THE PHILIPPINES - UNITED STATES TAX CONVENTION: SUGGESTIONS FOR A PERSPECTIVE

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PART I

The Philippines broke new ground in its international relations on October 5, 1964. On this date, it concluded with the United States a treaty officially designated as "Convention Between the Republic of the Philippines and the United States of America for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income".[1] If ratified by the Senate, this convention would mark our first experience in international agreement for the avoidance of double or multiple taxation[2] — an old game among highly-developed countries.[3] This

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1 Treaty negotiation began in Manila on January 13, 1964, upon the initiative of the United States. American interest to conclude a tax treaty with the Philippines dates back to 1946. See PHILLIPS, UNITED STATES TAXATION OF NONRESIDENT ALIENS AND FOREIGN CORPORATIONS 214 (1952).

2 A tax convention is sufficiently defined in terms of its objectives, e.g., avoidance of double taxation and cooperation in preventing tax evasion as in the case of the treaty under discussion. Its rationale, however, primarily turns upon the avoidance of international double taxation, that is, the imposition of comparable taxes on the same income by two or more states. See Slowinski, Haderlein & Meyer, **International Tax Treaties: Where Are We — Where Are We Going?**, 5 Va. J. Int'l L. 133 (1965); King, **Tax Conventions to Which United States is a Party**, 2 INSTITUTE ON PRIVATE INVESTMENTS ABROAD 479 (1960); King, **Tax Conventions**, in BITTKER & EBB, TAXATION OF FOREIGN INCOME 357 (1960); CROSSWELL, INTERNATIONAL BUSINESS TECHNIQUES, LEGAL AND FINANCIAL ASPECTS 51 (1963); 5 MERTENS, LAW OF FEDERAL INCOME TAXATION sec. 33.01 (1963). Also UNITED NATIONS, Economic and Social Council, **International Tax Problems**, Doc. E/2865, at 2 (1956); JOINT LEGISLATIVE-EXECUTIVE TAX COMMISSION ANN. REP. 45 (Manila 1965).

3 Agreements on the problem of double taxation and tax evasion date as far back as 1843 with the conclusion of a treaty between France and Belgium. Originally, tax treaties were confined to intra-European trade. For brief historical note, see UNESCO, **Treaty Provisions for the Avoidance of Double Taxation of Copyright Royalties**, 7 Copyright Bulletin 19 (1954). Also Kragen, **Double Income Taxation Treaties: The O.E.C.D. Draft**, 52 Calif. L. Rev. 306 (1964). Block & Heilemann, **International Tax Relations**, 55 Yale L.J. 1158, 1170-71 (1946); Wang, **International Double Taxation of Income: Relief Through International Agreement, 1921-1945**, 59 Harv. L. Rev. 73, 102-114 (1945). The United States has concluded tax treaties with 22 countries. For development of tax treaty law in the United States, see Owens, **Role of U.S. Income Tax Treaties in Relieving Double**

event seemed to have signalled a definite policy course toward adjusting Philippine tax jurisdiction to the demands of world economic integration through the development of international tax law. Barely a year from the conclusion of the treaty with the United States, the Philippines signed three more with the Scandinavian countries.[4] Other countries have signified intention to negotiate for similar agreements.[5] If this trend indicates the emergence of tax treaty law in the Philippines, it should point to the need for defining some perspective by which we may be able to locate our position in relation to the broad sweep of economic and political developments of which the tax convention is only an accessory mechanism.

The first part of this paper examines the mechanics of the Philippines-United States convention (hereinafter referred to as the Treaty), the component principles of which represent the standard features of tax conventions.[6] While such a close-up investigation may be useful by itself, the intention here is to relate the discussion of details to some generalizations in the attempt to construct a context in which tax convention as a specialized legal technique may be better understood. This is the task of the second part. The third part proposes to draw up some theoretical points suggested by the tax convention with respect to the legal relationship of two countries belonging to opposite poles of economic development, in particular countries whose relations with each other have been characterized by colonial ties of one kind or another.

Taxation, 4 INSTITUTE ON PRIVATE INVESTMENTS ABROAD 109 (1962); King, **Tax Conventions to Which United States is a Party, supra** note 1, at 484; Slowinski, **supra note 1.** The Scandinavian countries with which the Philippines recently signed treaties have considerable experience in tax agreements. As of last year, Denmark had 12 tax treaties; Norway, 12; and Sweden, 16. See INT'L BUREAU OF FISCAL DOCUMENTATION, TAXATION OF PATENT ROYALTIES, DIVIDENDS, AND INTEREST IN EUROPE 3.04 (Supp. 9, Nov. 1965), 13.08 (Supp. 6, Jan. 1965), 16.10 (Supp. 9, Nov. 1965).

4 Tax treaty with Denmark was signed at Copenhagen on September 17, 1965; with Norway, at Oslo on September 27, 1965. Treaty with Sweden was signed in the same year, but exact date of signature is not available as of this writing.

5 Federal Republic of Germany, France, Australia, and Japan. See TAX COMMISSION ANN. REP., **supra** note 2.

6 E.g., Foreign tax credit, permanent-establishment concept, personal exemptions, tax treatment of personal services, business, and investment incomes, nondiscrimination provision, exchange of tax information, and mutual assistance in tax collection. The uniform law movement in international tax relations has taken one more concrete step with the preparation of the Draft Double Taxation Convention by the Organization for Economic Cooperation and Development (OECD). See Kragen, **supra** note 3. The Draft contains most of these features.

I. Salient Features of the Philippines - United States Tax Convention

Philippine Tax Jurisdiction

The Philippines locates the nexus of its tax jurisdiction in the status of the taxpayer and the source of income. Status refers to citizenship, residence, or domestic incorporation. On this basis, Philippine citizens, alien individuals residing in the country, and corporations created under Philippine law are generally subject to tax on their entire income without regard to geographical source.[7] Jurisdiction by source of income makes a distinction between income derived from foreign sources and income from domestic sources. While the status rule imposes tax on foreign source income together with the domestic, the source-of-income rule asserts tax jurisdiction only on income arising from domestic sources. It is on the basis of the source-of-income rule that Philippine law defines the base and rate of income taxation of non-resident alien individuals and foreign corporations.[8]

The Treaty preserves the basic tax rule of the Philippines with respect to its citizens and residents, particularly insofar as their foreign source income is concerned. This is achieved by means of a "saving clause" according to which the Philippines reserves the right to tax its nationals as if there was no treaty at all.[9]

The significance of this reservation may be seen in the light of the treaty source-of-income rule which states that a "resident or corporation of one of the Contracting States shall be taxable by the other Contracting State only on income derived from sources within that other Contracting State".[10] As this rule restricts Philippine tax jurisdiction to income from Philippine sources, by itself, it gives rise to the argument that the Philippines cannot reach the U.S. source income of Philippine citizens residing in the United States. The saving clause shuts off this mischief and makes it clear that the Treaty is no bar to Philippine jurisdiction upon taxpayers thus situated. Likewise, by reason of this reservation, Philippine corporations doing business in the United States cannot escape Philippine tax upon their income from U.S. sources by taking refuge under treaty source-of-income rule.

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7 NAT. INT. REV. CODE, secs. 21 & 24(a).
8 NAT. INT. REV. CODE, secs. 22 & 24(b).
9 Art. 3, para. 3.
10 Art. 3, para. 1.

The application of the saving clause, however, is restricted by the tax credit benefit and the non-discrimination provisions of the Treaty where the national of one contracting party is also a resident of the other. This restriction is particularly relevant to these situations: (a) an American citizen is a Philippine resident; and a domestic corporation, owned or controlled by American nationals, does business in the United States.

In such cases, the Philippines cannot discriminate against the taxpayer on tax matters or deprive him of tax credit by resorting to tax "as if the present Convention had not come into effect".

In this respect, the Treaty involves no shift in the theory of tax jurisdiction. Philippine citizens and residents remain subject to tax on the basis of their world-wide income and, as clarified by the saving clause, the Treaty has the effect of merely affirming the Philippine source-of-income rule in the taxation of non-resident alien individuals and foreign corporations. At any rate, this should suggest the major concern of tax conventions: the national income-tax treatment of foreign income.

Coverage of the Treaty

The Treaty limits its coverage to income tax,[11] except that for the purpose of its nondiscrimination provisions[12] it "shall apply to taxes of every kind, and to those imposed at the national, state, or local level".[13] It expressly excludes the tax on improperly accumulated surplus and the personal holding company tax.[14]

On the part of the United States, the Treaty specifies that the subject of the agreement is the Federal tax, including surtax, imposed by Subtitle A of the Internal Revenue Code.[15] Such a coverage reflects two basic features peculiar to the tax system in the United States — a consideration which, as we shall see, freezes the reciprocal nature of the treaty within the four corners of the document.

