February 13, 2024

Hon. Romeo D. Lumagui, Jr.
Commissioner of Internal Revenue
Bureau of Internal Revenue
National Office
Agham Road, Diliman
Quezon City, Metro Manila

Subject: Position Paper on Revenue Memorandum Circular No. 5-2024

Dear Commissioner Lumagui:

We, the undersigned **MEMBERS OF THE BIR-PARTNERSHIP WITH MULTI-SECTORAL GROUP (PMSG) – PRIVATE SECTOR COMMITTEE**, respectfully submit our position paper on Revenue Memorandum Circular (RMC) No. 5-2024[1] dated January 10, 2024.

We understand that RMC No. 5-2024 was issued with the purpose of clarifying the proper tax treatment of cross-border services in light of the ruling of the Supreme Court in Aces Philippines Cellular Satellite Corp. v. Commissioner of Internal Revenue (hereinafter referred to as "Aces").[2] While we find the intention of providing a framework for assessing final withholding taxes (FWT) and final withholding Value-Added Tax (VAT) through informed determinations based on established legal principles useful and laudable, we likewise find that the RMC causes confusion and uncertainty on the taxability of income payments to non-resident foreign corporation (NRFCs) for cross-border services rendered to residents.

BACKGROUND

Confronted with the issue of whether the satellite air time fee payments by Aces Philippines, a domestic corporation, to Aces Bermuda, an NRFC, is subject to FWT, the Supreme Court applied a two-tiered test in Aces, to wit:

1. First, identifying the source of the income; and
2. Second, identifying the situs of that source.

The Supreme Court identified the gateway's receipt of the call as the source of the income as it coincides with: (1) the completion or delivery of the service; and (2) the inflow of economic benefits in favor of Aces Bermuda. The income-generating activity takes place not during the act of transmission but only upon the gateway's receipt of the call as routed by the satellite.

The Supreme Court ruled that the gateway's receipt of the routed call marks the completion or delivery of the service. Echoing the observation of the Court of Tax Appeals (CTA) En Banc, the Supreme Court stated that:

[1] Further Clarifying the Proper Tax Treatment of Cross-Border Services in the Light of the Supreme Court En Banc Decision in Aces Philippines Cellular Satellite Corp. v. Commissioner of Internal Revenue, G.R. No. 226680, dated August 30, 2022.
[2] G.R. No. 226680, August 30, 2022.

> x x x "there is a continuous and very real connection" within the components of the Aces System. While the satellite appears to be the focal point of the system, the Court cannot ignore that there is a two-/three-way inter-connection or inter-dependence between/among the satellite in outer space, the control center in Indonesia, and the terminals and gateways in the Philippines.

The Supreme Court noted that the fulfillment of Aces Bermuda's undertaking requires the satellite to have transmitted/routed the call (first segment) and a gateway to have received the call as routed by the satellite (second segment). Thus, it is only when the call is actually routed to its gateway that Aces Philippines is able to connect its local subscriber to the intended recipient of the call. In this sense, the gateway's receipt of the call signifies the completion/delivery of Aces Bermuda's service.

The Court likewise identified the following factors that established the Philippine situs of Aces Bermuda's income from satellite air time fee payments:

1. The income-generating activity is directly associated with the gateways located within the Philippine territory; and
2. Engaging in the business of providing satellite communication services in the Philippines is a government-regulated industry.

The Supreme Court ruled that the performance of Aces Bermuda's service does not cease at the point of transmission but continues until such time it delivers the satellite communication time (*i.e.,* routes the call) to the Philippine gateway. The Supreme Court went on to discuss that while Aces Philippines is the legal owner/operator of the Philippine gateways, it cannot be denied that these gateways were constructed primarily to serve the needs and requirements of the Aces System.

It was clear in the Supreme Court's disquisition that: (a) Aces Bermuda's income attaches to property operated and maintained in the Philippines; and (b) making Aces Bermuda's services available to Philippine subscribers, albeit through its local service provider, is an endeavor that requires the intervention of the Philippine government. The conclusion that the rendition of services requires the intervention of the Philippine government hinges on the fact that only telecommunications entities endowed with a state-granted franchise may operate within the Philippine territory. As such, a foreign satellite service provider who seeks to provide telecommunications services to Philippine subscribers or otherwise participate in the Philippine telecommunications industry necessarily invokes Philippine sovereignty and government intervention/protection. For the foregoing reasons, the Supreme Court concluded that it is only fair that the income be subjected to Philippine taxation.

