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 *

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The American economic presence in the Philippines is quite important and far-reaching. The history of such presence has taken several twists and turns since Dewey first sunk some old Spanish ships in Manila Bay, and new episodes continue to unfold. One of the recent significant developments in this regard has been the conclusion of an income tax treaty between the Philippines and the United States.

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. However, the ramifications from a national political and economic perspective assume a much greater significance when we consider that tax revenues are an important source of our government's funds and U.S. corporations are important sources of such taxes. This, in a country where government has designated itself to be the initiator and financier of economic development and therefore needs funds for that purpose: a country and a government which at present are very fund-starved due to the cessation of foreign credit lines and the directive that the government budget deficit be reduced.

Furthermore, the tax environment is an important component of the total investment environment which U.S. corporations consider and assess prior to a decision to invest in the Philippines. The assumption is that the inflow of foreign investments is desirable vis-a-vis the perceived need to fill the gap between necessary investment and domestic savings.

In the discussion that follows, we will therefore examine all of these considerations in the context of the treaty coming into effect—the legal

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and technical changes in the tax treatment of U.S. corporations, the effects on the perceived need to encourage investment by U.S. corporations in the Philippines, and the repercussions on Philippine tax revenues.

I. HISTORY OF THE TREATY

The income tax treaty between the Philippines and the United States[1] was signed on October 1, 1976[2] after the conclusion of negotiations between the respective governments of the two countries. To clarify the interpretation of certain provisions, an exchange of diplomatic notes was made on November 24, 1976.[3] The treaty was then transmitted by then U.S. President Gerald Ford to the U.S. Senate for its advice and consent to ratification on January 19, 1977.[4] The Senate in turn referred the treaty to its Committee on Foreign Relations.

The Committee on Foreign Relations held hearings on July 19 and 20, 1977[5] in order to decide on what action it should recommend the U.S.

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[1] Convention Between the Government of the United States of America and the the Government of the Republic of the Philippines With Respect to Taxes on Income, October 1, 1976 (hereinafter cited as Philippines-U.S. Income Tax Treaty). The text of the treaty is found in the Message from the President of the United States to the U.S. Senate, transmitting the Philippines-U.S. Income Tax Treaty and Exchange of Notes, S. Exec. Doc. C, 95th Cong., 1st Sess. 1 (1977) (available 1977, on Congressional Information Service, Inc. microfiche, CIS Accession No. S385-3); a mimeo version is available from the Bureau of Internal Revenue, Quezon City, Philippines. The treaty is reprinted in [1982] 2 TAX TREATIES (CCH) ¶ 6605, at 6607; in U.N. DEP'T. OF ECONOMIC AND SOCIAL AFFAIRS 9 SECOND PART C, INTERNATIONAL TAX AGREEMENTS, General Agreements on Income and Fortune No. 406, U.N. Doc. ST/ECA/SER. C/9 (the first series of treaties in the compilation was published in 1958); in DIAMOND, 12 INTERNATIONAL TAX TREATIES OF ALL NATIONS 249, Treaty No. 1200 (1982); and in [1977] 2 TAX TREATIES (P-H) ¶ 74, 102, at 74, 101.

[2] *Id.* An earlier income tax treaty between the Philippines and the United States was signed on October 5, 1964 and approved by the U.S. Senate with reservations on several provisions. The 1964 treaty was never ratified by the Philippines. *See* Statements on proposed income tax treaties with Philippines, Korea and the United Kingdom by Laurence N. Woodworth, Assistant Secretary of the Treasury, before the Senate Foreign Relations Committee, July 19, 1977, reprinted in [1977] 2 TAX TREATIES (P-H) ¶ 74, 133, at 74, 122. The 1964 treaty is reprinted in U.N. DEPT. OF ECONOMIC AND SOCIAL AFFAIRS, 9 SECOND PART A, INTERNATIONAL TAX AGREEMENTS, General Agreements on Income and Fortune Taxes No. 122, U. N. Doc. ST/ECA/SER. C/9 (the first series of treaties in the compilation was published in 1958).

[3] Exchange of Diplomatic Notes Between William E. Simon, Secretary of the Treasury of the United States, and Cesar Virata, Secretary of Finance of the Philippines, November 24, 1976. The text of the Exchange of Diplomatic Notes is contained in the Message from the President of The United States to the U.S. Senate transmitting the Philippines-U.S. Income Tax Treaty and Exchange of Notes, on Congressional Information Service, Inc. microfiche, (CIS Accession No. S385-3); the text of the exchange of diplomatic notes is also reprinted in [1977] 2 TAX TREATIES (P-H) ¶ 74, 131, at 75, 119.

[4] *See* S. Exec. Doc. C, 95th Cong., 1st Sess. (1977) (available 1977, on Congressional Information Service, Inc. microfiche, CIS Accession No. S385-3). The text of the letter of transmittal is reprinted in [1977] 2 TAX TREATIES (P-H) ¶ 74, 132 at 74, 120.

[5] *Tax treaties with the United Kingdom, the Republic of Korea, and the Republic of the Philippines: Hearings Before the Committee on Foreign Realtions, United States Senate,* 95th Cong., 1st Sess. (1977) (available 1978, on Congressional Information Service, Inc. microfiche, CIS Accession No. S381-10 [Hereinafter cited as *1977 Hearings*].