1. The whole income tax structure in the United States is a hierarchy of the federal, state, and local levels of taxation. A fairly established doctrine followed by American courts is that unless prohibited or restricted by its own constitution, a state has the power

[11] Art. 1, para. 1(a) & (b).
[12] Art. 6.
[13] Art. 1, para. 3.
[14] Art. 1, para. 1(a) & (b).
[15] Art. 1, para. 1(a).

to impose a tax on income.[16] One interpretation describes such power as inherent and an express grant of it under the state constitution superfluous.[17] A survey of state constitutions discloses that at least twenty-one states of the American Union enjoy specific constitutional grant of power to tax income.[18] Only one state suffers from prohibition to impose a tax "upon the income of residents and citizens".[19] Thirty-eight states have already adopted income taxation.[20] Generally, taxation under this level comprehends income arising from sources within the state's territorial jurisdiction.[21] Residence within the state is not a prerequisite to the exercise of taxing power; sufficient is the fact that the taxable property is located, or the taxable event occurred, within the state.[22] Accordingly, non-resident individuals and foreign corporations are subject to state tax with respect to income attributable to property or business within the state.[23]

The problem presented by state taxation is not brought into full relief by merely considering the impact of one or the other state's income tax taken separately. Rather the real difficulty is defined in terms of multiple taxation arising from the imposition

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16 Maxwell v. Kent-Coffey Mfg. Co., 204 N.C. 365, 168 S. E. 397, aff'd 291 U.S. 642 (1933); Welch v. Henry, 226 Wis. 595, 277 N.W. 183, aff'd 305 U.S. 134 (1938), reh. den. 305 U.S. 675 (1938): Sommers v. Patton, 399 Ill. 440, 78 N.E. 2d 313 (1948); State v. Kelly, 176 Wash. 689, 30 P. 2d 638 (1934).

17 Cook v. Walters Dry Goods Co., 212 Ark. 485, 206 S.W. 2d 742 (1948); Diefendorf v. Gallet, 51 Idaho 619, 10 P. 2d 307 (1932).

18 See appendix on state constitutional provisions relating to tax power in NEWHOUSE, CONSTITUTIONAL UNIFORMITY AND EQUALITY IN STATE TAXATION 771 (1959).

19 State of Florida. See art. IX, sec. 11 of its constitution in NEWHOUSE, supra note 18 at 779.

20 Swope, **Multistate Tax Problems, Introductory Remarks**, 44 Taxes 132 (1966): Eaton, **Comment on State Taxation**, 42 Taxes 284 (1965).

21 Chestnut Securities Co. v. Oklahoma Tax Commission, 125 F. 2d 571 (C.C.A. Okla.), cert. den. 316 U.S. 668 (1941): Reynolds Metal Co. v. Martin, 269 Ky. 378, 107 S.W. 2d 251, dism. 302 U.S. 646 (1937); Sun Oil Co. v. Gross Income Tax Division, 238 Ind. 111, 149 N.E. 2d 115 (1958).

22 International Harvester Co. v. Wisconsin Department of Taxation, 322 U.S. 435 (1943); First Wisconsin Trust Co. v. Wisconsin Department of Taxation, 237 Wis. 135, 294 N.W. 868 (1940).

23 Miller Bros. Co. v. State of Md., 347 U.S. 340, reh. den. 347 U.S. 968 (1953): McCulloch v. Franchise Tax Bd., 390 P. 2d 412, app. dism. 379 U.S. 133, reh. den. 379 U.S. 984 (1964); International Shoe Co. v. Fontenot, 236 La. 279, 107 So. 2d 640, cert. den. 359 U.S. 984 (1958); State v. Northwestern States Portland Cement Co., 250 Minn. 32, 84 N.W. 2d 373, aff'd 358 U.S. 450 (1958); ET & WNC Transp Co. v. Currie, 248 N.C. 560, 104 S.E. 2d 403, aff'd 359 U.S. 28, reh. den. 359 U.S. 976 (1958).

of income tax by two or more states on interstate commerce.[24] Thus, while very low tax rates normally prevail in the individual states, their cumulative application on the same business engaged in interstate activities could be as great as a burden as the federal tax. Yet the amount of tax is the least part of the burden. The compliance costs "which often completely overshadow the amount of tax involved", the different income-apportionment formulas of the income-tax states, and the wide variety of definitions of income in the various taxing jurisdictions are far more overwhelming to the taxpayer.[25] In addition, there should be no missing the fact that where appropriate authority is delegated either by the state constitution or statute, a municipal corporation may impose tax on income.[26] As of last year, more than 100 localities had adopted income taxation.[27]

From the foregoing survey it is immediately clear that by including only the federal income tax as the central subject of the agreement the Treaty is hardly a matter of consequence in the exceptional cases that a Philippine national may be able to do business

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24 "As of the end of 1964, there were in effect at the State level 38 sets of corporate income tax laws, 38 sales and use tax laws, 37 capital stock tax laws, and 8 gross receipts tax laws of general applicability. In addition, corporate income taxes were being imposed by over 100 local governments, sales taxes by over 2,300 localities, and gross receipts taxes by over 1,000 localities . . . . However, it is important to keep in mind that a company selling goods across State lines is usually subject not only to one or the other of these taxes, but rather must cope simultaneously with several of them, as well as with a variety of other taxes such as property taxes, gasoline taxes and various special excises. As troublesome as all of these taxes are when viewed separately, the difficulties which they present appear compounded when they are considered in terms of their cumulative effect." From the Report of the Special Subcommittee on State Taxation of Interstate Commerce of the Committee of Judiciary of the U.S. Congress (88th Cong., 2d Sess., H. Rep. 1480), quoted in Swope, **supra** note 20. For survey of problems in state taxation of interstate commerce, see Taylor, **House Study Finds State Taxation of Interstate Commerce Burdensome and Unfair,** 21 J. Taxation 120 (1964); Woodard, **State Taxation of Multistate Business,** 44 Taxes 491 (1966); Hartman, **State Taxation of Corporate Income From a Multistate Business,** 13 Vand. L. Rev. 21 (1959).

25 Taylor, **supra** note 24, at 121.

26 16 MCQUILLIN, LAW OF MUNICIPAL CORPORATIONS sec. 44.05 & 44.193 (1963).

27 Swope, **supra** note 24; Taylor, **supra** note 25. For more localities adopting income taxes since 1965, see **State Tax News,** 43 Taxes 159, 161 (1965).

of some significant scale in the United States.[27a] On two counts, the defect goes into the premises of the Treaty. First, the problem of double taxation on the part of Philippine nationals relates not only to the U.S. federal taxation but, perhaps more significantly, to state and local taxation as well. With the exclusion of the latter, the Treaty hardly fulfills its rationale, i.e., avoidance of double taxation, on the side of the Philippines. Secondly, the disparity of the treaty coverage nullifies considerably the reciprocity principle. When the Treaty specifies that it covers the "income tax imposed by Title II of the National Internal Revenue Code" in the case of the Philippines,[28] it comprehends the whole income tax system in the country. This is emphasized by the fact that under Philippine law, cities, municipalities, and municipal districts, are prohibited from imposing taxes "on income of any kind whatsoever".[29] While this coverage assures American nationals of relief from all taxes on income under the terms of the Treaty, the burden of state and local taxation remains in full play upon Philippine nationals similarly situated. This is concretized in the case of personal exemption benefits which the Treaty grants to teachers, students, trainees, and recipients of government salary.[30] To Philippine nationals, such benefits are meaningful only in relation to the the U.S. federal income tax; they remain subject to state and local taxation. But to American nationals, the exemption involves total relief from Philippine income taxation.

2. The United States federal income tax consists of two taxes: the normal tax and the surtax. In the case of individuals, the taxes have been combined under a single tax rate table since the 1954 amendments to the U.S. Internal Revenue Code.[31] In the case

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27(a) In contrast, proposed treaties with Norway and Sweden respectively include "municipal income tax" and "communal income tax", in addition to national income taxes. See Convention with Norway, art. 1, para. 1(b); and with Sweden, art. 1(a). It does not seem plausible to argue that such non-inclusion of state and local taxes is dictated by Constitutional prohibition on the part of the U.S. federal government to bind the individual states by its treaty-making power. U.S. treaties hold a position of supremacy over state constitutions and statutes. See U.S. Const: art: VI: Also U:S: v. Holland, 252: U:S: 416 (1919); Scandinavia Air Lines v. Los Angeles, 14 Cal. Rptr. 25, 40, 363 P. 2d, 40 (1961). The Treaty itself refutes that argument; its nondiscrimination provisions apply to taxes on state and local levels. See Treaty art. 1, para. 3.

28 Art. 1, para. 1(b).

29 Rep. Act No. 2264, sec. 2(g).

30 See arts. 14, 15 & 16

31 1 MERTENS, LAW OF FEDERAL INCOME TAXATION sec. 2.02 (1962).

of corporations, they remain separate.[32]

This double-tax feature of the U.S. federal income tax, as reflected in the coverage of the Treaty, carries significance in the application of Philippine tax credit in favor of an American citizen residing in the Philippines, or a domestic corporation dominated by American capital and deriving taxable income from U.S. sources. As shown in the following discussion, since the U.S. tax rate, including the surtax, is much higher than the Philippines the operation of tax credit involves greater tax relinquishment on the part of the Philippines.

