video tapes for use in connection with television; or
  (iii) tapes for use in connection with radio broadcasting; or
(f) total or partial forbearance in respect of the use of a property or right referred to in this paragraph."

[30] Quiroga v. Parsons Hardware, G.R. No. 11491, 38 Phil 501, Aug. 23, 1918.

fees. This problem always arises whenever the interpretation of the Tax Code or the Tax Treaty definition of royalties is in issue.

Service fees are income derived from the offer or sale of work or service to another. Article 1644 of the Civil Code defines lease of work or service:

> In the lease of work or service, one of the parties binds himself to execute a piece of work or to render to the other some service for a price certain, but the relation of principal and agent does not exist between them.

In a contract of work, one of the parties binds himself to produce a result of work or labor and the other party is obligated to pay remuneration. The contract of a surgeon to perform an operation, that of an artist to give a concert, and that of a contractor to construct a building, are contracts of work. On the other hand, in a contract of services, one of the parties binds himself to render some service, that is, his own activity or labor and not its result, and the other party binds himself to pay remuneration.

In Civil Law, a contract of work should be distinguished from a lease of service. In a contact of work, the result is the object to be delivered without considering the labor that produces it, while in a lease of services, the object of the contract is the service itself. "As such, a contract of work is executed with an architect to design a house, while the contract with the carpenter who works for the former is a lease of service."[31] This distinction, however, is not present for tax purposes; payments for both are considered service fees.

Analyzing the boundaries of service fees and royalties as discussed in the immediately preceding heading, there seems to be a very thin and vague line between royalties and service fees. As a result, local tax authorities and courts have long been at odds as to the proper limits of the said terms. Both the BIR and the courts have time and again issued nebulous and rather varied definitions of royalties, which resulted in many conflicting subsequent decisions. The definitions and interpretations given in recent rulings regarding royalties have become so broad that income arguably characterized as service fees may now be even characterized as royalties. This confusion was probably caused in no small measure by the expanded definition of royalties as used in the present Tax Code. Thus, it becomes very taxing, pardon the pun, if not impossible, to form a coherent rule.

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[31] ARTURO TOLENTINO, V CIVIL CODE OF THE PHILIPPINES 210 (1999).

The distinction sought to be clarified is very important in taxation, since royalties and service fees have very different tax implications. Moreover, the terms are mutually exclusive. A finding that a certain payment is a service fee precludes a finding that the same is royalty, and vice-versa.

Under the Tax Code, royalties and service fees are subjected to different tax systems. Royalties are generally subject to a 20% final withholding tax,[32] while service fees are generally subject to the graduated income tax rate[33] for individuals and the 32% regular corporate income tax[34] for corporations. They are also subject to different source rules, with situs for royalties being the place of use[35] and for service fees, the place of performance.[36]

Furthermore, under the treaties, royalties and service fees are generally covered by different provisions. Royalties are generally covered by article 12 of most tax treaties, while service fees are considered business profits under article 5 on Permanent Establishments and article 7 on Business Profits. In general, royalties are taxed at a preferential rate of 15%, subject to specified exceptions.

On the other hand, service fees may or may not be subjected to income tax by the source state, depending on the presence of a permanent establishment. If a permanent establishment is constituted in the source state, the latter is given the right to tax the said service fee. In our jurisdiction, the tax rate usually applied to these payments is the 32% Regular Corporate Income Tax (RCIT). Otherwise, the said payments are exempted from income tax in the source state.

The BIR, on several occasions had the opportunity to distinguish service fees from royalties. The BIR stated that to be considered royalties, there must be transfer into this country, technology, equipment or other property, where the payee has proprietary interest.[37]

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[32] TAX CODE, §§ 24(B)(1), 27(D)(1).
[33] § 24(A)(1).
[34] § 27(A).
[35] § 42(A)(4).
[36] § 42(A)(3).
[37] Bureau of Internal Revenue (hereinafter "BIR") Ruling No. 093-89, May 2, 1989.

A. BUREAU OF INTERNAL REVENUE RULINGS

BIR Ruling No. 093-89 decreed:

> [T]o be considered as rental or royalties within the purview of section 36(a)(4) [now § 42 (A)(4)] of the Tax Code, there must be *transferred into this country of technology, equipment or other property, where the payee has proprietary interest*. Specifically, under sub-paragraph (C) thereof, there must be transfer of scientific, technical, industrial or commercial knowledge or information. In the instant case, there is no such transfer of technology as the remuneration paid by the Government to SGS is for the latter's service of physical inspection so as to provide a clean report of findings on the quantity, quality and price comparison of imported goods in the country of supply. In other words, the remuneration of SGS under the facts of this case, is not considered royalty; it constitutes compensation for labor or personal service performed without the Philippines hence, the same is considered income from sources without the Philippines [§ 36(c)(3), Tax Code][now § 42 (A)(4)]. (emphasis added) [38]

The Bureau initially ruled that "the remuneration of the foreign inspection firm shall be considered as royalties for the supply of scientific, technical, industrial or commercial knowledge or information." The BIR later on reversed its own ruling in the same case after it conducted a "restudy." This time the concept of transfer of know-how, equipment or other property was brought to the fore. BIR Ruling No. 093-89 stated that in case there is "no such transfer of technology, as the remuneration paid" to the non-resident foreign corporation was for the latter's service of conducting a physical inspection, the remuneration constituted compensation for labor or personal services performed outside the Philippines and is hence not taxable.

This principle was reapplied in BIR Ruling No. 001-90,[39] which involved Pfizer, Inc. and Pfizer International, Inc. These corporations entered into a "Medical and Marketing Support Services Agreement" wherein Pfizer International would provide medical and marketing services to Pfizer "to achieve the economic benefits of centralization of various technical support services concerning the production and sale of pharmaceutical and animal health products."[40] Pfizer would pay Pfizer International the cost of medical and marketing support services without any

[38] *Id.*

[39] Jan. 4, 1990.

[40] BIR Ruling No. 001-90 (January 4, 1990).

mark-up profit in consideration of the said services to be rendered by the latter to the former. The BIR ruled that such payments were not royalties but simply "reimbursements of actual expenses" hence, not subject to Philippine income tax. The Bureau reiterated that for payments to be considered royalties, there must be a transfer in the Philippines of technology, equipment or other property where the payee has a proprietary interest. It added that "specifically, there must be transfer of scientific, technical, industrial or commercial knowledge or information."

B. PHILIPPINE REFINING CO. V. COMMISSIONER

In the absence of such a transfer, payments must be categorized as service fees. This BIR pronouncement was drawn from the Court of Tax Appeals decision in the case of *Philippine Refining Co. v. Commissioner of Internal Revenue*.[41] Here, petitioner and domestic corporation Philippine Refining Company, Inc. entered into an agreement with Unilever Ltd., a non-resident foreign corporation not engaged in business in the Philippines and organized under the laws of England. PRC was licensed to manufacture and sell Unilever's products in the Philippines, and the latter would perform the following services: (a) Training, (b) Research, (c) Availability of service and advisory departments of Unilever, (d) Trademarks, and (e) Communication of patents and secret processes.

The BIR imposed deficiency withholding tax at source for the years 1966-1971 and delinquency withholding tax at source for the years 1966-1967. The Bureau contended that the payments made by Philippine Refining to Unilever were not for services rendered, but royalty fees. It argued that the agreement in reality partook of a license. The Bureau further argued that "if the contracting parties intended to treat the alleged services as such, there should have been a contractual price for each and every service actually rendered and not an arbitrary fee on the net sales of the products in the Philippines."

The tax court declared that a payee must have a proprietary interest in the property from which the income arises before the payment is considered a royalty. Otherwise, the payment is a compensation for personal service.[42] It concluded that Unilever "does not have any interest or right to the services performed," and hence was not considered as receiving royalties.

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[41] CTA Case No. 2872, January 15, 1986.

[42] *Id.*, *citing* Ingram v. Bowers, 47 F.2d 925 (1931).

It appears therefore that in the two BIR Rulings as well as in the *Philippine Refining* case, the idea of "transfer of technology or technical know-how" and the concomitant proprietary interest in the transferred property are the dominant factors that distinguish royalties from service fees.

C. PHILAMLIFE INSURANCE CO. V. COURT OF TAX APPEALS

However, the CTA later contradicted itself in a subsequent decision when it abandoned this reliance on "transfer of know-how." *Philippine American Life Insurance Co., Inc. v. Commissioner of Internal Revenue*[43] completely disregarded the issue of whether or not there was in fact a transfer of know-how. It merely relied on the Tax Code's expanded definition of royalties. The Court of Appeals subsequently upheld the CTA's ruling in *Philippine American Life Insurance Co., Inc. v. Court of Tax Appeals*.[44]

In the CTA case, Philippine American Life Insurance Co., Inc. ("Philamlife") entered into a Management Services Agreement with American International Reinsurance Co., Inc., ("AIRCO") a non-resident foreign corporation, where AIRCO was to render underwriting and marketing, education and training, accounting and auditing, and other services. Taxes were imposed on these services and collected from Philamlife. The latter later applied for a refund, alleging that the compensation paid for advisory services rendered outside the Philippines cannot be "rentals and royalties from properties located in the Philippines" under section 37(a)(4) of the (1980) Tax Code. It emphasized that AIRCO has no properties located in the Philippines from which rentals or royalties may be collected. In affirming the CTA, the Court of Appeals reasoned:

> A reading of the various management services enumerated in the said Management Services Agreement will show that they can easily fall under any of the aforequoted expanded meaning of royalties. Basically, from the heading 'Investments' to 'Personnel', the services call for the supply by the non-resident foreign corporation of technical and commercial information, knowledge, advice, assistance or services in connection with technical management or administration of an insurance business – a commercial undertaking. Therefore, the income derived from the services performed by AIGI for PHILAMLIFE under the said management contract shall be considered as income from services within the Philippines. ...

