Commissioner of Internal Revenue vs. Smart Communications, Inc.
G.R. No. 179045-46; 25 August 2010

Facts:

Respondent Smart Communications, Inc. (Smart) is a corporation organized under Philippine law. It is an enterprise duly registered with the Board of Investments. Smart entered into three Agreements for Programming and Consultancy Services with Prism Transactive (Prism), a non-resident corporation duly organized under the laws of Malaysia. Under the agreements, Prism was to provide programming and consultancy services for the installation of the Service Download Manager (SDM) and the Channel Manager (CM), and for the installation and implementation of Smart Money and Mobile Banking Service SIM Applications (SIM Applications) and Private Text Platform (SIM Application).

Prism billed Smart in the amount of US$547k (for SDM Agreement, CM Agreement, SIM Application Agreement). Thinking that these payments constitute royalties, Smart withheld the amount of US$136k representing the 25% royalty tax under the RP-Malaysia Tax Treaty. Smart then filed its Monthly Remittance Return of Final Income Taxes Withheld for the month of August 2001. Thereafter, within the two-year period to claim a refund, Smart filed with the BIR an administrative claim for refund of the amount of ₱7M (US$136k).

Due to the failure of the petitioner CIR to act on the claim for refund, Smart filed a Petition for Review with the CTA. Smart claimed that it is entitled to a refund because the payments made to Prism are not royalties but "business profits," pursuant to the definition of royalties under the RP-Malaysia Tax Treaty, which were not taxable because Prism did not have a permanent establishment in the Philippines. Petitioner argued that respondent, as withholding agent, is not a party-in-interest to file the claim for refund, and that assuming for the sake of argument that it is the proper party, there is no showing that the payments made to Prism constitute "business profits."

CTA upheld respondent's right, as a withholding agent, to file the claim for refund. Upon review, CTA *En Banc* rendered a Decision affirming the partial refund granted to respondent. CTA En Banc said that although respondent and Prism are unrelated entities, such circumstance does not affect the status of [respondent] as a party-in-interest [as its legal interest] is based on its direct and independent liability under the withholding tax system and that payments made to Prism, specifically that the payments for the CM and SIM Application Agreements constitute "business profits," while the payment for the SDM Agreement is a royalty.

Issues:

(1) whether or not respondent has the right to file the claim for refund; and
(2) if respondent has the right, whether or not the payments made to Prism constitute "business profits" or royalties.

Held:

(1) Smart, as withholding agent, may file the claim for refund. The person entitled to claim a tax refund is the taxpayer [Sections 204(c) and 229 of the National Internal Revenue Code (NIRC)]. However, in case the taxpayer does not file a claim for refund, the withholding agent may file the claim.
Thus, in Commissioner of Internal Revenue v. Procter & Gamble Philippine Manufacturing Corporation: "a withholding agent was considered a proper party to file a claim for refund of the withheld taxes of its foreign parent company."

The CIR was incorrect in saying that this ruling applies only when the withholding agent and the taxpayer are related parties, i.e., where the withholding agent is a wholly owned subsidiary of the taxpayer.

Although such relation between the taxpayer and the withholding agent is a factor that increases the latter's legal interest to file a claim for refund, there is nothing in the decision in said case to suggest that such relationship is required or that the lack of such relation deprives the withholding agent of the right to file a claim for refund. Rather, what is clear in the decision is that a withholding agent has a legal right to file a claim for refund for two reasons.
First, he is considered a "taxpayer" under the NIRC as he is personally liable for the withholding tax as well as for deficiency assessments, surcharges, and penalties, should the amount of the tax withheld be finally found to be less than the amount that should have been withheld under law.
Second, as an agent of the taxpayer, his authority to file the necessary income tax return and to remit the tax withheld to the government impliedly includes the authority to file a claim for refund and to bring an action for recovery of such claim.

Silkair (Singapore) Pte, Ltd. vs. Commissioner of Internal Revenue (supra), cited by the CIR, was inapplicable as itinvolved excise taxes, not withholding taxes. In that case, it was ruled that the proper party to question, or seek a refund of, an indirect tax "is the statutory taxpayer, the person on whom the tax is imposed by law and who paid the same even if he shifts the burden thereof to another."
As an agent of the taxpayer, it is the duty of the withholding agent to return to the principal taxpayer what he has recovered. Otherwise, he would be unjustly enriching himself at the expense of the principal taxpayer from whom the taxes were withheld, and from whom he derives his legal right to file a claim for refund.

(2) The payments for the CM and SIM Application Agreements constituted "business profits" which were not taxable under the RP-Malaysia Tax Treaty. However, the payment for the SDM Agreement constituted taxable "royalty" under the same treaty.
The RP-Malaysia Tax Treaty defines "royalties" as 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." They are taxed at 25% of the gross amount.

Under the same Treaty, the "business profits" of an enterprise of a Contracting State is taxable only in that State, unless the enterprise carries on business in the other Contracting State through a permanent establishment. The term "permanent establishment" is defined as a fixed place of business where the enterprise is wholly or partly carried on. However, even if there is no fixed place of business, an enterprise of a Contracting State is deemed to have a permanent establishment in the other Contracting State if 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. In this case, it was established during the trial that Prism did not have a permanent establishment in the Philippines. Hence, "business profits" derived from Prism's dealings with Smart were not taxable.

Under its agreements with Smart, Prism had intellectual property right over the SDM program, but not over the CM and SIM Application programs as the proprietary rights of these programs belonged to Smart. Thus, out of the payments made to Prism, only the payment for the SDM program was a royalty subject to a 25% withholding tax; the payments for the CM and SIM Application programs constituted Prism's non-taxable "business profits." The BIR should, therefore, refund the erroneously withheld royalty taxes for the payments pertaining to the CM and SIM Application Agreements.