REPUBLIC OF THE PHILIPPINES
Court Of Tax Appeals
QUEZON CITY

SECOND DIVISION

MIRANT SUAL CORPORATION (formerly: SOUTHERN ENERGY PANGASINAN, INC.),
Petitioner,

-versus-

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

C.T.A. CASE NO. 6388

Members:

CASTAÑEDA, JR., Chairman
UY, and
PALANCA-ENRIQUEZ, JJ.

Promulgated:

AUG 22 2005 *Apolinario*

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DECISION

PALANCA-ENRIQUEZ, J.:

The crux of petitioner's claim for refund anchors on the erroneous withholding of final tax of its income payment to foreign corporations. Indisputably, income payments to foreign corporations are subject to a final tax of 32%. However, one of said payee foreign corporations, Engica, has created a "permanent establishment" in the Philippines, pursuant to the RP-UK Tax Treaty, thus, petitioner believes that Engica converted itself into a resident foreign corporation, and in so doing, the withholding of the final tax became improper.

THE CASE

This is a Petition for review filed by Mirant Sual Corporation (formerly: Southern Energy Pangasinan, Inc., hereafter "petitioner") praying for refund or issuance of a tax credit certificate in the amount of P6,526,677.20 representing erroneously paid final withholding tax for calendar year ended December 31, 2000.

THE FACTS

In their "Joint Stipulation of Facts and Restatement of the Issues", the parties submitted a summary of stipulated facts:

> "1. Petitioner MSC, formerly: Southern Energy Pangasinan, Inc., is a corporation duly organized and existing under and by virtue of the laws of the Republic of the Philippines with principal office located at Barangay Pangascasan, Sual, Pangasinan.
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> 2. Respondent is the duly appointed Commissioner of Internal Revenue(CIR) vested with the authority to act as such, including, *inter alia*, the power to decide, approve and grant claims for refunds or tax credits of erroneously paid internal revenue taxes as provided by law with office address at BIR National Office Building, Agham

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Road, Diliman, Quezon City, where he may be served summons and other court processes.

3. Petitioner is principally engaged in the business of power generation and the subsequent sale thereof to the National Power Corporation ('NPC') under a Build, Operate Transfer (BOT) Scheme.

4. Petitioner MSC is originally registered with the Securities and Exchange Commission (SEC) under the name Pangasinan Electric Corporation with SEC Registration No. ASO94-2935.

5. Pangasinan Electric Corporation was registered with the Bureau of Internal Revenue (BIR), RDO 5, Alaminos Pangasinan as a withholding agent on January 22, 1996 with Taxpayer Identification Number (TIN) 003-841-103.

6. On August 17, 1999. the corporate name Pangasinan Electric Corporation was officially changed to Southern Energy Pangasinan, Incorporated (SEPI) upon approval by the SEC and issuance of the Certificate of Filing of Amended Articles of Incorporation dated August 17, 1999 with SEC Registration Number ASO94-2935.

7. SEPI was registered with the BIR-RDO 5, Alaminos, Pangasinan, as a withholding tax agent with TIN 003-841-103.

8. Finally, on June 28, 2001. petitioner adopted the corporate name Mirant Sual Corporation (MSC) upon the approval by the SEC and issuance of the Certificate of Filing of Amended Articles of Incorporation dated June 28, 2001 with SEC Registration Number ASO94-002935.

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9. Petitioner under its new corporate name, MSC, is registered with the BIR-RDO 5, Alaminos, Pangasinan, as a withholding tax agent with TIN 003-841-103.

10. On January 30, 2001 and under its former name SEPI, petitioner filed with the BIR-RDO 5 its the Annual Information Return of Income Taxes Withheld on Compensation and Final Withholding Taxes (BIR Form No. 1604-CF) with the attached Alpha list of Payees subject to final withholding tax for calendar year 2000.

11. Section 22(H) of the National Internal Revenue Code of 1997 (NIRC) defines a resident foreign corporation as a foreign corporation engaged in trade and business within the Philippines.