[43] CTA Case No. 3504, 3743, Mar. 10, 1993.
[44] CA-G.R. SP No. 31283, Apr. 25, 1995.

> The argument of the Petitioner may be true perhaps prior to the amendment of section 37(a)(4) by P.D. 1457 on June 11, 1978. Prior to said amendment, the term 'rentals or royalties' has a very limited meaning. It refers only to rentals or royalties for 'the use of or for the privilege of using in the Philippines patents, copyrights, secret processes and formulas, goodwill, trademarks, trade brand, franchise and other like properties'. Prior to this amendment the jurisprudence cited by Petitioner and marked as Exh. 'B' would apply which states that 'in case of income derived from services, the factor which determines the source of income is not the residence of the payor or the place where the contract for the services is entered into or the place of payment. It is the place where the services are actually rendered.' However, when the said provision of law was amended to include the expanded meaning of royalties, this jurisprudence is accordingly modified to exclude all the type of services enumerated in the amended law.[45] (internal citations omitted)

American International Group, Inc., AIRCO's successor-in-interest following their merger in 1978, was thus held liable to pay a tax equal to 35% of the gross income received during each taxable year from all sources within the Philippines such as interest, dividends, rents, and royalties. This decision apparently reverses the general notion of royalties requiring the transfer of "technology or technical know-how" and "proprietary interest" to the payee. Consequently, an all-encompassing textual interpretation is given to the term "royalties" under the Tax Code, which includes all types of services enumerated in the present section (A)(4).

This deviation creates potential conflicts in the resolution of income characterization issues. Several questions may come to mind: What then is the proper rule for royalties? Does one still apply the "technical know-how" and "proprietary interest" rules? Or does one use a textual or "plain-letter law" definition as provided in section 42(A)(4)?

Returning to the general rules on statutory interpretation, lower courts are bound to apply principles enunciated by superior courts given substantially the same facts. This follows from the doctrine of *stare decisis et non quieta movere*, or roughly, "follow past precedents and do not disturb what has been settled."[46] Thus, it would seem that one must adhere to *Philamlife* and that BIR rulings to the contrary are void.

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[45] *Id.*

[46] Luzon Brokerage Co., Inc. v. Maritime Building Co., Inc., G.R. No. 25885, 86 SCRA 305 at 319 (1978). "The doctrine of *stare decisis* embodies the legal maxim that a principle or rule of law which has been established by the decision of a court of

However, a better question would be: Is the foregoing principle correct? If the principle in the *Philamlife* is legally infirm, one would do well to recall the Court's dictum in *Olaguer v. Military Comm'n No. 34:*

> Certainly, the rule of *stare decisis* is entitled to respect because stability in jurisprudence is desirable. Nonetheless, reverence for precedent, simply as precedent, cannot prevail when consti-tutionalism and the public interest demand otherwise. Thus, a doctrine which should be abandoned or modified should be abandoned or modified accordingly. After all, more important than anything else is that this Court should be right.[47]

As stated earlier, article 12(2) of the OECD Model also applies the expanded definition, and its wording is similar to that of section 42(A)(4).[48] The OECD Commentaries provide that payments for transfer of information to be considered as royalties, there must be a transfer of "know-how," which covers "all the undivulged technical information … necessary for the industrial reproduction of a product or process."[49]

It is submitted that the same must be adopted by the Philippines. Otherwise, payments made for "information" would fall under royalties. Since "information" is almost always present in services, especially professional services, the term "royalties" would indeed be very expansively interpreted. For example, payments made for audit, consultancy engineering, management and other professional services would almost always be considered royalties, if the requirements laid down by the *Philippine Refining* were put aside. This is clearly not the intent of the legislature. To allow such an overbroad interpretation would defeat the purpose of structuring an expanded definition of royalties, since it removes the need to distinguish between service fees and royalties.

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controlling jurisdiction will be followed in other cases involving a similar situation. It is founded on the necessity for securing certainty and stability in the law and does not require identity or privity of parties. This is explicitly fleshed out in article 8 of the Civil Code which provides that decisions applying or interpreting the laws or the constitution shall form part of the legal system. Such decisions 'assume the same authority as the statute itself and, until authoritatively abandoned, necessarily become, to the extent that they are applicable, the criteria which must control the actuations not only of those called upon to aside thereby but also of those in duty bound to enforce obedience thereto.'" Kilosbayan, Inc. v. Morato, G.R. No. 118910, 246 SCRA 540 (1995).

[47] Olaguer v. Military Commission No. 34, G.R. No. 54558, 150 SCRA 144 at 165 (1987).

[48] Model Convention, *supra* note 13.

[49] *Id.*

In a subsequent ruling issued by the Court of Appeals, it again alluded to the *Philippine Refining* doctrine:

> It is undeniable that payments for the use of technical know-how or secret formula or process may qualify as rentals and royalties for purposes of deduction. Article 13, par. (3), of the RP-US Tax Treaty defines royalties as payments of any kind received as a consideration, among others, for information concerning industrial, commercial or scientific experience. *To be considered royalties, there must be transferred in this country of technology, equipment or other property where the payee has proprietary interest (BIR Ruling No. 093-89, dated May 2, 1989).*[50] (emphasis added)

The same requirements were also applied in most BIR rulings issued on royalties. In BIR Ruling No. DA-149-98,[51] Sony Music Entertainment Philippines, Inc. entered into a marketing service agreement with Sony Music Entertainment, Inc., a non-resident American corporation. The latter was to provide the following services on a cost-reimbursement basis: implementation and interpretation of international artist contracts, recording promotion and distribution contracts, international marketing campaigns, creation of merchandising and publicity materials, control of manufacturing, quality control and operation of international warehouse operations, executive recruitment, and other allied services. It was stated that the said services were to be performed mostly in New York. The BIR held that the payment was not a royalty, since there was in fact no transfer of technology, equipment or other property in which Sony-US has proprietary interest.

In another ruling,[52] Philippine International Air Terminals Co., Inc. engaged Pacific Consultants International, a non-resident foreign corporation to perform certain engineering design services, to be generally performed in Japan. The BIR held that the payments involved were not royalties, again since the transfer described in *Philippine Refining* was absent. Consequently, payments made for the engineering services were considered service fees.

In still another ruling,[53] IIR Exhibitions Philippines, Inc. entered into a Marketing and Business Development Agreement with IIR Holdings Ltd., a non-resident Dubai corporation. The latter was to perform marketing

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[50] Comm'r of Internal Revenue v. Cynamid Phil, C.A. GR-SP No. 39933, Feb. 4, 1999.

[51] Apr. 20, 1998.

[52] BIR Ruling No. DA-226-98, Jun. 9, 1998.

[53] BIR Ruling No. DA-076-99, Feb. 8, 1999.

and sales support services outside the Philippines, to be paid based on time devoted to these services. Alluding to *Philippine Refining*, the BIR again ruled that the payments involved could not be considered as royalties, since there was no transfer of technology, but merely the rendition of marketing services.

D. FOREIGN TAX LAWS

1. United States

For a comprehensive examination of the term royalties, it may be prudent to examine the internal tax laws and jurisprudence of other countries. It is fitting to begin with the United States, since its jurisprudence has persuasive effects in this jurisdiction.[54]

Again, the United States Internal Revenue Code defines royalties as payments "for the use of or for the privilege of using in the United States patents, copyrights, secret processes and formulas, good will, trade-marks, trade brands, franchises, and other like property". Other than the foregoing provision, American legislation does not explicitly define royalties.

Since the United States applies the limited definition, it is proper to apply American precedents to interpret section 42(A)(4), par. (a) of the Philippine Tax Code. In *Sierra Club, Inc. v. Commissioner of Internal Revenue Service*,[55] the Ninth Circuit used the definition provided in Revenue Ruling 81-178, which provides that royalty is a payment relating "to a valuable right." It was also stated that:

> Payments for the use of trademarks, trade names, service marks, or copyrights, whether or not payment is based on the use made of such property, are ordinarily classified as royalties for federal tax purposes ... On the other hand, royalties do not include payments for personal services.[56]

The Ninth Circuit held that royalties, being payments for the right to use intangible property, are "by definition 'passive' and thus cannot include compensation for services rendered by the owner of the property."[57] The foregoing ruling shows a very simplistic approach to proper income

[54] Gestetner Ltd. v. Comm'r of Internal Revenue (Manila Wine Merchants case), CTA No. 3549, Nov. 29, 1990.

[55] 86 F.3d 1526 (9th Cir. 1996).

[56] *Id.*, at 1528.

[57] *Id.*

characterization of royalties and service fees. Pursuant to the said ruling, if the payment is made in exchange for the right to use intangible property and the payee is "passive," then the said income will be considered royalty.

Some authors criticize this approach as vague, in that the term "passive" has no clear boundaries. Specifically, does "passive" mean an absence of participation in the income generating activity, which is impossible, or does it mean that the taxpayer need not be "too active" to the point that the income losses its passive character?[58]

a. Proprietary Interest

In *Ingram v. Bowers*,[59] Enrico Caruso recorded master discs in a studio and was paid a percentage of sales. The court held that the income he received was a service fee and not a royalty, since he did not obtain any interest on the master record. Since the service was performed in the United States, the income was subject to the federal income tax.

The same issue was raised in *Karrer v. United States*.[60] Professor Karrer was doing patentable research on Vitamin E for Hoffman-La Rouche in Switzerland. The latter then assigned its patent application to Nutley, an American corporation. The Court held that the income received by Prof. Karrer was service income and not royalty, since he did not own the patent before the transfer to the Nutley. Thus, since the research was done outside the United States, it was exempt from its income tax.