Senate should take regarding the proposed treaty. During these hearings, the U.S. airline industry expressed vigorous objections to the ratification of the treaty by the United States. The treaty as signed did not include a provision for the reciprocal exemption of air transport income, and the position of the airline industry was that as a matter of policy, the United States should insist on the inclusion of such a provision in its income tax treaties with all countries. These objections resulted in the treaty not being reported out by the Committee to the full U.S. Senate during that time, with no recommendation being made wih respect to its ratification.[6]

It was to be four years later that the U.S. Senate Committee on Foreign Relations again took formal action with respect to the treaty. In the meantime, the U.S. Treasury had tried and failed to convince the Philippine government to agree to the amendments that the U.S. airline industry wanted.[7] A committee hearing was held on September 24, 1981.[8] The Committee then considered the proposed treaty on November 7, 1981,[9] and ordered it favorably reported[10] with two reservations and two understandings,[11] with the recommendation that the Senate give its advice and consent to the treaty's ratification.

On December 16, 1981, the U.S. Senate resolved to give its advice and consent to the ratification of the treaty, with the aforementioned reservations and understandings.[12]

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[6] *See* Statements on proposed income tax treaties with Philippines, Korea, and the United Kingdom by Laurence N. Woodworth, Assistant Secretary of the Treasury, before the Senate Foreign Relations Committee, July 19, 1977, reprinted in [1977] 2 TAX TREATIES (P-H) ¶ 74, 133 at 74, 123; *1977 Hearings, supra* note 5, at 57, 59, 62-63 (testimony of Norman J. Philion, Executive Vice President. Air Transport Association of America); *Three of Eleven Tax Treaties Contested at Senate Hearing,* TAX NOTES, October 5, 1981, at 772, 774.

[7] *See* Statement on proposed income tax treaty with the Philippines by Donald C. Lubick, Assistant Secretary of the Treasury for Tax Policy before the Senate Foreign Relations Committee, June 6, 1979, reprinted in [1981] 2 TAX TREATIES (P-H) ¶ 74, 135, at 74, 153.

[8] *Tax Treaties: Hearing before the Committee on Foreign Relations,* United States Senate, 97th Cong., 1st Sess. (1981) (available 1982, on Congressional Information Service Inc. microfiche, CIS Accession No. S381-15) (hereinafter cited as *1981 Hearings*).

[9] S. Exec. Rep. No. 39, 97th Cong., 1st Sess. 4 (1981) (available 1981, on Congressional Information Services Inc. microfiche, CIS Accession No. S384-35); reprinted in [1982] 2 TAX TREATIES (P-H) ¶ 74, 138, at 74, 182 (hereinafter all further citations of S. Exec. Rep. No. 39 will be of the reprinted version in TAX TREATIES (P-H). The date of approval of the treaty by the Foreign Relations Committee may actually have been November 17, 1981, see *Senate Committee Approves Philippine Treaty, supra* note 8.

[10] S. Exec. Rep. No. 39, *supra* note 9.

[11] *Id.* at 74, 180, 74, 182, and 74, 200.

[12] Resolution of Ratification [of] Tax Convention With the Republic of the Philippines, 97th Cong., 1st Sess., 188 CONG. REC. S15, 533 (1981). The resolution, together with its reservations and understandings, reads as follows:

TAX CONVENTION WITH THE REPUBLIC OF THE PHILIPPINES

Resolved, (two-thirds of the Senators present concurring therein). That the Senate advice and consent to the ratification of the Convention signed at Manila on October 1, 1976, between the Government of the United States of America and the Government of the Republic of the

The treaty was finally ratified and instruments of ratification were exchanged between the United States and the Philippines on September 16, 1982. It went into force and effect on October 16, 1982, with most of its provisions generally effective for the taxable years beginning on or after January 1, 1983.[13]

II. AN OVERVIEW OF INCOME TAXATION UNDER LOCAL PHILIPPINE TAX LAW OF U.S. AND OTHER FOREIGN CORPORATIONS DERIVING INCOME FROM PHILIPPINE SOURCES

2.1 ECONOMIC ACTIVITY REQUIRED FOR THE EXERCISE OF PHILIPPINE TAXING JURISDICTION—SOURCE OF INCOME PRINCIPLE

Local Philippine tax law does not require that a United States corporation should have a very great degree of economic contact with the Philippines, for the corporation[14] to be liable for Philippine taxes. Generally,

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Philippines with Respect to Taxes on Income, and an Exchange of Notes done at Washington on November 24, 1976, subject to the following:

(1) reservation that, notwithstanding the provisions of Article 14 relating to capital gains, both the United States and the Philippines may tax gain from the disposition of an interest in a corporation if its assets consist principally of a real property interest located in that country. Likewise, both countries may tax gain from the disposition of an interest in a partnership, trust or estate to the extent the gain is attributable to a real property interest in one of the countries. The term "real property interest" is to have the meaning it has under the law of the country in which the underlying real property is located.

(2) reservation that, notwithstanding the provisions of paragraph 2 of Article 9 of the Convention, the tax imposed 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 may be as much as, but shall not exceed, the lesser of one and one-half percent of the gross revenue derived from sources within that State, and the lowest rate of Philippine tax that may be imposed on profits of the same kind derived under similar circumstances by a resident of a third State;

(3) understanding that under Article 9 and paragraph (6) of Article 11 of the treaty, the Philippines may not impose on the earnings of a corporation attributable to a permanent establishment in the Philippines, which earnings are described in Article 9 of the treaty, a tax in addition to the tax which would be chargeable on the earnings of a Philippine corporation; and

(4) understanding that appropriate Congressional committees and the General Accounting Office shall afforded access to the information exchanged under this treaty where such access to the information exchanged is necessary to carry out their oversight responsibilities, subject only to the limitations and procedures of the Internal Revenue Code.

