Working Draft:  
Double Taxation Avoidance Agreements (DTAAs), the case of the Philippines

DTAs, an Overview

DTAs are bilateral tax conventions or treaties that are negotiated and entered into by countries to prevent and mitigate the situation of double taxation, defined as an “imposition of comparable taxes in two (or more) States on the same taxpayer in respect of the same subject matter and for identical periods” (OECD). In terms of corporate taxpayers, double taxation occurs when a corporation is taxed in the source country or the site of the investment and production, as well as in the country where it registered its main base of operations.

Already existing since the 19th century, tax treaties were at first only negotiated among North countries which were generally at the same level of economic development and were source and/or resident country at one time or another. Between developed and developing countries, they began to be negotiated from the 60s onwards, and increased markedly when FDI inflows to developing countries began to rise sometime in the early 2000s (UNCTAD) (Neumayer). The rise in DTAs has stemmed largely from the developing or the source countries.

There are no set general rules in international law addressing investments and tax nor is there a comprehensive framework (in the same way as trade through the World Trade Organization) on how TNCs should be taxed. What is in place, are “arrangements that define and divide the international corporate tax base… [which] have evolved over the last century or so with little explicit coordination (other than through bilateral treaties that touch only a subset of relevant matters)” (IMF)

To avoid the situation of double taxation which is seen as an obstacle to cross-border investments and trade, countries typically provide for credits and exemptions in their national tax codes. Vogel explains –

[T]he state of residence, to the extent it is not simultaneously the source state, allows a credit for the tax levied in the source state up to an amount equal to its own tax charge.
In other countries double taxation is avoided unilaterally through the allowance of exemptions: Switzerland exempts income from permanent establishments and real property located abroad; the Netherlands and Australia exempt foreign source income generally if the income is taxed in the source country. (Vogel 9)

Rixen and Schwarz raised the question why countries conclude DTAs when “double taxation can be prevented through unilateral double tax relief (Dagan, 2000; Whalley, 2001). Similarly, they noted the national tax laws in countries worldwide that prevent double taxation of international investments income “by deducting or crediting foreign taxes against taxes due in the residence country, or by exempting such income from taxation in the country of residence altogether” (Rixen and Schwarz)

However, it has been argued that these provisions are inadequate in avoiding or reducing double taxation because countries may deal differently with situations of double taxation according to varying tax rules. Tax treaties increasingly fill this gap with source and resident countries agreeing between them by how much the former is willing to where investments will be taxed and how much. But while still based on “source” and “residence”, these notions have become increasingly meaningless in the age
of the internet, more liberalized investment and finance controls, and the complex and opaque structures and operations of TNCs worldwide. The aggressive tax planning by TNCs, including the exploitation of tax treaties to shift profits where tax rates are nil or low would not have been possible before when trade and investments were more straightforward. An IMF Staff Report highlighted

... intra-firm transactions...and, more recently, of intangible assets of various kinds—patents, trademarks, other intellectual property (IP)—which can be much more easily relocated than can the bricks-and-mortar facilities of the world for which the current framework was initially built. The digitalization of economic activity also raises issues for which the present system was not designed.... Nor is the notion of residence entirely clear cut, in the sense that—however defined—companies can change it; and, moreover, the increasing disconnect between a company’s country of residence and that of its shareholders makes even the relevance of the concept less clear. (IMF)

Tax treaties cannot be expected to anticipate all the developments in the investments and trading landscape, notably the spread and ease of electronic and digitized commerce that, aside from blurring basic DTA concepts such as PE, also blurs heretofore established standards for intervening in tax avoidance and evasion activities. One of these is setting a standard or benchmark using the “arm’s length principle” in sales and other transactions, i.e. transacting equally with concerned entities, whether commercially related or unrelated. Even if domestic legislation establishes such benchmarks, in the current context, this has become increasingly difficult to detect. As the UN admits, “[t]raditional arm’s length pricing methods are quite often ineffective in determining arm’s length prices in highly integrated industries that do not exist in unintegrated form” (United Nations Department of Economic and Social Affairs).

Another way the treaty network is abused is through the practice “treaty shopping”. Simply, a TNC in a state that has an “unfavourable” or no tax treaty with another state can plan to set up a subsidiary or locate its business activities in a state that has a tax treaty with another state. This TNC can then reap the reduced tax rates and other advantages afforded by this treaty, avoiding otherwise higher tax rates. In this manner, the state where the TNC is based can continue maintaining investment and trade barriers against one contracting state while its multinational enterprises are already enjoying the preferential rates protected by a tax treaty. As phrased by the IMF Staff Report: “A treaty with one country can become a treaty with the world....” (27)

**DTA networks of Asian countries**

With no other international tax standards in place, tax treaties have been described as “the most important element of the international tax regime, i.e., the generally applicable rules governing income taxation of cross-border transactions” (Avi-Yonah). They now reportedly number more than 3,000 across the world, most of which follow the OECD Tax Convention Model (see succeeding section). Figure 1, prepared by a Singapore-based tax planning consulting firm, shows how extensive DTAs are.
The UN and OECD Tax Models

Countries today usually pattern their DTAs on only two models – the United Nation’s and the OECD’s Model Tax Convention, the latter having greatly shaped treaty practice worldwide, including in Asia.
There are other templates such as the US model and the Andean model developed by Latin American countries in 1971 as an alternative to the OECD Model but the UN and OECD Tax Model Conventions are focused on for purposes of this study.

The “OECD Tax Model Convention on Income and on Capital” traces its beginnings to the Fiscal Committee of the Organisation for European Economic Co-operation (OEEC) (eventually becoming the OECD). By 1963, there was a consolidated draft but the model was only published in 1977. The main question for developing the template was: “how might governments claim their rightful taxation from growing international businesses, while not leaving corporations worried about being unfairly taxed across the different jurisdictions in which they operate?” (Owens) Undergoing several adjustments over the years, the OECD model is today seen as the standard.

Kosters writes that even before, there was already consensus that the OECD model is “more appropriate” among developed countries because it grants more taxing rights to the countries where investors are registered as residents (). From this recognition, the UN began crafting its own tax treaty model. The Ad Hoc Group of Experts on Tax Treaties between Developed and Developing Countries was created in 1968, but it was only decades later in 1980 that the first UN Model Double Taxation Convention between Developed and Developing countries saw publication (Vogel).

The UN Model, though largely patterned from the OECD Model, expands opportunities for source countries to claim taxing rights. Kosters, comparing the 2001 UN model and the 2000 OECD model cites important differences in Art. 5 (Permanent establishment), Art. 7 (Business profits), Art. 9 (Associated enterprises), Art. 10 (Dividends), Art. 11 (Interest), Art. 12 (Royalties), Art. 13 (Capital gains) and Art. 21 (Other income) (). As explained by Michael Lennard, chief of the tax section of FfD UNDESA, “the OECD Model is more of a “residence country” model (therefore reducing source country taxing rights and being generally preferable to capital exporting countries) and the UN Model is a more “source country” oriented model, generally preferable to host countries of investment” (ADB Institute).

The following differences are highlighted.

**Permanent Establishment**

Permanent Establishment (PE) status is a critical concept in DTAs because it sets the conditions by which a corporation/taxpayer becomes subject to tax obligations in the source country. Many sources agree that under the UN model, there are more conditions whereby PE can be more quickly claimed, thus benefitting the investment-receiving country in terms of the tax revenues it can collect.

The difference is immediately apparent in the models’ definition of PE. The OECD model narrowly describes this as “a building site or construction or installation project”, which includes a place of management, branch, office, factory, workshop and a mine, oil or gas well, a quarry or any other site of extraction or exploitation of natural resources. The UN model, on the other hand, expands this definition to include “supervisory activities in connection with building sites, construction, assembly and installation projects”. A building/construction site or installation project would already trigger PE status if it lasts more than six months, while the OECD model requires more than 12 months (Art. 3).