These two cases vividly illustrate the proprietary interest requirement. In both cases, since the payees did not have any proprietary interest over the related intangible properties, payments made to them could not have been royalties. Thus, although the respective courts were silent as to the indispensability of this requirement, it is submitted that proprietary interest by the payee is more or less necessary before considering the payment as a royalty.

b. Transfer of Technical Know-How

There remains no clear ruling on the necessary level or magnitude of transfer of know-how. Some authors believe, however, that an ordinary level

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[58] Katherine VanYe, *Sierra Club v. Commissioner and the Royalty Exemption to the Unrelated Business Income Tax: How Much Activity is Too Much?*, 72 WASH. L. REV. 1171 (1997).

[59] 47 F.2d 925 (1931).

[60] 152 F.Supp. 66 (Ct.Cl. 1957).

of technology precludes a finding that a payment is a royalty.[61] If the state of the art in the source country considers the technology transferred to be ordinary, and not in the nature of "secret processes and formula," then the payment would be considered service income and not a royalty. Thus, these authors advocate a comparison of the state of the art in both the source country and the resident country to determine whether the requirement that there be "transfer of technical know-how" is satisfied.[62]

This seemingly straightforward test gives rise to two issues: First, how does one evaluate the current state of the art; and second, how does one apply this test when both payee and payor are residents of the same country?

Because of these two issues, it is submitted that the said test does not provide a viable criterion to determine whether the requirement is met. It is further submitted that a simpler approach be followed, using the concept of know-how as discussed in the OECD Commentaries. "Know-how" would comprise the knowledge not clearly apparent from the mere inspection of the product by a person competent in the art. Treated this way, it is akin to the phrase "secret formula or process" as used in our Tax Code and in the United States Internal Revenue Code.

The concept may be likened to the concept of inventive step used in patent law, which necessitates a showing that an invention is noticeably different from any product within the state of the art. It must also be shown that the product had resulted from a creative idea.[63] However, the concept of inventive step is clearly applied more strictly, and the concept of know-how should be applied liberally.

2. India

Recently, the Madhya Pradesh High Court of India has ruled on the proper limits of the term royalties for income tax purposes. In *Commissioner of Income Tax v. HEG Ltd.*, the taxpayer HEG, an Indian corporation, was in the business of dealing in carbon graphite electrodes and made payments to an American company for data on these. The Indian tax authorities held that these payments were royalties. The Indian court reversed, stating that not all

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[61] Chang Hee Lee, ***Taxation of U.S.-Korea Technology Transfer: A Developing Country's Point of View***, 10 INT'L TAX & BUS. LAW 1 (1992).

[62] *Id.* at 1.

[63] VICENTE. AMADOR, PATENTS UNDER THE INTELLECTUAL PROPERTY CODE 32 (2001).

payments for all types of information may be considered as royalties. It cited the definition of royalties under the Indian Income Tax Act: "the imparting of any information concerning technical, industrial, commercial or scientific knowledge, experience or skill." It then discussed that some sort of expertise or skill is required in the said information, before considering them royalties.[64]

3. Australia

In Income Tax Ruling IT 26/60, the Australian Taxation Office provided a helpful guide in determining whether a payment is a royalty or a service fee. It identified three basic ingredients for a contract to be considered a royalty or a "know-how" payment: First, the presence or existence of a product, such as knowledge, information, technique, formula, skill, process, or plan; second, the transfer of the product's use to the buyer; and last, the product's continuation in the hands of the seller, the buyer having only the right to use the said product.

It also identified several elements of service fees: First, the contractor undertakes to perform services which will result in the creation or the development of a product, used in the general sense as this may refer to non-"know-how" products; second, there is no transfer of know-how to the buyer by the contractor, the latter using his existing knowledge, skill and expertise for his own purposes; and last, the product created as a result of the services belongs to the buyer for his use without being required to obtain any further rights from the contractor with respect to the product. However, the said office noted that the by-product usually appended to the said service may still be covered by copyright, but this does not modify the nature of the contract from a service contract to a "know-how" contract.

The foregoing requirements outlined by the Australian Taxation Office provide a very clear and tangible yardstick to determine proper income characterization. It may be applied in Philippine jurisdiction, since its definition of royalties is substantially similar.

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[64] Deloitte & Touche, Tax Alert: India, *High Court Clarifies Definition of Royalty* (Aug. 27, 2003), *available at* http://www.in.kpmg.com/talert/taxalert_vol8issue4.pdf.

E. CURRENT AND EMERGING INTERNATIONAL ISSUES

1. Technical Service Fees

The BIR has consistently ruled that technical service fees paid to a non-resident foreign corporation by a domestic corporation in the country are considered royalties. The Bureau relies on the Tax Code's definition of royalties or the applicable tax treaties. Curiously, the concept of know-how in cases involving technical service agreements was *not* a factor at all, or at least not a major factor, in most rulings.

In several cases where the parties entered into either a "Technical Service Agreement," "Technical Services and Royalty Trademark Agreement," or "Service Agreement," the technical service fees paid in all instances were considered royalties.[65] In at least one case where the parties executed a technical service agreement where the payment for technical advice was termed "advisory fees," the BIR likewise considered the same royalties since they are payments "received as consideration, among others, for information concerning industrial, commercial or scientific experience."[66]

Three selected BIR Rulings illustrate this treatment.

In BIR Ruling No. 053-80, International Marbella Club Establishment was obligated to provide Marbella Club (Manila), Inc. technical assistance services "in the design, planning construction, financing, decoration and equipping" of a Marina and Club Development Project. The former's assistance consists in making available its expertise and experience to the architects, contractors, engineers and decorators of the latter. In addition, the services of key International Marbella personnel were to be extended. The Bureau held that the technical service fees paid to

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[65] BIR Ruling No. 053-80, May 13, 1980; BIR Ruling No. 136-89, Jul. 4, 1989; BIR Ruling DA-395-98, Aug. 28, 1998; ITAD Ruling No. 105-00, Aug. 7, 2000.

[66] BIR Ruling No. 305-88, Jul. 12, 1988, *citing* art. 13(3) of the RP-US Tax Treaty: "The term 'royalties' as used in this article 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 cinematographic films or films or tapes used for radio or television broadcasting, any patent, trade mark, design or model, plan, secret formula or process, or other like right of property, or for information concerning industrial, commercial or scientific experience. the term 'royalties' also includes gains derived from the sale, exchange or other disposition of any such right or property which are contingent on the productivity, use, or disposition thereof."

International Marbella were considered royalties for "the supply of scientific, technical, industrial or commercial knowledge or information."

In BIR Ruling No. 136-89, Kawasaki Heavy Industries, Ltd., a Japanese corporation, entered into a Joint Venture Agreement with the Philippine Government for the "construction, operation and management of a ship repair facility." Kawasaki was given a license by the Securities and Exchange Commission to establish a representative office in the Philippines. Pursuant to the Joint Venture Agreement, the parent and the Philippine office executed a Technical Service Agreement, where the former would provide the latter with "technical assistance in the management and operation of said project by sending such technical personnel as may be required."

The BIR decided that the technical service fees remitted to Japan by the Manila office were considered royalties as they were for the "technical advice, assistance or services rendered in connection with technical management or administration of any scientific, industrial or commercial undertaking, venture, project or scheme."[67]

In BIR Ruling No. DA-395-98, domestic corporation T & H Furnishing Industries, Inc. entered into a Service Agreement with Tsuneishi Forestry Construction Co., Ltd., a non-resident Japanese corporation. Under the agreement, Tsuneishi was to render "technical services to train Filipino workers on the technology of ship accommodation making." T&H was to pay a service fee of JPY11,672,766.00 per ship. Again, the Bureau considered this as royalty in that "the dispatch of the foreign corporation's technical personnel to provide technical assistance to T & H is a transfer of know-how subject of the Manufacturing, Patents and Technical Assistance Agreement" between the two corporations.[68]

It is noteworthy that the concept of transfer of know-how was cited only in the last ruling. What is more interesting is that this ruling, BIR Ruling No. DA-395-98, was handed down in 1998 – three years after the CA promulgated *Philamlife*. In view of probable dilemmas that may arise, it becomes necessary to ascertain whether the know-how requirement must be applied in all cases or in particular instances only when certain conditions or factual circumstances are met, or, alternatively, whether the know-how

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[67] BIR Ruling No. 136-89, Jul. 4, 1989.

[68] BIR Ruling No. DA-395-98, Aug. 28, 1998, *citing* BIR Ruling No. 026-94, Jan. 21, 1994.

requirement may somehow be harmonized with the expanded definition of royalties.

2. Management or Professional Service Fees

There is an apparent dearth of clear guidelines or consistency in the Bureau's decisions concerning the payment of management fees. In most cases, it has ruled that fees paid by a domestic corporation to a non-resident foreign corporation for services rendered under a management or consultancy agreement are considered royalties. It based its decisions on pertinent provisions of the Tax Code or tax treaties providing that fees paid for information concerning industrial, commercial, or scientific experience are deemed royalties. In a fairly recent ruling,[69] however, the concept of "transfer of know-how" became a new and important consideration.

