REPUBLIC OF THE PHILIPPINES
COURT OF TAX APPEALS
QUEZON CITY

EN BANC

COMMISSIONER OF INTERNAL REVENUE, Petitioner, -versus- **SMART COMMUNICATIONS, INC.,** Respondent.	**C.T.A. EB No. 206** (C.T.A. Case No. 6782)
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SMART COMMUNICATIONS, INC., Petitioner, -versus- **COMMISSIONER OF INTERNAL REVENUE,** Respondent.	**C.T.A. EB No. 207** (C.T.A. Case No. 6782) Present: **Acosta, *P.J.*,** **Castañeda, Jr.,** **Bautista,** **Uy,** **Casanova,** **Palanca-Enriquez, *JJ.*:** Promulgated: JUN 2 8 2007 ArApolinario

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DECISION

BAUTISTA, J.:

The Case

Before the Court *En Banc* are two Petitions for Review pursuant to Section 18 of Republic Act No. 1125, as amended by Section 11 of Republic Act No. 9282. The

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first petition docketed as C.T.A. EB No. 206 filed by the Commissioner of Internal Revenue seeks the reversal of the Decision dated February 23, 2006 and the Resolution dated July 18, 2006 of the Second Division of this Court ("Court in Division") in C.T.A. Case No. 6782 captioned *Smart Communications, Inc. vs. Commissioner of Internal Revenue,* which ordered the Commissioner of Internal Revenue to pay Smart Communications, Inc. the amount of ₱3,989,456.43 representing overpaid final withholding taxes for the month of August 2001.

On the other hand, the second petition docketed as C.T.A. EB No. 207 was filed by Smart Communications, Inc. praying that this Court render judgment granting its Petition that the payment for services provided for in the Service Download Manager Agreement ("SDM Agreement") be classified as business profits of Prism Transactive (M) Sdn Bhd ("Prism") and as such not subject to tax here in the Philippines since Prism is not engaged in business in the Philippines through a permanent establishment. In effect, Smart Communications, Inc. is praying that its entire claim for the refund or issuance of tax credit certificate in the amount of ₱7,008,840.43 be granted.

Since both Petitions for Review involve the same parties and subject matter, this Court deemed it necessary to consolidate the aforementioned petitions.

Antecedent Facts

As summarized by the Court in Division, the facts are:

> "In their 'Joint Stipulation of Facts', the parties submitted the following:
>
> '1.02. Petitioner is a corporation organized and existing under Philippine law with principal office at the Smart Tower, Ayala Avenue, 1226 Makati Avenue.
>
> 1.03. Respondent is the duly appointed Commissioner of Internal Revenue (CIR) vested with authority to exercise the functions of said office, including inter alia, the power to refund any internal revenue tax erroneously or illegally assessed or collected, or of any penalty claimed to have collected without authority, or any sum alleged to have been excessively or in any manner wrongfully collected, and holding office at the BIR National Office

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Building, Diliman, Quezon City, where he may be served with summons and other legal processes of this Honorable Court (ANSWER, par. 1).

1.04. SMART is an enterprise duly registered with the Board of Investment (BOI) on a preferred non-pioneer status, having been issued the following BOI Certificates:

BOI Certificate of Registration No.	Registered Activity
94-034 dated March 8, 1994	New operator of a nationwide enhanced Cellular Mobile Telephone System (CMTS)
94-628 dated December 29, 1994	New operator of International Gateway Facility ("IGF")
97-117 dated August 26, 1997	Expanding Operator of Nationwide Cellular Mobile Telephone System (CMTS)
2001-066 dated May 3, 2001	Expanding Operator of Telecommunication Systems (Nationwide Cellular Mobile Telephone Services – Global System for Mobile Communication (GSM) Network
2001-102 dated July 12, 2001	New IT Service Firm in the Field of Information Technology Service (Payment Infrastructure System)

1.05. In line with its Bespoke Project and the launching of its *mCommerce* service such as Smart Banking, Smart Money and ZED Mobile service initiatives, SMART entered into three (3) Agreements for Programming and Consultancy Services (collectively the 'Agreements') with Prism Transactive (M) Sdn Bhd, Inc. ('Prism').

1.06. Prism is a non-resident corporation duly organized and existing under the laws of Malaysia.

1.07 SMART withheld and paid to the BIR withholding taxes totaling Seven Million Eight Thousand Eight Hundred Forty and 43/100 Pesos (P7,008,840.43) applying the tax rate of 25%, as follows:

Particulars	Amount
Tax Base	US$ 547,822.45
Multiply by: Withholding Tax rate	25%
Final Withholding Tax	US$ 136,955.61
Multiply by: Prevailing Exchange Rate	51.176
FWT remitted to the BIR	P7,008,840.43

1.08. SMART filed its Monthly Remittance of Final Income Taxes Withheld (BIR Form No. 1601-F) for the month of August 2001 on September 25, 2001.

1.09. On September 23, 2003, SMART formally filed a claim with the BIR, through the International Tax Affairs Division ('ITAD'), for the refund of its overpaid or erroneously paid final withholding tax for the month of August 2001.

1.10. Respondent Commissioner has not acted upon or granted said written claim for refund. Thus, SMART filed the instant Petition to forestall the running of the prescriptive period.'

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

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'4. The 'Agreements' attached as Annexes 'I-K' of the petition are unnotarized documents. Respondent, thus has no way of checking the veracity of the scope of obligations of both parties under the agreements.

5. Further, the Completion of Work Certificate given by PRISM TRANSACTIVE (M) SDN. BHD. ('Prism') is unauthenticated by the Malaysian Embassy. Reliance cannot be had on the said certification absent authentication by the Malaysian Embassy or the Philippine Consulate Office in Malaysia.