13 *See* TAX NOTES, September 20, 1982 at 1069; also (1982) 2 TAX TREATIES (CCH) ¶ 6602, at 6603.

14 In this paper, the term "United States corporations" refers to entities which are considered as corporations under United States tax law. Certain associations with characteristics analogous to corporations are considered corporations for U.S. tax law purposes. *See* United States Internal Revenue Code of (1954). § 7701(a) (3) (1983); Morrisey v. Commissioner, 296 U.S. 344 (1935). Under Philippine law, for taxation purposes, corporations include partnerships except general professional partnerships and joint ventures formed to undertake constructions projects. PHILIPPINE NATIONAL INTERNAL REVENUE CODE OF 1977, Pres. Decree No. 1158, (1977), sec. 20(b) [hereinafter cited as N.I.R.C. OF 1977].

all that is necessary is that, in accordance with source rules found in the National Internal Revenue Code of the Philippines,[15] the corporation involved derive income from Philippine sources. This income may take the form of trade or business profits, or may be passive income such as dividends, interest, and royalties.

Under a scheme similar to that used in the Internal Revenue Code of the United States[16] (hereinafter referred to as "Internal Revenue Code"), the National Internal Revenue Code of the Philippines[17] (hereinafter referred to as "National Internal Revenue Code") divides gross income[18] into gross income from (1) sources within the Philippines,[19] (2) sources without the Philippines,[20] and (3) sources partly within and partly without the Philippines.[21] Likewise, net income is divided into net income from sources within, and net income from sources without the Philippines.[22]

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15 N.I.R.C. OF 1977, secs. 24(b) (1), 24(b) (2) in relation to sec. 37.

16 INTERNAL REVENUE CODE OF 1054 [hereinafter cited as I.R.C.].

17 N.I.R.C. OF 1977.

18 The definition of gross income under the N.I.R.C. OF 1977 is quite encompassing. Under sec. 29(b) of the Code, *Id.*,

> "Gross income" includes gains, profits, and income derived from professions, vocations, trades, business, commerce, sales, or from dealings in property, whether real or personal, or growing out of the ownership or use of property or any interest therein; and from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or *gains, profits and income of whatever kind and in whatever form derived from any source . . .*"

The Philippine B.I.R. (Bureau of Internal Revenue) Revenue Regulations No. 2 provide in part:

> (a) Income, in the broad sense, means all wealth which flows into the taxpayer other than as a mere return of capital. It includes the forms of income specifically described as gains and profits, including gains derived from the sale or other disposition of capital assets." § 36, Revenue Regulation No. 2.

As one Philippine commentator would put it,

> In plain, gross income, for income tax purposes, in this day and age would mean the totality of every conceivable economic gain, earning or profit in whatever form received or derived from lawful or unlawful source whatever, unless a law specifically states that it should be excluded or is exempt from income tax. E. CASTANEDA, COMMENTARIES AND JURISPRUDENCE ON THE NATIONAL INTERNAL REVENUE TAXES OF THE PHILIPPINES 69 (1973).

And with respect to a manufacturing, merchandising, or mining business,

> In the case of a manufacturing, merchandising, or mining business, "gross income" would mean the total sales, less the cost of goods sold, plus any income from investments and from incidental or outside operations or sources. No deduction shall be made for depreciation, depletion, selling expenses or loses, or for items not ordinarily used in computing the cost of goods sold. § 43, Revenue Regulations No. 2.

19 N.I.R.C. OF 1977, *supra* note 14, sec. 37 (a).

20 *Id.*, sec. 37(c).

21 *Id.*, sec. 37(e).

22 *Id.*, sec. 37(b), 37(d). This is hardly surprising, since the original National Internal Revenue Code of the Philippines, Com. Act No. 446, which took effect on July 1, 1939, was largely derived (in many instances, copied) from the United States Internal Revenue Code of 1939, 53 U.S. Statutes at Large (1959), approved by the 76th Congress of the United States on February 10, 1939, as well as from earlier U.S. tax laws. The remarkable similarity between the income tax provisions of the 1939 U.S. and Philippine Internal Revenue Codes is therefore no coincidence. A substantial part of the provisions and concepts of the 1939 Philippine Internal

The primary Philippine source rule is section 37 of the National Internal Revenue Code. Under this provision:

Interest on interest-bearing obligations of Philippine residents is income derived from Philippine sources.[23]

Dividend income received from a Philippine domestic corporation, or from a foreign corporation at least 50 percent of whose gross income was derived from Philippine sources, is dividend income from Philippine sources.[24]

Compensation for labor or personal service is considered derived from Philippine sources if the labor or services were performed in the Philippines.[25]

Rentals and royalties are considered as being from Philippine sources if such rentals and royalties are (1) from property located in the Philippines; (2) for the use of, or the right to use any copyright, patent, design, or model, plan, secret formula or process, goodwill, trademark, trade brand in the Philippines, and for any auxiliary or subsidiary assistance in connection with such use; (3) for the use of, or the right to use any industrial, commercial or scientific equipment in the Philippines, and for related auxiliary or subsidiary assistance; (4) for the supply of scientific, technical, industrial or commercial knowledge, together with auxiliary or subsidiary assistance in relation with such use; (5) for the supply of services in connection with the use of property or rights belonging to a non-resident person, or the installation or operation of any brand, machinery or other apparatus purchased from such person; (6) for technical advice, assistance or services rendered in connection with the technical management or administration of any scientific, industrial or commercial undertaking, or project; and (7) for the use of, or right to use motion picture and television films and tapes, as well as tapes for use in connection with radio broadcasting.[26]

Gains, profits, and income from the sale of real property located in the Philippines, as well as from the sale within the Philippines of personal property purchased either within or outside the Philippines are derived from Philippine sources.[27] A special rule is followed with respect to shares of stock in a Philippine corporation. Gain from the sale of such shares is treated as derived entirely from sources within the Philippines, regardless of where the shares are sold.[28]

Revenue Code are still embodied in the current Philippine National Internal Revenue Code of 1977. *See* E. CASTANEDA, COMMENTARIES AND JURISPRUDENCE ON THE NATIONAL REVENUE CODE OF THE PHILIPPINES 66 (1978).