In BIR Ruling No. 159-81, it was shown that the then Ministry of Natural Resources and Atlanta Industrieand Unternehmensberatung GMBU of West Germany executed a Consultants' Services Contract where Atlanta conducted the Wood Industry Development Study Project for the Ministry. The BIR held that the payments for the services of Atlanta under the said contract are deemed as royalties since the said payments are being made in consideration of Atlanta's technical advice, assistance or services rendered in connection with the technical management or administration of any scientific, industrial or commercial undertaking, venture, project or scheme.[70]

In BIR Ruling No. 198-85, Biophil, Inc., a domestic corporation registered with the Board of Investments as an export producer on a pioneer status, manufactured ribonucleic acid concentrate. It later entered into a Management Contract with Kanegafuchi Chemical Industry Co. Ltd of Japan, where the latter was to plan, direct, control, supervise and coordinate the manufacturing, marketing, administration, accounting, finance, costing, purchasing and other managerial operations. Biophil undertook to pay a management fee equivalent to 2% of sales, using products' total F.O.B. value. The BIR, applying article 12(4) of the RP-Japan Tax Treaty (1981), ruled that the services rendered constituted technical assistance and information concerning industrial, commercial or scientific experience, thus considering the fees paid as royalties.[71]

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[69] ITAD Ruling No. 145-02, Aug. 21, 2002.

[70] BIR Ruling No. 159-81, Aug. 21, 1981, *citing* TAX CODE, § 37(a)(4)(F) (1980).

[71] BIR Ruling No. 198-85, Nov. 7, 1985.

In ITAD Ruling No. 163-00, Lepanto Consolidated Mining Co. executed a Consultancy Agreement with PT Murray & Roberts Indonesia. Murray was to provide "consultancy and supervisory services for the Drilling, Charge-up and Blast, Spoil Mucking, Support-Rockbolt, Shotcreting for normal ground, Ventilation, Dumping, Installation of Services, Roadways stages of the execution of Phase II of the Nayak Internal Shaft Project and Nayak Decline Project." The Bureau ruled that payments to Murray were royalties, explaining that they constituted the use of information concerning industrial experience under article 12(4) of the 1983 RP-Indonesia Tax Treaty. It rejected Lepanto's contention that the fees were business profits exempt from tax because Murray had no permanent establishment in the Philippines. The Bureau explained that the "tax on royalties ... is a specific tax on the gross amount paid, the imposition of which is not dependent on the existence of a permanent establishment in the Philippines."[72]

Finally, in ITAD Ruling No. 145-02, the BIR considered the transfer of know-how in determining that fees paid were not royalties. Oakwood Management Services (Phil.), Inc. was a domestic corporation engaged in the business of managing and operating service apartments in the country, and entered into a Service Agreement with Oakwood Asia Pacific Ltd., a non-resident Malaysian corporation. Under the agreement, Oakwood-Asia obligated itself to render: "(1) general consultation and management (e.g., assist in strategic planning and forecasting); (2) training and personnel development (e.g., give advice on standards for recruitment of executive staff); (3) financial and budgetary planning (e.g., budget review, financial protection and analysis); and (4) marketing services (e.g., give advice on marketing strategies, business development and marketing analysis)." These were to be outside the Philippines for a fixed monthly fee..

The BIR considered these fees service fees, and argued that to be regarded as royalties, "there must be a transfer into the Philippines of technology, equipment or other property, where the payee has proprietary interest." The Bureau concluded that there was no transfer of technology, but simply the rendition of services as enumerated in the agreement, and Oakwood Asia would have no interest or right to the results of the services.[73]

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[72] ITAD Ruling No. 163-00, Oct. 30, 2000.

[73] ITAD Ruling No. 145-02, *citing* BIR Ruling No. 93-89, May 2, 1989; Philippine Refining Co. v. Comm'r of Internal Revenue, CTA Case No. 2872, Jan. 15, 1986. Again,

3. Royalty-free Contracts and Contract-Splitting

The number of international transactions involving computer software have grown exponentially in the past few years. As a result, many variations on these transactions have been concocted to provide tax consequences favorable to the licensor. Examples include the prepackaging of the software as a product or the customization or tailoring of the product to suit the needs of users. Software may also be distributed unbundled or in "shrink-wrapped" form or may be bundled with or pre-loaded into computer hardware upon purchase. These may also be sold with or without accompanying support or maintenance service.

The foregoing variations make for a very interesting discussion of the tax implications of each. Payments for software licenses may be considered as royalties when the transaction is considered as a transfer of the right to use a copyrighted article or a transfer of know-how. It is a gain on sale of properties when the transaction is considered as an outright sale of copyright,[74] and it is business profits when the transaction is considered as a service contract.

With regard to the structure of payments, the same may be fully-paid upon transfer, or may involve periodic payments or payments based on usage.[75] Some may even be royalty-free, as seen in contracts which do not require the licensee to pay for using the license. Such contracts are commonly used with software licenses bundled with supply of hardware or support services. In such cases, the transaction is designed in such a way that the whole consideration is paid for the accompanying hardware or support service, no part of which is attributed for the use of the license. Most tax practitioners suggest this tax planning measure since the effective tax rate for business profits and gains on sale of property are usually lower than that levied on royalties. Thus, it is usually more prudent to tax most if not all of the payments as either of the foregoing rather than royalties.

The BIR has ruled on these matters on several occasions. In BIR Ruling No. 20-99, WE SERVE Systems, Inc., a non-resident foreign

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the latter held, "[t]o distinguish between compensation for service and royalty payments, one must inquire on whether the payee has proprietary interest in the property giving rise to the income. If the payee has none, then the payment is a compensation for personal services, if the payee has proprietary interest then the payment is royalty."

[74] Except, however, under the 1983 RP-US Tax Treaty, where proceeds from sale of copyrights are still considered royalties.

[75] ROHATGI, *supra* note 6, at 523-24.

corporation entered into a contract with Smart Communications, Inc., where the former would supply hardware and software within the Smart Integrated Business System. The ruling considered the software portion of the contract royalty-free, which gave Smart the license to use, copy, modify or enhance WE SERVE's interface information software. The BIR held that payments made by Smart were not considered royalties under article 12(3) of the RP-Singapore Tax Treaty (1977), since the royalty-free stipulation in effect made the software a customary part of the hardware delivered under the contract. Thus, the entire payment was taxable as business profits under article 7. However, because the payee had no permanent establishment in the Philippines, these were not subject to Philippine income tax.[76]

In ITAD Ruling No. 46-02, the BIR tackled the same issues with greater detail. Compaq Computer Asia Pty., Ltd., a non-resident Singapore corporation, and ePLDT entered into a project consulting services agreement where the former was to provide:

> [A] CashCard Application System consisting of the supply and delivery by Compaq of both hardware and software which include servers, access servers, encryption-decryption equipment, cryptoservers, and routers ("Hardware") and ACI BASE 24 and NETS-Cashcard software which shall be customized by Compaq to meet the requirements of ePLDT as well as operating system software needed to operate the Hardware ("Software"); and training, maintenance, technical support and other services relating to the CashCard Application System.[77]

It was represented that the hardware aspect involved an outright sale and the equipment transferred became ePLDT's sole property. With regard to the software aspect, ePLDT was granted a non-exclusive, nontransferable, royalty-free, internal use license to copy, load, execute, modify or merge with other software on processors owned, leased and under the control of ePLDT. Ownership, however, was not granted to ePLDT.

The Bureau held that since the object of the contract was really the transfer of a specific system, the CashCard Application System, the hardware and software aspects of which are merely part of the whole. Thus, income arising from the sale of the system are business profits and not royalties. It also stated that even if the software and hardware aspects of the contract were construed separately, considering that the software aspect was

[76] ITAD Ruling No. 20-99, Feb. 24, 1999.
[77] ITAD Ruling No. 46-02, Apr. 10, 2002.

royalty-free and the acquisition of the software was for the personal or business use of ePLDT rather than for the purpose of developing or exploiting the software itself for its commercialization and distribution, the same would still be considered business profits. The opinion relied heavily on the OECD Commentaries.

III. PASSIVE ROYALTY INCOME V. ACTIVE ROYALTY INCOME

The distinction between active and passive sources of income is another important distinction in studying royalties. In local income taxation, active source royalties have very different tax implications compared to passive source royalties.[78] Passive source royalties are subject to 20% Final Withholding Tax pursuant to section 24(B) or 27(D) of the Tax Code, while active source royalties are taxed in the same manner as service fees.

Royalties are generally considered passive income, which includes dividend, interest and rent income. Under Philippine taxation laws, these passive income are among the components of a taxpayer's assessable and taxable income, furthermore, these items of passive income are usually subjected to a final tax, with various rates depending on the type of income. Passive income is differentiated from active income which is derived from trade, business or profession and employment.[79]

In *Banico & Sons, Inc. v. Court of Tax Appeals*, the Court of Appeals held that passive income covers those earned outside the regular course of trade or business of the taxpayer, or those "which can be realized with very little effort or no effort at all on the part of the recipient."[80] Black's Law Dictionary defines passive income as income earned from an activity in which an individual does not materially participate.[81]

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[78] This issue is not relevant in international taxation problems. Royalties in these are subject to the rates prescribed in the tax treaties. The relevant distinction for royalty problems in international tax is that provided article 12(3) of the OECD Model. This provides that article 7 on business profits will apply if the royalty owner or licensor also carries on business in the source state through a permanent establishment. This may be considered as the counterpart of the active-passive distinction in local income taxation.

[79] NATIONAL TAX RESEARCH CENTER, DEPARTMENT OF FINANCE, COMPARATIVE STUDY ON THE TAX TREATMENT, ASSESSMENT AND COLLECTION METHOD OF PASSIVE INCOME DERIVED FROM VARIOUS INVESTMENT INSTRUMENTS IN SELECT ASIAN COUNTRIES 1 (Jan. 18, 2002).

[80] Banico & Sons v. Court of Tax Appeals, CA-GR No. 32876, Oct. 20, 1994.

[81] BLACK'S LAW DICTIONARY, *supra* note 2, at 1124.

Thus, for income to be considered as "passive," the key factor is its realization with little or no participation from the taxpayer, or independently of his effort. In the case of royalties, for example, a licensor merely allows the payor to use the property or right, hence the common use of the term license. On the contrary, in an active activity, the licensor or owner performs certain acts in relation to the contract. This distinction is clearly seen in an equipment lease contract. If the contract requires the licensor merely to transfer the possession of the equipment, without the responsibility of maintaining it, then it is considered a passive activity. Otherwise, the contract becomes active.