The Supreme Court's decision has become final and should therefore apply to cases with similar factual milieu. However, we beg to differ on the Bureau's interpretation of Aces and its expanded application as provided in RMC No. 5-2024. We take the position that RMC No. 5-2024 has gone beyond the factual and legal bounds of Aces. We invite the Commissioner of Internal Revenue to take a second look at RMC No. 5-2024 and reconsider the implementation thereof based on the following grounds:

1. RMC No. 5-2024 unduly expanded the application of Aces;
2. The principles laid down in RMC No. 5-2024 run counter to the rules on the situs of the source of income under Section 42, Tax Code.[3]

[3] National Internal Revenue Code, as amended.

3. Exemption under tax treaties should be respected;
4. If RMC No. 5-2024 is applied, there will be no situation where an NRFC will not be subject to income tax in the Philippines;
5. Payment for services rendered outside the Philippines is not subject to VAT; and
6. Implementing RMC No. 5-2024 will result in increased cost of doing business in the Philippines.

We discuss each of these grounds below.

DISCUSSION

A. RMC No. 5-2024 unduly expanded the application of Aces.

One of the basic tenets of the Philippine legal system is that judicial decisions applying or interpreting the laws shall form a part of the legal system of the Philippines.[4] Once the Supreme Court has already settled the legal controversy in a case, the *ratio decidendi*, or "the reason" or "the rationale for the decision" may be applied in other cases which have identical or similar facts. However, such application should not result in the undue magnification of the scope of the case. Doing so will encroach upon the prerogatives of the judiciary. In case of discrepancy between the basic law and a rule or regulation issued to implement or interpret the law, the basic law prevails as said rule or regulation cannot go beyond the terms and provisions of the basic law.[5] Needless to state, a regulation that runs counter to the law and the construction given to it by the courts is invalid.[6]

In light of the foregoing, it is respectfully submitted that RMC No. 5-2024 went over and beyond the interpretation of the Supreme Court of the two contracts between Aces Philippines and Aces Bermuda in Aces when it applied the Court's interpretation to cross-border services.

RMC No. 5-2024 properly cited the Supreme Court's ruling in Aces that in ascertaining the income source, one must inquire into the property, activity, or service that produced the income, or where the inflow of wealth originated. This is consistent with the ruling of the Supreme Court in Commissioner of Internal Revenue v. British Overseas Airways Corporation which ruled that the source of an income is the property, activity, or service that produced the income. For the source of income to be considered as coming from the Philippines, it is sufficient that the income is derived from activity within the Philippines.[7]

The RMC was also correct to restate that it is insufficient to identify just any property, activity, or service and that the subject may only be regarded as an income source if the particular property, activity, or service causes an increase in economic benefits, which may be in the form of an inflow or enhancement of assets or a decrease in liabilities with a corresponding increase in equity other than that attributable to

[4] Article 8, Civil Code of the Philippines.
[5] Hijo Plantation, Inc. v. Central Bank, No. L-34526, August 9, 1988; see also Commissioner of Internal Revenue v. San Miguel Corp., G.R. Nos. 180740 & 180910, November 11, 2019.
[6] Commissioner of Internal Revenue v. vda. de Prieto, G.R. No. L-13912, September 30, 1960 citing Lynch v. Tilden Produce Co., 265 U.S. 315; Miller v. U.S., 294 U.S. 435; see also Commissioner of Internal Revenue v. Central Luzon Drug Corp., G.R. No. 159647, April 15, 2005.
[7] G.R. No. 65773-74, April 30, 1987, citing Howden & Co., Ltd. V. Collector of Internal Revenue, G.R. No. L-19392, April 14, 1965.

a capital contribution. However, the factual milieu in Aces is peculiar in the determination of the source and situs of the income and to justify the imposition of FWT. Among the crucial factual findings of the Supreme Court are the following:

1. Aces Bermuda's income attaches to property operated and maintained in the Philippines;
2. Making Aces Bermuda's services available to Philippine subscribers is an endeavor that requires the intervention of the Philippine government;
3. That income generation is dependent on the operations of facilities situated in the Philippines.
4. While the gateways are legally owned by Aces Philippines, Aces Bermuda has sufficient economic/beneficial interest in these Philippine properties; and
5. Only telecommunications entities endowed with a state-granted franchise may operate within the territory.