6. The billing statement relied upon to prove payment to Prism does not in any way show proof that the payment was made thereon. It does not show that remittance was made to Prism in the stated amount.

7. Petitioner is not the party-in-interest in this case to recover the amount it paid to the respondent. In fact, petitioner is deemed as the agent of the government in collecting the Seven Million Eight Thousand Eight Hundred Forty Pesos and Three Centavos (Php 7,008,840.03), constituting final tax on passive income of royalty to Prism. Even under the cited 'RP-Malaysia' Tax Treaty, it is Prism who is the proper party-in-interest to seek for the refund of said amount as it is deemed to be the one to have been prejudiced by the withholding of the tax on royalty payment. Thus, herein petitioner SMART is not the proper party-in-interest in this case. Clearer still, it is not entitled to the reliefs of the treaty provision as it is not a Malaysian Company entitled to privileges under the treaty.

8. Assuming in grantia arguenti that petitioner is the proper party in interest, it cannot rely its claim for refund on the treaty provisions:

> a. Petitioner failed miserably to establish that what were paid were business profits. Assuming that the payment for services rendered are not royalty payments, petitioner still failed to prove that what were remitted to Prism were business profits. Petitioner cannot rely on implications that since the payments were not royalty payments, they are business profits and thus covered by the treaty. An exemption from common burdens cannot be made to rely on vague implications (Asiatic Petroleum Co. {P.I.} v. Llanes, 49 Phil. 466).
>
> b. The interpretation by the Organization for Economic Cooperation and Development Committee on Fiscal Affairs through the Technical Advisory Group on Treaty Characterization of Electronic Commerce Payments is likewise not the authority on the matter. In a dispute between the petitioner and respondent, petitioner cannot rely on the construction of international agreements, which are not treaty provisions between the Philippines and Malaysia. These international agreements are not parts of the law of the land. In this claim for refund the governing authority is the ordinary meaning of royalties, as this is the one being used by the Philippine Government for taxation purposes. Royalties as generally used in this jurisdiction mean 'payment of any kind received as a consideration of the use of, or the right to use, any copyright of literary, artistic or scientific work including . . . any patent, trademark, 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'. From this general definition of royalties, it is perfectly lucid that the payments made by petitioner to Prism are royalty payments. This position is buttressed by recent Revenue Memorandum Circular No. 77-2003 issued by the respondent. Thus, petitioner could not be deemed to be in error in its payment of the amount being claimed for refund in this petition.

9. Petitioner's claim for refund is subject to administrative investigation/examination by the respondent. However, due to its act of belated filing, one day before the expiry of the two-year period, it deprived the respondent of reasonable opportunity to act on its claim for refund.

10. In an action for refund, the burden of proof is on the taxpayer to establish its right to refund. Failure to sustain the burden is fatal to the claim for refund/credit. This is so because exemptions from tax are highly disfavored in law, and he who claims exemption must be able to justify his claim by the clearest grant of organic or statutory law.

11. Claims for refund are construed strictly against the claimant, for the same partake the nature of exemption from taxation.'

Petitioner presented Rina Lorena R. Manuel and Jose Crisanto B. Magno, as witnesses, and 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 May 18, 2005, respondent manifested that he will no longer present 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. "

The Ruling of the Court in Division

In a Decision promulgated on February 23, 2006, the Court in Division ruled that as the withholding agent, petitioner Smart Communications, Inc. was the proper party to file the claim for refund.

As regards the SDM Agreement between petitioner and Prism, the Court in Division found that payments to Prism for the installation of the SDM are royalties, as contemplated under Article 12, paragraph 4 of the RP-Malaysia Tax Treaty[1] since the SDM remained to be the intellectual property of Prism. Therefore, the same are taxable as such.

With respect to the payments to Prism relative to the Channel Manager Agreement ("CM Agreement") and the SIM Applications Agreement, the Court in Division held that such payments are not royalties. They are business profits within the meaning of the RP-Malaysia Tax Treaty, which are taxable in the Philippines only if they are attributable to a permanent establishment in the Philippines, pursuant to

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[1] Agreement between the Government of the Philippines and the Government of Malaysia for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, January 1, 1985.

Article 7 in relation to Article 5 of the said Treaty. Considering that petitioner was able to prove that Prism did not establish a permanent establishment in the Philippines, then said payments are not taxable.

Since petitioner was able to show that it remitted and paid the amount of ₱7,008,840.43 representing final withholding taxes and considering that only the amount of $236,000.00 representing payment for the SDM Agreement is taxable under the Treaty, the Court in Division declared that petitioner was entitled to a refund in the reduced amount of ₱3,989,456.43.

The *fallo* of the aforementioned Decision reads as follows:

> "**WHEREFORE**, premises considered, the instant petition is hereby partially **GRANTED**. Accordingly, respondent Commissioner of Internal Revenue is hereby **ORDERED** to **REFUND** or **ISSUE** a **TAX CREDIT CERTIFICATE** to petitioner Smart Communications, Inc. in the amount of P3,989,456.43, representing overpaid final withholding taxes for the month of August 2001.
>
> SO ORDERED."

Smart Communications, Inc. filed a Motion for Partial Reconsideration of the aforementioned Decision of the Court in Division on March 22, 2006. The Commissioner of Internal Revenue likewise filed his Motion for Partial Reconsideration on March 21, 2006.

In a Resolution dated July 18, 2006, the Court in Division denied both Motions for Reconsideration for lack of merit.

