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Taxation of Software Payments

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Taxation of payments for software continues to be a complex issue.

Software products are no doubt somewhat different from other copyrighted works, say a book, a musical recording, a movie film, a painting or sculpture. Perhaps because the latter works can be said to be "passive" when being used or enjoyed –the purchaser simply reads, listens, watches or admires the work- while software products are somewhat "active" in that they appear to interact with the user –executing functions in response to commands-, people tend to think that any and all payments related to software are royalties. Because royalties arising from Mexico are subject to withholding tax, the conclusion is then reached that all software payments are subject to withholding taxes. And, by the same token, that the royalties are not deductible for Mexican flat rate tax (IETU) purposes.

This article discusses software payments in general and concludes that two specific types of payments—payments for the purchase of software products and payments for the right to distribute software products—cannot properly be characterized as royalties.

Royalties Defined

Nonresidents with no permanent establishment in Mexico are subject to taxation in Mexico exclusively on income from Mexican sources. Mexican-source income is defined, by way of limitation, in the law. Royalties arising in Mexico are expressly listed as generating Mexican-source income. Further, royalties paid to a related party are not deductible for Mexican IETU purposes.

Royalties are defined as follows:

"There are considered *royalties, among others, payments of any kind for the temporary use or enjoyment of patents, certificates of invention or improvement, trademarks, trade-names, copyrights for literary, artistic or scientific works, including motion picture films and television and radio recordings, as well as drawings or models, plans, formulas or industrial, commercial or scientific procedures and equipment, and the amounts paid for the transfer of technology or information relating to industrial, commercial or scientific experiences, or any other similar right or property.*

"For purposes of the preceding paragraph, the temporary use or enjoyment of copyrights of scientific works includes copyrights of computer programs or sets of instructions required for the operating processes thereof, or to perform applications, regardless of the medium on which they are transferred."

Diverging Interpretations

The second quoted paragraph brought in confusion. The legislative history gives no explanation as to why it was incorporated into the provision defining royalties. Thus, two diverging interpretations arose.

A first interpretation tried to hold that only payments for computer software are royalties, whilst other payments for software are not. This was the case of an action filed before the courts where the taxpayer argued that payments for software embedded in telephone switchboards were not payments for computer programs and, consequently, were not royalties and were not subject to withholding tax. The courts denied the petition and ruled that payments for the temporary use or enjoyment of telephone switchboard software are to be considered royalties, pursuant to the first paragraph quoted above.

On the other hand, this second paragraph has also been interpreted from the opposite perspective, to mean that any and all payments for computer software are royalties and, as such, taxable. However, this second paragraph cannot be interpreted in isolation. It should be interpreted in harmony with the first paragraph. Under this harmonic interpretation, the conclusion follows that only payments for the right to temporarily use ***copyrights*** over literary, artistic or scientific works are royalties and that, since computer software is defined as a scientific work, then payments for the right to temporarily use or enjoy ***copyrights*** over computer software can be properly characterized as royalties.

Sales of Software Products

In determining whether a given payment is for the right to temporarily use or enjoy copyrights, recourse should be had to the provisions of Mexico's Copyright Law.

Our Copyright Law defines copyrights as follows:

"Copyright is the recognition given by the State to all creators of literary and artistic works provided in Article 13 of this Law, whereby ***protection is granted for the author to enjoy the exclusive prerogatives and privileges of a personal and economic nature. The former constitute so-called moral rights, while the latter are economic rights."***

Not all payments for software products can be properly characterized as royalties. Only payments for the temporary use or enjoyment of the inherent copyright itself.

The moral rights are inherent to the author. He is the sole, original and perpetual owner of these rights. They cannot be transferred and are not subject to prescription, waiver or encumbrance. These rights include the right to be recognized as the author of the work, to oppose any transformation, mutilation or modification of his work, to himself modify his work, to determine if the work is to be published or not and to withdraw the work from the market.

The economic rights entitle the author or the copyright holder to exclusively exploit his works or authorize others to do so in any way, within the limits provided by law.