Further, only the UN model recognizes the presence of a PE if within more than six months, services were delivered by an enterprise (Art. 5, 3b), while the OECD model treats services in the same way as goods.
(b) The furnishing of services, including consultancy services, by an enterprise through employees or other personnel engaged by the enterprise for such purpose, but only if activities of that nature continue (for the same or a connected project) within a Contracting State for a period or periods aggregating more than six months within any twelve-month period (United Nations).

Without economic presence of permanence over a fixed period of time, services would not constitute a PE under the OECD model and would therefore not justify the source country in claiming tax obligations.

Another condition for PE that the UN model provides and not the OECD model is with regard the maintenance of stocks by an agent acting on behalf of the corporation. In the UN model, an enterprise shall be deemed to have PE in the source country if this agent regularly maintains a stock of goods or merchandise from which merchandise is delivered on behalf of the enterprise (Art. 5b) (Kosters). “This is founded upon a view that the presence of stock, and the delivery of it by the agent, constitutes a sufficient economic nexus to the host country so as to justify taxation by the host [source] country” (Lennard).

Business Profits

These differing appreciations of PE affect other provisions of the treaty models with the UN model allowing more profits to be attributed to a PE than the OECD model. Not only would the PE be taxable in the country where there is PE status but the profits as well from the sale of similar goods that are sold in the PE and from other business activities similar to those undertaken in the PE (Art. 7). In the OECD model, only the profits that can be attributed to the PE will be subjected to tax in the country of the PE (Kosters).

Dividends, interest and royalties (passive income)

The OECD model specifies a maximum tax of 5% in the source countries for foreign investment dividends and a maximum 15% for portfolio investment dividends, which the former UN Group of Experts deemed as “[entailing] too large a loss of revenue for the source country”. Unable to reach consensus on maximum rates, these were left to the state parties to negotiate bilaterally (United Nations 178). The former Group of Experts working on the UN model as it was being developed “...felt that as a matter of principle dividends should be taxed only by the source country.... One of those members emphasized that there was no necessity for a developing country to waive or reduce its withholding tax on dividends, especially if it offered tax incentives and other concessions”. The consensus reached, and which is currently reflected in developing-developed country DTAs, was that dividends may be taxed in the resident country. “Double taxation is eliminated or reduced through a combination of exemption or tax credit in the residence country and reduced withholding rates in the source country” (United Nations 176-177).

Withholding tax rates for interest are not provided by the UN model and are left to negotiations by the state parties (Article 11).

In relation to royalties (Article 12), the UN model allows for the possibility of royalties being claimed in the source country, with a provision for a bilaterally negotiated cap on what can be charged by the source state, similar to Article 10 and 11.
“[R]oyalties may also be taxed in the Contracting State in which they arise and according to the laws of that State, but if the beneficial owner of the royalties is a resident of the other Contracting State, the tax so charged shall not exceed ____ per cent (the percentage is to be established through bilateral negotiations) of the gross amount of the royalties” (United Nations).

Lennard notes that this recognizes “...that the country of use of intellectual (including industrial) property has a right to tax profits from such use accruing to the intellectual property owner”. In comparison, the OECD model is restrictive in that the royalties arising in one state and beneficially owned by a resident of the other state treaty partner will be taxed exclusively in the resident state (Lennard).

**Capital Gains**

Citing an advantage for source countries under Article 13 (Capital Gains), Lennard observes that the UN model favors the source country’s tax rates of gains on a company’s conveyance or alienation of the shares of the capital stock in situations where the property used in its business activities “...consists directly or indirectly principally of immovable property situated in a Contracting State” (presumably the host country where the investment is made). The OECD model eventually reflected this (Lennard).

Cui takes note of the “inconsistency” of the articles on capital gains in both models in applying the principle of equivalence of income and capital gain, i.e., “if the non-capital-gain income from an asset is taxable in a source country (e.g. because the asset is properly viewed as being located in that country), then the capital gain from the disposition of that asset should be taxable in the same country”. Stressing the need for a legal framework on taxing non-residents for capital gains, Cui wrote that non-capital-gain income that may be derived from a given country can generally be crystalized in the form of capital gain on the disposition of the income-generating asset. This is true of most important types of income, be it rent, interest, royalty, dividend, or business profit. Taxing capital gain, therefore, is invariably needed to ensure that income from assets in one’s country is properly subject to tax. In this sense, capital gain taxation is intrinsically about protecting the tax base from erosion. (Cui)

**International treaty-making**

It is important to note that as treaties, DTAs are subject to the provisions of the Vienna Convention on the Law on Treaties (emanating from Article 26) which generally takes precedence over domestic laws when conflicts arise. UNDESA cautions that “...[T]ax treaties establish which Contracting State shall have jurisdiction to tax a given item of income or capital and under what conditions and subject to which limitations it may do so. Consequently, countries wishing to enter into bilateral tax treaty negotiations should analyse carefully the applicable provisions of their domestic tax laws in order to assess the implications of applying the treaty”. Thus, with a treaty in place, it becomes very difficult to apply changes in domestic law that are contrary to the terms of the treaty; a new treaty will have to be negotiated and concluded. “[I]f countries do not exert certain taxing rights in domestic law, and see no likelihood of that charging, they generally do not seek to retain the ability to exert that taxing right under their treaties. Should their policy change, the domestic law may later be introduced to exert the
domestic taxing right, but it would only operate to the extent that it was consistent with the treaty relationships” (United Nations).

However, it has also been clarified by the UN that the Vienna Convention, even with rules set in Articles 31 and 33 on interpreting tax treaties, states can apply existing domestic laws and jurisprudence addressing tax avoidance. “[N]othing prevents the application of similar judicial approaches to the interpretation of the particular provisions of tax treaties. If, for example, the courts of one country have determined that, as a matter of legal interpretation, domestic tax provisions should apply on the basis of the economic substance of certain transactions, there is nothing that prevents a similar approach to be adopted with respect to the application of the provisions of a tax treaty to similar transactions” (United Nations).

**DTAs, the Philippines’ Experience**

*The Philippine Tax System: A Legacy of Colonizers*

The Philippines tax system, like other tax systems of former colonial states, emerged as part of the governance systems imposed by the Spanish and American colonizers.

Various taxes maintained the Spanish conquest and colonial rule in the Philippines from the 16th to the 19th centuries. In the early period of colonialization, the main form of taxation was the enforced tribute, a direct, personal tax or uniform poll tax which went into maintaining the colonial bureaucracy (including rewards for as well as the Spanish clergy’s mission of spreading Catholicism. The need to collect taxes more efficiently also shaped the physical organization of the indigenous population from the dispersed self-governing and sufficient barangays to pueblos (towns). From this arrangement rose a land-owning class of encomenderos who received land from the Spanish Crown in return for services rendered, primarily the collection of the tribute. Over time, the tribute no longer sufficed to support the opening up of foreign trade activities, and a new wave of taxes was imposed. The native population was forced to sell their produce at the lower customs prices and not the market price, the difference making up the repartamiento, or the new tax added to the tribute. Mayors, governors, village chieftains who collected the tribute and their families were tax exempt for three years or during their term of office. (Alvarez).

Up until the time the United States took over from Spain as the new colonialists, there was a system in place of indirect and direct taxes, including special taxes for the Chinese and other foreigners; incentives and exemptions.

The Bureau of Internal Revenue (BIR), established in 1904, was a creation of the American colonial period. Placed under the Secretary of Finance, the BIR was first governed by US-appointed Collectors or Commissioners. It was only under the Filipinization policy of President William McKinley, that Filipino Commissioners were appointed by the US through the American colonial government.

One of the BIR’s milestones after its re-establishment in 1946, following the grant of Philippine Independence, was the implementation of the withholding tax system in 1951 by virtue of Republic Act 690. In later periods, the Philippines would embark on two major tax reforms – the
1986 Tax Reform Package and the 1997 Comprehensive Tax Reform Program. Of the changes made under the 1986 Tax Reform Package pertinent to this study, was the adoption of a 20% flat rate for royalties (previously 15%) and for the final withholding tax rate on interest income (previously 17.5%). This measure also removed the final withholding tax on dividends. Further, the old dual schedules for compensation and profit incomes were unified; the Corporate Income Tax Rate in particular was levied a rate of 35%. As for indirect taxes, a Value Added Tax (VAT) rate of 10% replaced sales tax and other taxes. Export taxes were also removed to allow for more cuts in tariff rates (Aldaba).