Source-of-Income Rule

The Treaty contains three main features in its approach to international double taxation and fiscal cooperation, namely: (1) relief from double taxation; (2) elimination of discrimination on tax matters; and (3) administrative cooperation. The relief provisions embody three rules: (1) the source-of-income rule; (2) the foreign tax credit; and (3) the permanent-establishment rule.

The source-of-income rule of the Treaty requires that the Philippines shall tax a U.S. resident or corporation only as to income derived from Philippine sources, and that the U.S. federal income tax shall apply to Philippine resident or corporation only on the basis of income earned within the United States.[33] This coincides with the tax treatment of non-resident alien individuals and foreign corporations under Philippine law.[34] Thus, both the Treaty and the Philippine tax Code consider income from personal services as derived from the country in which such services are performed.[35] As in Philippine law, the Treaty takes income from real property as taxable in the country where the property is located.[36]

An exception to the treaty source-of-income rule comes in the case of personal services "performed aboard ships or aircraft ope-

[32] The normal tax on corporations for taxable year beginning after December 31, 1963 is 22%. In addition, taxable income beyond $25,000 is subject to surtax of 26% for taxable year beginning after December 31, 1964. Total corporate taxes for income in excess of surtax exemption is 48%. See U.S. INT. REV. CODE (1954), secs. 11(b)(2) & 11(c)(3), as amended by sec. 121 of the Rev. Act of 1964, Pub. Law 88-272, 88th Cong., 2d Sess., approved Feb. 26, 1964.

[33] See art. 3, para. 1.

[34] NAT. INT. REV. CODE, secs. 22 & 24(b).

[35] Treaty art. 5, para. 1, in relation to NAT. INT. REV. CODE, secs. 37(a)(3) & 37(c)(3).

[36] Treaty art. 11, in relation to NAT. INT. REV. CODE, secs. 37(a)(4) & (5), & 37(b)(4) & (5).

rated by a resident or corporation of a Contracting State and, in the case of the United States, registered in the United States".[37] The treaty rule is that such particular kind of income, where the services are rendered by a member of the regular complement of the ship or aircraft, shall be treated as income from Philippine source if a Philippine resident or corporation operates the ship or aircraft, or as income from United States source if the ship or aircraft is registered in the United States.[38] The same effect is achieved by the Treaty in exempting compensation from personal services performed aboard ships or aircraft registered in, or operated by a national of, one Contratcing State from the income tax of the other.[39] In this respect, it would seem that Philippine rule adheres strictly to the source-of-income standard and therefore diverges from the treaty provision. In defining gross income from Philippine sources with respect to compensation for personal services, Philippine law disregards the residence of the payor, the place in which the contract was made, or the place of payment. Thus, "[w]ages received for personal services rendered inside the territorial limits of the Philippines and wages of alien seamen earned on a coastwise vessel are to be regarded as from sources within the Philippines".[40] Since the source of earnings here is determined by the nature of the vessel's trade in relation to the actual situs of the personal services, apportionment of income on time basis may be used where the vessel is engaged in foreign trade, that is, "there shall be included in the gross income an amount which bears the same relation to the total compensation which the services within the Philippines bears to the total number of days of performance of labor or services for which the payment is made."[41] The Treaty replaces this criterion with the test that source of income shall be determined by the nationality of the vessel's operator or the place of its registry, as the case may be[41a].

Tax Credit

On reciplocal basis, the Treaty provides that the amount of tax paid to the United States by a resident or corporation of the Philippines shall be credited against the Philippine income tax liability of such national.[42] On the part of the Philippines, the credit shall be

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37 Art. 5, para. 1.
38 Ibid.
39 Art. 13, para. 4.
40 Income Tax Regulations, sec. 155.
41 Ibid.
41a Apparently, this principle is derived from U.S. INT: REV: CODE, sec: 212, 231(d).
42 Art. 4, para. 1 & 2.

based on the full amount of income tax paid to the United States.[43] In other respects, it shall be allowed in accordance with Philippine revenue laws.[44]

The Treaty introduces no new rule nor changes any existing one in Philippine income taxation. Under its own law, the Philippines allows its citizens, residents, and domestic corporations to credit taxes they pay to the United States against their Philippine income tax.[45] In fact, Philippine tax credit provisions are derived from U.S. revenue laws.[46]

But the treaty tax credit is just the same significant as it secures a bilaterally established rule that the Philippines and the United States allow credit to each other's nationals. Minus the Treaty, a resident or corporation of either country is declared as allowed credit by a unilateral ruling of the Philippines or the United States, as the case may be, and based upon the credit device of its own law.

The credit provisions of both countries require that a resident alien is entitled to credit only if the foreign country of which he is a citizen, in imposing income tax, allows a similar privilege to citizens of the Philippines or the United States residing in that foreign country.[47] The Treaty completes the credit provisions of either country by providing that the contracting parties satisfy each other's cridit requirements. In point of fact, however, American citizens residing in the Philippines have been alloyed credit on the basis of Philippine credit provisions in relation to the corresponding American credit rule and practice.[48]

Under Philippine law, tax credit is open only to citizens, domestic corporations, and resident alien individuals.[49] Non-resident individuals, engaged in business here or not, and foreign corporations, resident or non-resident, are not eligible for credit since they are subject to tax only on income arising from Philippine sources.[50]

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43 Art. 4, para. 2.

44 Ibid.

45 NAT. INT. REV. CODE, sec. 30(c)(3).

46 See U.S. INT. REV. CODE (1954), secs. 901-905. The Philippine provision seems to have been substantially taken from the American counterpart as found in sec. 131 of U.S. Internal Revenue Acts of 1932, 1934, 1936, 1938 and 1939.

47 See U.S. INT. REV. CODE (1954), sec. 901(b)(3), in relation to NAT. INT. REV. CODE, sec. 30(c)(3)(B).

48 See BIR Ruling, October 3, 1954.

49 NAT. INT. REV. CODE, sec. 30(c)(3)(A) & (B).

50 See NAT. INT. REV. CODE, secs. 22 & 24(b).

The amount of credit a taxpayer is entitled to is subject to each of the following limitations:[51]

1. The "per-country" limitation limits the amount of credit to the claimant's Philippine tax[52] multiplied by the ratio of his taxable income from sources within the *foreign country to which he paid taxes,* to his total income from all sources, domestic as well as foreign. This assures that the amount to be credited will not exceed the Philippine tax attributable to the claimant's income from sources within a particular foreign country.

2. The "over-all" limitation prescribes that the maximum credit allowable shall not exceed the Philippine tax due on the claimant multiplied by the ratio of his taxable income from *all foreign sources* (less foreign losses), to his total taxable income from all sources, domestic and foreign. The credit ceiling is the Philippine tax due on his entire income from foreign sources.

In fine, the object of these limitations is to restrict the application of the credit device to the amount of Philippine tax corresponding to the foreign source income, thereby preventing the reduction of Philippine tax on domestic source income.

The effect of the tax credit is that to the extent that the United States may impose creditable taxes on its citizens residing in the Philippines or domestic subsidiaries of American corporations, the Philippines gives up tax jurisdiction over such individuals or entities with respect to income derived from U.S. or other foreign sources. This result is practically the same as exemption of taxpayers so situated granted by the Philippines for the reason that they have already paid taxes of comparable amount to the United States. To such extent the operation of the credit device necessarily involves tax relinquishment, and how much in taxes is given up depends upon the rate of the foreign tax. If the foreign rate is lower than the Philippines', the taxpayer pays to the Philippines only so much of his Philippine tax liability as represented by the excess of the Philippine rate over the foreign rate. But if the foreign rate equals or exceeds the Philippines', the Philippine tax liability of the taxpayer is completely wiped out since he may even have paid much more that what Philippine credit rule allows. Philippine tax could apply on foreign source income only where the foreign tax rate is less than the Philippine rate. Thus, since

[51] NAT. INT. REV. CODE, sec. 30(c)(4).

[52] Creditable taxes are those on income, war-profits, and excess-profits, either paid or accrued. See supra note 49.

the U.S. rate is higher than that of the Philippines a credit allowed to an American citizen residing here or a domestic subsidiary of an American parent firm operates to free such taxpayers from Philippine tax to the fullest extent allowed by the per-country or over-all limitation, whichever is the lesser. Tax sacrifice on the part of the Philippines may be greater where the domestic subsidiary of an American corporation derives the bulk of its income from foreign operations. American advantage over the Philippines arising from the application of the credit device, though apparently reciprocal, is strenghtened by such other factors as the currency ratio between the two countries and the American additional tax (surtax).