Based on the broad spectrum of the economic rights, it would, in principle, appear that any payment to the copyright holder is a consideration for the economic exploitation of the work and, as such, an exploitation of the copyright. If this were correct, payments for the purchase of copies of a copyrighted work would be payments for the exploitation of the work and, as such, characterized as royalties.

However, the law clarifies that payments for the purchase of a copy of a copyrighted product are not payments for the copyright. What the law says is that copyright rights are not linked to ownership of the physical medium in which a copyrighted work is embodied and, thus, that unless otherwise agreed by the parties, the sale of the physical medium embodying a work does not transfer to the purchaser any copyright rights over the copyright work.

Therefore, unless otherwise agreed between the copyright holder and the purchaser, payments for the purchase of copies of software products are not royalties because they are not payments for the temporary use or enjoyment of copyrights.

This conclusion has been confirmed by the copyright office in a private letter ruling and also by the tax administration itself in an internal criterion.

Distribution of Software Products

Aside from the provision dealing specifically with the sale of copies of a copyrighted work, discussed above, the Copyright Law provides that the economic rights of a copyright holder include the authority to authorize or prohibit:

Distribution of the work, including sales or other forms of transmitting ownership of the physical media embodying it, as well as any form of transmitting use or exploitation.

As seen, the economic right of exploitation of copyrights includes the right to authorize or prohibit any form of distribution of copyrighted work in any way, including sales of copies.

Now, the Tax Administration develops internal criteria, which it publishes on its webpage. These criteria are binding only within the tax administration itself, not for taxpayers. As pertains to the distribution of software products, the following is included as an internal criterion:

Royalties for the temporary use or enjoyment of copyrights over literary, artistic or scientific works. *Payments made under any legal act whose purpose is the distribution of a work have that character.*

Article 15-B, first paragraph, of the Federal Fiscal Code provides that there are considered royalties, among others, payments of any type for the temporary use or enjoyment of copyrights over literary, artistic or scientific works.

Article 5, second paragraph, of the Federal Fiscal Code allows supplementary application of federal common law. In this sense the concepts referred to in the preceding paragraph can be interpreted in accordance with the Federal Copyright Law.

Article 27 of this law sets forth the events when the copyright holders can exploit their economic rights over a work, which include the right to authorize a third party the temporary use or enjoyment of such rights. Specifically, section IV of this last-mentioned paragraph contemplates, as one of the events in which the temporary use or enjoyment of the copyrights can be granted to a third party, distribution of the work, including the sale or other forms of transmitting ownership of the physical media embodying them, as well as any form of transmission of use or exploitation. Likewise, the mentioned section provides that when distribution is made by means of sales this opposition right shall be deemed exhausted after the first sale, except for the event expressly contemplated by Article 104 of the aforementioned law.

In this sense, payments made by virtue of any legal act whose purpose is distribution of a work, referred to in Article 27, section IV, of the Federal Copyright Law, are royalties in accordance with Article 15-B, first paragraph, of the Federal

Fiscal Code.

Your author disagrees with such a position taken by the tax administration.

Article 27 of the Copyright Law -to which the criterion refers- has a most important caveat, which the Tax Administration failed to take into consideration. The caveat expressly provides:

When distribution is made through sales, this right of opposition is understood to be exhausted after the first sale is made, except for the event contemplated in Article 104 of this law.

This caveat, together with the general rule in Article 27, clearly shows the following:

- That the copyright holder has, among his economic copyrights, the right to authorize or prohibit distribution of the copyrighted works, e.g. the distribution of copies of a software program.
- That where the copyrighted works are distributed by selling copies, the right of the copyright holder is exhausted once the first sale is made.

That is, once a copy of a software program is introduced into the market, the copyright holder can no longer authorize or prohibit distribution through further sales. In other words, whoever purchases a copy of a software program has the inherent right to resell it without the need for authorization from the copyright holder because the latter's copyright rights have been exhausted.

Based on the foregoing, any subsequent payment made for the right of distribution is no longer attributable to the copyright rights. Consequently, any such payments cannot – contrary to the Tax Administration's position – be characterized as a royalty.

It is interesting to note that this caveat is not an invention by the Mexican Copyright Law. Quite the contrary. It reflects the internationally accepted principle known as the "exhaustion of IP rights" or "first-sale doctrine".