The second wave of tax reforms embodied in the CTRP ushered in various tax laws, notably the Tax Reform Act of 1997. The restructuring of individual and corporate income tax was made possible through several provisions such as the progressive reduction of the CIT from 35% in 1997 to 32% from 2000 onwards; adoption of net operating loss carry forward (NOLCO); and exemption of inter-corporate dividends from the final withholding tax. A significant gap was the failure of Congress to address the rationalization of incentives, which was one of the key reasons for proposing the reform program. (Ibid)

The Expanded VAT (EVAT) Law under CTRP was superseded in November 2005 by Republic Act 9337, which raised VAT to 12% starting February 2006. It also provided for a 10% VAT on oil and electricity, and an increase in the CIT rate from 32% to 35% until 2008, and its reduction to 30% by January 2009. (Ibid)

**Legal Framework and Environment and Treaty-Making in the Philippines**

There are several sources for the Philippines’ legal environment relevant to DTAs, starting with the 1987 Philippine Constitution. Relevant provisions include Section Article VI, Section 28 (1) which states that “[t]he rule of taxation shall be uniform and equitable” and that “Congress shall evolve a progressive system of taxation”. Further, “[n]o law granting any tax exemption shall be passed without the concurrence of a majority of all the Members of the Congress” (2) (Republic of the Philippines)

The President may be authorized by Congress “to fix within specified limits, and subject to such limitations and restrictions as it may impose, tariff rates, import and export quotas, tonnage and wharfage dues, and other duties or imposts within the framework of the national development program of the Government”. The President also can veto “any particular item/s in an appropriation, revenue, or tariff bill” (Section 27, 2) (Republic of the Philippines).

Tax rules are codified as the National Internal Revenue Code of 1997 (or the Tax Reform Act of 1997, Republic Act 8424). The law provides for lower rates which could be availed of by non-resident foreign corporations with head companies domiciled in countries with which the Philippines has signed a tax treaty. Under Chapter VI on Computation of Gross Income, Section B (5) provides for “Income Exempt under Treaty” which is defined as “Income of any kind, to the extent required by any treaty obligation binding upon the Government of the Philippines” (Republic of the Philippines).

It is important to note that this law interacts with or is shaped by other laws that altogether reflect the high premium placed on attracting FDIs, using many tax and non-tax incentives as main mechanisms. This means that while PE triggered by a firm makes it liable to comply with source country (Philippines) tax rules, if it undertakes the types of activities covered by these laws, it can also avail of the host of tax incentives that they provide, the same as domestic and resident companies (see section on the
Philippines-US DTA). Among the most significant are the Omnibus Investments Code of 1987 (Executive Order 226), the Foreign Investments Act of 1991 (Republic Act 7042, amended by Republic Act 8179), the Special Economic Zone Act of 1995 (Republic Act 7916) and the Bases Conversion and Development Act of 1992 (Republic Act 7227). These laws put in place an investment incentives system that offers income tax holidays, tax credits and exemptions, duty exemptions, exemptions from local taxes, tax deductions for labor, training and infrastructure expenses, and a host of non-fiscal incentives (Aldaba).

In general, domestic corporations under RA 8424, as amended, are liable to pay tax of 35% on their income from all sources, whether in the Philippines or abroad (amended to 30% effective January 1, 2009). On the other hand, a foreign corporation, whether or not it has an active economic presence in the Philippines, is liable to income tax only on income generated in the Philippines (Chapter II, Section 23) (Republic of the Philippines).

Graph 1. Philippine Corporate Tax Rate

![Graph 1. Philippine Corporate Tax Rate](source: http://www.tradingeconomics.com/philippines/corporate-tax-rate)

Foreign corporations are classified as “resident” or “non-resident” in the tax code. Resident corporations refer to those “organized, authorized, or existing under the laws of any foreign country, [and] ”engaged in trade or business within the Philippines”. Non-resident corporations are not engaged in trade or business within Philippines and simply derive income from Philippine sources through such forms of passive income as dividends, interests, royalties, salaries, premiums, rent, etc. Income tax rate for both resident and non-resident foreign corporations was set at 30% as of January 1, 2009.

The meaning of being “engaged in trade or business within the Philippines” – a key concept in determining whether taxable income lies in the source or resident country -- was neither elaborated in the National Internal Revenue Act of 1977 (nor in the amended Tax Reform Act of 1997). Nonetheless, according to Medalla, Philippine statutory and case laws provide some parameters as to what “‘doing business’” in the Philippines means. **The ‘doing business in the Philippines’ standard under both Philippine tax and corporate law is essentially an amalgam of two other standards: territoriality and**


2 At the time of publication of Medalla’s commentary in the Philippine Law Journal, the 1977 tax code had not been amended yet.
continuity. The question to ask is whether there is a regular series of transactions or acts the situs of which is, or is deemed to be Philippine soil" (The Income Tax Treaty Between the Philippines and the United States: Its Impact on the Taxation of U.S. Corporations Deriving Income from Philippine Sources, and Its Effects on Philippine Investment Policies and Tax Revenues 308).

The 1981 Omnibus Investments Code (amended in 1987) as the “statutory standard” broadly refers to a range of activities that include

...soliciting orders, purchases, service contracts, opening offices, whether called "liaison" offices or branches; appointing representatives or distributors who are domiciled in the Philippines or who in any calendar year stay in the Philippines for a period or periods totalling one hundred eighty days or more; participating in the management, supervision or control of any domestic business firm, entity or corporation in the Philippines, and any other act or acts that imply a continuity of commercial dealings or arrangements and contemplate to that extent the performance of acts or works, or the exercise of some of the functions normally incident to, and in progressive prosecution of, commercial gain or of the purpose and object of the business organization.

(Emphasis supplied)\(^3\) (Medalla Jr. 308)

The same definition appears in the Foreign Investments Act of 1991 (Republic Act 7042) but is expanded thus in Section 3 (d), to elaborate that

“doing business” shall not be deemed to include mere investment as a shareholder by a foreign entity in domestic corporations duly registered to do business, and/or the exercise of rights as such investor nor having a nominee director or officers to represent its interests in such corporation; nor appointing a representative or distributor domiciled in the Philippines which transacts business in its own name and for its own account;....

The Implementing Rules and Regulations of RA 7042 spell out further in Section 1 (f) what “doing business” does not include:

1. Mere investment as a shareholder by a foreign entity in domestic corporations duly registered to do business, and/or the exercise of rights as such investor;
2. Having a nominee director or officer to represent its interest in such corporation;
3. Appointing a representative or distributor domiciled in the Philippines which transacts business in the representative’s or distributor’s own name and account;
4. The publication of a general advertisement through any print or broadcast media;
5. Maintaining a stock of goods in the Philippines solely for the purpose of having the same processed by another entity in the Philippines;
6. Consignment by a foreign entity of equipment with a local company to be used in the processing of products for export;
7. Collecting information in the Philippines; and
8. Performing services auxiliary to an existing isolated contract of sale which are not on a continuing basis, such as installing in the Philippines machinery it has manufactured or

\(^3\) The definition is unchanged in the 1987 version.
exported to the Philippines, servicing the same, training domestic workers to operate it, and similar incidental services.

As for case law, Medalla cites examples of settled Supreme Court cases emphasizing the element of continuity or progression in business activity to be legally recognized as “doing business” in the Philippines. But a body of jurisprudence also recognizes single transactions as long as they can be shown as purposively intended and thus contributing to a plan of conducting commerce within the country.