12. Section 2.57.2 of Revenue Regulations No. 2-98 provides, to wit:

> '**Sec. 2.57.2 Income Payment subject to creditable withholding tax and rates prescribed thereon.** – Except as herein otherwise provided, there shall be withheld a creditable income tax at the rates herein specified for each class of payee from the following items of income payments to persons residing in the Philippines:
>
> A. xxx
>
> B. Professional fees, talent fees, etc. for services of taxable juridical persons – On the gross professional, promotional and talent fees, or any other form of remuneration enumerated in the preceding subparagraph for the services of taxable juridical persons – five percent (5%)

xxx xxx xxx"

13. On February 6, 2002, petitioner filed an administrative claim for refund with the Bureau of Internal Revenue (BIR) in the total amount of P6,526,677.20, representing erroneously paid final withholding tax of petitioner for various months of taxable year 2000.

14. On February 8, 2002, the Petition for Review for the recovery of its erroneously paid final withholding tax was filed with the this honorable court."

In his answer, respondent alleged by way of special and affirmative defenses:

"3. The petitioner erred in treating Engica Technology Systems International as a resident foreign corporation. The 1997 Tax Code defines a resident foreign corporation as foreign corporation engaged in trade or business in the Philippines. Although there is no general rule or governing principle which has been laid down as to what constitutes 'doing' or 'engaging' or 'transacting' business, the true tests, however, seem to be whether the foreign corporation is continuing the body or substance of the business or enterprise for which it was organized or whether it has substantially retired from it and turned over to another *(Traction Co. vs. CIR, 223 F 984).* The term implies a continuity of commercial dealings and arrangements, and contemplates, to that extent, the performance of acts or works or the exercise of some of the functions normally incident to, or in progressive prosecution of, the purposes and objectives of its organization *(Mentholatum Co. vs. Mangaliman, 40 OG 1839).* In other words, it appears necessary, at least in our jurisprudence to constitute 'transacting business', that the foreign corporation has (1) continuity of its personality, (2) continuity of commercial dealings and arrangements in the Philippines *(See Commentaries & Jurisprudence on Phil. Commercial Laws, Martin T.C., p. 221).*

4. Section 2 of the Residence Tax Law, Commonwealth Act No. 465, provides that all corporations, no matter how created or organized whether domestic or resident foreign, engaged in trade or doing business in the Philippines are subject to residence taxes. Petitioner failed to show that Engica has established either an office or place of business nor established an agency to conduct its trade or business in the Philippines.

5. Petitioner has the burden of proving its claim that Aggreko (Singapore) Pte. Ltd. falls within the purview of Section 22 (I) and Section 28 (B) (4) of the Tax Code. Petitioner's alleged claim for refund is subject to administrative routine/examination by respondent's Bureau;

6. Taxes paid and collected by the Bureau of Internal Revenue are presumed to have been made in accordance with law, and the burden of proof to prove otherwise is upon the petitioner;

7. Assuming but without admitting the fact that petitioner is entitled to tax refund, it is incumbent upon the latter to show that it has complied with the provisions under Sections 204 (C) and 230 of the Tax Code. Otherwise, its failure to prove the same is fatal to the claim for refund;

8. Claims for refund are construed strictly against the claimant for the same partakes the nature of exemption from taxation (*Commissioner of Internal Revenue vs. Ledesma, 31 SCRA 95*) and as such, they are looked upon with disfavor (*Western Minolco Corp. vs. Commissioner of Internal Revenue, 124 SCRA 1211*)."

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Petitioner presented Judee Cadelina, Yancy Gabriel Velasco & Roger Quingquing, as witnesses, & submitted its Formal Offer of Evidence, which was admitted by the Court, subject to a final evaluation as regards their probative value.

On the other hand, at the hearing on February 9, 2005 respondent manifested that he will no longer present testimonial and documentary evidence, and moved that the parties be given thirty (30) days therefrom within which to file their simultaneous memoranda, which the Court granted.