Note that the operation of the tax credit may have the same effect as the application of the source-of-income rule. This happens where the foreign tax (e.g., the U.S. tax) to be credited against the Philippine tax liability is higher than that of the Philippines — so high as to reach the very limit imposed by the per-country and the over-all limitations, whichever is the lesser. In that case, the amount of credit is enough to eliminate the Philippine tax attributable to income from foreign sources. What remains of the taxpayer's liability is that portion of the tax corresponding to income derived from Philippine sources. In other words, Philippine tax jurisdiction excludes foreign source income — as in the application of the source-of-income rule. The difference, however, is that while the source-of-income rule particularly applies to non-resident alien individuals and foreign corporations, the tax credit device benefits resident aliens or foreign capital in the form of domestic corporations. At any rate, both could operate complementarily in relation to alien business: it obtains tax advantage thru the credit device when it maintains its situs within the country, and thru the source-of-income rule when it is non-resident.

In a case [53] involving American residents claiming deduction of taxes paid to the United States, the Supreme Court observed that —

> To allow an alien resident to deduct from his gross income whatever taxes he pays to his own government amounts to conferring on the latter the power to reduce the tax income of the Philippine government simply by increasing the tax rates on the alien resident. Everytime the rate of taxation imposed upon an alien resident is increased by his government, his deduction from Philippine taxes would correspondingly increase, and the proceeds for the Philippines dimi-

[53] Commissioner v. Lednicky, G.R. Nos. L-18169, 18286 & 21434, July 31, 1964. This case concerns deduction of certain taxes from gross income on the basis of sec. 30(c)(1) & (2).

nished, thereby subordinating our own taxes to those levied by a foreign government. Such a result is incompatible with the status of the Philippines as an independent and sovereign state.

Such patriotism may as well direct its fire upon the whole institution of foreign tax credit, for tax credit operates with the same effect, except that here the "status of the Philippines as an independent and sovereign state" is saved by the two limitations we have discussed.[54] At any rate, the implications of the tax credit device we have outlined above should suggest a basic re-thinking on the subject on our part, this time in the light of our contemporary economic needs as a country separate from, and independent of, the United States.

The history of the tax credit system under U.S. law makes it clear that tax credit was adopted as a measure geared to the policy of encouraging American business to invest abroad. It was intended to relieve American commercial operations overseas from the burden of double taxation on their foreign source income.[55] Significantly enough, the revenue law[56] which introduced the tax credit device came in about the second decade of the American expansionist era. Amendments to this law emphasized the more the adjustment of income taxation to the demands of a growing appetite for markets. The 1921 amendment liberalized the credit by providing that, where a United States corporation owned the majority of the voting stock of a foreign corporation from which it received dividends, it would be deemed to have paid the foreign income tax on the accumulated profits from which the dividends were paid, without regard as to whether such tax was actually paid by the subsidiary or not.[57] In 1942, such credit was extended to apply where a foreign subsidiary of an American parent corporation controlled another foreign corporation with respect to taxes paid by both subsidiaries on the accumulated profits from which they paid dividends to the parent.[58] This gave American corporations incentive to effect economic penetration in the form of subsidiary corporation. The 1942 amendment also broadened the

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54 Tax credit developed from deduction. See 5 MERTENS, LAW OF FEDERAL INCOME TAXATION sec. 33.01 (1963). In the Philippines, before the enactment of the National Internal Revenue Code (Com. Act No. 466), an unqualified deduction was allowed for taxes paid. See Act No. 2833, secs. 5(a), 6(a), & 12(a).

55 Hinkel, **Foreign Tax Credits,** 17 INSTITUTE ON FEDERAL TAXATION 391 (1959); Anthoine & Bloch, **Tax Policy and the Gold Problem,** 61 Colum. L. Rev. 323, 326 (1961); Owens, **United States Income Tax Treaties: Their Role in Relieving Double Taxation,** 17 Rutgers L. Rev. 432, 446 (1963).

56 Hinkel, **supra** note 55; MERTENS, **supra** note 54.

57 Hinkel, **op. cit. supra** at 392, citing U.S. Revenue Act of 1921, sec. 238(c).

58 Hinkel, **op. cit. supra** at 393, citing U.S. Revenue Act of 1942, sec. 158.

definition of foreign "income tax" for credit purposes.[59] All this indicates the progressive congruence of income taxation and foreign economic policy,[59a] intended to make it "less difficult for American corporations to transact business abroad".[60]

Consistent with the rationale of the foreign tax credit system, should the Philippine tax credit provision be taken then as an incentive for investment of Philippine capital abroad, giving premium to the flight of capital from the country? Since such rationale can be meaningful only in the policy context of a well-developed economy, embarking on international trade and investment, what relevance does the tax credit device bear to our economic backwardness? As we inquire into the history of tax credit in the Philippines, we see no policy of particular economic content to justify it. Apparently, nothing explains its adoption beyond the fact that it came as a result of the direct administrative rule over the country as an American possession, with the obvious intent of extending to U.S. citizens and corporations in the Philippine Islands so many tax privileges as they already had at the time under U.S. federal revenue laws.

Our present tax credit provision has remained unchanged since its adoption in 1939, in the same form as the American tax credit provision as found in the U.S. revenue acts of the early 1930's.[61] Thus, as provided in Philippine law, tax credit does not seem to to have any respect for political and economic changes. However, although its form has not changed for about three decades now, we are presently experiencing a shift in its function. While under colonial days tax credit merely constituted part of the tax benefits extended to U.S. nationals in the Philippine Islands through the Commonwealth law, it is now emerging as a tax incentive for the entry of foreign investments. Curiously enough, its new function, or rather its rationalization, dovetails with the foreign policy objective of the United States to open up some breathing space for American capital especially in under-developed countries — regions which provide monopoly opportunities, cheap labor, abundant raw

[59] MERTENS, supra note 54; also at sec. 33.04.

[59a] See Tillinghast, Current Issues in the Taxation of Foreign Income in SHAW (ed.), LEGAL PROBLEMS IN INTERNATIONAL TRADE AND INVESTMENT 175 (1962)

[60] MERTENS, supra note 54.

[61] See supra note 46. See also TAX SERVICE OF THE PHILIPPINES, THE PHILIPPINE NATIONAL INTERNAL REVENUE CODE, HISTORICALL DEVELOPED TO JUNE 20, 1964 (no date).

materials, and therefore high rate of profit.[62] Even so, tax credit by itself could not be expected to perform a positive role in attracting foreign investments. The most it could do is "to achieve neutrality respecting capital flows".[63] Either we have chosen the wrong technique, or the excuse belongs somewhere else.

Permanent-Establishment Rule

Under Philippine law, a foreign corporation is either resident or non-resident, depending on whether it is "engaged in trade or business" in the country or not.[64] But this classification decides merely the basis and rate of tax,[65] not its taxability. Whether resident or not, it is always taxable so long as it has income flowing from Philippine sources. Its taxability is determined not by its classification, but by the situs of its income.

Accordingly, a foreign corporation does not have to engage in trade or business to be subject to Philippine tax. Taxability is based on the mere fact of income having been derived from Philippine source, not on a particular form of deriving income from such source. In *Philippine Guaranty Co. v. Commissioner*,[66] the Supreme Court made it clear that—

> Section 24 of the Tax Code does not require a foreign corporation to engage in business in the Philippines in subjecting its income to tax. It suffices that the activity creating the income is performed or done in the Philippines. What is controlling, therefore, is not the place of business but the place of activity that created the income.

The absurd effect of equating taxability with doing "business" has been pointed out by the Court in *Alexander Harden & Co. v. Collector*,[67] thus:

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62 Rothkopf, **Current Developments in the Field of International Tax Affairs**, 44 Taxes 87, 92, 95 (1966); Meier, **Legal-Economic Problems of Private Foreign Investment in Developing Countries**, 33 U. Chi. L. Rev. 463, 466 (1965); Walker, **Treaties for the Encouragement and Protection of Foreign Investment: Present United States Practice**, 5 Am. J. Comp. L. 229, 231 (1956); Lockwood & Schmeisser, **Restrictive Practices in International Trade**, 11 Law & Contemp. Prob. 663, 666 (1946). See also BARLOW & WENDER, FOREIGN INVESTMENT AND TAXATION xvii (1955).

63 Anthoine & Bloch, **supra** note 45, at 345.

64 See NAT. INT. REV. CODE, sec. 24(b).

65 Thus, for resident foreign corporations the basis of tax is the total net income on which the rate is 22% if such income is not more than ₱100,000, and 30% for the income in excess of said amount. The rate for the non-resident class is 30% with gross income as the base. In both cases, only the domestic source income is subject to tax. See NATL INT. REV. CODE, sec. 24(b).

66 G.R. No. L-22074, April 30, 1965.

67 G.R. No. L-19392, April 14, 1965.

> If by source of income is meant the business of the taxpayer, foreign corporations not engaged in business in the Philippines would be exempt from taxation on their income from sources within the Philippines.

Through its permanent-establishment rule, the Treaty seeks to revise such treatment of foreign enterprises. It provides on reciprocal basis that an American corporation shall be subject to Philippine tax on its "industrial or commercial profits" (business income) only if it maintains a "permanent establishment" in the country.[68] It proceeds to refine this rule (a) by specifying the kind of income covered and (b) by defining the term "permanent establishment".