Foreign corporations could steer clear of establishing domestic business activity and incurring tax liabilities on the basis of the above guidelines which have not significantly changed in substance from previous legislation. Medalla’s example of the implications on US companies would still thus hold:

A United States corporation may instead set up either a wholly-owned, or a controlled Philippine subsidiary corporation. Absent anything else, the U.S. corporation itself will not be considered as being "engaged in trade or business" as in the Philippines under Philippine tax law as embodied in the National Internal Revenue Code, and in the statutory and case law just discussed. However, from a business and economic (as opposed to a purely tax, corporate law, and otherwise legal) viewpoint, the U.S. corporation can be considered as doing business in the Philippines in a very real and concrete sense. In fact,..., the tax treatment of branches and subsidiaries of foreign corporations under local Philippine tax law is practically equal. (The Income Tax Treaty Between the Philippines and the United States: Its Impact on the Taxation of U.S. Corporations Deriving Income from Philippine Sources, and Its Effects on Philippine Investment Policies and Tax Revenues 310)

A Note on Treaty-Making in the Philippines

In relation to treaty matters, Article VII, Section 21 stipulates that there should be concurrence by at least two-thirds of the Senate for a treaty or international agreement to be valid and effective. Under Article VIII, the powers of the Supreme Court include reviewing, modifying, reversing or affirming final judgments and orders of lower courts in “a) [a]cases in which the constitutionality or validity of any treaty, international or executive agreement, law, presidential decree, proclamation, order, instruction, ordinance, or regulation is in question” and “b) all cases involving the legality of any tax, impost, assessment, or toll, or any penalty imposed in relation thereto” (Republic of the Philippines).

The Philippines is a state party to the Vienna Convention on the Law on Treaties and enters into tax treaties the same way as other international treaties. Treaties are by definition in the Convention, legally binding, i.e., “a party to a treaty/MOA-type agreement may compel the other party to comply with its terms in case of a breach, including a possible recourse to a third-party compliance mechanism”. Because tax treaties provide privileges that are different from national tax policy including tax exemptions which only Congress can grant, they require legislative concurrence after executive concurrence to be considered valid and in force (Article VII, Section 21, 1987 Philippine Constitution). The same is true for free trade agreements.
Only the President has the sole power to ratify treaties; the Senate *concurs* with the Chief Executive’s ratification of a treaty. “The role of the Senate,..., is limited only to giving or withholding its consent, or concurrence to the ratification.”

*The Philippines’ DTAs*

The earliest tax treaties on income and capital were signed in 1976 by the Philippine government with Belgium, France, the UK and the US, but they vary in the period of negotiations before coming into force. DTAs were signed by the Philippine government with other countries almost every year hence until 2009, but some of them have been renegotiated and amended as recent as 2013 such as the DTAs with Germany and France.

As of this writing in the BIR website, the Philippines has entered into 38 DTAs with different countries worldwide, including six protocols amending tax treaties with Belgium, France, Japan, Norway, Thailand and Germany.

**Table 1. Philippine Double Taxation Agreements**

<table>
<thead>
<tr>
<th>Country</th>
<th>Date and Venue of Signature</th>
<th>Effectivity</th>
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| 1. Australia | May 11, 1979  
Manila, Philippines | January 1, 1980 |
| 2. Austria    | April 4, 1981  
Vienna, Austria          | January 1, 1983 |
| 3. Bahrain     | November 7, 2001  
Manila, Philippines     | January 1, 2004 |
| 4. Bangladesh  | September 8, 1997  
Manila, Philippines     | January 1, 2004 |
| 5. Belgium     | October 2, 1976  
Manila, Philippines     | January 1, 1981 |
| Protocol amending the tax treaty | May 11, 1996  
Manila, Philippines | January 1, 2000 |
| 6. Brazil      | September 29, 1983  
Brasilia, Brazil        | January 1, 1992 |
| 7. Canada      | March 11, 1976  
Manila, Philippines     | January 1, 1977 |
| 8. China       | November 18, 1999  
Beijing, China          | January 1, 2002 |
Manila, Philippines     | January 1, 2004 |
| 10. Denmark    | June 30, 1995  
Copenhagen, Denmark     | January 1, 1998 |
| 11. Finland    | October 13, 1978  
Manila, Philippines     | January 1, 1982 |
| 12. France     | January 9, 1976  
Kingston, Jamaica       | January 1, 1978 |
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<tr>
<th>Protocol amending the tax treaty</th>
<th>Date and Location</th>
<th>Date of Entry into Force</th>
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<td>Protocol amending the tax treaty</td>
<td>February 2013</td>
<td></td>
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<tr>
<td>Protocol amending the tax treaty</td>
<td>September 9, 2013</td>
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<tr>
<td>15. India</td>
<td>February 12, 1990, Manila, Philippines</td>
<td>January 1, 1995</td>
</tr>
<tr>
<td>18. Italy</td>
<td>December 5, 1980, Rome, Italy</td>
<td>January 1, 1990</td>
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<tr>
<td>Protocol amending the tax treaty</td>
<td>December 9, 2006, Manila, Philippines</td>
<td>January 1, 2009</td>
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With a DTA, the 32% generally applied on gross income of non-resident foreign corporations can be substantially reduced, as provided for in the Philippine Tax Code:

A non-resident foreign corporation is generally taxable at 32% on gross income from Philippine sources while interest income from a loan is subject to 20%. Significant relief may however be enjoyed in terms of lower tax rates or exemptions if the payee corporation is a resident of a country with which the Philippines has a tax treaty. For example, Philippine sourced business profits may be exempt from Philippine income tax if the nonresident foreign corporation has no permanent establishment in the Philippines, as defined in the treaty. Lower rates are also available for dividends (10% - 25%), interests (10 – 15%) and royalties (10% - 25%) as well as gains from sale of shares of stocks, individual compensation income and rental income.

**The US-Philippines DTA**

This section focuses on the US-Philippines tax convention not only because the country’s experience with negotiating DTAs is traced to this first attempt of concluding a DTA in 1964. It is highly significant because “this is the first income tax treaty with a developed industrialized state wherein the Philippines
has agreed to provisions of this kind,” as will be discussed forthwith. The US Senate ratified the treaty with a number of reservations on certain provisions but it failed to win the concurrence of the Philippine Senate. Negotiations finally pulled through between the two countries, and the DTA was signed more than 10 years later on the 1st of October 1976. The DTA has elements of the OECD and UN Model Tax Convention but it is primarily the US’ Model Tax Convention.

In the period before the treaty was finally ratified in 1983, differing interpretations of certain provisions were the subject of several hearings of the US Senate Committee on Foreign Relations and exchange of diplomatic notes between then Secretary of the Treasury William Simon (of Gerald Ford’s presidency) and former Finance Minister Cesar Virata of the Marcos government. These eventually introduced in the RP-US DTA significant precedent-setting elements, such as claiming Most Favored Nation (MFN) treatment, reciprocity of exemptions between treaty partners and “non-discrimination” between domestic and foreign companies. Medalla comments: “From a legal and technical point of view, the treaty is important because it substantially alters the tax treatment by the Philippines of U.S. Corporations” (301).

A contentious point was on “reciprocal exemption”. In a document prepared for the Committee on Foreign Relations to guide its recommendations to the US Senate on the treaty’s ratification, the US Joint Committee on Taxation highlighted that:

(1) The proposed treaty departs from prior U.S. treaties and does not provide for a reciprocal exemption of income from the operation of ships or aircraft in international traffic in accordance with their own domestic laws. In the case of income from the operation of ships in international traffic the tax imposed by either country is not to exceed 1.5 percent of the gross revenues derived from outgoing traffic originating in that country. Under this provision (article 9) U.S. residents operating ships or aircraft in international traffic may be subject to more burdensome transaction in the Philippines than Philippine corporations, which under normal treaty rules would violate the provisions against discrimination, which under normal treaty rules would violate the provisions against discrimination. (Emphasis added) However, the treaty specifically exempts this provision from the discrimination provisions (article 24). (US Congress-1).

Under the treaty, the US and the Philippines may apply their national tax rules in international air traffic operations; for ships, both countries should not levy taxes exceeding 1.5% of the gross revenues generated by outgoing traffic from either country. The objection was that US shipping and airlines corporations (which had more incoming flights to the Philippines) could be more heavily taxed than Philippine shipping and airline corporations because of a specific exception in the provision on non-discrimination (US Congress-1).