Both parties having complied thereto, the case was deemed submitted for decision.

ISSUES

As stipulated upon by the parties, the following are the issues for this Court's consideration:

I

WHETHER OR NOT ENGICA TECHNOLOGY SYSTEMS INTERNATIONAL IS A RESIDENT FOREIGN CORPORATION.

II

WHETHER OR NOT INCOME PAYMENTS TO ENGICA ARE SUBJECT TO EXPANDED WITHHOLDING TAX.

III

WHETHER OR NOT RENTAL PAYMENTS TO AGGREKO (SINGAPORE) PTE. LTD. ARE SUBJECT TO 7.5% FINAL WITHHOLDING TAX.

THE COURT'S RULING

The petition is partly meritorious.

First Issue:
Is Engica a Resident Foreign Corporation?

Petitioner in the course of its business, engaged the services of Engica, a foreign corporation established in the United Kingdom, for the installation, configuration and customization of the Q4 system (a computer inventory system), which was purchased by the petitioner from the latter (*Exhibits "P" and "P-1" to "P-20"*). In view of the fact that Engica is a foreign corporation, petitioner withheld 32% final taxes on its income payment to the former and remitted the same to the Bureau of Internal Revenue (hereafter "BIR"). After its post-audit, however, petitioner is of the opinion that Engica is a resident foreign corporation for income tax purposes by virtue of the RP-UK Tax Treaty, thus, the income payments

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to the latter should have only been subjected to a 5% creditable withholding tax, pursuant to *Section 2.57.2 of Revenue Regulations No. 2-98*, and not to 32% final tax, contrary to what was previously withheld.

In the resolution of this case, We need to first determine whether Engica is a resident foreign corporation to justify the refund of the excess withholding final tax of 32%.

Significant, therefore, is the examination of the provisions of the RP-UK Tax Treaty, specifically *Article 5(3)(b)*, in relation to *Article 7(1)* thereof, which provides as follows:

"Article 5
Permanent Establishment

(1) For the purposes of this Convention, the term permanent establishment means a fixed place of business in which the business of the enterprise is wholly or partly carried on.

(2) xxx xxx

(3) An enterprise of a Contracting State shall likewise be deemed to have a permanent establishment in the other Contracting State if:

xxx xxx xxx

(b) it furnishes services, including consultancy services, in that other Contracting State through its employees or other personnel

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> (other than agents of an independent status within the meaning of paragraph (7) of this Article) for a period exceeding in the aggregate 183 days within any twelve-month period.
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> Article 7
> Business Profits
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> (1) The profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other State but only so much of them as are directly or indirectly attributable to that permanent establishment."

Evidently, the above-quoted provisions enumerate what constitutes a "permanent establishment". Although a foreign corporation may not have a fixed place of business, it would, nonetheless, be considered as having established a "permanent establishment" if it has "furnished services through their employees or other personnel for a period or periods the aggregate of which is more than 183 days in a twelve-month period".

Thus, petitioner claims that inasmuch as Engica had rendered installation services, through its employee, Mr. Simon Toward, for 185 days in connection with its purchase of the inventory system software

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(Q4 system), a permanent establishment has been created. Petitioner presented as evidence the timesheets of Mr. Toward showing an aggregate actual work rendered of 185 days to prove this fact (*Exhibits "N-1" to "N-48"*). To this fact, the Court is of the view that Engica has indeed established a "permanent establishment" in the Philippines pursuant to the RP-UK Tax Treaty.

However such pronouncement notwithstanding, this Court cannot grant petitioner's claim for refund of the alleged erroneous withholding of 32% final tax on the income payment to Engica, for the following reasons to be discussed hereunder.