This rule covers only "industrial or commercial profits" which the Treaty defines as "income derived from the active conduct of a trade or business", especially profits from manufacturing, mercantile, agricultcral, fishing, and mining activities.[69] It does not apply to investment income and personal services income.[70]

"Permanent establishment" is defined as a "fixed place ot business through which a resident or corporation of one of the Contracting States *engages in trade or business*".[71] It includes, among others, a branch office, a store or other sales outlet, a factory a warehouse a mine, a quarry or other place of extraction of natural resources.[72] The term, however, is given special meaning such that even a "fixed place of business" shall not constitute a permanent establishment is used by a U.S. corporation for any one or more of the following purposes: (1) storage, display, or delivery of its goods; (2) maintenance of its stock of goods for storage, display and/or delivery, or for processing by another person; (3) purchase of goods or merchandise; (4) collection of information; (5) advertising or supply of information; and (6) scientific research or "other similar activities which have a preparatory or auxiliary character".[73] Moreover, an American corporation shall not be deemed to have established a permanent establishment if it uses the services of an independent broker or agent acting in the ordinary course of its business.[74] Also excluded from the permanent establishment definition is a domestic agent who regularly makes purchases of goods and merchandise for such corporation upon an "authority to conclude contracts" in the name of its prin-

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68 Art. 7, para. 1.
69 Art. 7, para. 3.
70 **Ibid.**
71 Art. 8, para. 1. Underscoring supplied.
72 Art. 8, para. 2.
73 Art. 8, para. 3.
74 Art. 8, para. 8.

cipal.[75] The mere fact that an American corporation controls or is controlled by a domestic corporation shall not make the latter entity the permanent establishment of the former.[76] Neither shall the fact that both are under common control, by itself, be considered for the same purpose.[77]

With respect to business income at least, the Treaty proposes to introduce a radical change in Philippine tax jurisdiction. Such a change presents two aspects. First, the Treaty revises the concept of residence. Second, it changes the application of residence in relation to tax jurisdiction. While Philippine law determines residence by the broad fact that a foreign corporation is "engaged in trade or business" within the country, the Treaty specifies that it shall not be deemed resident unless it is "engaged in trade or business through a permanent establishment". As thus specially defined by the Treaty, residence not merely decides the amount of tax by indicating the appropriate tax base and the corresponding rate; it is made the criterion for determining whether a given business income is in the first place within Philippine jurisdiction or not. The plain result is the contraction of Philippine tax jurisdiction through the device of equating taxability with a particular form of doing business, i.e., through a permanent establishment — a situation which legitimizes the absurd result pointed out in the *Alexander Howden* ruling,[78] cited above. Foreign corporations are taxable only as to income arising from domestic sources. The effect of the Treaty is to restrict further taxable area with respect to business income of American Corporations; such income is subject to Philippine tax only if earned by a permanent establishment. The source-of-incomer rule becomes the permanent-establishment-income rule.

Tax relinquishment through the operation of the permanent-establishment rule is concretized in the innumerable cases where income-yielding transactions, though isolated or irregular, are realized through some "fixed place of business" excluded from the permanent establishment definition. By means of such exclusions, an American corporation could engage in a wide range of business activities in the Philippines without its business income subjected to tax despite the presence here of its place of business from which it may derive casual, or even determinable, profits. Major com-

[75] Art. 8, para. 7.
[76] Art. 8, para. 6.
[77] **Ibid.**
[78] See **supra** note 67.

mercial operations, for example, may be conducted through any of the following arrangements:

1. Purchasers place orders with the company's home office which cables them to its Philippine branch the authority and function of which is limited to storage of merchandise for delivery and purchase of goods. The branch purchases goods to fill the orders and either ships them to the home office for forwarding to purchasers or sends them directly to purchasers. The branch bills the purchasers and receives payment by drawing against letters of credit opened by purchasers. The branch office remits the proceeds of the sale, retaining a commission.[79]

2. A foreign corporation makes negotiations for the sale of goods in the United States. The goods, produced or mined in the Philippines, are shipped directly to the purchasers in the United States by the company's Philippine agent, who holds "authority to conclude contracts in the name of the corporation" with respect to the purchase of goods. The sale is subject to confirmation and control of the agent as to the price and terms of delivery, since it is the agent who is acquainted with the market conditions at source.[80]

3. A foreign enterprise uses the services of an independent agent or broker in the Philippines to solicit orders. It maintains an office here for display and storage of goods from which the agent fills the orders.[81]

4. A foreign corporation, which maintains a stock of goods and facilities for storage, display and delivery in the Philippines, secures orders by mail or cable. Orders are filled from its stock of good locally maintained.[82]

In transactions such as these the sale may be considered as consummated in the Philippines under the "title passage" test, and profits therefrom may be attributable to Philippine sources. Such profits, even if constituting merely casual gains now form part of the taxable income of non-resident foreign corporations.[83] The Treaty, however, would operate to exclude them from Philippine jurisdic-

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79 See Briskey Co. v. Commissioner, 29 BTA 987 (1934) aff'd 78 F. 2d 813 (3rd Cir. 1935), for analogical reference in relation to Treaty art. 7, para. 2(b) & art. 8, para. 3(a), (b) & (d).

80 See Compañia General de Tabacos v. Collector, 51 Phil. 154 (1927), aff'd 279 U.S. 306 (1928), for analogical reference in relation to Treaty art. 8, para. 4(a).

81 See Treaty art. 8, para. 3(a) & (b), & para. 5.

82 Treaty art. 8, para. (a) & (b).

83 Rep. Act No. 3841.

tion on the ground that they were not earned through a permanent establishment.

As we shall show more extendedly in the second part of this paper, tax convention is primarily an instrument to facilitate the free flow of trade and investment. This function becomes more specific through the permanent-establishment rule which would make possible extensive economic penetration without much concern for income taxation. In the first place, the rule would be useful as a guide in planning export operations such that they would avoid payment of tax. It could be a convenient tax protection for exploratory efforts to develop the market or to see whether there is enough profit foreseeable before a foreign corporation would be willing to move into the country by establishing a permanent establishment. It is significant to note that the concept of permanent establishment in the Treaty is of broader scope than that employed in other United States conventions, permitting more business activities not involving a permanent establishment.[84] Under the Treaty, an American corporation could send salesmen into the country to solicit orders or make sales, or technicians to provide services; make sales in its own name through a local broker or agent; conduct a full-scale trade promotions through a branch office; maintain a laboratory for product development out of local materials; and purchase huge amount of raw materials for resale abroad — and in all this it could protect itself from Philippine taxation under cover of the permanent-establishment rule[85] This is not to suggest that such transactions necessarily involve taxable events; the question of taxability which the application of the rule may bring up could only be defined by the fact-situation of each particular case. The aim here is merely to explain that the underlying reason of the permanent-establishment rule is rooted in the economic imperatives of a highly-developed trading country. It is not difficult to see that, though this rule is calculated to apply on reciprocal basis, its operation would result in anomalous disparity if we consider our colonial-feudal economy in relation to the industrial wonders of the United States. Is it not plain here that

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[84] The definition of permanent establishment in the Treaty is taken from the Draft Double Taxation Convention of the Organization for Economic Cooperation and Development. Compare Treaty art. 8 with O.E.C.D. Draft art. 5 in Kragen, **Double Income Taxation Treaties: The O.E.C.D. Draft**, 52 Cal. L. Rev. 306, at note 25. This definition, is broader than the one which has been generally used by the United States, except in its treaty with Luxemburg. See Slowinski, Haderlein & Meyer, **International Tax Treaties: Where Are We — Where Are We Going?**, 5 Va. J. Int'l L. 133, 148 (1965).

[85] See Carroll, **How Tax Treaties Benefit U.S. Companies**, 8 J. Taxation 248 (1958); Gordon, **The Role of Tax Treaties**, 43 Taxes 463 (1965).

he who has the goods has the law on his side?

Other Provisions in Aid of Foreign Enterprise

Consistent with the purpose of tax convention to assist the enterprise of one country to invest or operate in the territory of another, the Treaty provides for a number of reciprocal concessions.

1. *National treatment clause.* The Treaty assures the same tax treatment to U.S. nationals as accorded to Philippine citizens and corporations in the Philippines. It provides that the nationals of one of the contracting parties, while residing in the other shall not be subjected therein to other or more burdensome taxes than are imposed on the nationals of the latter.[86] This protection extends to permanent establishments.[87] Under the Treaty, the concept of "national treatment" acquires significant development. It reflects the shift in the basis of protection of foreign private property: from legal relationship to economic interest. Thus, the Treaty disregards the corporate fiction and extends protection to foreign capital in domestic corporations. It prevents the Philippines from establishing any discrimination on tax matters against a domestic corporation the capital of which is "wholly or partly owned by one or more citizens or corporations" of the United States.[88] Note that the phraseology is vague as to how much American equity participation is necessary for a Philippine corporation to be entitled to the nondiscrimination benefit. It does not seem to require that American interest be necessarily controlling. Such ambiguity makes it difficult to determine to what extent the Philippines is restrained in dealing with corporations created under its law. On the part of the United States, this gives recognition to the prominence of corporate form of doing business abroad.[89] For this reason, one writer observed, "[t]he first task [of the United States] in developing a treaty pattern after the late War, consequently, was to devise ways of providing adequately for the rights of corporations".[90]

2. *Computation on net basis.* Under Philippine law, nonresident foreign corporations are subject to tax on the basis of *gross* income arising from domestic source, while the resident class

86 Art. 6, para. 1.

87 Art. 6, para. 2.

88 Art. 6, para. 3.

89 Walker, Treaties for the Encouragement and Protection of Foreign Investment: Present United States Practice, Am. J. Comp. L. 229, 232 (1956).