The US airlines industry further pointed out that “ratification of the proposed treaty will be considered as a precedent by those countries, particularly less-developed countries, which want tax treaties with the United States but also want to tax U.S. airlines”. In addition, the tax rates imposed by the US and the Philippines on either country’s airlines will not be reciprocal or the same because US airlines operating in the Philippines would be liable to pay 4.5 percent of their gross revenues from Philippine sources. “In contrast, the U.S. tax on Philippine Air Lines will be insignificant because there are few PAL flights to the United States and the U.S. will tax PAL only on income it earns within the U.S. 3-mile limit” (US Congress-2 7-8).
Those who favored the treaty, as worded, countered that the U.S. engages in the same practice, i.e., it claims source-of-income taxes from foreign airlines whose countries do not afford reciprocal exemptions for US airlines. “[W]hile it has in the past been U.S. treaty policy to provide for reciprocal exemption of airlines and will presumably continue to be U.S. policy in the future, it is not clear that the United States should treat reciprocal exemptions as an overriding issue if the other country, particularly a developing country such as the Philippines, insists on collecting at least some tax from foreign airlines operating in its commerce”. Moreover, paying the Philippine taxes would not translate to an actual increase in the tax burden of US airlines because they could claim foreign tax credits (US Congress-2).

The Joint Committee also called attention to withholding taxes on dividends, interests and royalties, invoking nondiscrimination and Most Favored Nation treatment. For instance, in relation to taxes tax on royalties, it explained that while the Philippines sets its withholding tax on royalty income at 25% as opposed to the US’ 15%, the Philippines provides “exceptions for royalties paid with respect to investments under Philippine incentive programs which are subject to a 15 percent withholding tax” as well as exceptions “in any case where the Philippines agree by treaty with a third country to a low withholding tax on any type of royalty income”.

(Emphasis added) It also reassures that “[t]he proposed treaty contains a nondiscrimination provision (article 24) which applies to all taxes of every kind proposed at the national, State or local levels of either country”. However, it also informs that there are incentives provided by law for Filipinos under certain conditions such as investing in pioneer industries and tax deductions for export production costs of 60%-owned Philippine exporters (US Congress-1).

It was only in December 1981 that the US Senate agreed to ratify the treaty upon the recommendation of the Foreign Relations Committee. The tax treaty was finally ratified in October 1982 and went into effect beginning January 1, 1983, with two reservations and two understandings

The first reservation makes reference to Article 14, which contains the provision that “gains derived by a resident of a Contracting State from the alienation of ships, aircraft or containers operated by such resident in international traffic shall be taxable only in that State” – an issue raised by the US airlines industry. Nonetheless, source rules are retained as both the US and the Philippines may require capital gains tax “from the disposition of an interest in a corporation if its assets consist principally of a real property interest located in that country,” as well as from the disposition of an interest in a partnership.

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4 “A reservation is a declaration made by a state by which it purports to exclude or alter the legal effect of certain provisions of the treaty in their application to that state. A reservation enables a state to accept a multilateral treaty as a whole by giving it the possibility not to apply certain provisions with which it does not want to comply. Reservations can be made when the treaty is signed, ratified, accepted, approved or acceded to. Reservations must not be incompatible with the object and the purpose of the treaty. Furthermore, a treaty might prohibit reservations or only allow for certain reservations to be made” [Arts.2 (1) (d) and 19-23, Vienna Convention of the Law of Treaties 1969].

“In practice, reservations change U.S. obligations without necessarily changing the text, and they require the acceptance of the other party,” Garcia notes, citing the Congressional Research Service, Treaties and Other International Agreements: The Role of the United States Senate, A Study Prepared for the Senate Comm. on Foreign Relations 4 (Comm. Print 2001) Invalid source specified..

Also cited by Garcia from Treaties and Other International Agreements: ... is the definition: “Understandings are ‘interpretive statements that clarify or elaborate provisions but do not alter them’” Invalid source specified.
trust or estate to the extent the gain is attributable to a real property interest in one of the countries” (Convention Between The Government of the United States Of America and the Government of the Republic of the Philippines with Respect to Taxes on Income).

The second reservation relates to a provision in Article 9 (Shipping and Air Transport) which states that “[n]othing in the Convention shall affect the right of a Contracting State to tax, in accordance with domestic laws, profits derived by a resident of the other Contracting State from sources within the first-mentioned Contracting State from the operation of aircraft in international traffic”. Notwithstanding this provision, the US agrees to a tax on profits derived by a resident of one of the Contracting States from sources within the other Contracting State from the operation of aircraft in international traffic” on condition that rates be pegged at whichever is lower – one and one-half percent of the gross revenue from sources within that state and, based on the MFN principle, “the lowest rate of Philippine tax that may be imposed on profits of the same kind under similar circumstances by a resident of a third state”.

The understandings emphasize nondiscrimination as well by stressing that under Article 9 and Article 11 (Dividends) of the Treaty, “the Philippines may not impose on the earnings of a corporation attributable to a permanent establishment in the Philippines,.... a tax in addition to the tax which would be chargeable on the earnings of a Philippine corporation;......” In other words, the tax on dividends of American corporations with PE presence should be the same as the tax imposed on Philippine firms. Under Article 11, these cover “income from shares, mining shares, founders' shares or other rights, not being debt-claims, participating in profits, as well as income from other corporate rights assimilated to income from shares by the taxation law of the State of which the corporation making the distribution is a resident”.

Application of MFN clauses

A predictable consequence of MFN clauses in DTAs is that preferential tax rates offered to a treaty partner must be made available to other DTA partners with whom MFN treatment has been agreed upon. Since all of the Philippines’ tax treaties contain MFN provisions, the lowest tax rates offered under similar circumstances can be availed of by all tax treaty partners.

The RP-China DTA entered into force in January 2002. One of its provisions on Royalties provides for “10 per cent of the gross amount of royalties arising from the use of, or the right to use, any patent, trade mark, design or model, plan, secret formula or process, or from the use of, or the right to use, industrial, commercial, or scientific equipment, or for information concerning industrial, commercial or scientific experience” (Article 12 (2)b). In comparison, the RP-US DTA contains general guidelines that the tax imposed by the Philippines should be “the least of (i) 25 percent of the gross amount of the royalties, (ii) 15 percent of the gross amount of the royalties, where the royalties are paid by a corporation registered with the Philippine Board of Investments and engaged in preferred areas of activities, and (iii) the lowest rate of Philippine tax that may be imposed on royalties of the same kind paid under similar circumstances to a resident of a third State” (Article 13 (2)(b) (Bureau of Internal Revenue).

In November 2004, the BIR issued a circular explaining the implications of the RP-China tax treaty on the RP-US tax treaty. Specifically, it clarified that with China’s entitlement to not more than 10% of the gross amount of royalties related to the activities mentioned, the same rate will be applied to transactions involving the RP-US DTA on the basis of its MFN clause.
The purpose of this clause is to grant to the other Contracting State a tax treatment that is no less favorable than which is granted to the “most favored” among other countries. Therefore, the tax treatment of royalty payments to a US entity must be taken in relation to other tax treaties, which provide for a lower rate of tax on the same type of income. US residents may, therefore, invoke the preferential tax rate of 10% on royalties, accruing beginning January 1, 2002, arising in the Philippines “from the use of, or the right to use, any patent, trademark, design or model, plan, secret formula or process, xxx, or for information concerning industrial, commercial or scientific experience” under the RP-China tax treaty, pursuant to the “most-favored-nation” clause of the RP-US tax treaty.” (Ibid)

The US has also claimed lower tax rates enjoyed by other Philippine DTA partners on the strength of the US-RP tax treaty’s provision on MFN and non-discrimination. In the case of royalties, although US companies are to be taxed at 25% for the gross amount, and at 15% where the gross amount is included in the Board of Investments’ preferred activities, the treaty provides as well for the “lowest rate of Philippine tax that may be imposed on royalties of the same kind paid under similar circumstances to a resident of a third State”. Pursuant to this MFN provision, a US firm was able to invoke and gain a BIR ruling (BIR Ruling No. 126-11, 15 April 2011) on its entitlement to the 10% tax on royalties under the RP-Czech Tax Treaty (Grant Thornton).