This illustration is better appreciated in light of *Banico*. Here, the taxpayer is principally engaged in the business of leasing out real properties. However, it is also generating income from other sources, such as the sale of copra, rentals and dividends, among others. The CA categorically held that although less than 1% of Banico's revenue was derived from copra sales, the same was nonetheless income from "active business concerns." On the other hand, income from the lease of real property and dividends, which constituted almost 100% of its income, were passive. Under this ruling, the test used is the income's intrinsic nature, and not the income's relation to the corporation's principal purpose under its Articles of Incorporation.

The BIR has also issued several rulings to clarify this distinction. In BIR Ruling No. 57-2000, Midas-Kapiti International Inc. (Philippines) was tasked by its United Kingdom affiliate to distribute, support and use Licensed Systems owned by the latter in the Philippines. The former had no proprietary rights over the system, but occasionally provided consultancy and support services in connection with it.

A Licensing Agreement granted a client bank the non-exclusive right to use the Licensed Systems or its modified form. The BIR held that royalties arising from this agreement were subject to the 33% (now 32%) Regular Corporate Income Tax, instead of the 20% final withholding tax. It ratiocinated that the use of 'certain passive income' as the caption preceding the provision on royalty income denotes that income must arise from a royalty payment and must be passive in nature for the said income to be subject to 20% rate. Since the income was generated in the active pursuit and performance of its primary purpose, the lower rate is not applicable.[82]

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[82] BIR Ruling No. 57-2000, Nov. 7, 2000.

In BIR Rulings No. DA-249-01 and DA-187-02, Fun Characters, Inc. sublicensed the right to use Walt Disney trademarks and characters to third persons. It was also in the business of providing customer awareness of these trademarks and characters through various marketing activities, such as design support services, advertising, and customer promotions, among others. It did not acquire proprietary rights over the Disney trademarks.

The BIR held that the services rendered by FCI were subject to the 32% instead of the 20% rate, since the latter is only applicable for royalty payments considered as passive income. On the other hand, the services rendered by FCI were in the nature of active income arising from the active pursuit of its business, because these were in accordance with its primary purpose of sublicensing materials to Philippine clients and performing related support services.[83]

Similarly, in BIR Ruling No. DA-195-02, Oracle Philippines was tasked to distribute Oracle Corporation's software programs by licensing. In addition, it also provided consultancy services to clients, depending on the software package offered. The American Oracle retained all intellectual property rights. Again, the BIR applied the 32% corporate income tax rate because the services involved such as licensing computer software, consulting and training services, technical maintenance and updating of software programs were in the exercise of Oracle Philippines' primary purpose as distributor and licensee, thus these income constitute active income.

At first glance, these rulings appear inconsistent with *Banico*. In the BIR rulings, the principal consideration was a corporation's primary purpose, as provided in its Articles of Incorporation. On the other hand, *Banico* did not consider this relevant, and in fact completely brushed this aside. It held that the business of leasing real properties was passive, notwithstanding the fact that it was the taxpayer's primary business, comprising more than 99% of the revenues of the said corporation. It likewise held that the business of selling copra was considered active, notwithstanding the fact that it comprised less than 1% of the total transactions of the taxpayer. The relevance of a business' primary purpose was in fact the very *lis mota* of that case. The rulings discussed effectively added another condition to the term 'passive income' which was clearly not

[83] BIR Ruling No. DA-249-01, Dec. 3, 2001; BIR Ruling No. DA-187-02, Oct. 16, 2002.

intended in the Tax Code. It is submitted that this apparent overreaching should be properly threshed out in subsequent rulings.

SOFTWARE LICENSES

Recently, the BIR issued RMC No. 77-2003,[84] dealing *inter alia* with the proper income tax treatment of software licenses. The Bureau held that local subsidiaries, resellers and distributors are subject to 32% corporate income tax on the royalties received from the distribution of software licenses to end-users, if done in the ordinary course or in the active pursuit of business. If, however, the income was not derived in the ordinary course or in the active pursuit of business, then the same is considered a passive income subject to the 20% final withholding tax.

It also held that payments made by these subsidiaries, resellers and distributors to the foreign licensor or owner are subject to the 32% rate. This presumes that this licensor is a non-resident foreign corporation. This rate will arguably not apply if the licensor is a resident foreign corporation or if the licensor resides country with which the Philippines has an existing tax treaty.

Although its discussion of the active-passive distinction was not explicit, the circular may still be analyzed in this context. Seen in this light, for software licenses, the 32% rate applies when the distribution is done in the active pursuit or ordinary course of business. Otherwise, the 20% rate applies. The clause "in the active pursuit or ordinary course of business" refers to an active business activity; the clause "not in the active pursuit or ordinary course of business" refers to a passive activity.

IV. TAXABILITY

A. RATES

1. Under the Tax Code

As discussed earlier, the taxation of payments approximating royalties depends on whether the payments are actually royalties or service fees. If considered royalties, it must first be determined whether the said payments are considered active or passive.

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[84] Nov. 19, 2003.

If the payments are considered service fees, then it is generally subject to either the graduated rate for individuals or the 32% rate for corporations.[85] Note that non-resident aliens not engaged in trade or business and non-resident foreign corporations are not subject to the foregoing rates; they are subject to the 25% and 32% final withholding tax, respectively.[86] However, note also that it is impossible for non-resident aliens not engaged in trade or business and non-resident foreign corporations to be subjected to the tax on service fees, since these entities by definition receive only passive income from the Philippines. When these entities enter into active income activities, they become either non-resident aliens engaged in trade or business or resident foreign corporations.

If the payments are considered royalties, there must first be a determination of the nature of the royalty, whether it is characterized as active or passive. If the source is deemed actively sourced income, then the royalty is considered as a service fee and is taxed as such. Otherwise, the 20% final withholding tax will apply to citizens and resident aliens,[87] non-resident aliens engaged in trade or business,[88] domestic corporations,[89] and resident foreign corporations.[90] Again, the 25% and 32% rates, respectively, apply to non-resident aliens not engaged in trade or business and non-resident foreign corporations.[91]

This discussion is summarized in the following table:

[85] TAX CODE, §§ 22(F), 25(A)(1).
[86] §§ 25(B), 28(B)(1).
[87] § 24(B)(1).
[88] § 25(A)(2).
[89] § 27(D)(1).
[90] § 28(A)(7)(a).
[91] §§ 25(C), 28(B)(1).

Taxpayer Class	Types of Income					
	Service Fees		Royalties			
			Active Source		Passive Source	
	Tax Rate	Tax Base	Tax Rate	Tax Base	Tax Rate	Tax Base
Individuals						
Citizens	Graduated Rates of 5% to 32%	Taxable Income	Graduated Rates of 5% to 32%	Taxable Income	20%	Gross Income
Resident Aliens	Graduated Rates of 5% to 32%	Taxable Income	Graduated Rates of 5% to 32%	Taxable Income	20%	Gross Income
Non-resident Aliens (engaged in trade or business)	Graduated Rates of 5% to 32%	Taxable Income	Graduated Rates of 5% to 32%	Taxable Income	20%	Gross Income
Non-resident Aliens (not engaged in trade or business)	25%	Gross Income	25%	Gross Income	25%	Gross Income
Corporations						
Domestic Corporations	32%	Taxable Income	32%	Taxable Income	20%	Gross Income
Resident Foreign Corporations	32%	Taxable Income	32%	Taxable Income	20%	Gross Income
Non-resident Foreign Corporations	32%	Gross Income	32%	Gross Income	32%	Gross Income

Note, however, that there are exceptions to the above general rates depending on the applicability of special laws and tax treaties. Entities falling within the conditions specified by special laws and enterprises residing or established under the laws of treaty countries may apply the preferential tax treatment and/or exemptions granted to them. This matter will be discussed more fully in a subsequent portion of this paper.

2. Under the Inventors and Incentives Act

Rep. Act No. 7459 or the Inventors and Incentives Act provides, *inter alia*, tax incentive and exemptions to Filipino inventors, to encourage the development of new and innovative products to spur economic growth. For national taxes, it provides:

> Tax Exemption. — To promote, encourage, develop and accelerate commercialization of technologies developed by local researchers or adapted locally from foreign sources including inventions, any income derived from these technologies shall be exempted from all kinds of taxes during the first ten (10) years from the date of the first sale, subject to the rules and regulations of the Department of Finance: Provided, that this tax exemption privilege pertaining to invention shall be extended to the legal heir or assignee upon the death of the inventor.
>
> The technologies, their manufacture or sale, shall also be exempt from payment of license, permit fees, customs duties and charges on imports.[92]

To implement the foregoing provision, the Department of Finance issued Revenue Regulation No. 19-93 which requires certain conditions to be met before granting the foregoing tax exemptions to an inventor:

> A. Filipino inventor and/or owner of technology, shall submit his application for tax exemption in a form prescribed thereafter, in triplicate, to the Commissioner of Internal Revenue, Attn: Legislative, Ruling and Research Division (LRRD), together with the following documents:
>
> a. Certification issued by the FIS that the invention is new or original, and the technology is newly developed by local researches or adopted locally from foreign sources;
>
> b. Confirmation by the Screening Committee;

[92] Rep. Act No. 7459, § 6 (1992).

c. Certification from the BIR that the manufacture and/or sale of the invention products from technology developed is made on a commercial scale;

d. Taxpayer Identification Card (TIN) and registration as non—VAT taxpayer;

e. Initial capitalization required to fund the invention/technology; and

f. Volume/capacity/amount required in the manufacture and fabrication of the invention/technology to attain the status of commercial scale.