[23] *Id.*, sec. 37(a) (1).

[24] *Id.*, sec. 37(a) (2).

[25] *Id.*, sec. 37(a) (3).

[26] *Id.*, sec. 37(a) (4).

[27] *Id.*, secs. 37(a) (5), (6).

[28] *Id.*, secs. 37(e).

And under what is in effect a source rule with respect to international carriers which are considered under the National Internal Revenue Code as being engaged in trade or business in the Philippines, the gross revenue of such carriers realized from uplifts *anywhere in the world,* of passengers, cargo or mail (provided that the cargo or mail originates from the Philippines), are considered as being derived from Philippine sources *if the passage documents are sold in the Philippines.*[29]

There are also special rules with respect to income from sources partly within and partly without the Philippines. These have to be apportioned into income from Philippine sources, and income from foreign sources.[30] These kinds of income include those derived from transportation or other services rendered partly within and partly without the Philippines; from the sale of personal property produced by the taxpayer within the Philippines and sold outside the Philippines; and from the sale in the Philippines of personal property produced or manufactured outside the Philippines.[31]

The combined effect of these rules and the expansive definition that can be given to the concept of what constitutes income under the National Internal Revenue Code is that when U.S. corporations participate in the economic life of the Philippines, a substantial number of their transactions would, under local Philippine tax law, come under the ambit of Philippine taxation jurisdiction.

2.2 Modes of Economic Presence—The Doing Business Dichotomy

Under local Philippine tax law, for purposes of Philippine taxation, a United States corporation may establish a taxable presence in the Philippines in either of two ways. When it has an *active* economic presence in the Philippines, being "engaged in trade or business within the Philippines," it is classified as a "resident foreign corporation" under the National Internal Revenue Code.[32] It is so engaged when it establishes a branch[33] in the Philippines. However, the formal establishment of a Philippine branch is not necessary for such a corporation to be considered as being "engaged in trade or business" in the Philippines.

When the corporation merely derives income from Philippine sources, not being engaged in trade or business in the Philippines, it is classified as a "non-resident foreign corporation" under the National Internal Revenue Code.[34]

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[29] *Id.*, secs 24(b) (2) (i).
[30] *Id.*, sec. 37(e).
[31] *Id.*
[32] N.I.R.C. of 1977, *supra* note 14, secs. 20(h), 34(b) (2).
[33] The term "branch" will be used throughout this paper to refer to a "division, office or other unit of business located at a different location from the main office or headquarters," see Black's Law Dictionary 170 (rev. 5th ed. 1979), which does not have a legal personality separate from the corporation of which it is a part.
[34] N.I.R.C. of 1977, *supra* note 14, secs. 20(i), 24(b) (1).

Although the National Internal Revenue Code itself does not contain a definition of the term "engaged in trade or business in the Philippines," both Philippine statutory and case law provide guidelines as to when a foreign corporation shall be deemed to be "doing business" in the Philippines. The "doing business in the Philippines" standard under both Philippine tax and corporate law is essentially an amalgam of two other standards: territoriality and 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. This doing business standard has of course to be differentiated from the concept of 'doing business' in the ordinary sense of the term which is from an economic and business viewpoint.

The statutory standard is stated in the Omnibus Investments Code.[35] Under this law, the concept of doing business has a very wide scope. The Code states:

> [T]he phrase "doing business" shall included 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.*[36] (Emphasis added).

However, the very broad sweep of this definition is tempered by the rules and regulations[37] implementing the Omnibus Investments Code.

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35 OMNIBUS INVESTMENTS CODE, Pres. Decree No. 1789 (1981).

36 *Id.*, art. 65. The phrase "doing business" is defined in the context of a foreign corporation needing authority from the Philippine Board of Investments before it can do business in the Philippines.

37 The relevant portion of the rules and regulations state:

SECTION 1. For the purposes of these rules —***

(f) The performance within the Philippines of any act or combination of acts enumerated in Section 1(1) of the Act shall constitute "doing business" therein. In particular, "doing business" includes:

1. Soliciting orders, purchases (sales) or service contracts. Concrete and specific solicitations by a foreign firm or by an agent of such foreign firm, not acting independently of the foreign firm, amounting to negotiation or fixing of the terms and conditions of sales or service contracts, regardless of where the contracts are actually reduced to writing, shall constitute doing business even if the enterprise has no office or fixed place of business in the Philippines. The arrangements agreed upon as to manner, time and terms of delivery of the goods or the transfer of title thereto is immaterial. A foreign firm which does business through middlemen, acting in their own names, such as indentors, commercial brokers or commission merchants, shall not be deemed doing business in the Philippines. But such indentors, commercial brokers or commission merchants shall be the ones deemed to do business in the Philippines.