This doctrine is briefly explained by the World Intellectual Property Organization as follows (http://www.wipo.int/edocs/mdocs/mdocs/en/cdip_8/cdip_8_inf_5_rev.pdf):

1. Exhaustion means the consumption of rights in intellectual property subject matter as a consequence of the legitimate transfer of the title in the tangible article that incorporates or bears the intellectual property asset in question. Exhaustion, therefore, is a natural consequence of the intangible nature of the assets covered by intellectual property, such as expressions, knowledge, reputation, quality, origin. Because of their intangible nature, they do not follow the tangible article with which they are associated.

From a legal standpoint, Mexico's undertakings under the first-sale doctrine originate from the World Trade Organization Copyright Treaty, adopted in Geneva on December 20, 1996. Article 6 of this treaty provides:

Right of Distribution

(1) Authors of literary and artistic works shall enjoy the exclusive right of authorizing the making available to the public of the original and copies of their works through sale or other transfer of ownership.

(2) Nothing in this Treaty shall affect the freedom of Contracting Parties to determine the conditions, if any, under which the exhaustion of the right in paragraph (1) applies after the first sale or other transfer of ownership of the original or a copy of the work with the authorization of the author.

In exercising the freedom referred to in the treaty, Mexico enacted Article 27, which we discussed above, whereunder it determined no special conditions for exhaustion of the rights to apply after the first sale. The exhaustion is absolute.

Note that the issue was raised before the Tax Court as to whether the right of exhaustion applied only after the first sale in Mexico or if it applies under an international approach, when the first sale is made outside of Mexico. The Court found that that the international approach should be followed, as the law makes no distinction in this respect and, thus, that the Mexican buyer/importer cannot be prevented from reselling the copies of the copyrighted works that it had purchased.

In a similar vein, as Mexican law draws no distinction, the conclusion follows that even where the sale is made by the copyright holder himself, his right to authorize or prohibit further sales is exhausted. This has been confirmed by the Copyright Office in a private letter ruling.

Based on the above analysis, clearly when the copyright holder or any third party with a legal right makes a sale of a copyrighted work, his copyright rights to authorize or prohibit further distribution are exhausted. Thus, any payment the copyright holder may receive for the right to distribute copies of his work are not payments stemming from his copyright rights but, rather, payments under a relationship governed by general Commercial Law.

Therefore, contrary to the criterion published by the Tax Administration, any such payments for the right of distribution following the first sale are not payments for the temporary use or enjoyment of copyrights, thus they are not royalties.

Moreover, in the specific case of the distribution of software products, the distributor does not typically pay for the right of distribution proper. The distributor simply purchases the products (typically from the copyright holder himself) and pays the purchase price. In these scenarios, as there is no payment for the distribution rights, the question of whether the payments may or may not constitute royalties is moot. Furthermore, as discussed in the preceding section, sales of copyrighted products do not convey any rights over the copyrights, so payment of the purchase price we are referring to would not constitute royalties either.

As a final comment, the caveat in Article 27 we are

discussing ends up saying that the exhaustion does not apply in the event contemplated in Article 104 of the Copyright Law. Article 104 reads:

As an exception to the provisions of Article 27, Section IV, the holder of a copyright over software … shall keep, even after the sale of copies thereof, the right to authorize or prohibit rental of such copies.

As we are discussing sales and not rentals of the copies of software products purchased, the exception in Article 104 is of no relevance to this article.

Conclusion

Not all payments for software products can be properly characterized as royalties. Only payments for the temporary use or enjoyment of the inherent copyright itself.

Payments for the sale of copies of software products cannot be characterized as royalties.

Similarly, payments for the right to distribute, through sales, copies of software products are not royalties when they follow the first sale of the products, by the copyright holder himself or by any other person authorized to sell the products. Finally, where there are no payments for the distribution rights proper but rather for the products being purchased and resold, no royalties arise either.

The parties involved in these transactions must place special care in drafting the corresponding agreements to avoid an improper characterization as royalties by the Tax Administration, which would call for the withholding of taxes and would not be deductible for Mexican IETU purposes.

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