The foregoing factual segments, taken together, guided the Supreme Court's conclusion that "there is a continuous and very real connection" within the components of the Aces System such that the situs of the income-producing activity is concluded to be within the Philippines. Unfortunately, the foregoing crucial factual bases may not be present in the rendition of other types of cross-border services such as consulting services, IT outsourcing, financial services, telecommunications, engineering and construction, education and training, tourism and hospitality, and other similar services. Other cross-border services can actually be rendered or performed remotely, and are not dependent on facilities located in the Philippines. Other cross-border services also do not require government regulation.

It is submitted that the standard provided in Aces which led the Supreme Court to consider the income-generating activity in satellite communication is in the Philippines cannot be applied automatically to international service provision (or cross-border services).

For instance, in Aces, the satellite transmission services are considered Philippine-sourced income because (1) the income-generating activity is directly associated with gateways located within the Philippine territory, and (2) the provision of satellite communication services in the Philippines is a government-regulated industry. These factors are not necessarily present in other cross-border services. Other cross-border services (e.g., consulting services) can actually be rendered or performed remotely, and not dependent on facilities located in the Philippines. Other cross-border services do not also require government regulation.

Further, unlike in Aces where income can only be accrued when the airtime is successfully delivered and utilized by Philippine subscribers, other cross-border services are not dependent on the successful utilization by the Philippine purchaser of the service for income to be accrued.

It will also be noted that Aces did not involve the income tax treatment of reimbursable and allocated expenses as income of the NRFC as this issue was not resolved by the Supreme Court.

What is apparent in RMC No. 5-2024 is that the interpretation did not account for several crucial factual elements in *Aces* which qualified the income-generating activity as one complete and integral process. For this reason, the ruling of the Supreme Court in Aces should be confined to cases with similar factual scenarios and should not be indiscriminately applied to other types of cross-border services and industries as done in RMC No. 5-2024.

The truth of the matter is that the Supreme Court painstakingly dissected each stage of the business model

and the process of transmission of the satellite signal in Aces before it arrived at a conclusion on the taxability of the satellite air time fees. It, therefore, becomes too simplistic for the Bureau to indiscriminately apply the Aces ruling to the broad categories of cross-border services enumerated in RMC No. 5-2024 without consideration of the facts and circumstances under which such services were provided.

B. The principles laid down in RMC No. 5-2024 run counter to the rules on the situs of the source of income under Section 42, Tax Code.

Not only did RMC No. 5-2024 erroneously expand the application and interpretation of the decision of the Supreme Court in Aces, it likewise contradicted the provisions of the Tax Code on the situs of the source of income.

Section 42, Tax Codes provides the immutable rules in determining the situs of the income-generating activity. In the case of services, Section 42(A)(3), Tax Code provides that compensation for labor or personal services performed in the Philippines shall be treated as gross income from sources within the Philippines. On the other hand, under Section 42(C)(3), Tax Code, compensation for labor or personal services performed without the Philippines shall be treated as income from sources without the Philippines.

However, under RMC No. 5-2024, even if the services of the NRFC are performed abroad, these income payments for these services can still be considered derived from sources within the Philippines if the activities to be performed in the Philippines are so essential that the entire service transaction cannot be accomplished without them, to wit:

> Even if the services are conducted or paid abroad, but there are activities to be performed in the Philippines so essential that the entire service transaction cannot be accomplished without them, then, the benefit-received theory applies. This means that the revenue-generating activity actually occurs within the Philippines. The income generated by the foreign company providing the services, which are considered sources within the Philippines, shall be subject to income tax and, consequently to final withholding tax.[8]

Under the Tax Code, an NRFC is only taxable on income from sources within the Philippines. However, applying RMC No. 5-2024, where a service-based company operates in various countries, providing services to clients, and their income earned is allocated to the countries where the services are performed, the source of income thereon may still be considered to be derived within the Philippines for so long as the services performed in the Philippines are deemed essential.

This rule, which is a modification of the situs rule, finds no support in Aces as well as in both domestic and international law. RMC No. 5-2024 arbitrarily identified major industries with cross-border operationalities, thus essentially eliminating the distinction between resident foreign corporations and NRFCs with regard to the taxability of their source of income.

Further, the RMC misapplied the benefits-received theory in taxation. The RMC states that:

[8] A7, RMC No. 5-2024.

