REPUBLIC OF THE PHILIPPINES
DEPARTMENT OF FINANCE
BUREAU OF INTERNAL REVENUE

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15 March 2024

REVENUE MEMORANDUM CIRCULAR NO. 38-2024

Subject : Clarifying the Issues Raised on Revenue Memorandum Circular No. 5-2024

To : All Revenue Officers, Employees and Others Concerned

This Circular is being issued to address and clarify the issues raised on Revenue Memorandum Circular (RMC) No. 5-2024.[1]

Q1: Does the ruling in *Aces Philippines Cellular Satellite Corp. v. Commissioner of Internal Revenue,*[2] finding that the source of income of the Satellite Air Time Purchase Agreement between *Aces Bermuda* and *Aces Philippines* to be within the Philippines and, thus, subject to income tax, automatically apply to international service provision or cross-border services agreements listed in Question No. 2 of RMC No. 5-2024?

A1. No. Question No. 2 of RMC No. 5-2024 listed international service provision or cross-border services (*e.g.,* Consulting Services, IT Consulting, Financial Services, *etc.*) only to highlight that - like *Aces Philippines* - these services are likewise performed, rendered, delivered, or supplied by a non-resident foreign corporation (NRFC) to a domestic/resident entity in the Philippines. There is nothing therein expressly stating that the decision in *Aces Philippines*, finding the source of income of the service agreement to be within the Philippines and, thus, subject to final withholding tax, automatically applies to the listed international service provision or cross-border services.

The determination on whether the source of income of the listed cross-border services is within the Philippines is found in Question No. 3 of RMC No. 5-2024 using the long-standing rule that, *the source of income is in the Philippines if the property, activity or service that produces the income is in the Philippines. The flow of wealth proceeded from, and occurred within the Philippine territory, enjoying the protection accorded by the Philippine government.*

The determination of the source of income involves an examination of all the components of the cross-border service agreement involving two tax jurisdictions (*i.e.*, residence of the NRFC and the Philippines), taking into account the services to be performed in its entirety, and not singled out or compartmentalized one particular activity as the income producing activity. This approach is aligned with the Civil Code provision that, there is performance when "*the thing or service in which the obligation consists has*

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1 Further Clarifying the Proper Tax Treatment of Cross Border Services in 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. 226680 dated 30 August 2022

been completely delivered or rendered, as the case may be". [3] Crucial factors to such determination are on whether the cross-border services are dependent on the successful use, consumption or utilization by the Philippine purchaser of the service for income to be accrued; or on whether the performance of the service depends on the facilities located in the Philippines; or on whether the particular stages occurring in the Philippines are so integral to the over-all transaction that the business activity would not have been accomplished without it; among others.

Q2: Do the principles laid down in RMC No. 5-2024 run counter to the rules on the source of income under Section 42 of the National Internal Revenue Code of 1997, as amended (Tax Code)?

A2: No. Question No. 3 of RMC No. 5-2024 clearly spelled out the main guideline in determining the source of income for cross-border services identified in Question No. 2 (Consulting Services, IT Outsourcing, Financial Services, etc.), and, that is, "*the source of income is in the Philippines if the property, activity or service that produces the income is in the Philippines. The flow of wealth proceeded from, and occurred within the Philippine territory, enjoying the protection accorded by the Philippine government.*"

Notably, the traditional rule on recognizing income under Section 42(A)(3) and (C)(3) of the National Internal Revenue Code of 1997, as amended (Tax Code), for labor or personal service is where the labor or service is performed. But in *Aces Philippines*, the Supreme Court held that, "*[i]n ascertaining the income source, We must inquire into the property, activity, or service that* ***produced the income, or where the inflow of wealth originated.*** ***It is insufficient to identify just any property or activity, or service. 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 a capital contribution.*"

Ultimately, therefore, following the above-pronouncement, the situs of the source of income for labor or personal service is not just the location but, more importantly, the location of the service **that produces the income or where the inflow of wealth originates.**

Q3: What is the meaning of the following statements in Question No. 7 of RMC 5-2024?

> "*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 benefits 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.*"

A3: The premise of such statements is that the service agreement occurs in multiple stages across different taxing jurisdictions, *i.e.*, jurisdiction of the NRFC and the Philippines. In

[3] Civil Code, Article 1233

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such a situation, it is vitally important to examine all the components of the cross-border service agreement directly between the NRFC and the domestic/resident entity in the Philippines, looking at the services to be performed in its entirety, and not singled out or compartmentalized one particular activity as the income producing activity. Again, this approach is consistent with the Civil Code provision that, there is performance when "*the thing or service in which the obligation consists has been completely delivered or rendered*". As stated in Question No. 3 of RMC 5-2024, *"in such instances,* ***it becomes imperative to ascertain whether the particular stages occurring in the Philippines are so integral to the overall transaction that the business activity would not have accomplished without them****. 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 services or factors for income generation should be entitled to tax that income."*

In the end, what applies in the aforesaid scenario is still the well-established rule that, *"[i]n ascertaining the income source, we must inquire into the property, activity, or service that* ***produced the income, or where the inflow of wealth originated****"*, highlighting that, ***'it is insufficient to identify just any property or activity, or service. 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 a capital contribution."*

Q4: Essentially, what is the benefits-received theory as reiterated and applied by the Supreme Court in *Aces Philippines* for purposes of determining the *situs* or place of taxation?