Hence, both respondent Commissioner of Internal Revenue and petitioner Smart Communications, Inc. filed their respective Petitions for Review with the Court of Tax Appeals *En Banc* (hereafter "this Court") on September 7, 2006. The appeal by the Commissioner of Internal Revenue was docketed as C.T.A. EB No. 206 while Smart Communications, Inc.'s appeal was docketed as C.T.A. EB No. 207. In a Resolution dated February 8, 2007, this Court ordered the consolidation of C.T.A. EB No. 206 with C.T.A. EB No. 207. Considering that both parties are petitioners and respondents at the same time, they shall be referred to by their respective names throughout the rest of this Decision. Thus, the term "Commissioner" shall refer to the Commissioner of Internal Revenue and the name "Smart" shall refer to Smart Communications, Inc.

The Issues

The following are the issues raised by the parties in their respective Petitions for Review:

C.T.A. EB No. 206
Commissioner of Internal Revenue vs. Smart Communications, Inc.

1. WHETHER OR NOT RESPONDENT IS ENTITLED TO A REFUND EVEN IF IT BROUGHT THE CLAIM FOR REFUND, INDEPENDENT OF, AND WITHOUT AUTHORITY, FROM THE TAXPAYER FROM WHOM THE TAXES WERE WITHHELD;

2. WHETHER OR NOT THE PAYMENTS MADE BY PETITIONER TO PRISM ARE CONSIDERED ROYALTY REMITTANCES SUBJECT TO FINAL WITHHOLDING TAX, AND ARE THUS, NOT COVERED BY THE TAX TREATY PROVISIONS ON BUSINESS PROFITS; AND

3. WHETHER OR NOT A TAX CREDIT CERTIFICATE CAN BE ISSUED IN THE NAME OF RESPONDENT, DESPITE THE FACT THAT IT IS NOT THE PARTY ECONOMICALLY PREJUDICED BY WITHHOLDING OF THE TAXES.

C.T.A. EB No. 207
Smart Communications, Inc. vs. Commissioner of Internal Revenue

1. THE SECOND DIVISION OF THE CTA ERRED IN PARTIALLY DENYING THE PETITIONER'S CLAIM FOR REFUND IN THE AMOUNT OF FIFTY NINE THOUSAND US DOLLARS (US$59,000.00) EQUIVALENT TO THREE MILLION NINETEEN THOUSAND THREE HUNDRED EIGHTY FOUR PESOS (₱3,019,384.00) REPRESENTING OVERPAID 25% FINAL WITHHOLDING TAX ON PAYMENT MADE BY PETITIONER TO PRISM ON THE SDM AGREEMENT FOR THE MONTH OF AUGUST 2001; AND

2. THE SECOND DIVISION OF THE CTA ERRED IN RULING THAT PAYMENTS MADE BY PETITIONER IN RESPECT OF THE SDM

AGREEMENT WERE CONSIDERED AS ROYALTIES INSTEAD OF PAYMENTS FALLING UNDER THE RULES OF BUSINESS PROFITS.

THE COMMISSIONER'S ARGUMENTS IN C.T.A. EB No. 206

The Commissioner avers that Smart, in all its representations before the BIR, and this Court, is prosecuting the claim for refund in its own name, and never in behalf of its supposed principal, Prism. In addition, there is no indication that the economic incidents of the refund will redound to Prism. The cases cited by the Court in Division are inappropriate as the withholding agents therein are also wholly owned subsidiaries of the payees. Thus, in said cases, the economic incidence of the refund will ultimately redound to the benefit of the payees of the remittances. In the instant case, Smart and Prism are unrelated. Their relationship was occasioned only by the contracts between them. It was thus erroneous for the Court in Division to rule that Smart is an agent of Prism for purposes of the prosecution of this claim for refund.

The Commissioner also argues that the claim for refund in the instant case is based on the provisions of the RP-Malaysia Tax Treaty on royalties and business profits. Thus, it should be Prism, a Malaysian company, which should be the principal party in the case. Smart can never bring an action in its own name citing treaty provisions to which it is not entitled.

The Commissioner likewise contends that all the payments made by Smart to Prism pursuant to the SDM and CM Agreements are in the nature of royalty payments since Prism retained intellectual property rights over the programs. Hence, such payments are subject to final withholding tax under the National Internal Revenue Code ("NIRC"), and not as business profits under the Treaty.

Lastly, the Commissioner posits that since tax refunds are in the nature of tax exemptions, they are construed strictly against the person or entity claiming the exemption. Accordingly, Smart has the burden of proof to establish the factual and legal bases of its claim for refund, as well as its right to file the subject claim for refund as a party in interest. As Smart fell short of proving its entitlement to the refund, its claim should be denied in its entirety.

SMART'S ARGUMENTS IN C.T.A. EB No. 207

Smart asserts that the payments it made to Prism pursuant to the SDM Agreement should not be considered royalties but business profits using the criteria set by paragraph 29 of the OECD Commentary[2], *to wit*:

> "29. The Group recognizes that the distinction between payments for services rendered and payments for the supply of know-how may sometimes raise practical difficulties. It considers that the following criteria, developed in a ruling by the Australian Tax Office, may be useful in that respect.
>
> - under a contract for the supply of know-how:
>
>   (a) a "product" (i.e. knowledge, information, technique, formula, skills, process, plan, etc.) which has already been created or developed or is already in existence is transferred;
>
>   (b) the product which is the subject of the contract is transferred for use by the buyer (i.e. it is supplied); and
>
>   (c) except in the case of a disposition where the seller divests himself completely of any further interest in the product, the property in the product remains with the seller. All that is obtained by the buyer is the right to use the product. Subject to the terms of the contract, the seller retains the right to use the product himself and to transfer it to others.
>
> - by contrast, in a contract involving the performance of services:
>
>   (d) the contractor undertakes to perform services which will result in the creation, development, or the bringing into existence of a product (which may or may not be know-how);
>
>   (e) in the course of developing a product, the contractor would apply existing knowledge, skill and expertise – there is not a transfer (i.e. supply) of know-how from the contractor to the buyer as such but a use by the contractor of his knowledge for his own purposes; and
>
>   (f) the product created as a result of the services belongs to the buyer for him to use without having to obtain any further rights in respect of the product. Xxx"

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[2] The Organization for Economic Cooperation and Development ("OECD") Committee on Fiscal Affairs through the Technical Advisory Group (TAG) on Treaty Characterization of Electronic Commerce Payments released a document describing 26 categories of e-commerce transactions and presenting the preliminary conclusions of the Group, and their analysis, on how the payments arising from these transactions should be classified for tax treaty purposes.