90 See id. at 233.

is taxable on its *net* income from the same sources.[91] Thus, the amount of tax is relatively greater in the former case, as no deductions are allowed before tax.[92] The Treaty, however, allows American corporations (and citizens) to compute the tax on certain kinds of investment income "on a net basis", without making a distinction between resident and non-resident taxpayers.[93] In effect, an American corporation may be treated as resident and non-resident at the same time with respect to different kinds of income. As to business income, it may not be subject to tax for the reason that its conduct in the Philippines does not have the status of a permanent establishment. At the same time, it may be treated as though it had established a permanent establishment with respect to certain forms of investment income, such as rentals from real property, profits from sale or exchange of such property, profits from sale or exchange of such property, and mineral royalties; thus, it could take advantage of appropriate deductions by electing to use net income as the tax base.

3. *Tax-free transfers.* The Treaty exempts from tax a U.S. corporation (or citizen) with respect to profit that may be realized in an exchange of its property for stock of a Philippine corporation, under the condition that as a result of the exchange U.S. corporation, alone or with "any other persons making similar transaction", owns stock of the transferee corporation to the extent of "all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation".[94] The value of the property when transferred and recorded in the books of the transferee should not exceed its value as recorded in the books of the transferor.[95] Despite this limitation, the valuation of the property and, hence, the price of the controlling interest in the tranferee corporation, is largely determined by the American transferor.

The importance of the exemption is that it removes the tax barrier in the formation of joint ventures, particularly one where the property exchanged by the American corporation is in the form of patent, copyright, or industrial technique. It constitutes a tax incentive to a take-over by American interest of substantially all of the stock of a domestic corporation.

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91 See NAT. INT. REV. CODE, sec. 24(b); BIR Ruling, June 25, 1960.

92 See MATIC, FUNDAMENTALS OF PHILIPPINE TAX LAW AND PROCEDURE 141 (1966).

93 Art. 11.

94 Art. 12.

95 Ibid.

Barely a year after the Treaty was signed, an amendment to our capital-gains rule introduced practically the same tax privilege. It provides that no gains (and loss) shall be recognized in the exchange of property for stock of a corporation if as a result the transferor of the property, alone or with not more than four persons, gains control of the transferee corporation.[96] This rule would complement the Treaty in two respects. First, to be exempt from the capital gains tax, the consequent control required under the domestic rule is more easily achieved, that is, only 51% of the voting stock[97]; this would qualify more property-stock exchanges to exemption than is possible under the Treaty, provided the property valuation requirement in the Treaty is met. Second, since the Treaty rule exempts only a U.S. corporation (or citizen), "any other persons" not nationals of the United States who may be united with it in the consequent control would be excluded from the benefit; however, the application of the domestic rule would operate to confer to such persons the same tax privilege, provided they are not more than four.[99]

4. *"Commercial travelers" clause.* On reciprocal basis, the Treaty provides that a U.S. resident shall be exempt from Philippine tax with respect to his income from personal services performed in the Philippines if he is present in the country for a period not exceeding 90 days during the taxable year provided that such income is not more than $3,000 and has not been deducted in computing the profits of a permanent establishment in the Philippines.[100] This exemption includes income from services performed by such resident as employee of a resident American corporation.[101] It also applies to employment income of officers or directors of corporations.[102]

96 NAT. INT. REV. CODE, sec. 35(2), as amended by Rep. Act No. 4522 (approved June 19, 1965).

97 Id, sec. 35(2) & (5)(c).

98 Quaere: By application of the treaty "saving clause", may the Philippines deprive a U.S. resident who is a Philippine citizen of this exemption? See Treaty art. 3, para. 3 & 4.

99 See supra note 96.

100 Art. 13, para. 1(a) & (b).

101 Art. 13, para. 1(c).

102 Art. 13, para. 2.

CONVENTION BETWEEN THE REPUBLIC OF THE PHILIPPINES AND THE UNITED STATES OF AMERICA FOR THE AVOIDANCE OF DOUBLE TAXATION AND THE PREVENTION OF FISCAL EVASION WITH RESPECT TO TAXES ON INCOME *

The Government of the Republic of the Philippines and the Government of the United States of America, desiring to conclude a convention for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income, have appointed for the purpose their respective Plenipotentiaries:

The Government of the Republic of the Philippines:

Mauro Mendez, Secretary of Foreign Affairs of the Republic of the Philippines, and
Rufino G. Hechanova, Secretary of Finance of the Republic of the Philippines,

The Government of the United States of America:

Dean Rusk, Secretary of State of the United States of America,

who, having communicated to each other their respective full powers, found in good and due form, have agreed upon the following Articles:

ARTICLE I

Taxes Covered

(1) The taxes which are the subject of the present Convention are:

(a) In the case of the United States, the Federal income tax, including surtax, imposed by Subtitle A of the Internal Revenue Code (but not including the tax on improperly accumulated earnings or the personal holding company tax).

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* Signed in Washington, 5 October 1964, pending ratification in the Senate of the Philippines.

(b) In the case of the Philippines, the income tax imposed by Title II of the National Internal Revenue Code but not including the tax on improperly accummulated earnings or the personal holding company tax).

(2) The present Convention shall also apply to taxes substantially similar to those covered by paragraph (1) of this Article which are subsequently imposed in addition to, or in place of, existing taxes.

(3) For the purpose of Article 6, this Convention shall also apply to taxes of every kind, and to those imposed at the national, state, or local level.

ARTICLE 2

General Definitions

(1) In the present Convention, unless the context otherwise requires:

(a) The term "United States" means the United States of America, and when used in a geographical sense means the States thereof, the District of Columbia, and Wake Island;
(b) The term "Philippines" means the Republic of the Philippines, and when used in a geographical sense means the territories comprising the Philippines;
(c) The terms "one of the Contracting States" and "the other Contracting State" mean the United States or the Philippines, as the context requires;
(d) The term "person" comprises an individual, a corporation and any other body of individuals or persons;
(e) The term "corporation" means any body corporate, association or joint stock company or other entity which is treated as a body corporate for tax purposes;
(f) The term "United States corporation" means a corporation created or organized under the laws of the United States or of any State thereof or the District of Columbia;
(g) The term "Philippine corporation" means a corporation created or organized under the laws of the Philippines;
(h) The terms "resident or corporation of one of the Contracting States" and "resident or corporation of the

other Contracting State" mean a resident or corporation of the United States or a resident or corporation of the Philippines, as the context requires;

(i) The term "competent authority" means:

(1) in the United States, the Secretary of the Treasury or his delegate;

(2) in the Philippines, the Secretary of Finance or his delegate.

(2) As regards the application of the present Convention by a Contracting State, any term not otherwise defined shall, unless the context otherwise requires, have the meaning which it has under the laws of that Contracting State relating to the taxes which are the subject of the present Convention.

ARTICLE 3

General Rules of Taxation

(1) A resident or corporation of one of the Contracting States shall be taxable by the other Contracting State only on income derived from sources within that other Contracting State.

(2) A resident or corporation of one of the Contracting States shall be taxed by the other Contracting State on income taxable under paragraph (1) in accordance with the limitations set forth in the present Convention. Any income to which the provisions of the present Convention are not expressly applicable shall be taxable by each of the Contracting States in accordance with its own law. The provisions of the present Convention shall not be construed to restrict in any manner any exclusion, exemption, deduction, credit or other allowance now or hereafter accorded (a) by the laws of one of the Contracting States in the determination of the tax imposed by that state or (b) by any other agreement between the Contracting States.

(3) Except as provided in paragraph (4), a Contracting State may tax an individual who is a citizen or resident of that Contracting State (whether or not such person is also a resident of the other Contracting State) as if the present Convention had not come into effect.

(4) The provisions of paragraph (3) shall not affect —

(a) the benefits conferred by a Contacting State under Articles 4 and 6;
(b) the benefits conferred by the United States under Article 18; and
(c) the benefits conferred by a Contacting State under Articles 14, 15, 16 and 17 upon individuals other than citizens of, or individuals having immigrant status in that Contracting State.

ARTICLE 4

Relief from Double Taxation

Double taxation of income shall be avoided in the following manner:

(1) The United States shall allow as a credit against its tax specified in subparagraph (1) (a) of Article I the appropriate amount of taxes paid to the Philippines. Such appropriate amount shall be based upon the full amount of tax paid to the Philippines, and such credit shall, in other respects, be allowed in accordance with the applicable revenue laws of the United States. It is agreed for this purpose that the Philippine tax specified in subparagraph (1) (b) of Article 1 shall be considered to be an income tax, and that by virtue of the provisions of paragraph (2) of this Article the Philippines satisfies the similar credit requirement prescribed by section 901 (b) (3), Internal Revenue Code of 1954, with respect to taxes paid to the Philippines.