B. Upon approval of the application, a Certificate of Tax Exemption shall be issued by the Commissioner of Internal Revenue which shall be effective on the date of approval thereof.

C. The certification shall include the following information:

a. Name, address, and other personal circumstances of the inventors.

b. Technical description, comparative date, and other matters indicating the utility models, industrial design of the invention/technology.[93]

After meeting the foregoing requirements, the inventor is granted tax exemptions on income tax derived from the sale of invention products, Value Added Tax on the gross receipts or revenues derived from the sale of said invention products[94] and excise taxes directly payable in connection with the sale of invention products.[95] Thus, royalties paid to the inventor for the use of the patented product or technology is exempted from income tax for the first ten years of commercial utilization.

3. Under the Tax Treaties

Under the tax treaties, the applicable rate primarily depends on three things: First, whether one must apply article 7 on Business Profits or article

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[93] Rev. Regs. 19-93, § 4.

[94] "Provided, however, that an inventor shall not be exempt from taxes for which he is not directly liable, e.g., VAT on his purchases of raw materials, supplies and equipment/machineries, which may be shifted to him as part of goods sold or for services rendered."

[95] § 3(C).

12 on Royalties; second, if article 7 applies, whether or not a permanent establishment was constituted; and last, if article 12 applies, the proper rate applicable.

Article 12(3) of the OECD Model provides:

> The provisions of paragraph 1 shall not apply if the beneficial owner of the royalties, being a resident of a Contracting State, carries on business in the other Contracting State in which the royalties arise, through a permanent establishment situated therein, or performs in that other State independent personal services from a fixed base situated therein, and the right or property in respect of which the royalties are paid is effectively connected with such permanent establishment or fixed base. In such case, the provisions of article 7 or article 14, as the case may be, shall apply.

As a general rule, all royalties are covered by article 12, and the tax rates must be taken from it. However, the above provision provides an exception. Where the licensor or owner engages in trade or business in the Source State through a permanent establishment or a fixed base, article 7 applies and it is subject to tax on a net basis or based on taxable income.[96]

This is applied, however, in conjunction with the effective connection test, and the royalty must be effectively connected with the permanent establishment. The phrase "effectively connected" refers to any economic connection or relationship between a certain income type and the business activity.[97] This requirement precludes application of the "force of attraction" principle.[98] Thus, not all royalties derived in the Source State may be taxed as business profits upon finding that a permanent establishment has been constituted.

If an effective connection is clearly shown, then the permanent establishment will be subject to the 32% corporate income tax. Otherwise, article 12 applies, following the general rule.

The final tax rates on royalties are found in article 12(2) of the various treaties. All contain general and preferential final tax rates on royalties. For example, the RP-Singapore Tax Treaty prescribes a general final tax rate of 25% for all royalties, except where the Philippines, as Source State, is allowed to levy a special 15% rate on payments made by BOI-

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[96] ROHATGI, *supra* note 6, at 98.

[97] *Id.*, at 85.

[98] Model Convention, *supra* note 13, at 118.

registered companies and those for cinematograph films or tapes for television or broadcasting.

To summarize:[99]

Royalties					
With PE				No PE	
Effectively Connected		Not Effectively Connected			
Tax Rate	Tax Base	Tax Rate	Tax Base	Tax Rate	Tax Base
2%	Taxable Income	32% or treaty rate, whichever is lower	Gross Income	32% or treaty rate, whichever is lower	Gross Income

a. Most-Favoured-Nation Clause

Article 13(2) of the RP-US Tax Treaty provides a good example of a standard Most-Favored-Nation (MFN) Clause:

> However, the tax imposed by that other Contracting State shall not exceed.... In the case of the Philippines, the least of:
>
> 25 percent of the gross amount of the royalties,
>
> 15 percent of the gross amount of the royalties, where the royalties are paid by a corporation registered with the *Philippine Board of Investments* and engaged in preferred areas of activities, and *the lowest rate of Philippine tax that may be imposed on royalties of the same kind paid under similar circumstances to a resident of a third State.* (emphasis added)

This provision is substantially similar to the treaties with Austria, Canada, Hungary, Israel and Norway. The Supreme Court has explained its purpose:

> The purpose of a most favored nation clause is to grant to the contracting party treatment not less favorable than that which has

[99] *See* Model Convention, *supra* note 13.

> been or may be granted to the "most favored" among other countries. The most favored nation clause is intended to establish the principle of equality of international treatment by providing that the citizens or subjects of the contracting nations may enjoy the privileges accorded by either party to those of the most favored nation. The essence of the principle is to allow the taxpayer in one state to avail of more liberal provisions granted in another tax treaty to which the country of residence of such taxpayer is also a party provided that the subject matter of taxation, in this case royalty income, is the same as that in the tax treaty under which the taxpayer is liable.[100]

Thus, the lowest tax rate imposed by the Philippine Government on royalties paid under similar circumstances to a resident of a third state shall be applied for royalty payments made to a resident of the above countries. It should be noted that the lowest tax rate imposed by the Philippines on royalties is 10%, as provided under article 12 of the RP-West Germany Tax Treaty (1985).

In BIR Ruling No. 263-86,[101] a domestic corporation, McGeorge Food Industries, Inc., entered into a licensing agreement with McDonald's (USA), a non-resident foreign corporation. McGeorge was granted the right to use the latter's trademarks, secret formulas, technology and patented processes, and sought to confirm the proper application of the RP-US treaty's most-favored-nation provision vis-à-vis the 10% tax rate on royalties granted by the RP-Germany treaty.

The BIR held that the 10% "most-favored" rate applied to royalties received by McDonald's USA pursuant to the RP-US treaty's MFN provision. The BIR believed that all requirements for the application of the MFN provision were met, with the license agreement being approved by the Transfer Technology Board of the Ministry of Trade and Industry.

BIR Rulings 87-88[102] and 53-97[103] resolved substantially similar issues. Gillette (Philippines), Inc. entered into a licensing agreement with Gillette Co., USA to manufacture and package Gillette products. Both agreements were registered with the Technology Transfer Board. The BIR held that the 10% rate was similarly applicable.

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[100] Comm'r of Internal Revenue v. S.C. Johnson and Son, Inc., G.R. No. 127105, 309 SCRA 87 at 107-08 (1999).

[101] Nov. 27, 1986.

[102] Mar. 8, 1988.

[103] Apr. 14, 1997.

However, the Supreme Court, in *Commissioner of Internal Revenue v. S.C. Johnson and Son, Inc.*,[104] reversed this rule. Here, S.C. Johnson and Son, Inc. entered into a license agreement with SC Johnson and Son, United States of America, a non-resident corporation. The former was granted the right to use the trademark, patents and technology owned by the latter including the right to manufacture, package and distribute certain products and secure assistance in management, marketing and production. The License Agreement was duly registered with the Technology Transfer Board.

The Commissioner of Internal Revenue appealed that the Philippine corporation was entitled to the preferential rate of 10% provided in the RP-West Germany Tax Treaty. The Supreme Court ruled that the RP-US treaty's MFN clause would not entitle American residents to the lower rate enjoyed by German residents. It reasoned that both treaties, among other reasons, did not contain similar provisions regarding royalties. The RP-Germany treaty allows a 20% matching tax credit on the gross amount of royalties against German income,[105] a provision not present in the RP-US treaty.

The clause "the lowest rate of Philippine tax that may be imposed on *royalties of the same kind paid under similar circumstances* to a resident of a third State" was interpreted by the Supreme Court in a very strict manner, in line with the basic principle that "tax exemptions should be strictly construed against the taxpayer." It held that for another treaty to meet this requirement, it must also have the same tax credit rules as provided in article 24 of the RP-US Tax Treaty, specifically the tax credit equivalent only to the actual tax paid and not the 20% deemed paid credit as allowed in the RP-Germany Tax Treaty. The Supreme Court stated the reason for this:

> The reason for construing the phrase "paid under similar circumstances" as used in article 13 (2) (b) (iii) of the RP-US Tax Treaty as referring to taxes is anchored upon a logical reading of the text in the light of the fundamental purpose of such treaty which is to grant an incentive to the foreign investor by lowering the tax and at the same time crediting against the domestic tax abroad a figure higher than what was collected in the Philippines.

As such, it is not enough that the other treaty should provide a tax credit for taxes paid in the Philippines. It should also provide that the tax credit be merely limited to the actual amount paid in the Philippines.

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[104] G.R. No. 127105, 309 SCRA 87 (1999).
[105] art. 24(1).

Deemed paid credits allowed by the other tax treaty will preclude the application of its preferential rates when applying the MFN clause. Thus, the concessionary rates given to German residents may not be applicable to American residents.

In several post-*S.C. Johnson* rulings issued by the BIR, it attempted to clarify the proper application of the RP-US MFN clause. Most of these rulings used the RP-Netherlands (1992) or the RP-Russia (1988) Tax Treaties to substitute the RP-West Germany Tax Treaty used in the *S.C. Johnson* decision. Thus, a higher tax rate of 15% became the norm for royalty payments to US companies, instead of the 10% provided in the RP-Germany treaty.

In one such ruling, the applicant sought to apply the rates provided in the RP-Denmark, RP-Finland, RP-Malaysia (1985) and RP-UK (1978) Tax Treaties. In ITAD Ruling 67-01,[106] the applicant was confirming the proper treatment of royalties paid under a Franchise Agreement by Warner Bros. (F.E.), Inc. — Philippine Branch to Warner Bros. The BIR confirmed the proper tax rate to be 15% pursuant to RP-US MFN clause.