Based on the foregoing, Smart submits that payments it made pursuant to the SDM Agreement are payments for a contract for services, *viz*:

> "(a) the contractor (Prism) undertakes to perform services which will result in the creation, development or the bringing into existence of a product, i.e., SDM Application, which is software application (see **Annex 'N'**);
>
> (b) in the course of developing a product, the contractor (Prism) would apply existing knowledge, skill and expertise – there is not a transfer (i.e. supply) of know-how from the contractor to the buyer as such but a use by the contractor of his knowledge for his own purposes (see **Annex 'N'**); and
>
> (c) the product created as a result of the services belongs to the buyer (Smart) for him to use without having to obtain any further rights in respect of the product. However, in the course of rendering services, the contractor would, in most cases, also produce as a by-product a work (e.g. plan, design, specification, report, etc., - which could contain knowledge, etc. not otherwise known to the buyer and which may or may not be protected by patents, etc..) in which copyright subsist. Unless specifically agreed otherwise, the contractor is the owner of such copyright and the buyer or any other person is, by law, precluded from using the property in which the copyright subsists for any purpose other than the purpose for which it was originally designed without first obtaining the approval of the contractor. This would not alter the nature of the contract which would remain one for the performance of services (see **Annex 'N'**)."

Thus, considering that the payment to Prism is not in the nature of "royalties," such payment constitutes "business profits," which is taxable in the Philippines only if it is attributable to a permanent establishment in the Philippines pursuant to Article 7 of the RP-Malaysia Tax Treaty. Since Prism does not maintain any permanent establishment in the Philippines, and considering further that its consultants stayed in the Philippines for less than six (6) months, the payment to Prism is therefore not subject to Philippine taxes.

Smart likewise asseverates that pursuant to OECD Commentaries,[3] it can be concluded that payments made for partial transfer of rights would represent royalties in very limited circumstances, such as, where the transferor is the author of the software and placed part of his rights at the disposal of a third party to enable the

[3] The Commentaries of the Organization for Economic Cooperation and Development (OECD) Committee on Fiscal Affairs on the Model Tax Convention, par. 12-17. Commentary on Article 12 (Royalties),©1998, pp. 152 -153.

latter to exploit the software itself commercially. However, if the acquisition of the software is for the personal or business use of the purchaser, the payment will be considered as commercial income subject to the rules on Article 7 on business profits. Moreover, where the payments are made for the transfer of full ownership, the payment cannot represent royalty and the provisions on Article 12 (Royalties) are not applicable. In the present case, the acquisition by Smart of the SDM is for its internal business use, not for commercial distribution or exploitation and there is full transfer of ownership. Hence, payments made for its acquisition should not be considered as royalties, but instead commercial income.

Lastly, Smart opines that based on Revenue Memorandum Circular ("RMC") No. 44-2005, even assuming without admitting that payments for SDM are considered as royalties, the Court in Division failed to consider that a portion of such payment for the customization of such SDM is payment for provision of services rendered. Hence, such portion should be treated as income from services and taxable as such.

The Ruling of the Court En Banc

The petition is bereft of merit.

A withholding agent can file a claim for refund

This Court shall first discuss the issue of whether Smart is the proper party in interest to claim the subject refund.

The Court in Division, in holding that Smart is a party in interest, made the following disquisition:

> "The issue of whether or not a withholding agent is the proper party to claim for the refund of overpayment of withholding tax is not novel, as the issue

had, in a number or so of cases, been previously ruled upon by the Supreme Court.

In *Commissioner of Internal Revenue vs. Wander Philippines, Inc., 160 SCRA 577*, the Supreme Court said that Wander Philippines, as the Philippine counterpart, is the proper party who should claim for the refund, and ruled as follows:

> 'In any event, the submission of petitioner that Wander is but a withholding agent of the government and therefore cannot claim reimbursement of the alleged overpaid taxes, is untenable. It will be recalled, that said corporation is first and foremost a wholly owned subsidiary of Glaro. The fact that it became a withholding agent of the government which was not by choice but by compulsion under Section 53 (b) of the Tax Code, cannot by any stretch of the imagination be considered as an abdication of its responsibility to its mother company. Thus, this Court construing Section 53 (b) of the Internal Revenue Code held that "the obligation imposed thereunder upon the withholding agent is compulsory." It is a device to insure the collection by the Philippine Government of taxes on incomes, derived from sources in the Philippines, by aliens who are outside the taxing jurisdiction of this Court (Commissioner of Internal Revenue vs. Malayan Insurance Co., Inc., 21 SCRA 944). In fact, Wander may be assessed for deficiency withholding tax at source, plus penalties consisting of surcharge and interest (Section 54, NLRC). Therefore, as the Philippine counterpart, Wander is the proper entity who should claim for the refund or credit of overpaid withholding tax on dividends paid or remitted by Glaro.'