First, if We go along with the position of herein petitioner that Engica is a resident foreign corporation, then it must follow that Engica should be subjected to income tax at the rate of 32% on its net taxable income, to wit:

> "Sec. 28. Rates of Income Tax on Foreign Corporations. –
>
> (A) Tax on Resident Foreign Corporations. –
>
> (1) In General – Except as otherwise provided in this Code, a corporation organized, authorized, or existing under the laws of any foreign country, engaged in trade or business within the Philippines, shall be subject to an income tax

> equivalent to thirty-five percent (35%) of the taxable income derived in the preceding taxable year from all sources within the Philippines: Provided, That effective January 1, 1998, the rate of income tax shall be thirty-four percent (34%); xxx and effective January 1, 2000 and thereafter, the rate shall be thirty-two percent (32%)." (Underscoring supplied)

Further, Engica should also be required to file annual tax returns, as like any other domestic corporations, viz:

"Sec. 52. Corporation Returns. –

> (A) Requirements. – Every corporation subject to the tax herein imposed, except foreign corporation not engaged in trade or business in the Philippines, shall render, in duplicate, a true and accurate quarterly income tax return and final or adjustment return in accordance with the provisions of Chapter XII of this Title. The return shall be filed by the president, vice-president, or other principal officer, and shall be sworn to by such officer and by the treasurer or assistant treasurer."

To these requirements, petitioner failed to show that Engica, allegedly a resident foreign corporation, has filed its tax return and paid its income tax in the Philippines. Thus, it would be inequitable for the government to grant the refund to petitioner absent any corresponding payment of tax from the taxpayer. It will be the height of absurdity to allow the refund where in fact Engica has never filed its proper income

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tax as a resident foreign corporation, and, for all intents and purposes, Engica could have already benefited from the previously withheld final tax by applying the same as a tax credit in the United Kingdom.

Secondly, if Engica is a resident foreign corporation, then it has the capacity to file, on its own, the instant claim for refund. Engica, in the instant case, is the proper party to claim the refund for it is the income earner from whose account the tax was withheld, on the other hand, petitioner only withheld the final tax. Though, jurisprudence suggests that withholding agents are allowed to claim for refund on behalf of the payee, the same does not apply in the instant case, since what were involved in those long line of cases, were foreign corporations not doing business in the Philippines, and in the instant case Engica, as alleged by petitioner, is a resident foreign corporation doing business in the Philippines. Moreover, Engica never authorized nor designated petitioner to file, on its behalf, the instant refund.

Third, Revenue Memorandum Order 01-2000 must be read in conjunction with said treaty. In the parallel case of *Mirant (Philippines) Operations Corporation (formerly: Southern Energy Asia-Pacific Operations [Phils.] Inc.) vs Commissioner of Internal Revenue, C.T.A.*

E.B. No. 40, promulgated on June 7, 2005, this Court En Banc ruled that: "Under Revenue Memorandum Order 01-2000 of the Bureau of Internal Revenue, it is provided that the availment of a tax treaty provision must be preceded by an application for a tax treaty relief with its International Tax Affairs Division (ITAD). This is to prevent any erroneous interpretation and/or application of the treaty provisions with which the Philippines is a signatory to. The implementation of the said Revenue Memorandum Order is in harmony with the objectives of the contracting state to ensure that the granting of the benefits under the tax treaties are enjoyed by the persons or corporations duly entitled to the same."

This Court finds nothing in the records of the case, nor was it claimed by the petitioner, that it observed the provisions of the foregoing order. Therefore, non-observance of the above revenue memorandum order is fatal to petitioner's cause of action.

All the foregoing arguments taken collectively support the denial of petitioner's claim for refund.

And lastly, We pose this question: Having established a "permanent establishment" in the Philippines, is Engica now considered a resident foreign corporation in our jurisdiction? We cannot find anything

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in the said treaty that supports this allegation, other than the statement that "…the profits of the enterprise may be taxed in the other State but only so much of them as are directly or indirectly attributable to that permanent establishment." Such statement addresses only the tax treatment of the profits of the permanent establishment. The treaty does not convert the foreign corporation into a resident corporation under our tax jurisdiction, but rather it speaks only of how it should be taxed.

Finding Engica to have created a permanent establishment only made it liable to pay taxes to our government, but it does not convert its status into a "resident foreign corporation" in the Philippines.