Availment of preferential rates under tax treaties – the case of the Philippines - Germany DTA on Income and Capital

A DTA involved in setting precedent and changing the interpretation of national tax laws is the Philippines – Germany tax treaty. The Supreme Court ruling that eventually settled the issue between the Philippine branch of a German bank and the BIR is considered a landmark decision for its precedent-setting implications on the primacy of tax treaties over national law and the claiming of tax treaty benefits in the Philippines.

On October 21, 2003, Deutsche Bank AG Manila (DB Manila) withheld and remitted to the BIR, Php67,688,553, or the 15% Branch Profit Remittance Tax (BPRT) on its income for 2002 and previous taxable years’ that was to be remitted to Deutsche Bank Germany (DB Germany). This was in compliance with Section 28(A)(5) of the National Internal Revenue Code of 1997, which states that “[a]ny profit remitted by a branch to its head office shall be subject to a tax of fifteen percent (15%) which shall be based on the total profits applied or earmarked for remittance without any deduction for the tax component thereof (except those activities which are registered with the Philippine Economic Zone Authority) (Deutsche Bank AG Manila Branch vs. Commissioner of Internal Revenue).

However, two years after on October 4, 2005, DB Manila filed an administrative claim for a tax refund with the BIR. It also sought confirmation of being entitled to the preferential rate of 10% under the Philippines-Germany DTA. Receiving no action on this claim, it then filed on October 18, 2005 before the Second Division of the Court of Appeals a Petition for Review, with the intent of being refunded of more than Php22.5 million, or the difference between the regular rate and the tax treaty rate. (Ibid)

In August 2008, the Second Division of the CTA dismissed the petition for lack of merit, thus rejecting denying DB Manila’s petition for a tax refund. Among the reasons cited was the failure of DB Manila to formally invoke the treaty provisions by applying with the International Tax Affairs Division (ITAD) of the
BIR; a previously decided case had also set legal precedent that a foreign corporation wishing to avail of preferential rates under tax treaties should invoke this claim⁵. Citing BIR Memorandum Order 01-2000, the CTA decision said that DB Manila should have made this application “at least 15 days before the transaction, i.e., payment of dividends, royalties, etc., accompanied by supporting documents justifying the relief”. DB Manila in fact only invoked its entitlement to the preferential rate of 10% under the Philippines-Germany Tax treaty in October 2005 or around two years from said overpayment. The Court rules found the “petitioner’s non-compliance with the procedural requirements set forth under Section III of RMO 01 -2000 fatal to its claim for refund”. It further stressed that administrative issuance have the strength of law and thus the procedural requirements for tax treaty relief are mandatory. (Ibid)

DB Manila moved for a reversal of the division court’s decision but the Court of Tax Appeals en banc supported the Second Division’s promulgation, citing jurisprudence that administrative procedures must be followed. The petition for review was dismissed for holding no merit in May 2009 (Deutsche Bank AG Manila Branch vs. Commissioner of Internal Revenue).

Finally, in 2013, DB Manila elevated the case to the Supreme Court (First Division), and won a reversal of the CTA ruling from the high court. Completely disagreeing with the CTA, the SC supported DB Manila’s claim and allowed the issuance of a tax credit certificate to refund the overpayment. In addition to pointing out that the precedent used by the CTA was not binding, the SC supported DB Manila’s argument that the treaty does not explicitly state that entitlement to tax treaty benefits must be formally confirmed with the ITAD (Deutsche Bank AG Manila Branch vs. Commissioner of Internal Revenue).

Further, the SC affirmed the doctrine of pact sunt servanda, i.e., that “Every treaty in force is binding upon the parties, and obligations under the treaty must be performed by them in good faith”.

“A state that has contracted valid international obligations is bound to make in its legislations those modifications that may be necessary to ensure the fulfillment of the obligations undertaken.” [Tañada v. Angara, 388 Phil. 546, 592 (1997)] Thus, laws and issuances must ensure that the reliefs granted under tax treaties are accorded to the parties entitled thereto. The BIR must not impose additional requirements that would negate the availment of the reliefs provided for under international agreements. (Deutsche Bank AG Manila Branch vs. Commissioner of Internal Revenue 7)

The obligation to comply with a tax treaty must take precedence over the objective of RMO No. 1-2000. Logically, noncompliance with tax treaties has negative implications on international relations, and unduly discourages foreign investors” (Deutsche Bank AG Manila Branch vs. Commissioner of Internal Revenue 8).

The Philippine government through the BIR was ordered by the SC to issue a TCC amounting to PhP22,562,851.17 to refund the difference between PhP67,688,553.51 (15% BPRT) DB Manila had paid and the PhP45,125,702.34 (10% BPRT) it is entitled to under the tax treaty.

⁵ Mirant (Philippines) Operations Corporation (jonnery: Southern Energy Asia-Pacific Operations [Phils.], Inc.) v. Commissioner of Internal Revenue
The BIR filed a Motion for Reconsideration thereafter, but the SC in January 2014 denied the motion and affirmed with finality its earlier ruling. As the SC itself stated in its promulgation, the BIR should “merely operate to confirm the entitlement of the taxpayer to the relief” (Deutsche Bank AG Manila Branch vs. Commissioner of Internal Revenue). The BIR would also have to amend its procedures to be consistent with the SC decision. The BIR was reported to have said at an International Tax Forum hosted by the Philippines in November 2014 that “the issue on the self-executory nature of tax treaties entered into the Philippines has already been settled by the Supreme Court” (Cagahastian).

In addition to the favorable decision gained by Germany from the SC ruling, the renegotiation of the Philippines-Germany DTA in September 2013 ushers in more tax benefits in terms of lesser source-based taxation and lower preferential rates.

The Philippines-Germany DTA – before and after renegotiations

<table>
<thead>
<tr>
<th>Article</th>
<th>Tax rate under the previous DTA</th>
<th>New tax rate under the renegotiated DTA</th>
</tr>
</thead>
<tbody>
<tr>
<td>Article 10 on Dividends</td>
<td>10%</td>
<td>5%</td>
</tr>
<tr>
<td>Article 11 on Interest</td>
<td>15%</td>
<td>10% (unless exempted)</td>
</tr>
<tr>
<td>Interest in connection with sale on credit of a commercial or scientific equipment and of an enterprise-to-enterprise sale on credit, if the recipient is also the beneficial owner thereof</td>
<td>Taxed in the source state at 10%</td>
<td>Taxable only in the residence state</td>
</tr>
<tr>
<td>Article 12 on Royalties</td>
<td>Taxed at either 15 percent or 10 percent, depending on the type of royalty.</td>
<td>10 percent, regardless of type</td>
</tr>
</tbody>
</table>

The current Philippines – Germany treaty also highlights that between tax treaty partners there is even greater leeway to speed up the race to the bottom for lower tax rates through amendments or protocols.

Outcomes of Other Tax Treaty Amendments

<table>
<thead>
<tr>
<th>Philippines Tax Treaty with</th>
<th>Outcomes</th>
</tr>
</thead>
</table>

(Miguel)
<table>
<thead>
<tr>
<th>Country</th>
<th>Details</th>
</tr>
</thead>
</table>
| Japan   | - Royalty payments made by a Philippine Economic Zone Authority (PEZA)- registered enterprise to a non-resident Japanese corporation are subject to the 25% preferential tax rate on the gross amount of the royalties under the RP-Japan Tax Treaty. However, starting January 1, 2009, these royalty payments shall be subject to the 10% preferential tax rate pursuant to the amendatory Protocol to the RP-Japan Tax Treaty. (http://www.proinfinity.com/acpapp/images/stories/tax_bulletin_march20111.pdf)
- The general rate applicable on dividends was reduced from 25% to 15%.
- The ownership threshold for big shareholders to avail of the 10% tax rate was also reduced from 25% to 10% of voting shares or total shares issued. (Article 10)
- The general rate applicable on interest was reduced from 15% to 10%. Previously, the 10% rate applied only on interest paid in respect of government securities, or bonds or debentures and those paid by BOI-registered firms. The distinction has been removed. (Article 11) |
| New Zealand | - Rates on dividends was reduced from a split rate of 15% and 25% to a flat rate of 15%; on interest from 15% to 10%; and on royalties from a split rate of 15% and 25% to a flat rate of 15%. |
| Thailand | - The maximum dividend withholding tax rate was reduced from 20% to 15%, while those directly holding at least 25% equity of the paying company would be entitled to a 10% rate (formerly 15% rate with direct equity ownership of 15% with additional conditions for Thai companies).
- Branch profits remittance tax is also expressly included and capped at a maximum rate of 10%.
- All interest payments from the Philippines will suffer withholding tax at the general rate of 15%. The lower (10%) rate on interest related to publicly issued bonds, debentures or similar obligations was eliminated.
- Royalties will now be taxed at a uniform withholding tax rate of 15% regardless of the nature of the royalty payments or status of the licensee. |
**Fallout from the Deutsche Bank Manila case**

