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Taxation of Ukrainian Royalties – Conflicting Interpretations

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Topic of the Issue:

Taxation of Royalties

Taxation of Ukrainian Royalties – Conflicting Interpretations

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Ukrainian civil and tax legislation contains different definitions of the term, "royalties", which results in considering payments determined as royalties under the civil legislation as non-royalties under the tax law. The exemption of royalties from value added tax and the deduction from taxable income makes it essential to determine the criterion of "tax royalties". Further we refer to the term "royalties" established in the Law "On Taxation of Profit of Enterprises" (hereinafter referred to as "the law").

Tax Royalties

Royalties – are payments of any kind, received as consideration for use or for granting the right to use any copyright on literary work, work of art or science, including computer programs, other recording mediums, video or audiotapes, movies, or tapes for radio and TV broadcasting; for purchasing any patent, registered trademark, designs, patterns, formulas, process, right for information on industrial, commercial or scientific experience (know-how).

Further, the law determines what payments are not considered as royalties. These are payments for receiving the above-mentioned objects in disposition or ownership or if the terms of use of such objects empower the user to sell or otherwise dispose such objects.

As already mentioned, the above-stated definition of term "royalties" is unreasonable and incorrect from the point of view of copyright. For example, it is incorrect to speak about the existence of copyright for video or audiotapes, or other tapes for radio and TV broadcasting.

Problems relating to payments for the use of copyright

The definition of the term "royalties", and especially its second part, casts doubt on the appropriateness of considering payments as royalties under license agreements which establish the right of the user to transfer the right to use copyright on the object to third parties (right to sublicense). There are several approaches to this problem, which are considered further.

First approach. Some specialists consider that payments under license agreements, establishing the right to sublicense, cannot be determined as royalties. Adherents of such an approach try to divine the initial intention of the legislature. In spite of the fact that the law says nothing about the licensee's right to sublicense the copyright object but about his right to sell or otherwise dispose of such an object, followers of this approach consider that the legislature initially meant the right to sublicense. They support their position with a fact that any user *a priori* is unable to sell or dispose of any copyright object. Hence, the legislature must have meant precisely the right to sublicense.

"In practice, tax authorities follow the first approach: they consider payments under license agreements, establishing the right to sublicense, as non - royalties, consequently they claim the obligation to charge VAT."

Second approach. Proponents of the second approach maintain that payments under license agreements, establishing the right to sublicense, should be considered royalties. This approach is based on the fact that transfer of the right to use any copyright object is neither sale nor disposition of the copyright object itself since the owner retains the exclusive rights to the object. As a result, conditions, established under the law are not met.

Payments for trademarks are royalties

Another problem arising from the definition of royalties refers to trademarks. The first part of the definition of royalties states that royalties are payments for purchasing trademarks. According to the second part of the definition, such payments cannot be considered as royalties. During a long period of time this issue was disputable and caused many disputes with tax authorities. After all, in practice, the approach where payments for the use of trademarks should be considered as royalties prevailed.

Payments for related rights are not royalties

Furthermore, note that payments regarding the use of related rights (right to use phonograms, performances) are not considered royalties according to the law. The transfer of such rights is considered a taxable VAT operation on a general basis.

Payments for software

Another disputable issue is whether payments for the use of software for business (internal) use of the purchaser can be considered as royalties and thus deducted from taxable income of the purchaser or not. An example of such software can be Microsoft programs (Windows). The purchaser has no right for commercial development or exploitation of the software (for example, to distribute it).

The issue is whether the right to use copyright to such software is transferred or not in this case.

Unfortunately, current Ukrainian legislation doesn't give a direct and simple answer to the question. Hence there are different approaches regarding the issue: a) to include payments for software as royalties into the gross expenditures; b) to depreciate expenses for purchasing software as a non-intangible asset; c) to depreciate expenses for purchasing software as a fixed asset.

From our point of view, this issue should be considered along with the rules of software taxation.

According to the law, software is included into the fixed assets of the fourth group, which means that expenses related to it are depreciated at the annual rate of 60%. Software can be determined as a fixed asset if its cost exceeds UAH 1 000 (appr. Euro 130) and expected term of use exceeds 1 year.

As to the definition of software, the law refers to the Law of Ukraine "On Copyright and Related Rights". **Under broad interpretation** of the definition, if the purchaser receives only the right to use copyright to the software it also receives the software itself from the point of view of the Law "On Copyright and Related Rights".

This means that even under license agreements, the purchaser is obliged to consider software as a fixed asset, which is subject to depreciation. We consider such approach appropriate if the purchaser receives **only the right to the internal use of software.**

If the purchaser receives the right to use software for commercial purposes (for example, to sublicense software, to copy and distribute software) payments to the owner, in our opinion, should be treated as royalties deductible for the purposes of CPT.