

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

Facts: Smart Communications, Inc. (Smart) entered into 3 agreements with Prism Transactive (M) Sdn. Bhd. (Prism), a non-resident Malaysian corporation, under which Prism would provide programming and consultancy services for the installation of the Service Download Manager (SDM Agreement) and the Channel Manager (CM Agreement), and for the installation and implementation of Smart Money and Mobile Banking Service SIM Applications and Private Text Platform (SIM Application Agreement). Prism billed Smart US\$547,822.45. Thinking that the amount constituted royalties, Smart withheld from its payments to Prism the amount of US\$136,955.61 or ₱7,008,840.43, representing the 25% royalty tax under the RP-Malaysia Tax Treaty.

Within the 2-year period to claim a refund, Smart filed an administrative claim with the Bureau of Internal Revenue (BIR) for the refund of the withheld amount (₱7,008,840.43). When the Commissioner of Internal Revenue (CIR) failed to act on its claim, Smart filed a Petition for Review with the Court of Tax Appeals (CTA). Smart averred that its payments to Prism were not royalties but “business profits,” as defined in the RP-Malaysian Tax Treaty, which were not taxable because Prism did not have a permanent establishment in the Philippines. The CIR countered that Smart, as a withholding agent was not a party-in-interest to file the claim for refund, and even if it were the proper party, there was no showing that the payments to Prism constituted “business profits.”

The CTA’s Second Division sustained Smart’s right to file the claim for refund, citing the cases of *Commissioner of Internal Revenue vs. Wander Philippines, Inc.* [243 Phil. 717 (1988)], *Commissioner of Internal Revenue vs. Procter & Gamble Philippine Manufacturing Corporation* (G.R. No. 66838, 2 December 1991, 204 SCRA 377) and *Commissioner of Internal Revenue vs. The Court of Tax Appeals* [G.R. No. 93901, 11 February 1992 (*Minute Resolution*)]. However, it granted only the refund of the withholding tax on Smart’s payment for the SDM Agreement (₱3,989,456.43) because only the payment for the SDM Agreement constituted “royalty” which was subject to withholding tax. The court considered the payments for the CM and SIM Application agreements as “business profits” which were not subject to tax under the RP-Malaysia Tax Treaty.

On appeal, the CTA *En Banc* affirmed its Second Division’s ruling. The CIR, thus, brought the case to the Supreme Court for review, arguing that the cases cited by the CTA in upholding Smart’s right to claim the refund, were inapplicable because the withholding agents therein were wholly owned subsidiaries of the taxpayers, unlike in this case where the withholding agent was unrelated to the taxpayer. The CIR maintained that the proper party to file the refund was the taxpayer, Prism, citing the case of *Silkair (Singapore) Pte, Ltd. vs. Commissioner of Internal Revenue* (G.R. No. 173594, 6 February 2008, 544 SCRA 100). The CIR further argued that assuming Smart was the proper party to file the claim, it was still not entitled to any refund because its payments to Prism were taxable as royalties, having been made in consideration for the use of the programs owned by Prism.

Issues: (1) Whether or not Smart had the right to file the claim for refund; and (2) whether Smart’s payments to Prism constituted “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* (G.R. No. 66838, December 2, 1991, 204 SCRA 377), 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 it involved 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.

The BIR was ordered to issue a Tax Credit Certificate to Prism in the amount of ₱3,989,456.43.