A4: In *Aces Philippines,* the Supreme Court held that, *"...where the inflow of wealth and/or economic benefits proceeds from, and occurs within the Philippine territory, it enjoys protection of the Philippine government. In consideration of such protection, the flow of wealth should share the burden of supporting the government,*[4] *and thus, is subject to tax*. This is essentially the benefits-received theory.

Q5: Are the rules enunciated in RMC No. 5-2024 inconsistent with the provisions of tax treaties?

A5. No. As propounded above, RMC No. 5-2024 merely set forth the guidelines to establish the source of taxation for cross-border services listed in Question No. 2 (Consulting Service, IT Outsourcing, Financial Services, etc), which is, that *the source of taxation is the property, activity, or service that produces the income or where the inflow of wealth originates.*

Once the source of income is **established** to be within the Philippines using the aforesaid guidelines, then, the affected taxpayer can invoke the application of a particular tax treaty to assert that the income derived or sourced within the Philippines (*e.g.,* business profits, dividends, royalties or interests) is exempt from income tax for lack of permanent

[4] Alexander Howden & Co., Ltd. v. Collector of Internal Revenue, 121 Phil. 579 [1965]; Commissioner of Internal Revenue v. British Overseas Airways Corporation, 233 Phil. 406-438 [1987]

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establishment or subject to preferential rate, as the case may be. In short, the application of the benefits of the tax treaty, such as tax exemption of business profits for lack of permanent establishment, presupposes that the *situs* of the source of income is in the Philippines.

Currently, the Philippines has forty-four (44) existing tax treaties with other tax jurisdictions.[5]

The provisions, therefore, of RMC No. 5-2024 are not inconsistent with those of the tax treaties entered into by the Philippines.

Q6: If it is established that the source of income of cross-border services is within the Philippines applying the rule that the source of income is the location of the property, activity, or service that produces the income, will the subject transaction be also subject to VAT?

A6. Yes. Sections 105 and 108 of the Tax Code provide that services rendered or performed in the Philippines by non-resident foreign persons are subject to VAT.

Section 108 also subject non-resident foreign persons from VAT if their services involve, among others:

(a) the lease or the use of or the privilege to use any copyright, patent, design or model, plan, secret formula or process, goodwill, trademark, trade brand or other like property or right;
(b) the lease or the use of, the right to use of any industrial, commercial or scientific equipment;
(c) the supply of scientific, technical, industrial or commercial knowledge or information;
(d) the supply of technical advice, assistance or services rendered in connection with technical management or administration of any scientific, industrial or commercial undertaking, venture, project or scheme; among others.

Pursuant to Section 114(C) of the Tax Code, and as implemented by Section 4.114-2 of Revenue Regulations (RR) No. 16-2005, as amended, the mode of VAT collection on payment for lease or use of property rights owned, and other services rendered in the Philippines, by non-resident foreign persons is thru withholding.

Q7: Why is Question No. 4 on reimbursable or allocable expenses for cross-border services between or among related parties also included in RMC No. 5-2024?

A7: RMC No. 5-2024 further clarifies the proper tax treatment of cross-border services in light of the *Aces Philippines* decision. Cross-border services usually involve related parties, common of which are intra-group services, like management, financial and administrative services; technical and support services; purchasing, marketing and distribution services; and other commercial services provided in connection with the nature of the group's business. As these are intra-group services, issues, such as on whether their pricing of such services is arm's length, may arise. As such, it is deemed

[5] Latest tax treaty entered into by the Philippines is with Bahrain.

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necessary to also lay down the basic rules on reimbursable or allocable expenses for services between or among related parties to have a wholistic approach insofar as the determination of the proper tax treatment of cross-border services is concerned.

Like any other cross-border service agreement, the source of income is not determined by where income is disbursed or physically received but rather where the business activity that produced such income is actually conducted. [6] The determination of the source of income for the charges made by the parent entity or affiliates to a related local company for the services made by the former to the latter is still the time-honored rule, as reiterated by the Supreme Court in *Aces Philippines*, that, "*in ascertaining the income source, we must inquire into the property, activity, or service that produced the income, or where the inflow of wealth originated,*" putting emphasis 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 a capital contribution.*"

Q8: Is the 25% final withholding on gross income received by non-resident foreign person from all sources within the Philippines, including the 12% final withholding VAT on payment for lease or use of properties rights owned, and other services rendered in the Philippines, by non-resident foreign person, a new imposition?

A8: No. The 25% final withholding on gross income received by non-resident foreign person from all **sources** within the Philippines is clearly provided for in Sections 25(B) and 28(B) of the Tax Code. On the other hand, the 12% final withholding VAT on payment for lease or use of property rights owned, and other services rendered in the Philippines, by non-resident foreign person is pursuant to Sections 105, 108 and 114(C) of the Tax Code, and as implemented by Section 4.114-2 of RR No. 16-2005, as amended.

All internal revenue officers, employees and others concerned are hereby enjoined to give this Circular the widest dissemination and publicity as possible.

This Circular shall take effect immediately.

ROMEO D. LUMAGUI, JR.
Commissioner of Internal Revenue

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[6] CIR v. Baier-Nickel, 531 Phil. 480 (2006)c