In *Commissioner of Internal Revenue vs. Procter and Gamble Philippine Manufacturing Corporation, 204 SCRA 384-387*, the Supreme Court, in its Resolution granting Procter and Gamble Philippine Manufacturing Corporation's Motion For Reconsideration and setting aside the decision of the Second Division promulgated on April 15, 1988, ruled that a withholding agent is properly regarded as a 'taxpayer' within the meaning of *Section 309 of the NIRC*, and is impliedly authorized to file the claim for refund and the suit to recover such claim, as follows:

xxx xxx xxx

Then, in *Commissioner of Internal Revenue vs. The Court of Tax Appeals, G.R. No. 93901, February 11, 1992*, which involved the issue of whether or not Hawaiian Philippines Co. has legal capacity to file a claim for refund of withholding tax on behalf of its non-resident U.S. stockholders, the Supreme Court ruled that a withholding agent has sufficient legal interest to bring an action to recover tax overpayment.

The foregoing rulings treated the withholding agent as a taxpayer in view of its direct and independent liability under the withholding tax system. Pursuant to the aforequoted decisions of the Supreme Court, the withholding agent is the agent of both the government and the taxpayer. With respect to the filing of the necessary income tax return and the actual payment of the tax which includes the authority to file a claim for refund and to bring an action for recovery of such claim, he is the agent of the taxpayer, and with respect to the collection and/or withholding of the tax, he is the Government's agent (*Principles and Remedies, 2nd ed. 2005, pp. 190-191, by Justice Japar B. Dimaampao*).

Consequently, We rule that herein petitioner, as the withholding agent, is the proper party to file the present claim for refund."

The Commissioner's contention that the aforementioned cases cited by the Court in Division are inapplicable to this case as the withholding agents therein are wholly owned subsidiaries of the payees, whereas in this case, Smart and Prism are unrelated corporations, is untenable.

Section 2, Rule 3 of the 1997 Rules of Civil Procedure defines a party in interest as follows:

> "SEC. 2. Parties in interest. — A real party in interest is the party who stands to be benefited or injured by the judgment in the suit, or the party entitled to the avails of the suit. Unless otherwise authorized by law or these Rules, every action must be prosecuted or defended in the name of the real party in interest."

Smart, a party to the subject Agreements with Prism, is the resident withholding agent and payor in control of payment that shall be responsible for payments that may arise in relation to said Agreements pursuant to Section 57(A) of the National Internal Revenue Code ("NIRC") of 1997, as amended, considering that Prism is a non-resident foreign corporation. Moreover, under Section 2.57(A) in relation to Section 57-1(I)(I) of Revenue Regulations No. 2-98, as amended, implementing said provision of law, Smart, as the withholding agent, has the responsibility to withhold and remit said final withholding tax to the Philippine government. Section 2.57(A) provides:

> "SECTION 2.57. Withholding of Tax at Source
>
> (A) Final Withholding Tax. — Under the final withholding tax system the amount of income tax withheld by the withholding agent is constituted as a full and final payment of the income tax due from the payee on the said income. **The liability for payment of the tax rests primarily on the payor as a withholding agent. Thus, in case of his failure to withhold the tax or in case of under withholding, the deficiency tax shall be collected from the payor/withholding agent.** The payee is not required to file an income tax return for the particular income. "*(Emphasis supplied)*

Based on the foregoing, failure on the part of the withholding agent to withhold and subsequently remit said final tax would constitute liability on the instituted withholding agent, in this case, Smart. Given the said responsibility and liability to withhold and remit said tax, there is legal basis to make the said withholding agent a real party in interest entitled to a refund for erroneously withheld tax.[4]

While it is true that Smart and Prism are unrelated entities, such circumstance does not affect the status of Smart as a party in interest in the instant claim for refund. It is a party in interest based on its direct and independent liability under the withholding tax system, as correctly pointed out by the Court in Division.

Royalties vs. Business Profits

At this juncture, this Court will delve into the characterization of the payments under the three (3) Agreements between Smart and Prism. Necessarily, since Prism is a resident of Malaysia, this Court shall refer to the pertinent provisions of the RP-Malaysia Tax Treaty, *viz*:

"Article 7
BUSINESS PROFITS

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 on so much thereof as is attributable to that permanent establishment. xxx"

"Article 5
PERMANENT ESTABLISHMENT

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

2. The term 'permanent establishment' shall include especially:

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[4] Unilever Philippines, Inc. v. Commissioner of Internal Revenue, C.T.A. Case No. 6517, July 26, 2006.

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(a) a place of management;
(b) a branch;
(c) an office;
(d) a factory;
(e) a workshop;
(f) a mine, an oil or gas well, a quarry or other place of extraction of natural resources including timber or other forest produce;
(g) a farm or plantation; a building site or construction, installation or assembly project which exists for more than 6 months.

xxx xxx xxx

4. An enterprise of a Contracting State shall be deemed to have a permanent establishment in the other Contracting State if:

(a) it carries on supervisory activities in that other State for more than 6 months in connection with a construction, installation or assembly project which is being undertaken in that other State; or

(b) substantial equipment is in that other State being used or installed by, for or under contract with, the enterprise."

"Article 12
ROYALTIES

1. Royalties arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other State, if such resident is the beneficial owner of the royalties.

2. Such royalties may also be taxed in the contracting State in which they arise, and according to the laws of that State. However, if the recipient is the beneficial owner of the royalties:

a. xxx
b. in the case of the Philippines:

the tax so charged shall not exceed:

(i) 15 per cent of the gross amount of the royalties where the royalties are paid by a registered enterprise as well as royalties defined in paragraph 4(a)(ii); and

(ii) 25 per cent of the gross amount of the royalties in all other cases.

xxx xxx xxx."

Under the foregoing treaty provisions, if the service fees paid by Smart to Prism are business profits and not royalties and Prism carries on business in the Philippines through a permanent establishment, such profits may be taxed in the

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Philippines but only so much of them as are attributable to such permanent establishment. In other words, if the income is in the form of business profits, the same will only be subject to Philippine income tax if a permanent establishment is created in the Philippines. Conversely, if there is no permanent establishment, there will be no tax consequences in the Philippines.