In ITAD Ruling No. 46-01,[107] Unisys Australia Ltd.-Phil. Branch and its head office, Unisys Australia Ltd., a non-resident foreign corporation based in the United States, entered into an Intellectual Property License Agreement. The former was granted a non-exclusive license to reproduce, translate, distribute and prepare derivative works of, and use in its business such present and future rights in patents, copyrights, trademarks, trade secrets, software, documentation, know-how, maintenance and products support materials and professional service support materials under patent, copyright, trade secret and trademark law in the Philippines of the American parent. This agreement was registered with the Intellectual Property Office.

The BIR held that the royalty payments were properly subjected to the 15% tax rate under the RP-Denmark Tax Treaty, notwithstanding its different wording, since article 23 of both treaties referred to the same tax

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[106] Aug. 15, 2001.
[107] May 11, 2001.

credit method.[108] Both allow the use of actual tax paid to the Philippines as the credit on taxes paid in the United States and Denmark.

These precedents have been effectively superseded with the entry into force of the RP-China Tax Treaty (2002), whose article 12(2)(b) provides a concessionary tax rate of 10% for the use of or the right to use, any patent, trade mark, design or model, plan, secret formula or process, or from the use of, or the right to use, industrial, commercial, or scientific equipment, or for information concerning industrial, commercial or scientific experience. Taken together with MFN clauses, it would seem that the 10% concessionary rate may also benefit the residents of Austria, Canada, Hungary, Israel, Norway and the United States.

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[108] Article 23 of RP-US Tax Treaty reads:

"RELIEF FROM DOUBLE TAXATION

Double taxation of income shall be avoided in the following manner:

1. In accordance with the provisions and subject to the limitations of the United States (as it may be amended from time to time without changing the general principle hereof), the United States shall allow to a citizen or resident of the United States as a credit against the United States tax the appropriate amount of taxes paid or accrued to the Philippines and, in the case of a United States corporation owning at least 10 percent of the voting stock of a Philippine corporation from which it receives dividends in any taxable year, shall allow credit for the appropriate amount of taxes paid or accrued to the Philippines by the Philippine corporation paying such dividends with respect to the profits out of which such dividends are paid. Such appropriate amount shall be based upon the amount of tax paid or accrued to the Philippines, but the credit shall not exceed the limitations (for the purpose of limiting the credit to the United States tax on income from sources within the Philippines or on income from sources outside the United States) provided by United States law for the taxable year. . . ."

On the other hand, article 23 of the RP-Denmark Tax Treaty provides:

"ELIMINATION OF DOUBLE TAXATION

2. In Denmark, in accordance with the provisions and subject to the limitations of the laws of Denmark, as may be amended from time to time without changing the general principle hereof, double taxation shall be eliminated as follows:

a) Subject to the provisions of sub-paragraph (c), where a resident of Denmark derives income which, in accordance with the provisions of this Convention, may be taxed in the Philippines, Denmark shall allow as a deduction from the tax on the income of that resident, an amount equal to the income tax paid in the Philippines;

b) such deduction shall not, however, exceed that part of the income tax, as computed before the deduction is given, which is attributable to the income which may be taxed in the Philippines;

c) where a resident of Denmark derives income which, in accordance with the provisions of this Convention shall be taxable only in the Philippines, Denmark may include this income in the tax base, but shall allow as a deduction from the income tax that part of the income tax, which is attributable to the income derived from the Philippines..."

With regard to the tax credit method in the RP-China treaty, article 23 thereof provides:

> Methods for the Elimination of Double Taxation
>
> 1. In the Philippines, double taxation shall be eliminated as follows:
>
> Subject to the laws of the Philippines and the limitations thereof regarding the allowance of a credit against Philippine tax of tax payable in any country other than the Philippines. Chinese tax payable in respect of income derived from China shall be allowed as credit against the Philippine tax payable in respect of that income.
>
> 2. In China, double taxation shall be eliminated as follows:
>
> Where a resident of China derives income from the Philippines the amount of tax on that income payable in the Philippines in accordance with the provisions of this Agreement, may be credited against the Chinese tax imposed on that resident. The amount of the credit, however, shall not exceed the amount of the Chinese tax on that income computed in accordance with the taxation laws and regulations of China.

This seems to be similar to article 23 of the RP-US Tax Treaty, which provides for tax credits to diminish taxes to be paid in the United States based on the actual tax paid in the Philippines. Both treaties do not apply the matching credit method in the RP-Germany treaty. Thus, royalties under the RP-China Tax Treaty may be considered as being "paid under similar circumstances" with royalties under the RP-US Tax treaty, following the *S.C. Johnson* case.

This treatment has been confirmed by the BIR in the RMC 46-02.[109] Here, the BIR confirmed that the methods used to eliminate double taxation in the two treaties are substantially similar, notwithstanding the difference in the wording used. The BIR, however, reiterated several requirements before the MFN clause benefits may be applied:

> 1. It is necessary that there be an agreement or a contract whereby the royalties paid to the US must originate from the use of, or the right to use any patent, trademark, design or model, plan, secret formula or process, or from the use, or the right to use, industrial, commercial or scientific experience; and

[109] Sept. 2, 2002

2. For as long as the contract or agreement is subject to approval under Philippine law, the same must be duly approved by the Philippine competent authorities.

B. SITUS

Tax situs or source-of-income rules determine the place where income is derived. These rules may not be relevant to taxability for transactions executed within a certain territory or between entities both residing in the same territory. However, these rules are crucial points of discussion in international business transactions.

In the Philippines, it has been widely accepted that the primary test of taxability is the source or situs. The source of an income is that activity which produced the income.[110] It refers to whether or not the income arises or is derived from sources within or sources outside the Philippines. Situs is more relevant to the cases of non-resident citizens, resident and non-resident aliens, and resident and non-resident foreign corporations. These entities are subject to Philippine income tax only on their income derived from sources within the Philippines.

As earlier noted, service fees and royalties have different source rules. Source rules for service fees are covered by section 42(A)(3) of the Tax Code, while those involving royalties are provided in section 42(A)(4). The former considers services performed in the Philippines to be income derived therein, while the latter considers the place of use as determinative of the royalty's situs.

The landmark case of *Alexander Howden & Co., Ltd. v. Commissioner of Internal Revenue*[111] gives us the source rules on services. Here, the issue was whether reinsurance premiums earned by non-resident foreign insurance companies from the insurance of properties located in the Philippines are subject to Philippine income tax. The *ponencia* of Justice Cesar Bengzon declared this oft repeated line: "The source of an income is the property, activity or service that produced the income."[112]

It held that the reinsurance premiums involved were derived from the Philippines primarily because the activity which produced the

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[110] JOSE VITUG & ERNESTO ACOSTA, TAX LAW AND JURISPRUDENCE 167 (2nd ed. 2000).

[111] G.R. No. 19392, 13 SCRA 601 (1965).

[112] *Id.* at 604.

reinsurance premiums took place in the Philippines, namely the reinsurance of the 32 foreign insurance companies of properties located in the Philippines and originally insured with Commonwealth Insurance Co. In justifying the taxability of the said premiums in the Philippines, the Court said that the flow of wealth was from the Philippines and such enjoyed the protection of the Philippine government.

This may be analyzed in light of Justice Florentino Feliciano's brilliant dissent in *Commissioner of Internal Revenue vs. British Overseas Airways Corporation:*[113]

> For purposes of income taxation, it is well to bear in mind that the "source of income" relates not to the physical sourcing of a flow of money or the physical situs of payment but rather to the "property, activity or service which produced the income."

In *Howden*, the Court dealt with the applicable source rule relating to reinsurance premiums paid by a local insurance company to a foreign reinsurance company with respect of risks located in the Philippines. The Court stated:

> The source of an income is the property, activity or service that produced the income. The reinsurance premiums remitted to appellants by virtue of the reinsurance contracts, accordingly, had for their source the undertaking to indemnify Commonwealth Insurance Co. against liability. Said undertaking is the activity that produced the reinsurance premiums, and the same took place in the Philippines. — [T]he reinsured, the liabilities insured and the risks originally underwritten by Commonwealth Insurance Co., upon which the reinsurance premiums and indemnity were based, were all situated in the Philippines.[114]

The Court may be seen as saying that it is the underlying prestation which is properly regarded as the activity giving rise to the income that is sought to be taxed. In *Howden*, that underlying prestation was the indemnification of the local insurance company. Such indemnification could take place only in the Philippines where the risks were located and where payment from the foreign reinsurer, in case the casualty insured against occurs, would be received in Philippine pesos under the reinsurance contract. The Court accordingly held that the reinsurance premiums paid by

[113] G.R. Nos. L-65773-74, April 30, 1987, 149 SCRA 395 (1987).

[114] *Supra* note 111 at 604.

the local insurance companies constituted Philippine source income of the foreign reinsurers.

The concept of "source of income" for purposes of income taxation originated in the United States income tax system. The phrase "sources within the United States" was first introduced into the American tax system in 1916, and was subsequently embodied in the 1939 United States Tax Code. As is commonly known, the Philippine Tax Code, Commonwealth Act No. 466, was patterned after the 1939 United States Tax Code. It is thus useful to refer to a standard American text on federal income taxation:

> The Supreme Court has said, in a definition much quoted but often debated, that income may be derived from three possible sources only: (1) capital and/or (2) labor and/or (3) the sale of capital assets. While the three elements of this attempt at definition need not be accepted as all-inclusive, they serve as useful guides in any inquiry into whether a particular item is from 'sources within the United States' and suggest an investigation into the nature and location of the activities or property which produce the income. If the income is from labor (services) the place where the labor is done should be decisive; if it is done in this country, the income should be from 'sources within the United States.' If the income is from capital, the place where the capital is employed should be decisive; if it is employed in this country, the income should be from 'sources within the United States.' If the income is from the sale of capital assets, the place where the sale is made should be likewise decisive. Much confusion will be avoided by regarding the term 'source' in this fundamental light. It is not a place; it is an activity or property. As such, it has a situs or location; and if that situs or location is within the United States the resulting income is taxable to nonresident aliens and foreign corporations. The intention of Congress in the 1916 and subsequent statutes was to discard the 1909 and 1913 basis of taxing nonresident aliens and foreign corporations and to make the test of taxability the 'source,' or situs of the activities or property which produce the income. . .[115]

Thus, to determine the source of service income, one must first identify the prestation or subject of the obligation. Then, one may determine where the said prestation has taken or is to take place, which is where the service income is derived.