(2) The Philippines shall allow to a resident or corporation of the Philippines as a credit against its tax specified in subparagraph (1) (b) of Article 1 the appropriate amount of taxes paid to the United States. Such appropriate amount shall be based upon the full amount of tax paid to the United States, and such credit shall, in other respects, be allowed in accordance with the revenue laws of the Philippines. It is agreed for this purpose that the United States tax specified in subparagraph (1) (a) of Article 1 shall be considered to be an income tax and that by virtue of the provisions of paragraph (1) of this Article the United States satisfies the similar credit require-

ment prescribed by section 30 (c) (b), National Internal Revenue Code, with respect to taxes paid to the United States.

ARTICLE 5

Source of Income

For purposes of Article 3 and 4:

(1) Income from the performance of personal services (including private pensions and annuities paid in respect of such services) or the furnishing of personal services shall be treated as income from sources within the State in which such services are performed. Compensation for personal services performed aboard ships or aircraft operated by a resident or corporation of a Contracting State and, in tne case of the United States, registered in the United States (including private pensions and annuities paid in respect of such services) shall be treated as income from sources within that Contracting State, if rendered by a member of the regular complement of the ship or aircraft.

(2) The source of any item of income to which the provisions of this Article are not expressly applicable shall be determined by each of the Contracting States in accordance with its own law.

ARTICLE 6

Nondiscrimination

(1) A citizen of one of the Contracting States who is resident of the other Contracting State shall not be subjected in that other Contracting State to more burdensome taxes than is a citizen of that other Contracting State who is a resident therein.

(2) A permanent establishment which a citizen or corporation of one of the Contracting States has in the other Contracting State shall not be subject in that other Contracting State to more burdensome taxes than is a citizen or corporation of that other Contracting State carrying on the same activities. This paragraph shall not be construed as obliging either Contracting State who are not resi-

dents of the former Contracting State any personal allowances or deductions which are by its law available only to residents of that former Contracting State.

(3) A corporation of one of the Contracting States, the capital of which is wholly or partially owned by one or more citizens or corporations of the other Contracting State, shall not be subjected in the former Contracting State to more burdensome taxes than is a corporation of the former Contracting State, the capital of which is wholly owned by one or more citizens or corporations of that former Contracting State.

ARTICLE 7

Business Profits

(1) A resident or corporation of one of the Contracting States shall be subject to tax in the other Contracting State with respect to its industrial or commercial profits only if that resident or corporation has a permanent establishment in that other Contracting State.

(2) In the imposition of such tax —

(a) There shall be allowed as deductions ordinary and necessary expenses, wherever incurred, which are allocable, to the reasonable satisfaction of the competent authority of that Contracting State, to income from sources within that Contracting State; and

(b) No profits shall be deemed to be derived from sources within that Contracting State merely by reason of the purchase of goods or merchandise.

(3) For purposes of paragraph (1) the term "industrial or commercial profits" means income derived from the active conduct of a trade or business. It includes profits from manufacturing, mercantile, agricultural, fishing and mining activities, and from the furnishing of personal services. It does not include income from the performance of personal services, dividends, interest, royalties, income from the rental of personal property, income from real property, insurance premiums, or gains derived from the sale or exchange of capital assets.

ARTICLE 8

Definition of Permanent Establishment

(1) The term "permanent establishment" means a fixed place of business through which a resident or corporation of one of the Contracting States engages in trade or business.

(2) The term "a fixed place of business" includes, but is not limited to, a branch; an office; a store or other sales outlet; a workshop; a factory; a warehouse; a mine, a quarry or other places of extraction of natural resources; a building site, or construction or installation site, which exists for more than three months.

(3) The term "permanent establishment" shall not be deemed to include any one or more of the following:

(a) facilities used for the purpose of storage, display or delivery of goods or merchandise belonging to the resident or corporation;
(b) the maintenance of a stock of goods or merchandise belonging to the resident or corporation for the purpose of storage, display and/or delivery;
(c) the maintenance of a stock of goods or merchandise belonging to the resident or corporation for processing by another person;
(d) a fixed place of business maintained for the purpose of purchasing goods or merchandise, and/or for the collection of information, for the resident or corporation;
(e) a fixed place of business maintained for the purpose of advertising, for the supply of information, for scientific research, or for similar activities which have a preparatory or auxiliary character, for the resident corporation.

(4) Even if a resident or corporation of one of the Contracting States does not have a permanent establishment in the other Contracting State under paragraphs (1) — (3) of this Article, nevertheless she shall be deemed to have a permanent establishment in the latter State if he engages in trade or business in that State through an agent who —

(a) has an authority to conclude contracts in the name of that resident or corporation and regularly exercises that authority in the latter State unless the exercise of the authority is limited to the purchase of goods or merchandise;

(b) regularly secures orders in the latter State for that resident corporation; or

(c) maintains in the latter State a stock of goods or merchandise belonging to that resident or corporation from which he regularly makes deliveries or fills orders.

(5) Notwithstanding paragraph (4) of this Article, a resident or corporation of a Contracting State shall not be deemed to have permanent establishment in the other Contracting State merely because it uses the services in that of a bonafide broker, general commission agent, forwarding agent, indentor or other agent of independent status acting in the ordinary course of its business. For this purpose, an agent shall not be considered to be an agent on independent status if it acts as an agent exclusively or almost exclusively for the resident or corporation (or for that resident or corporation and any other person controlling, controlled by, or under common control with that resident or corporation) and carries on any of the activities described in paragraph (4) of this Article.

(6) The fact that a corporation of one of the Contracting States controls or is controlled by or is under common control with (a) a corporation of the other Contracting State or (b) a corporation which engages in trade or business in that other Contracting State (whether through a permanent establishment or otherwise) shall not be taken into account in determining whether the activities or fixed place of business of either corporation constitutes a permanent establishment of the other corporation.

(7) A resident or corporation of one of the Contracting States shall be deemed to have a permanent establishment in the other Contracting State if that resident or corporation provides the services in the latter State of public entertainers referred to in Article 13, paragraph (3).

(8) If a resident or corporation of one of the Contracting States has a permanent establishment in the other Contracting State at any time during the taxable year, it shall be considered to have a permanent establishment in that other Contracting State for the entire taxable year.

ARTICLE 9

Related Persons

(1) Where a resident or corporation of a State deriving commercial and industrial profits in one of the Contracting States and any other person are related and where such related persons make arrangements or impose conditions between themselves which are different from those which would be made between independent persons, then any income which would, but for those arrangements or conditions, have accrued to such resident or corporation but, by reason of those arrangements or conditions, has not accrued, may be included in the income of such resident or corporation for purposes of the present Convention and taxed by that Contracting State accordingly.

(2) (a) A person other than a corporation is related to a corporation if such person participates directly or indirectly in the management, control or capital of the corporation.

(b) A corporation is related to another corporation if either participates directly or indirectly in the management, control or capital of both corporations.

ARTICLE 10

Interest

Interest received by the Government of one of the Contracting States or any agency or instrumentality wholly owned by that Government shall be exempt from tax by the other Contracting State.

ARTICLE 11

Income from Real Property

A resident or corporation of one of the Contracting States subject to tax in the other Contracting State on income from the rental of buildings or from real property which is improved with buildings, including gains derived from the sale or exchange of such property, or on royalties in respect of the operation of mines, quarries or other natural resources may elect for any taxable year to compute that tax on such income on a net basis.

ARTICLE 12

Gains upon Transfers to Controlled Corporations

A resident or corporation of one of the Contracting States shall be exempt from tax in the other Contracting State with respect to gain realized upon the transfer of property to a corporation in exchange for stock in such corporation —

(1). If immediately thereafter such resident or corporation, or such person together with any other persons making similar transfers as part of the same transaction, owns stock of such corporation of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation; and

(2) Where the transferee corporation is a Philippine corporation, if the property is transferred and recorded on the books of account of the corporation at a value not exceeding the value at which such property was recorded on the books of account of the transferer.

ARTICLE 13

Income from Personal Services

(1) An individual who is a resident of one of the Contracting States shall be exempt from tax by the other Contracting State with respect to income from personal services if —

(a) he is present within the latter Contracting State for a period or periods not exceeding in the aggregate 90 days during the taxable year, and
(b) such income is not deducted in computing the profits of a permanent establishment of a resident or corporation of the former Contracting State subject to tax in the latter Contracting State, and
(c) in the case of employment income, the services are performed as an employee of a resident or corporation of the former Contracting State, and
(d) the aggregate amount of such income does not exceed $3,000 (or its equivalent in Pesos).

(2) For purposes of paragraph (1) of this Article, the term "income from personal services" included employment in-

come and income earned by an individual from the personal services in an independent capacity. The term "employment income" includes income from services performed by officers and directors of corporations. Income from personal services performed by partners shall generally be treated as income from the performance of services in an independent capacity, but a salary or other fixed amount paid by a partnership to an active partner shall be considered income from employment by the partnership, if similar payments are not made to inactive partners.