Hence, it is essential to differentiate between business profits and royalties. Under Article 12 (paragraph 4) of the RP-Malaysia Tax Treaty, the term "royalties" is defined as follows:

> "4. (a) The term 'royalties' as used in this Article means payments of any kind received as consideration for:
>
> (i) the use of, or the right to use, any patent, trade mark, design or model, plan, secret formula or process, any copyright of literary, artistic or scientific work, or for the use of, or the right to use, industrial, commercial, or scientific equipment, or for information concerning industrial, commercial or scientific experience;
>
> (ii) the use of, or the right to use, cinematograph films, or tapes for radio or television broadcasting."

The treaty defines "royalties" to include "payment of any kind received as a consideration for information concerning industrial, commercial or scientific experience."

In relation thereto, the Bureau of Internal Revenue ("BIR") has consistently applied the rule that in order for service fees to be considered as royalties, there must be a transfer in the Philippines of scientific, technical, industrial or commercial knowledge or information or other property where the payee has proprietary interest in the property giving rise to the income.[5] Such rule has also been recognized by the Honorable Court of Tax Appeals.[6] Moreover, the International Tax Affairs Division

[5] BIR Ruling No. 036-90 dated March 27, 1990, BIR Ruling No. [DA-148-98] dated April 20, 1998, and BIR Ruling No. [DA-037-04] dated February 2, 2004.
[6] Commissioner of Internal Revenue v. Cyanamid Philippines, Inc., CA-G.R. SP No. 39933, February 4, 1999.

("ITAD") of the BIR explained in one ruling that such knowledge or information refers to the concept of "know-how."[7] To quote:

> "According to the commentaries of the ORGANISATION FOR ECONOMIC COOPERATION AND DEVELOPMENT (OECD) Committee on Fiscal Affairs on the Model Tax Convention [par. 11 and 12, Commentary on Article 12 (Royalties), © 2003, p. 175], such information alludes to the concept of 'know-how'. The definition adopted by the said Committee 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 mere examination of the product and mere knowledge of the progress of technique.' In a know-how contract, one of the parties agrees to impart to the other, so that he can use them for his own account, his special knowledge and experience which can remain unrevealed to the public. (BIR Ruling DA-ITAD No. 57-05 dated June 17, 2005)"

It is settled that the interpretation of an administrative government agency like the BIR, which is tasked to implement a statute, is accorded great respect and ordinarily controls the construction of the courts. The reason behind this rule was explained in *Nestle Philippines, Inc. vs. Court of Appeals* in this wise: "The rationale for this rule relates not only to the emergence of the multifarious needs of a modern or modernizing society and the establishment of diverse administrative agencies for addressing and satisfying those needs; it also relates to the accumulation of experience and growth of specialized capabilities by the administrative agency charged with implementing a particular statute."[8]

On the concept of business profits, generally speaking, such profits (or industrial and commercial profits) include payments for the supply of goods, for the supply of services, and for the lease of personal properties. In this regard, the Court of Tax Appeals has ruled as follows:[9]

> "To 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

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[7] DA ITAD BIR Ruling No. 056-06 dated May 22, 2006.
[8] 203 SCRA 504 [1991].
[9] Philippine Refining Co., Inc. v. Commissioner of Internal Revenue, CTA Case No. 2872, January 15, 1986 *citing Ingram vs. Bowers, 5 F 2d 65 and Oppenhein vs. Commissioner of Internal Revenue, 31 BTA 563.*

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compensation for personal services, if the payee has proprietary interest then the payment is royalty."

Guided by the foregoing discussion, this Court shall proceed to examine the provisions of each of the 3 Agreements between Smart and Prism.

Payments under the CM Agreement are business profits under the Treaty

Paragraphs 1 and 1.4 of the Programming Services (Schedule A) of the CM Agreement[10] provide:

"1. CHANNEL MANAGER

The Channel Manager ('CM') will provide the content interface to the WIB via DP5. There are two CM platforms defined. One will provide ZED functionality and the other would provide Mobile Banking and Smart Money transactions to the SIM.

The ZED version of CM will be delivered first and must be in place when the first SIMs are released to the market. The Mobile Banking and Smart Money applications are hidden when the SIM is released and as such, the CM that enables these services will be provided after the ZED CM.

The ZED Channel Manager will be developed as Enterprise Java Beans ('EJB') to be run on the Netscape iPlanet application server. A set of servlets will receive the SIM requests via DP5 and then hand the transaction request to the EJB components. The SMART Money / MBS Channel Manager will be developed under the PHP development environment.

xxx xxx xxx

1.4 Intellectual Property Rights (IPR)

The IPR of all components of the CM belong to the Client with the exception of the following components, which are provided, without technical or commercial restraints or obligations:

- ConfigurationException.java
- DataStructures (DbLinkedList.java, DblListNode.java, List EmptyException.java,ListFullException.java, ListNodeNotFoundException.java, QueueEmptyException.java, QueuFullException.java, QueueList.java, QueuListEx.java, and QueueNodeNotFoundException.java)
- FieldMappedObject.java
- LogFileEx.java
- Logging (BaseLogger.java and Logger.java)
- PrismGeneric Exception.java
- PrismGenericObject.java

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[10] Pages 251 to 252, CTA Records, CTA Case No. 6782.