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[115] Justice Feliciano, dissenting opinion in *Commissioner of Internal Revenue vs. British Overseas Airways Corporation, supra* note 113, citing 8 Mertens, Law of Federal Income Taxation, § 45.27 (1957).

At first glance, this may be contrary in some respects to *Philamlife*.[116] Here, the Court of Appeals held that a non-resident foreign corporation may be taxed on compensation derived from sources within the Philippines even if the services are performed abroad. It added that when the non-resident foreign corporation enters into a management contract with a domestic corporation here in the Philippines, it becomes subject to what is now section 42(A)(4) of the Tax Code, even though the non-resident foreign corporation has no properties within the country.

A deeper analysis reveals that the deviation was primarily due to the different income characterization given by the court on the management contract. The Court held that the contract was a royalty contract pursuant to the expanded definition in section 42(A)(4). Thus, the applicable source rule would then be the place of use of the information provided by the management contract and not the place where the said contract is performed.

On the other hand, for royalties, it is clear in *Philamlife* that the proper situs for such payments is the place of use of the intellectual property, valuable asset or information. To elaborate, the decision of the United States Tax Court in *SDI Netherlands B.V. v. Commissioner*[117] is instructive. SDI Netherlands B.V. was licensed by its affiliate, SDI Ltd., based in Bermuda, to use its IBM-based computer software. SDI Netherlands, in turn, sublicensed this software to an affiliate based in the United States. The license granted to SDI-Netherlands was valid worldwide, while that given to this affiliate was valid only in the United States. The American affiliate paid royalties to SDI Netherlands, which in turn paid a percentage to SDI, Ltd. This is known as "cascading royalties."

The United States Tax Court held that the two license contracts were independent of each other, thus the two sets of royalties were of different characters. Thus, the sources of both payments should be determined independently, even though payment made by SDI Netherlands was taken from the payment made by its American affiliate. It ruled that the latter were considered sourced from the United States, while the second set paid by SDI Netherlands was held to be derived from sources outside the country.

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[116] CA-GR No. 31283, Apr. 25, 1995.
[117] 107 TC No. 10, October 2, 1996.

CONCLUSION

Global trade has altered existing tax laws and regulations. The increasing variations in conducting trade transactions have in turn amplified the definition and coverage of royalty payments.

National laws have traditionally provided for specific tax treatment for particular types of income. However, exceptions and variations in tax treatment are inevitable in the case of two States entering into a treaty. Such treaties provide foreign traders with an opportunity to obtain tax exemptions or minimize tax exposure and double taxation upon fulfillment of specified conditions under the treaty.

Yet another layer of exceptions is created when rulings and regulations are promulgated by the proper government authorities. Thus, despite the presence of treaty provisions on the taxation of specific trade activities and royalty payments, traders are still not assured of predictable application of such treaty provisions. These regulations are promulgated to assure that tax laws and treaty provisions are properly applied. Modern day business transactions and global trade have churned out interminable ways of conducting business, hence, the need to issue regulations for clarification of specific tax treatment of certain types of business profits. However, inconsistencies in the interpretation of legislation and treaty provisions are unavoidable. It is in this area where careful analysis is required so as not to frustrate the goals and benefits of the law and the treaties entered into with other states. The proper government authorities are called upon to be circumspect in explaining and implementing the law to assure the country of the continuous flow of needed foreign capital.

With every new business practice and development, taxation laws in the country and in other nations have tried to adjust and adapt themselves to emerging new practices in global trade. Great care must be exercised in crafting tax laws to complement both existing local and international conditions because tax laws are considered as fundamental factors which greatly affect the workings of a state.

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APPENDIX "A"

MAXIMUM TAX RATES FOR ROYALTY PAYMENTS UNDER TREATIES

Country	General Rate	Special Rates	MFN
Australia	25%	-15% on royalties paid by a BOI-registered company	None
Austria	15%	-10% on royalties paid by a BOI-registered company	With
Belgium	15%		None
Brazil	15%	-20 % on cinematographic films or tapes for television or broadcasting	None
Canada	25%		With
China	10%	-15% on royalties for literary, artistic and scientific copyrights including cinematograph films or tapes for television or broadcasting	None
Denmark	15%		None
Finland	25%	-15% on royalties paid by an enterprise registered with and engaged in preferred areas of activities and also royalties in respect of cinematographic films or tapes for television or broadcasting and royalties for the use of, or the right to use, any copyright of literary, artistic or scientific work	None
France	25%	-15% on royalties paid by a BOI-registered company and cinematograph films or tapes for television or broadcasting	None
Germany	10%	-15% on royalties for literary, artistic and scientific copyrights including cinematograph films or tapes for television or broadcasting	None
Hungary	15%		With
India	32%	-15% on royalties paid by a BOI-registered company	None
Indo-nesia	25%	-15% on royalties paid by a BOI-registered company	None
Israel	15%		With
Italy	25%	-15% on royalties paid by a BOI-registered company and cinematograph films or tapes for television or broadcasting	None
Japan	25%	-10% of royalties paid by BOI-registered companies -15% of royalties for cinematographic films and tapes for television of broadcasting	None
Korea	15%	-10% of royalties paid by BOI-registered companies	None
Malaysia	25%	-15% of royalties for cinematographic films and tapes for television of broadcasting	None
Netherla nds	15%	-10% on royalties paid by an enterprise registered with and engaged in preferred areas of activities	None
New Zealand	25%	-15% on royalties paid by a BOI-registered company	None
Norway	32%	-25% on royalties, gross rentals or amounts paid for the use of, or the right to use, motion picture films, films or tapes for radio or television broadcasting -7.5% of the gross rentals or amount paid for the use of or the right to use containers -10% on royalties paid by a BOI-registered company	With
Pakistan	25%	-15% on royalties paid by an enterprise engaged in preferred areas of activities	None
Romania	25%	-10% of royalties paid by BOI-registered companies -15% of royalties for cinematographic films and tapes for television of broadcasting	None
Singa-pore	25%	-15% on royalties paid by a BOI-registered company and cinematograph films or tapes for television or broadcasting	None
Spain	15%	-10% on royalties paid by a BOI-registered company -20 % on cinematographic films or tapes for television or broadcasting	None

Country	General Rate	Special Rates	MFN
Sweden	25%	-15 % on royalties paid by an enterprise registered with and engaged in preferred areas of activities and also royalties in respect of cinematographic films or tapes for television or broadcasting and royalties for the use of, or the right to use, any copyright of literary, artistic or scientific work	None
Switzer-land	15%		None
Thailand	25%	-15% on royalties paid by a BOI-registered company and cinematograph films or tapes for television or broadcasting	None
United Kingdom	25%	-15% on royalties paid by a BOI-registered company and cinematograph films or tapes for television or broadcasting	None
United States	25%	-15% on royalties paid by a BOI-registered company	With

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APPENDIX "B"

DEFINITIONS OF ROYALTIES IN VARIOUS TREATIES

Phrase A: "the use of, or the right to use, any copyright, patent, design or model, plan, secret formula or process, trademark, or other like property or right"

Phrase B: "the use of, or the right to use, any individual, commercial or scientific equipment"

Phrase C: "the supply of scientific, technical, industrial or commercial knowledge or information"[118]

Phrase D: "the supply of any assistance that is ancillary and subsidiary to, and is furnished as a means of enabling the application or enjoyment of, any such property or right as is mentioned in paragraph (a), any such equipment as is mentioned in paragraph (b) or any such knowledge or information as is mentioned in paragraph (c)"

Phrase E: "the use of, or the right to use - (i) motion picture films; (ii) films or video tapes for use in connection with television; or (iii)tapes for use in connection with radio broadcasting"

Phrase F: "total or partial forbearance in respect of the use of a property or right referred to in this paragraph"

Phrase G: "includes gains derived from the sale, exchange or other disposition of any such right or property which are contingent on the productivity, use, or disposition thereof"

Country	*A*	*B*	*C*	*D*	*E*	*F*	*G*
Australia	X	X	*	X	X	X	
Austria	X	X	X		X		
Belgium	X		X		X		
Canada	X	X	*		X		
China	X	X	X		X		
Denmark	X	X	X		X		
Finland	X	X	X				
France	X	X	X		X		

[118] All Philippine treaties except the RP-Australia and RP-Canada Tax Treaties use the word "experience" in this phrase.

Country	*A*	*B*	*C*	*D*	*E*	*F*	*G*
Germany	X	X	X		X		
Hungary	X	X	X		X		
India	X	X	X		X		
Indonesia	X	X	X		X		
Israel	X	X	X		X		
Italy	X	X	X		X		
Japan	X	X	X		X		
Korea	X	X	X		X		
Malaysia	X	X	X		X		
Netherlands	X	X	X		X		
New Zealand	X	X	X		X		
Norway	X	X	X				
Pakistan	X	X	X		X		
Romania	X	X	X		X		
Russia	X	X	X		X		
Singapore	X	X	X		X		
Spain	X	X	X		X		
Sweden	X	X	X		X		
Switzerland	X		X		X		
Thailand	X	X	X		X		
United Kingdom	X	X	X		X		
United States	X		X		X		X

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