Under these rules and regulations, a foreign firm will not be considered to be doing business in the Philippines when it: (1) does business through independent middlemen; (2) appoints a representative or distributor domiciled in the Philippines who transacts business in its own name and for its own account; (3) appoints as its representative or distributor, an alien who enters the Philippines as a non-immigrant, and who does not stay in the Philippines for 180 days or more during a calendar year; (4) merely invests in a Philippine enterprise with a distinct legal personality of its own, the foreign firm exercising rights as such investor.

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2. Appointing a representative or distributor who is domiciled in the Philippines unless said representative or distributor has an independent status, i.e., it transacts business in its name and for its own account, and not in the name or for the account of a principal. Thus, where a foreign firm is represented in the Philippines by a person or local company which does not act in its name but in the name of a foreign firm, the latter is doing business in the Philippines.

3. Appointing as representative or distributor an alien who entered the Philippines as a non-immigrant solely or principally to act as such representative or distributor staying in the Philippines continuously for 180 days or more, or for a total period of 180 days or more in any calendar year although the stay is not continuous. To be deemed doing business in the Philippines, said representative or distributor need not maintain a stock of goods produced by the enterprise whom he represents.

4. Opening offices, whether called "liaison" offices, agencies or branches, unless proved otherwise.

5. Establishing a factory, workshop or processing plant.

6. Undertaking building, construction or assembly projects.

7. Opening a store, whether wholesale or retail, without prejudice to the provisions of the Retail Trade Act.

8. Maintaining or operating a warehouse for business purposes, including the storage, display or delivery of its own products.

9. Participating in the management, supervision or control of any domestic business firm, entity or corporation in the Philippines. This includes an individual or entity that acts as manager of a domestic enterprise pursuant to a management contract. An individual serving as director or officer of a domestic enterprise by virtue of occupying such position shall not be deemed doing business in the Philippines.

Mere investment in a domestic enterprise which has a distinct legal personality and duly licensed to transact business in the Philippines and/or the exercise of the rights as such investor, shall not constitute doing business therein.

10. 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 or in the progressive prosecution of, commercial gain or of the purpose and object of the business organization.

The following acts by themselves shall not be deemed doing business in the Philippines:

1. The publication of general advertisement through newspapers, brochures or other publication media or through radio or television.

2. Maintaining a stock of goods in the Philippines solely for the purpose of having the same processed by another entity in the Philippines.

3. Collecting information in the Philippines. Thus, sending a roving correspondent to gather news in the Philippines does not of itself constitute doing business therein.

4. Performing services auxiliary to an existing isolated contract of sale, such as installing in the Philippines machinery it has manufactured or exported to the Philippines, servicing the same, training domestic workers to operate it and similar incidental services.

In the leading Philippine case of *The Metholatum Co. Inc. v. Mangaliman*,[38] "doing business" was held as implying a "[*C*]*ontinuity of commercial dealings* and arrangements, and contemplates 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, the purpose and object of the firm's organization.*"[39] (Emphasis added). In another case, it was held that a single act may constitute "doing business" if the "single act or transaction is not merely incidental or casual, but is of such a character as distinctly to indicate a purpose on the part of the foreign corporation to do other business in the state, and to make the state a basis of operations for the conduct of a part of the corporation's ordinary business,"[40] or in other words, where it is "[I]ntended to be the beginning of a series of transactions."[41] However, the general rule in Philippine case law still is that "there [should be] a continuity of transactions which are in pursuance of the normal business of the corporation."[42]

A United States corporation may instead set up either a wholly-owned, or a controlled Philippine subsidiary corporation.[43] Absent anything else, the U.S. corporation itself will not be considered as being "engaged in trade or business' or as "doing business" 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, as will be discussed later, the tax treatment of branches and subsidiaries of foreign corporations under local Philippine tax law is practically equal.

2.21 *Doing Business*

2.211 *Through an Extension of the Same Corporate Entity— a Philippine Branch*

A United States corporation, when it does business in the Philippines through a branch (which under both Philippine and United States law,

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[38] 72 Phil. 524 (1941). The phrase "doing business" was being construed in connection with the Philippine statutory rule to the effect that a foreign corporation doing business in the Philippines without a license cannot sue in Philippine courts. This rule is now embodied in THE CORPORATION CODE OF THE PHILIPPINES, Batas Pambansa Blg. 68 sec. 133 (1980).

[39] *Id.* at 528-529.

[40] Far East Int'l. Import and Export Corp vs. Nankai Kogyo Co., Ltd., G.R. No. 13525, November 30, 1962, 6 SCRA 725, 734 (1962).

[41] J. CAMPOS and M. CAMPOS, CORPORATION CODE, COMMENTS, NOTES AND SELECTED CASES, 999 (1981).

[42] *Id.*, at 1013.

[43] The term "Philippine corporation" will be used throughout this paper to refer to a corporation created, organized and existing under Philippine law. The term "subsidiary" or "subsidiary corporation" will be used throughout this paper to refer

would not have a legal personality separate from the U.S. corporation), would, under local Philippine tax law, be taxable like a domestic Philippine corporation, on its total net income[44] from all sources within the Philippines.[45]

For purposes of computing its total net income from Philippine sources, it would be entitled to the following deductions: ordinary and necessary expenses paid or incurred in carrying on any business or trade conducted within the Philippines exclusively;[46] interest expense in the proportion which its gross income from Philippine sources bears to its worldwide or total gross income;[47] Philippine taxes, only if and to the extent that they are connected with income from Philippine sources;[48] losses actually sustained during the year incurred in business or trade conducted within the Philippines, or in transactions entered into for profit in the Philippines;[49] bad debts that arise in the course of business or trade conducted within the Philippines;[50] depreciation in respect of property located in the Philippines;[51] and depletion in respect to oil and gas wells or mines located in the Philippines.[52]