- ProtocollBuilders/CIMD2 (Alive.java, BaseMessageData.java, DeliverMessage.java, Login.java, Logout.java, Nack.java, SubmitMessage.java,
- TemplateManagement (FileTemplateDataBag.java, TemplateDataBag.java, TemplatgeManagerExBag.java, and TemplateParserExBag.java)
- TemplateManager.class
- TemplateServer.class
- TemplateServer$RequestThread.class
- Template Server_skel.class
- TemplateServer_stub.class
- TemplateService.class
- Prism Crypto Server module for PHP4

xxx xxx xxx"
(Emphasis and italics supplied)

According to the Court in Division, under the CM Agreement, Prism applied existing knowledge, skills and expertise in the development of the CM. The product or software created as a result of the services belongs to Smart. There is no existing product that Smart is availing from Prism. Thus, the Court in Division concluded that payments to Prism with respect to the CM Agreement are payments for professional services which are considered business profits within the meaning of the RP-Malaysia Tax Treaty.

This Court agrees with the said ruling of the Court in Division. Moreover, the cited provisions of the CM Agreement clearly show that Prism does not have any interest or right to whatever is the result of services performed. The results of all of the services rendered by Prism are owned by Smart. Prism has no proprietary interest or right to them. Furthermore, the payments by Smart to Prism are business profits, since there is nothing in the CM Agreement which would require the transfer into the Philippines of technology, equipment or other property where Prism has proprietary interest or would otherwise permit Prism to impart to Smart its special knowledge and experience which remain unrevealed to the public.

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As previously discussed, such business profits will be taxable in the Philippines if it is attributable to a permanent establishment in the Philippines. This Court concurs with the findings of the Court in Division that Smart was able to show that Prism has no permanent establishment in the Philippines based on the Completion of Work Certificate No. SM0102[11] relating to the CM Agreement which showed that the consultants and employees of Prism stayed in the Philippines from July 23, 2001 to November 2, 2001 or for less than six (6) months from the time of the engagement until the CM Agreement was completed. Consequently, payments under the CM Agreement are not taxable in the Philippines.

Payments under the SIM Applications Agreement are business profits under the Treaty

Paragraphs 1 and 1.3 of the Programming Services (Schedule A) of the SIM Applications Agreement[12] provide:

> **"1. SMART MONEY AND MOBILE BANKING SERVICE SIM APPLICATIONS**
>
> In order to deliver the advanced level of SIM application that the Client requires in the timeframes requested, Prism will perform the WIB script development on the SIM, concluding with the 64k WIB script code referred to later.
>
> The activities to be performed will be:
>
> - Proof of concept and demonstration
> - Several iterations of requirement analyses — rapid turnaround prototyping
> - SIM application development and debugging
> - Backend simulation development for application requirements refinement, application testing and functional/technical/performance evaluation for marketing acceptance sign-off.
>
> **1.1 Terms of Reference**

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[11] Exhibit "N", page 276, CTA Records, CTA Case No. 6782.
[12] Pages 270 to 271, Ibid.

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The general terms of reference for the SIM Applications are set out below.

xxx xxx xxx

1.3 Intellectual Property Rights (IPR)

The Client shall own the IPR for the Specifications and the Source Code for the SIM Applications. PRISM shall develop an executable compiled code (the 'Executable Version') of the SIM Applications for use on the aSIMetric card which, however, shall only be for the Client's use. The Executable Version may not be provided by PRISM to any third parties without the prior written consent of the Client. It is further recognized that the Client anticipates licensing the use of the SIM Applications, but it is agreed that no license fee will be charged to PRISM or to a licensee of the aSIMetrix card from PRISM when SIMs are supplied to the Client." *(Emphasis and italics supplied)*

The Court in Division ruled that, under the SIM Applications Agreement, Prism applied existing knowledge, skills and expertise in the development of the SIM Applications. The product or software created as a result of the services belongs to Smart. There is no existing product that Smart is availing from Prism. Thus, the Court in Division concluded that payments to Prism with respect to the SIM Applications Agreement are payments for professional services which are considered business profits within the meaning of the RP-Malaysia Tax Treaty.

This Court concurs with the said ruling of the Court in Division. Moreover, the cited provisions of the SIM Applications Agreement clearly show that Prism does not have any interest or right to whatever is the result of services performed. The results of all of the services rendered by Prism are owned by Smart. Prism has no proprietary interest or right to them. Furthermore, the payments by Smart to Prism are business profits, since there is nothing in the SIM Applications Agreement which would require the transfer into the Philippines of technology, equipment or other property where Prism has proprietary interest or would otherwise permit Prism to impart to Smart its special knowledge and experience which remain unrevealed to the public.

As previously discussed, such business profits will be taxable in the Philippines if it is attributable to a permanent establishment in the Philippines. This Court agrees with the findings of the Court in Division that Smart was able to show that Prism has no permanent establishment in the Philippines based on the Completion of Work Certificate No. SM0101[13] relating to the SIM Applications Agreement, which shows that the consultants and employees of Prism stayed in the Philippines from June 1, 2001 to July 27, 2001 or for a period of less than six (6) months from the time of the commencement of the engagement until the SIM Applications Agreement was completed. Consequently, payments under the SIM Applications Agreement are also not taxable in the Philippines.

Payments under the SDM Agreement are royalties under the Treaty

Paragraph 1 of the Programming Services — Schedule A of the SDM Agreement provides:[14]

> **"1. SERVICE DOWNLOAD MANAGER**
>
> The Service Download Manager ("SDM") provides the functionality to manage WIB applications on the SIM. It allows application to be downloaded to the SIM in a queue fashion and integrates with Smart Trust's DP5 platform in this regard. It also performs the required cryptographic operations on the download instructions prior to sending the message to the SIM. ***The SDM is the intellectual property of PRISM.***
>
> **1.1 SDM Functions**
>
> The functions that the SDM perform include:
>
> - Updating a database of the available applications that can be downloaded to a SIM
> - Updating a database of the current status of the SIM with respect to installed applications, available space for applications etc.

[13] Exhibit "P", page 278, CTA Records, CTA Case No. 6782.
[14] Exhibit "I", page 234, Ibid.