Second Issue:
Is the Income Payment to Engica Subject to Expanded Withholding Tax?

Considering that petitioner failed to establish that Engica is a resident foreign corporation, the Court hereby holds and declares that Engica is a non-resident foreign corporation. Accordingly, there was no erroneous payment of final withholding taxes made to the Bureau of Internal Revenue. It follows, then, that Engica is subject to the final withholding tax, under *Section 28(B)(1) of the NIRC of 1997, as amended*, which provides:

> "SEC. 28. Rates of Income Tax on Foreign Corporations.
>
> xxx xxx.
>
> (B) Tax on Nonresident Foreign Corporation. –
>
> (1) In General. – Except as otherwise provided in this Code, a foreign corporation not engaged in trade or business in the Philippines, shall pay a tax equal to thirty-five percent (35%) of the gross income received during each taxable year from all sources within the Philippines, such as interests, dividends, rents, royalties, salaries, premiums (except reinsurance premiums), annuities, emoluments or other fixed or determinable annual, periodic or casual gains, profits and income, and capital gains, except capital gains subject to tax under subparagraphs 5(c) and (d): Provided, that effective January 1, 1998, the rate of income tax shall be thirty-three percent (33%), and effective January 1, 2000 and thereafter, the rate shall be thirty-two percent (32%)."

The provision on "creditable withholding tax" mentioned in Section 2.57.2 of Revenue Regulations No. 2-98, invoked by petitioner is not applicable because said section pertains to income payments to persons residing in the Philippines. To reiterate, Engica has no license and certificate to transact business in the Philippines and has no office or place of business in the Philippines to be classified as a resident foreign corporation.

Third Issue:
Rental Payments To Aggreko Are Subject to 7.5% Final Withholding Tax

As regards the last issue, the Court, however, agrees with petitioner that its rental payments for machineries and equipment of Aggreko, a nonresident foreign corporation, are subject to 7.5% final withholding tax and not to 32% tax.

Section 28(B)(4) of the NIRC of 1997 provides:

> "SEC. 28. Rates of Income Tax on Foreign Corporations
>
> xxx xxx
>
> (B) Tax on Nonresident Foreign Corporation. –
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> xxx xxx
>
> (4) Nonresident Owner or Lessor of Aircraft, Machineries and Other Equipment. – Rentals, charters and other fees derived by non-resident lessor of aircrafts, machineries and other equipment shall be subject to a tax of seven and one-half percent (7 1/2%) of gross rentals or fees."

Considering that petitioner has subjected its rental payments in the amount of P127,679.03 to 32% final tax instead of 7.5%, it is but rightful that the excess final tax withheld of 24.5% should be refunded to Aggreko. Based on the evidence presented, the Court finds that

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petitioner exceeded its remittance of final taxes in the amount of P31,281.36, computed as follows:

32% Final Tax on Rental Payments to Aggreko (*Exhibits "D & E"*)	P40,857.29
Less: 7.5% Final Tax (*P127,679.03 x 7.5%*)	9,575.93
Amount Excessively Remitted	P31,281.36

WHEREFORE, foregoing premises considered, the Petition for Review is hereby **PARTIALLY GRANTED**. Respondent is hereby **ORDERED** to **REFUND** or to **ISSUE A TAX CREDIT CERTIFICATE** in favor of petitioner in the amount of P31,281.36, representing excess remittance of final withholding tax in behalf of Aggreko.

SO ORDERED.

OLGA PALANCA-ENRIQUEZ
Associate Justice

WE CONCUR:

JUANITO C. CASTAÑEDA, JR.
Associate Justice

ERLINDA P. UY
Associate Justice

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C E R T I F I C A T I O N

I hereby certify that the decision was reached after due consultation with the members of the Division of the Court of Tax Appeals in accordance with Section 13, Article VIII of the Constitution.

Juanito C. Castañeda, Jr.
JUANITO C. CASTAÑEDA, JR.
Associate Justice
Chairman, Second Division

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