The net income from Philippine sources would be taxable at 25 percent for the first one hundred thousand pesos, and at 35 percent on the excess over one hundred thousand pesos.[53] A special tax rate would be applicable to dividends which the U.S. resident foreign corporation receives from a Philippine corporation. This would be subject to a final tax of 10 percent.[54]

Corporations which are international carriers (companies operating ships and aircraft in international traffic) which do business in the Philippines (are resident foreign corporations under the N.I.R.C.), are subject to a special tax rate—2½ percent of "gross Philippine billings."[55]

The definition of gross Philippine billings is viewed as quite broad by the American airline industry, and was one of the reasons which made

to "[a corporation] in which another corporation owns at least a majority of the shares and thus has control. (It is) said of a company more than 50 percent of whose voting stock is owned by another." *See* BLACK'S LAW DICTIONARY 1280 (rev. 5th ed. 1979).

44) Net income is gross income minus deductions. N.I.R.C. OF 1977, *supra* note 14, sec. 29(a).

45 N.I.R.C. OF 1977, *supra* note 14, sec. 24(b) (2) (i).

46 *Id.*, sec. 30(a) (2).

47 *Id.*, sec. 30(b) (2).

48 *Id.*, sec. 30(c) (2) (A).

49 *Id.*, sec. 30(d) (3).

50 *Id.*, sec. 30(e) (2).

51 *Id.*, sec. 30(f) (3).

52 *Id.*, sec. 30(g) (3).

53 *Id.*, sec. 24(a) in relation to sec. 24 (b) (2) (i). At an exchange ratio of ten pesos to one dollar as of May, 1983 (an exchange ratio that from the Philippine point of view continues unfortunately to deteriorate), 100,000 pesos would be approximately 10,000 dollars.

54 *Id.*, sec. 24 (c).

55 *Id.*, sec. 24(b) (2) (i).

them oppose the Philippines-United States income tax treaty. Under the National Internal Revenue Code, gross Philippine billings include gross revenue realized by international carriers from uplifts anywhere in the world of passengers, cargo and mail, so long as the passage documents covering the uplifts are sold in the Philippines (with an exception regarding chartered flights). With respect to uplifts of cargo or mail, the cargo or mail has to originate from the Philippines to be part of gross Philippine billings; the gross revenue includes the gross freight charge up to the final destination. Furthermore, gross revenue from chartered flights originating from the Philippines is deemed to form part of gross Philippine billings, regardless of the place of sale or payment of the passage documents; and for purposes of determining the taxability of revenues from chartered flights, the term "originating from the Philippines" includes flights of passengers who stay in the Philippines for more than forty-eight hours prior to embarkation.[56]

The rules and regulations implementing these Code provisions are even more expansive. Under the rules, an off-line international carrier (not servicing the Philippines directly) is considered as doing business in the Philippines for purposes of the National Internal Revenue Code, and hence subject to the gross billings tax if it, or its agents (including general sales agents) regularly sell its tickets in the Philippines.[57]

In addition to the regular income tax, a U.S. corporation which is considered to be a resident foreign corporation under the National Internal Revenue Code, could be subject to the additional tax on improperly accumulated surplus,[58] and to the tax on personal holding companies,[59] if it comes within the ambit of the relevant provisions of the Code. It would be subject to the Philippine personal holding company tax with respect to its income from Philippine sources.[60]

When a branch remits its profits to its head office, the profit remitted is subject to a tax of 15 percent.[61] However, for purposes of this tax, only income effectively connected with the conduct by the branch of a trade or business within the Philippines is considered branch profits.[62]

2.212 *Through a Separate Philippine Corporate Entity—A Philippine Subsidiary*

As we pointed out earlier, a U.S. corporation may decide to 'do business' (from an economic and business, but not from a Philippine tax,

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[56] *Id.*
[57] Revenue Regulations No. 3-76, March 15, 1976, reprinted in E. CASTANEDA, *supra* note 22, at 204-205.
[58] N.I.R.C. OF 1977, *supra* note 14, sec. 25.
[59] *Id.*, sec. 63-66.
[60] Revenue Regulations No. 2, sec. 218, reprinted in E. CASTANEDA, *supra* note 22, at 258.
[61] N.I.R.C. OF 1977, *supra* note 14, sec. 24(b) (2) (ii).
[62] *Ibid.*

corporate, or otherwise legal viewpoint) by setting up a wholly-owned or controlled Philippine subsidiary corporation. The subsidiary itself, being a Philippine corporation, will be taxed like any other Philippine corporation.[63] There will be no attempt to look into the nationality or nationalities of its stockholders. The prominent exception would be with respect to the availment of tax incentives under the various incentive laws of the Philippines. In many instances, these laws require that a certain minimum percentage of the stock of eligible corporations be held by citizens of the Philippines.

The subsidiary will be taxed on its net income, at the rate of 25 percent of the first one hundred thousand pesos, and 35 percent of any amount in excess of one hundred thousand pesos[64] just like a branch.