> If the income-generating activities in the Philippines are deemed essential, the income derived from these activities would be considered as sourced from the Philippines for tax purposes, irrespective of where the payment is ultimately received. This principle aligns with the **benefits-received theory** in taxation, which submits that the jurisdiction providing the essential service or factors for income generation should be entitled to tax that income.
>
> The payment or income generated from service fees paid to the foreign company, including those made through the internet or other electronic means with the use of IT, is considered an inflow of economic benefits in favor of the foreign company.[9]

The benefits-received theory in taxation, initially developed by two Swedish economists, Knut Wicksell (1851-1926) and Erik Lindahl (1891-1960) is based on the premise that the government may levy taxes on the people who benefit from government spending.[10] Stated differently, there must be some government service or benefit provided to a taxpayer in order to justify taxation under the benefits-received theory. In Aces, the Supreme Court concluded that the Philippines conferred some benefit to Aces Bermuda because Philippine government intervention/protection was necessary for Aces Bermuda to provide telecommunications services to Philippine subscribers, hence, it is only fair that Aces Bermuda's revenues be subject to tax in the Philippines.

However, the RMC misconstrued the benefits-received theory as applied by the Supreme Court in Aces. Instead of the rule that taxes may be imposed by a government on a taxpayer who enjoyed benefits or services *provided by that government*, the RMC formulated a new rule and misapplied the benefits-received theory of taxation. Under the RMC, if essential services or factors of income generation occur in the Philippines, i.e., the entire service transaction cannot be accomplished without them, then the benefits-received theory of taxation purportedly applies and the income of the NRFC is subject to income tax, and final withholding tax, in the Philippines. The RMC does not indicate the presence of any service or benefit granted or provided by the Philippine government to the NRFCs performing the services abroad which will justify the imposition of taxes under the benefits-received principle. Hence, it is incorrect to rely on the benefits-received theory of taxation as the basis for the RMC's new sourcing rule to impose taxes on these NRFCs. The RMC also provides that the payment of service fees to the NRFCs through the Internet or other electronic means is an inflow of economic benefits, which may imply that payment from Philippine sources will be subject to Philippine tax. This contradicts A3 in the RMC which states that the source of income is not necessarily determined by the location where the payment is disbursed.

C. Exemption under tax treaties should be respected.

Under the Business Profits article of Philippine tax treaties, profits of an enterprise of one of the Contracting States shall be taxable only in that State unless the enterprise carries on business in the Other Contracting State through a permanent establishment (PE) 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 as is attributable to the PE.

The Philippines adopts the generally accepted principles of international law as part of the law of the

[9] A3, RMC No. 5-2024.
[10] https://www.sciencedirect.com/topics/economics-econometrics-and-finance/benefit-principle

land.[11] The time-honored international principle of *pacta sunt servanda* demands the performance in good faith of treaty obligations on the part of the states that enter into the agreement. Every treaty in force is binding upon the parties, and obligations under the treaty must be performed by them in good faith.[12]

Aces involved satellite airtime fees received by a tax resident of Bermuda which does not have an existing tax treaty with the Philippines. However, there are a number of bilateral treaties that the Philippines has entered into with other Contracting States to which it is expected to observe compliance in good faith.[13] The purpose of these international agreements is to reconcile the national fiscal legislations of the contracting parties in order to help the taxpayer avoid simultaneous taxation in two different jurisdictions.[14] The tax conventions are drafted with a view towards the elimination of international juridical double taxation, which is defined as the imposition of comparable taxes in two or more states on the same taxpayer in respect of the same subject matter and for identical periods.[15] For this reason, the application of the provisions of the Tax Code must be subject to the provisions of tax treaties entered into by the Philippines with foreign countries.[16]

Needless to state, noncompliance with tax treaties has negative implications on international relations, and unduly discourages the free flow of goods and services across borders. The Supreme Court has already ruled that laws and issuances must ensure that the reliefs granted under tax treaties are accorded to the parties entitled thereto.[17]

D. If the RMC is applied, there will be no situation where an NRFC will not be subject to income tax in the Philippines.

In RMC No. 5-2024, the Bureau equates the utilization/consumption of the NRFC's services as benefits to the local company/income-payer which needs to be taxed in the Philippines. If this is so, then all services rendered by NRFCs to domestic companies may be deemed to give rise to Philippine-sourced income. No company will avail itself of the services of the NRFC if there are no benefits that can be derived therefrom. Under the RMC, if there are no benefits derived, the local entity runs the risk of being found to have shifted profits to a foreign entity or attempted to evade taxes.[18]

E. Payment for services rendered outside the Philippines are not subject to VAT

Under Section 108(A), Tax Code, the 12% VAT is imposed on gross receipts derived from the sale or exchange of services in the Philippines. Even if it is argued that income has accrued in the Philippines, it