(3) Notwithstanding paragraph (1) of this Article, the income from personal services of public entertainers, such as athletes, musicians and actors, from their activities as such, may be taxed in the Contracting State in which the services are performed if such income exceeds either $100 (or its equivalent in pesos) for each day the individual is present in the latter Contracting State or an aggregate amount of $3,000 (or its equivalent in pesos).

(4) Compensation received by an individual or personal services performed aboard ships or aircraft operated by a resident or corporation of a Contracting State (and, in the case of the United States, registered in the United States) shall, subject to paragraph (3) of Article 3, be exempt from tax by the other Contracting State, if the services are rendered by a member of the regular complement of the ship or aircraft.

ARTICLE 14

Teachers

An individual who is a resident of one of the Contracting States at the beginning of his visit to the other Contracting State and who, at the invitation of the Government of the other Contracting State or of a university or other accredated educational institution situated in the other Contracting State, visits the latter Contracting State for the purpose of teaching or engaging in research, or both at a university or other accredited educational institution shall be exempt from tax by the latter Contracting State on his income from personal services for teaching or research at such educational institution, or at other such institutions, for a period not exceeding two years from the date of his arrival in the latter Contracting State.

ARTICLE 15

Students and Trainees

(1) (a) An individual who is a resident of one of the Contracting States at the beginning of his visit to the other Contracting State and who is temporarily present in the other Contracting State for the primary purpose of —

(i) studying at a university or other accredited educational institution in that other Contracting State,
(ii) securing training required to qualify him to practice a profession or professional specialty, or
(iii) studying or doing research as a recipient of a grant, allowance, or award from a governmental, religious, charitable, scientific, literary or educational organization,

shall be exempt from tax that other Contracting State with respect to —

(A) gifts from abroad for the purposes of his maintenance, education, study, research or training;
(B) the grant, allowance, or grant; and
(C) income from personal services performed in the other Contracting State in an amount not in excess of $2,000 of its its equivalent in pesos for any taxable year; or, if such individual is securing training necessary for qualification in a medical profession or medical specialty, including any physician, medical technologists, nurse, pharmacist or other person under the Exchange Visitors Program, not in excess of $5,000 or its equivalent in pesos for any taxable year.

(b) The benefits under this paragraph shall only extend for such period of time as may be reasonable or customarily required to effectuate the purpose of the visit, but in no event shall any individual have the benefits of this paragraph for more than five taxable years.

(2) A resident of one of the Contracting States who is present in the other Contracting State for a period not exceeding one year, as an employee of, or under contract

with, a resident or corporation of the former State, for the primary purpose of —

(i) acquiring technical, professional, or business experience from a person other than that resident or corporation of the former Contracting State, or

(ii) studying at a university or other accredited educational institution in that other Contracting State,

shall be exempt from tax by that other Contracting State with respect to his income from personal services performed in the other Contracting State for that period in an amount not in excess of $5,000 or its equivalent in pesos.

(3) A resident of one of the Contracting States who is present in the other Contracting State for a period not exceeding one year, as a participant in a program sponsored by the Government of the other Contracting State, for the primary purpose of training, research, or study shall be exempt from tax by that other State with respect to his income from personal services performed in that other Contracting State and received in respect of such training, research, or study in an amount not in excess of $10,000 or its equivalent in pesos.

ARTICLE 16

Governmental Salaries

Wages, salaries, and similar compensation, and pensions, annuities, or similar benefits paid by, or directly out of public funds of, one of the Contracting States or the political subdivisions thereof to an individual who is a national of that Contracting State for services rendered to that Contracting State or to any of its political subdivisions in the discharge of governmental functions shall be exempt from tax by the other Contracting State.

ARTICLE 17

Rules Applicable to Personal Service Articles

(1) For purposes of Article 13, 14, 15, and 16, reimbursed travel expenses shall be considered to be income from personal services or compensation, but shall not be taken into account in computing the maximum amount of exemptions

specified in Articles 13 and 15.

(2) An individual who qualifies for benefits under more than one of the provisions of Article 13, 14 and 15 may select the application of that provision most favorable to him, but he shall not be entitled to the benefits of more than one provision in any taxable year.

ARTICE 18

Deduction for Charitable Contributions

In the computation of taxable income under the United States income tax, a deduction shall be allowed to citizens and residents of the United States and United States corporations for contributions to any organization created or organized under the laws of the Philippines which constitutes a non-profit organization under section 27 (e) of the National Internal Revenue Code of the Philippines if —

(a) such contributions are used entirely within the Philippines and

(b) the recipient organization has qualified as a tax-exempt organization under subsection 501 (c) (3) of the United States Internal Revenue Code.

Such deductions shall not, however, exceed an amount which would have been allowable under the United States Internal Revenue Code if such organization had been created or organized under the laws of the United States and if such contributions were used within the United States.

ARTICLE 19

Consultation and Taxpayers Claims

(1) The competent authorities of the Contracting States may communicate with each other directly for the purpose of giving effect to the provisions of the present Convention. Should any difficulty or doubt arise as to the interpretation or application of the present Convention, or its relationship to conventions between one of the Contracting States and any other State, the competent authorities shall endeavor to settle the question as quickly as possible by mutual agreement.

(2) The competent authorities may consult together for the purpose of considering the amendment of this Convention to add provisions dealing with such matters affecting income taxation and not covered in this Convention as may be deemed appropriate.

(3) In particular, the competent authorities of the Contracting States may consult together to endeavor to agree —

(a) to the same apportionment of industrial or commercial profits between a resident or corporation of one of the Contracting States and its permanent establishment situated in the other Contracting State; or

(b) to the same allocation of income between a resident or corporation and a related person, dealt with in Article 9, and to the appropriate procedure for effectuating such apportionment or allocation.

(4) A taxpayer shall be entitled to present his case to the Contracting State of which he is a citizen or resident, or, if the taxpayer is a corporation of one of the Contracting States, to that State, if he considers that the action of the other Contracting State has resulted, or will result for him in taxation contrary to the provisions of the Convention. Should the taxpayer's claim be considered to have merit by the competent authority of the Contracting State to which the claim is made, it shall endeavor to come to an agreement with the competent authority of the other Contracting State with a view to the avoidance of taxation contrary to the provisions of the Convention.

ARTICLE 20

Exchange of Information

(1) The competent authorities of the Contracting States shall exchange such information as is necessary for the carrying out of this Convention and of the domestic laws of the Contracting States concerning taxes covered by this Convention insofar as the taxation thereunder is in accordance with this Convention. Any information so exchanged shall be treated as secret and shall not be disclosed to any persons or authorities other than those concerned with the assessment, collection or enforcement of the taxes which are the subject of this Convention (including a court or

administrative body);

(2) In no case shall the provisions of paragraph (1) be construed so as to impose on one of the Contracting States the obligation;

(a) to carry out administrative measures at variance with the laws or administrative practices of that Contracting State or the other Contracting State; or
(b) to supply particulars which are not obtainable under the laws of, or in the normal course of administration in, that Contracting State or in the other Contracting State; or
(c) to supply information which would disclose any trade, business, industrial commercial or professional secret or trade process, or information, the disclosure of which would be contrary to its public policy.

ARTICLE 21

Assistance in Collection

(1) Each of the Contracting States shall endeavor to collect such taxes imposed by the other Contracting State as will insure that any exemption granted under the present Convention by the other State shall not be enjoyed by persons not entitled to such benefits. The Contracting State making such collections shall be responsible to the other Contracting State for the sums thus collected.

(2) In no case shall the provisions of this Article be construed so as to impose upon either of the Contracting States the obligation to carry out administrative measures at variance with the regulations and practices of the Contracting State endeavoring to collect the tax or which would be contrary to that State's sovereignty, security, or public policy.

ARTICLE 22

Exchange of Legal Information

(1) The competent authorities of the Contracting States shall notify each other of any amendments of the tax laws referred to in Article 1, paragraph (1), and of the adoption of any taxes referred to in Article 1, paragraph (2),

by transmitting the texts of any amendments or new statutes a least once a year.

(2) The competent authorities of the Contracting States shall exchange the texts of all published material interpreting the present Convention under the laws of the respective States, whether in the form of regulations, rulings or judicial decisions.

ARTICLE 23

Effective Dates and Ratification

(1) The present Convention shall be ratified and the instruments of ratification exchanged at Manila as soon as possible.

(2) After the exchange of instruments of ratification, the present Convention shall have effect with respect to taxable years beginning on or after the first day of January of the year following that in which such exchange takes place.

(3) The present Convention shall continue in effect indefinitely, but it may be terminated by either of the Contracting States, on the initiative of the competent authority of that State, at any time after five years from the date specified in paragraph (2) of this Article, provided that at least six months' prior notice of termination has been given. In such event, the present Convention shall cease to be effective with respect to taxable years beginning on or after the first day of January next following the six-month period.