For dividends which the subsidiary receives from another Philippine corporation, the tax will be at 10 percent of the amount of the dividends. This tax on dividends is a final tax, and the dividend income will not be included in the determination of the gross income of the subsidiary.[65]

However, unlike a U.S. corporation operating through a branch in the Philippines, which is taxable only on its net income from Philippine sources, a subsidiary, being a Philippine corporation, will be taxed on its worldwide net income, on its income from all sources.[66] As a logical consequence, in computing its net income, it is entitled to deduct ordinary and necessary business expenses,[67] interest expense,[68] taxes,[69] losses,[70] bad debts,[71] depreciation,[72] and depletion[73] from its gross income, without any of the territorial and other limitations applicable to branch operations. With respect to income, war profits, and excess profits taxes, it may choose to take a tax credit instead of a deduction.[74] Like a United States corporation operating through a branch, the subsidiary could also be liable for the additional tax on improperly accumulated surplus[75] or the personal holding company tax,[76] in addition to the regular income tax.

When dividends are received by a United States corporation (a nonresident foreign corporation) from its Philippine subsidiary, the dividends

[63] A Philippine corporation is referred to in the National Internal Revenue Code as a "domestic corporation," a corporation created or organized under Philippine law. *Id.*, sec. 24(a).
[64] *Id.*, sec. 24(a).
[65] *Id.*, sec. 24(c).
[66] *Id.*, sec. 24(a).
[67] *Id.*, sec. 30(a) (1).
[68] *Id.*, sec. 30(b) (1).
[69] *Id.*, sec. 30(c) (1).
[70] *Id.*, sec. 30(d) (2).
[71] *Id.*, sec. 30(e) (1).
[72] *Id.*, sec. 30(f) (1), (2).
[73] *Id.*, sec. 30(g) (1), (2).
[74] *Id.*, sec. 30(c) (3) (A).
[75] *Id.*, sec. 25.
[76] *Id.*, sec. 63.

will be subject to a withholding tax at a 15 percent rate[77] which is the same as the rate of tax on remittances of branch profits.

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[77] *Id.*, sec. 24 (b) (iii). The regular rate is actually 35 percent, but the tax is reduced to 15 percent "[S]ubject to the condition that the country in which the non-resident foreign corporation is domiciled shall allow a credit against the tax due from the non-resident foreign corporation, taxes deemed to have been paid in the Philippines equivalent to 20 percent which represents the difference between the regular tax (35 percent) on corporations and the [reduced rate of] tax [of] . . . 15 percent." The Philippine Bureau of International Revenue in Ruling No. 76-004 dated July 19, 1976 ruled that the reduced rate of 15 percent is applicable to dividends received by U.S. corporations from their Philippine subsidiaries by virtue of the operation of the direct and "deemed paid" credit allowed U.S. corporations under I.R.C. secs. 901, 902 (1982). Mathematically, this ruling is correct. (Ruling No. 76-004 was premised on the former U.S. tax credit provisions applicable to dividends from less developed country corporations, the dividends from which were not subject to the "gross-up" requirements of I.R.C. sec. 78 and sec. 902 (1983). The distinctions as to the operation of the U.S. tax credit provisions on less developed and developed country subsidiaries no longer exist, but Ruling No. 76-004 is still mathematically correct, because the deemed-paid credit under the gross-up requirement is even greater than the one previously applicable to less developed country corporations.)

The operation of sec. 24 (b) (iii) can be illustrated as follows:

(1) Given (a) $100 accumulated profits or income of the Philippine subsidiary; (b) full remittance of dividends.

(2) Philippine income tax on the subsidiary will be 35 percent of $100, or $35, leaving $65 as the amount to be remitted as dividends.

(3) At the regular withholding rate of 35 percent, the tax on the dividends would be 35 percent of $65, or $22.75.

(4) The withholding rate will be at 15 percent, or $9.75, if the U.S. gives credit not only for the 15 percent withholding tax paid, but also for the tax "deemed to have been paid" to the Philippines, which is 20 percent of $65, or $13.

Under the reasoning of Bureau of Internal Revenue Ruling 76-004, this condition is fulfilled by virtue of the operation of I.R.C. secs. 901 and 902, as follows:

(1) Under sec. 901, a direct credit will be given for the $9.75 (15 percent withholding tax actually paid).

(2) Under sec. 902, an indirect "deemed paid credit" will be allowed the U.S. corporaiton for taxes paid by its Philippine subsidiary, which is *mathematically* greater than the 20 percent "deemed paid" credit required by Philippine law. Illustratively, the indirect credit under sec. 902 would be as follows:

dividends / accumulated profits in excess of income tax paid by subsidiary	x	Income tax paid by subsidiary on accumulated profits	=	Indirect Credit

or in figures:

$$\frac{\$65}{\$65} \times \$35 = \$35$$

$35 is greater than the $13 required under sec. 24 (b) (iii) of the National Internal Revenue Code.

However, there is a conceptual difficulty with B.I.R. Ruling 76-004. The reduction of withholding rates under the National Internal Revenue Code sec. 24 (b) (iii) seems to be anchored on tax-sparing considerations, and the requirements of said section are designed so that ". . . [I]f the Philippines will give up a part of the tax, we want to see and we want to expect that the tax that we gave up for this particular investment is not taxed by the other country . . ." and to provide incentive to foreign investors by the assurance that benefits of the reduced tax shall inure actually to the benefit of the foreign investor," and there will not merely be a "transfer ... [of] collections from the Philippine Treasury to the U.S. Treasury ..." *See* Toledo, *International Aspects of Taxation*, Lecture delivered at the 11th Annual Institute on Tax Law of the University of the Philippines Law Center (Dec. 1-6, 1975), in INTERNATIONAL ASPECTS OF TAXATION 18-19 (1976); E. CASTANEDA, *supra* note 22, at 203. As we will discuss later, the deemed paid credit of I.R.C. sec. 902 is