[11] Article II, Section 2, 1987 Constitution.
[12] Deutsche Bank AG v. Commissioner of Internal Revenue, G.R. No. 188550, August 19, 2013.
[13] Commissioner of Internal Revenue v. Interpublic Group of Companies, Inc., G.R. No. 207039, August 14, 2019.
[14] Commissioner of Internal Revenue v. S.C. Johnson and Son, Inc., G.R. No. 127105, June 25, 1999.
[15] *Id* citing the Committee on Fiscal Affairs of the Organization for Economic Co-operation and Development (OECD).
[16] Air Canada v. Commissioner of Internal Revenue, G.R. No. 169507, January 11, 2016.
[17] Deutsche Bank AG v. Commissioner of Internal Revenue, G.R. No. 188550, August 19, 2013.
[18] A5, RMC No. 5-2024.

does not follow that the same will be subject to VAT in the absence of services rendered in the Philippines.

It will be noted that Aces dealt only with FWT and not VAT. Thus, Aces cannot be used as basis for the position that the income payments to NRFCs for services rendered abroad but which were utilized or consumed in the Philippines is subject to VAT.

F. Implementing RMC No 5-2024 will result in Increased cost of doing business in the Philippines.

When a foreign entity deals with Philippine clients, it does so with the understanding that the tax costs of the transaction are manageable from a whole entity perspective and that the transaction will still generate a profit for the foreign entity. Once the tax costs do not justify doing business with Philippine clients, e.g., the tax rates are prohibitive, then foreign entities will more than likely look for other jurisdictions where the tax costs are lower. In this light, it is respectfully submitted that subjecting the income of NRFCs from services rendered abroad will lead to an increase in the tax cost of doing business, which, may drive away foreign entities from conducting business in the Philippines.

Furthermore, subjecting the income payments to NRFC to FWT will result in either of two scenarios: (1) the NRFC receives a lesser amount for services rendered due to the FWT without any certainty that the taxes withheld in the Philippines may be used as a tax credit in its home country; or (2) the local client who was constituted as the withholding agent may be constrained to gross up the income payments to the NRFC to keep the NRFC whole and will ultimately be left to shoulder the tax burden of the income tax on the NRFC. More often than not, the resultant scenario will be the second.

RELIEF SOUGHT

In the scheme of judicial tax administration, the need for certainty and predictability in the implementation of tax laws is crucial.[19] The administrative issuances are relied upon by taxpayers and government authorities alike. For this reason, the BIR, in issuing these regulations may not enlarge, alter, or restrict the provisions of the law it administers.[20] The issuance should not muddle up interpretations not contemplated by the legislature, or in this case, by the judiciary. To do so will invite unnecessary audit findings which would discourage the free flow of goods across the countries. Worse, the application of RMC No. 5-2024 to other services may run afoul with other jurisprudentially settled principles on taxation of offshore services or services rendered outside the taxing jurisdiction of the Philippines.[21]

A regulation that operates to create a rule out of harmony with the statute, is a mere nullity.[22] An

[19] Commissioner of Internal Revenue v. Central Luzon Drug Corp., G.R. No. 159647, April 15, 2005 citing Lim Hoa Ting v. Central Bank of the Philippines, G.R. No. L-10666, September 24, 1958.
[20] *Id*.
[21] See for instance, Commissioner of Internal Revenue v. Marubeni Corporation, G.R. No. 137377, December 18, 2001.
[22] *Commissioner of Internal Revenue v. Vda. de Prieto,* G.R. No. L-13912, September 30, 1960 citing *Lynch v. Tilden Produce Co.*, 265 U.S. 315; Miller v. U.S., 294 U.S. 435; *see also Commissioner of Internal Revenue v. Central Luzon Drug Corp.,* G.R. No. 159647, April 15, 2005.

administrative issuance must not override, supplant, or modify the law, but must remain consistent with the law they intend to carry out. Inasmuch as RMC No. 5-2024 unduly expands the application of Aces, on the basis of all of the foregoing, we respectfully request the Commissioner to revisit, review and reconsider the various provisions RMC No. 5-2024, considering its severe consequences and repercussions to foreign or local businesses. We also request that the immediate effectivity of the RMC be revoked and/or suspended in the meantime that it is being reconsidered in light of the foregoing discussion.

We trust that you will find our request meritorious.

Very truly yours,

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