Following the Supreme Court decision, several multinational corporations sought action from the BIR-ITAD or filed cases with the Court of Tax Appeals based on the same arguments that granted relief to DB Manila. The reaffirmation of the SC decision in the DB Manila case that the 15-day period for tax treaty relief application under RMO No. 1-2000 is not a pre-requisite to enjoying treaty benefits was invoked by the CTA in the following suits against the Commissioner of Internal Revenue. In the DB Manila case, the bank belatedly filed for confirmation of availing of tax treaty benefits, but in the Penn Philippines Inc., there was no application at all. The table below shows only a few of these cases where the DB Manila decision is reiterated; including the DB Manila case, foregone revenues of these few tax treaties (from court reversals or cancellations of BIR claims on the basis of treaty obligations) already amount to more than PhP250 million.

<table>
<thead>
<tr>
<th>Corporation Involved</th>
<th>DTA invoked</th>
<th>Decision</th>
<th>Refund/Foregone Revenues (in PhP)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Deutsche Bank AG Manila Branch</td>
<td>Philippines-Germany</td>
<td>January 2014: SC rules with finality that TTRA is not a pre-requisite to enjoying the 10% final withholding tax rate. Since DB Manila followed the regular 15% FWT, it is entitled to a refund of the difference between the two rates (Deutsche Bank AG Manila Branch vs. Commissioner of Internal Revenue).</td>
<td>22,562,851.17</td>
</tr>
<tr>
<td>Lindberg Subic SA</td>
<td>Philippines-Denmark</td>
<td>Feb. 11, 2014: Lindberg Subic is entitled to the preferential tax rate of 10% under the treaty. Thus, it should not be held liable for deficiency FWT for taxable year 2007 on interest payments (Lindberg Subic, Inc. vs Commissioner of Internal Revenue).</td>
<td>1,438,549.22</td>
</tr>
<tr>
<td>Carrier Air Conditioning, Philippines, Inc. vs. RP-US</td>
<td>RP-US</td>
<td>March 17, 2015: Petitioner is entitled to refund or issuance of a TCC representing final tax withheld and remitted</td>
<td>11,395,574.20</td>
</tr>
<tr>
<td>Name</td>
<td>Country</td>
<td>Date</td>
<td>Description</td>
</tr>
<tr>
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<td>---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------</td>
</tr>
<tr>
<td>Masin-AES Pte Ltd – Philippine Branch</td>
<td>Philippines - Singapore</td>
<td>10 April 2014:</td>
<td>The petitioner correctly applied the tax treaty rate of 15% (not the regular 20% rate) in computing the final withholding tax on the interest payments on foreign loans. Petitioner thus cannot be held liable for the assessed deficiency taxes and penalties (MASIN-AES Ltd. Pte. Philippine Branch).</td>
</tr>
<tr>
<td>Kepco Ilijan Corporation</td>
<td>Philippines – Republic of Korea</td>
<td>10 July 2014:</td>
<td>The income payments made to the non-resident foreign corporation Kepco, pursuant to a Management and Technical Services Agreement between them is exempt from final withholding tax. Petitioner (the domestic corporation) is thus not liable to pay any deficiency final withholding tax on the income payments made to KEPCO (Kepco Ilijan Corporation vs Commissioner of Internal Revenue).</td>
</tr>
<tr>
<td>Penn Philippines Inc.</td>
<td>Philippines-Spain</td>
<td>Feb. 12, 2014:</td>
<td>CTA En Banc upheld the decision of the Court in Division cancelling the final withholding tax deficiency assessment corresponding to the management and consultancy fee paid to its parent company in Spain which has not attained permanent establishment status in the Philippines. Penn Philippines Inc. is thus exempt from 2002 FWT on management and consultancy fees paid to Dogi International Fabrics S.A.</td>
</tr>
</tbody>
</table>
A recent reiteration of the DB Manila decision was made by the Supreme Court in January 2015 when it ruled in favor of the claim for overpayment and prayer for refund by CBK Power, a domestically organized partnership mainly engaged in the development and operation of the Caliraya, Botocan, and Kalayaan hydroelectric power generating plants in Laguna (CBK Project) (CBK Power Company Limited v. Commissioner of Internal Revenue). This illustrates a case where a multinational corporation invoked several tax treaties of the Philippines, specifically with Belgium, Austria and Japan.

CBK Power had obtained in August 2000 a syndicated loan from several Japanese banks, such as BNP Paribas, Dai-ichi Kangyo Bank, Limited, Industrial Bank of Japan, Limited, and Societe General (original lenders), acting through an Inter-Creditor Agent, Dai-ichi Kangyo Bank, a Japanese bank that subsequently merged with the Industrial Bank of Japan, Limited (Industrial Bank of Japan) and the Fuji Bank, Limited (Fuji Bank), with the merged entity being named as Mizuho Corporate Bank (Mizuho Bank). Some portions of loan were later assigned or transferred to other banks which included Fortis Bank (Nederland) N.V. (Fortis-Netherlands) and Raiffesen Zentral Bank Osterreich AG (Raiffesen Bank). Fortis-Netherlands, in turn, assigned its portion of the loan to Fortis Bank S.A./N.V. (Fortis-Belgium), a resident of Belgium. (Ibid)

CBK Power borrowed money from these banks for which it remitted interest payments from May 2001 to May 2003, and reportedly withheld final taxes from said payments based on the following rates: 15% for Fortis-Belgium, Fortis-Netherlands, and Raiffesen Bank; and 20% for Industrial Bank of Japan and Mizuho Bank. However, CBK Power later invoked the tax treaties between the Philippines and the countries of which the banks are residents, to claim the preferential tax rate of only 10% on the interest income derived by these financial entities. (Ibid)

<table>
<thead>
<tr>
<th>BANK</th>
<th>COUNTRY OF RESIDENCE</th>
<th>PREFERENTIAL RATE UNDER THE RELEVANT TAX TREATY</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fortis Bank S.A./N.V.</td>
<td>Belgium</td>
<td>10% (Article 11\textsuperscript{1}, RP-Belgium Tax Treaty)</td>
</tr>
<tr>
<td>Industrial Bank of Japan</td>
<td>Japan</td>
<td>10% (Article 11\textsuperscript{3}, RP-Japan Tax Treaty)</td>
</tr>
<tr>
<td>Raiffesen Zentral Bank Osterreich AG</td>
<td>Austria</td>
<td>10% (Article 11\textsuperscript{3}, RP-Austria Tax Treaty)</td>
</tr>
<tr>
<td>Mizuho Corporate Bank</td>
<td>Japan</td>
<td>10% (Article 11\textsuperscript{3}, RP-Japan Tax Treaty)</td>
</tr>
</tbody>
</table>

The SC’s decision reiterated:

In Deutsche Bank, the Court categorically held that the BIR should not impose additional requirements that would negate the availment of the reliefs provided for under international agreements, especially since said tax treaties do not provide for any prerequisite at all for the availment of the benefits under said agreements...It bears reiterating that the application for a tax treaty relief from the BIR should merely operate to confirm the entitlement of the taxpayer to the relief.