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- Providing a SIM update service for non-application updates to the SIM eg. List updates
- Formatting the Prism SIM specific application update WML to byte code
- Logging all SIM updates performed either successful or unsuccessful
- Queuing all requested SIM updates and ensuring that all SIM update requests are attempted within a specific period of time

1.2 Deliverables

The deliverables to the Client, which shall also be subject to Acceptance Testing as set out in Clause (3), shall comprise the following:

- Successful User Acceptance Testing ("UAT") of all abovementioned functions
- Delivery of SDM API specifications
- Delivery of SDM runtimes with installation documentation

1.3 Intellectual Property Rights (IPR)

The SDM shall be installed by PRISM, including the SDM Libraries, the IPR of which shall be retained by PRISM. PRISM, however, shall provide the Client the APIs for the SDM at no cost to the Client. The Client shall be permitted to develop programs to interface with the SDM or the SDM Libraries, using the related APIs as appropriate." *(Emphasis and italics supplied)*

Relative to the foregoing, the Court in Division ruled as follows:

"Under the above provision of the Programming Services, it is clear that the SDM is the intellectual property of PRISM. It further provides that the SDM shall be installed by PRISM, including the SDM Libraries, the intellectual property right of which shall be retained by PRISM.

Petitioner availed an already existing program "SDM" from PRISM, contrary to its statement that PRISM is to undertake to perform service which will result in the creation, development or bringing into existence of a product, like SDM. Thus, payments to PRISM for the installation of the SDM are clearly royalties and are therefore taxable."

This Court affirms the aforementioned ruling of the Court in Division. It bears stressing that the cited provisions of the SDM Agreement evidently reveal that Prism has a proprietary interest or right to the SDM as it retains the intellectual property rights thereto. For this reason, the payments by Smart to Prism are royalties, since the SDM Agreement required the transfer into the Philippines of technology, equipment or other property where Prism has proprietary interest and permitted

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Prism to impart to Smart its special knowledge and experience which remain unrevealed to the public.

Smart cited the following criteria recommended by the OECD Commentaries in distinguishing between payments for services which constitute business profits and payments for know-how which constitute royalties:

> "29. The Group recognizes that the distinction between payments for services rendered and payments for the supply of know-how may sometimes raise practical difficulties. It considers that the following criteria, developed in a ruling by the Australian Tax Office, may be useful in that respect.
>
> - **under a contract for the supply of know-how:**
>
>   (a) a "product" (i.e. knowledge, information, technique, formula, skills, process, plan, etc.) which has already been created or developed or is already in existence is transferred;
>
>   (b) the product which is the subject of the contract is transferred for use by the buyer (i.e. it is supplied); and
>
>   (c) except in the case of a disposition where the seller divests himself completely of any further interest in the product, the property in the product remains with the seller. All that is obtained by the buyer is the right to use the product. Subject to the terms of the contract, the seller retains the right to use the product himself and to transfer it to others."
>
> - **by contrast, in a contract involving the performance of services:**
>
>   (d) the contractor undertakes to perform services which will result in the creation, development, or the bringing into existence of a product (which may or may not be know-how);
>
>   (e) in the course of developing a product, the contractor would apply existing knowledge, skill and expertise – there is not a transfer (i.e. supply) of know-how from the contractor to the buyer as such but a use by the contractor of his knowledge for his own purposes; and
>
>   (f) the product created as a result of the services belongs to the buyer for him to use without having to obtain any further rights in respect of the product. Xxx" *(Emphasis supplied)*

Applying the foregoing criteria, this Court finds that payments made by Smart pursuant to the SDM Agreement are indeed royalties:

> (a) a "product" i.e. the SDM which has already been created, developed and is already in existence is transferred by Prism to Smart;

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(b) the SDM which is the subject of the contract is transferred for use by Smart (i.e. it is supplied); and

(c) the property in the SDM remains with the Prism. All that is obtained by Smart is the right to use the product.

Smart also relied on the provisions of RMC No. 44-2005 in arguing that assuming that payment for SDM is considered as royalties, a portion of such payment for the customization of such SDM is payment for provision of services rendered. Hence, such portion should be treated as income from services and taxable as such.

RMC No. 44-2005[15] (Taxation of Payments of Software) dated September 1, 2005 took effect on September 8, 2005[16] and its effectivity clause provides that it shall cover software payments paid or payable starting said effectivity date. It is apparent therefore, that RMC No. 44-2005 cannot be applied to the payment under the SDM Agreement as based on the records, the same is dated May 25, 2001 and the fee pursuant thereto was paid in August 2001.

In fine, this Court finds no compelling reason to reverse the assailed Decision promulgated on February 23, 2006 and the Resolution dated July 18, 2006.

WHEREFORE, the instant petition is hereby **DISMISSED.** Accordingly, the assailed Decision and Resolution are hereby **AFFIRMED**.

SO ORDERED.

LOVELL R. BAUTISTA
Associate Justice

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[15]This RMC substantially amended RMC No. 77-2003 (Classification of Payments for Software for Income Tax Purposes) which mandated the observance of its provisions regarding the taxation of software payments made on November 18, 2003 up to September 7, 2005.
[16] DA ITAD BIR Ruling No. 17-07 dated February 9, 2007.

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WE CONCUR:

ERNESTO D. ACOSTA
Presiding Justice

JUANITO C. CASTAÑEDA, JR.
Associate Justice

ERLINDA P. UY
Associate Justice

CAESAR A. CASANOVA
Associate Justice

OLGA PALANCA-ENRIQUEZ
Associate Justice

CERTIFICATION

Pursuant to Section 13, Article VIII of the Constitution, it is hereby certified that the above Decision has been reached in consultation with the members of the Court *En Banc* before the case was assigned to the writer of the opinion of this Court.

ERNESTO D. ACOSTA
Presiding Justice

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