The BIR was ordered to make the refund in favor of CBK Power Company Limited amounting to P15,672,958.42 representing the said excess final withholding taxes for 2001 to 2003. (Ibid)
Expansion of the scope of “royalties”

With the issuance of the 2003 OECD Tax Treaty Model, many of the Philippines DTAs adopted its definition of royalties, i.e., “payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work including cinematograph films, any patent, trade mark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience”. This has not been consistently applied, however, such that some treaties use this definition while others contain additional conditions as to what should activities should be considered as subject to royalties or to service fees.

For example, the RP-US DTA, while reflecting the OECD definition, includes in its understanding of royalties, “gains derived from the sale, exchange or other disposition of any such right or property which are contingent on the productivity, use, or disposition thereof”. Similarly, the treaty with the UK and Canada consider as royalties not only “the use of, or the right to use, industrial, commercial or scientific experience” but also “information concerning industrial, commercial or scientific experience”. In most of the treaties, royalties include payment for the use of, or the right to use industrial, commercial or scientific equipment but in other treaties, this is not specifically mentioned.

Among the treaties with the most modifications are the Philippine DTAs with Australia (see italics):

The term “royalties” in this Article means payments or credits, whether periodical or not, and however described or computed, to the extent to which they are made as consideration for -

a) the use of, or the right to use, any copyright, patent, design or model, plan, secret formula or process, trademark, or other like property or right;

b) the use of, or the right to use, any individual, commercial or scientific equipment;

c) the supply of scientific, technical, industrial or commercial knowledge or information;

d) the supply of any assistance that is ancillary and subsidiary to, and is furnished as a means of enabling the application or enjoyment of, any such property or right as is mentioned in paragraph (a), any such equipment as is mentioned in paragraph (b) or any such knowledge or information as is mentioned in paragraph (c);

e) the use of, or the right to use -

   (i) motion picture films;
   (ii) films or video tapes for use in connection with television; or
   (iii) tapes for use in connection with radio broadcasting; or

f) total or partial forbearance in respect of the use of a property or right referred to in this paragraph.

These ambiguities have resulted in an ambiguous situation as well, concerning such issues as determining whether royalty or service fees should apply or whether certain royalty incomes should be considered as passive or active incomes. From the definition under the current tax code and court
interpretations, royalties “have become so broad that income arguably characterized as service fees may now be characterized as royalties”. The implications are serious as stressed by legal scholars. “The distinction sought to be clarified is very important in taxation, since royalties and service fees have very different tax implications. Moreover, the terms are mutually exclusive. A finding that a certain payment is a service fee precludes a finding that the same is royalty, and vice-versa” (Joven and Varias 350).

As pointed out by Joven and Varias, “Consequently, there is a difference in the income characterization and taxability of such payments compared to the treatment under other treaties. If a taxpayer is covered by the RP-US treaty and the foregoing income accrues to him, then the income is considered as royalties. The taxpayer is thus taxed subject to that treaty’s article 13. Otherwise, the said income is taxed subject to the provisions on business profits or capital gains, generally articles 7 and 13 of the OECD Model, respectively.” Under Articles 7 and 13, the resident state is assigned the authority to collect on the firm’s tax obligations.

Under the national tax code, royalties and service fees are categorized by different tax schedules. Passive income, which includes royalties, of individual citizens and individual resident aliens of the Philippines (Sec. 24, B, 1) and of domestic corporations (Sec. 27, D, 1), are liable to pay a 20% final withholding tax rate. On the other hand, service fees would be subject to the regular progressive income tax rates for individuals (Sec. 24, A, 1) and currently, 30% for corporate income of foreign firms (Sec. 28, A, 1) would apply for service fees. (Ibid) (Tax Reform Act of 1997).

Under the DTAs, royalties and service fees are also treated differently under separate provisions. Royalties are covered by Article 12 in the treaty template while services fees fall under Article 5 on Permanent Establishment and Article 7 on Business Profits. Except for some amended treaties such as the RP-Germany DTA which sets for royalties a uniform rate of 10% of the gross amount received, most Philippine DTAs levy preferential rates anywhere from 15-25% (depending also on whether enterprises are registered or not with the Board of Investment’s preferred activities). If the foreign enterprise has permanent establishment presence, this leads to resident status that is thus subject to obligations under the national tax code, i.e., the 30% regular corporate income tax. Otherwise, collection of tax on service fees is exempt in the Philippines as the source state, since this is supposedly collected in the residence state under the DTA.

Hence, tax planners and consultants predictably advise clients to take note of BIR conditions defining what are considered taxable for royalty. If not deemed as such, absent the conditions defining royalties, and are paid out to a non-resident corporation without PE status, the payments are exempt from the regular final withholding tax in the source state as they are presumed under tax treaties to be taxed in the resident state.

Conclusions

Like many other developing countries that put premium on attracting foreign investment as key to their development, the Philippines has followed the trend of falling corporate income tax and withholding tax rates under its national tax laws and tax-related policies. Now numbering more than 40, the DTAs it has signed since the mid-70s follows the same trend, and includes several protocols with developed countries that have pushed tax rates even lower.
Although source-based elements of the UN Tax Treaty Model have been incorporated into the DTAs entered into by the Philippines, most of the tax treaties remain residence-based following the template of the OECD Tax Treaty Model. This model has been shown to work against the right of South countries such as the Philippines to raise resources from taxation on and channel these into development needs since investments today flow heavily from developed to developing countries rather than the reverse.

Residence-based DTAs enable various means of shifting of tax revenues to the developed countries where investors are usually based. In effect, revenues that host countries would ordinarily raise from exercising their sovereign right to have the first call at taxing business activity within the scope of their financial jurisdictions are, in effect, reaped in the residence countries.

The cases cited in this paper are only a few of the many claims for tax refunds by corporations invoking the DTAs to seek relief for overpayment. Critical mechanisms exploited in the standard tax treaties are the provisions on MFN and non-discrimination whereby a treaty partner can claim the lowest tax rates offered by the Philippines to a third state. Several corporations in fact sue for refunds not on the basis of their own countries’ DTAs with the Philippines but to claim lower rates offered by the Philippines with other treaty partners or other states.

Equally open to abuse is the permanent establishment concept that, in defining the conditions by which entities can incur regular (and higher) tax obligations under domestic law, gives them the very guidelines by which liabilities can be avoided altogether through aggressive tax planning.

In addition, states have exploited the treaty-partner relationship to negotiate and bring in more resource-eroding changes. The recently amended DTAs with Germany and Japan, for example, are prime examples of how withholding taxes can be steadily reduced and how corporate income tax rates can be cut by more than half through the preferential rates of the DTAs, and slashed even further through the negotiation of protocols.

The accountability of the Philippine government in entering these disadvantageous arrangements is all too clear. It already offers many tax privileges to foreign investors under the national tax code and an extensive incentives system that is supposed to encourage pioneer investments while protecting local production but whose preferred list of activities has shortened over time. Studies have shown no strong conclusive links between these tax privileges to increased FDI, as compared to, say, more definitive factors such as infrastructure and political stability.

Yet the state through its treaty-making powers and legal authority continues to play a crucial role in steadily weakening the source principle in national tax laws as illustrated by the RP-US DTA and in little by little ceding sovereign taxing rights over the income and profits generated in its jurisdiction. The Supreme Court itself has definitively interpreted tax treaties in favor of the Philippines’ treaty partners on the basis of the primacy of international agreements, reversing national administrative procedures previously held in jurisprudence to have the strength of law. However, there are clear moral and justice questions in insisting on the principle of pact sunt servanda (i.e., agreements must be kept), considering the immediate and strategic needs for development resources of South countries such as the Philippines.

By all indication, the number of the Philippines’ DTAs will continue to increase, and in a manner that will generate little information and critical insights into their content and implications. It should be stressed that international treaties signed by the Executive are legally binding instruments that become part of
the law of the land and commit states to amend their domestic laws for compliance. Thus, entering into bilateral treaties such as the DTAs should be more than just an act of the Executive concurred with by Congress but should require diligent examination by both the government and civil society. The experiences of a number of states that have unilaterally cancelled tax treaties found discriminatory and disadvantageous to national interest are worth examining. At the very least, there must be a critical examination and citizens’ awareness of the public revenues traded off for the oft-cited investment returns from DTAs.
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