Thus, the broad outlines of Philippine taxation point to roughly equal tax treatment of branch and subsidiary operations (especially when the subsidiary's operations are confined only to the Philippines and the U.S. corporation receives no other income from the Philippines except from its subsidiary's operations).[78] Philippine policy is "[T]o equalize...taxation between foreign branches operating in the Philippines and . . . subsidiary corporations operating in the Philippines."[79]

2.22 *Through Mere Derivation of Income From Philippine Sources*

2.221 *In General and in Relation to Philippine Source Rules*

U.S. corporations either produce goods (manufacturing corporations) or render services (service corporations); or merely trade in, or sell goods manufactured by others (trading companies or sales subsidiaries). However, in all three cases, the ultimate aim is to make a profit by selling or leasing the produced goods, or by performing the services for customers. In the active pursuit of its business (manufacturing and sale, or merely sale), a U.S. corporation could exploit the Philippine market in different ways, each with differing tax consequences under local Philippine tax laws.

The manufacturing corporation may decide to both manufacture, and sell or lease its products in the Philippines. The service corporation may decide to perform services for Philippine customers on a regular and continuous basis. As an alternative, the manufacturing corporation or the service corporation could set up either a branch or a subsidiary in the Philippines whose function was merely the sale of such goods or services. In both cases, the U. S. corporation would have an active presence *in the Philippines,* and depending on the form of business organization it chose, would be taxed on a resident foreign corporation—branch or on a subsidiary basis, as previously discussed.

Likewise a trading company may set up a branch or subsidiary corporation in the Philippines, or regularly *make sales in the Philippines* to Philippine residents. Depending on the form of business organization it chose, it would be taxed in a similar manner.

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not given because of tax sparing considerations, but in order to maintain the neutrality, tax-wise, between domestic and foreign investment of U.S. corporations. Thus, it would seem that the interpretation of sec. 24(b) (iii) in Ruling 76-004 is not in consonance with the above enunciated policies.

78 The effective Philippine tax rate on income remitted to either the U.S. head office or the U.S. parent corporation by a branch or subsidiary corporation respectively, is 44.75 percent. Given $100 of income, for a branch the tax would be 35 percent of $100 (income tax) plus 15 percent of $65 (branch profits remittance tax); for a subsidiary corporation the tax would be 35 percent of $100 (income tax) plus 15 percent of $65 (reduced rate on dividend remittannces).

79 Keynote speech by Minister of Finance Cesar Virata delivered at the 11th Annual Institute on Tax Law of the University of the Philippines Law Center (Dec. 1-6, 1975), in INTERNATIONAL ASPECTS OF TAXATION 4 (1976).

An intermediate step the manufacturing or service corporation may take, without crossing the Philippine tax threshold of "doing business" and without consequently being classified as a resident foreign corporation, would be to enter into a licensing agreement with a Philippine firm which is not its subsidiary, transferring technology and/or know-how in exchange for royalty payments.

If the corporation were a bank or a lending institution, it could, also without being technically deemed as "doing business" in the Philippines, make loans directly (i.e., not through a branch office) to Philippine residents, earning interest on such loans. In much the same manner, an investment company could receive dividends from its investments in Philippine corporations, or interest from Philippine bonds, or a company in the business of leasing personal property such as ships or airplanes, could lease such property in return for rentals.

As a final alternative, the manufacturing corporation may choose to sell or lease its products directly (not through a Philippine branch) to Philippine customers without any sales solicitation in the Philippines. Likewise, the trading company or the foreign (non-Philippine) sales subsidiary of the manufacturing corporation may sell its products directly to residents of the Philippines. The service corporation may also choose to render services in the Philippines without the degree of regularity or continuity that would constitute "doing business" for purposes of tax law.

In these scenarios—licensing, loan agreements, rental agreements, direct sales, isolated service transactions—U.S. corporations would not have an active economic presence in the Philippines. The U.S. corporation involved would be classified under the National Internal Revenue Code as a "non-resident foreign corporation[80] . . . not engaged in trade or business in the Philippines."[81] It would still be taxable on the income which it derives from Philippine sources, but on a different basis from resident foreign corporations. Its tax base would be its gross income[82] from Philippine sources, and the regular tax rate would be 35 percent.[83]

Another way for a U.S. corporation to participate in economic activity in the Philippines and to derive income from Philippine sources would be to make an equity investment in a Philippine corporation (but in an amount not large enough to make the Philippine corporation its controlled subsidiary) and receive dividend income from the Philippine corporation. The

[80] N.I.R.C. OF 1977, *supra* note 14, sec. 24(b) (1) in relation ot sec. 20(i).

[81] *Id.*

[82] [Gross income] in the case of a manufacturing, merchandising, or mining business, means the *total sales, less the cost of goods sold* plus any income from investments and from outside operations or sources . . ." *See* B.I.R. Revenue Regulations No. 2, sec. 43.

[83] N.I.R.C. OF 1977, *supra* note 14, sec. 24(b) (1).

U.S. corporation would again be classified as a non-resident foreign corporation and taxed as such.

2.222 *Taxation of the Different Kinds of Derived Income*

With respect to direct sales of manufactured goods by a U.S. manufacturing corporation to Philippine customers, the tax would be 35 percent on that part of the gross income deemed to be from Philippine sources, gross income from products manufactured outside the Philippines and sold within the Philippines being gross income from sources partly within and partly without the Philippines.[84] If the goods are purchased outside the Philippines by a U.S. trading company or a non-Philippine sales subsidiary of a U.S. manufacturing corporation which then sells such goods in the Philippines, the tax would be 35 percent of the gross income derived by the trading company or sales subsidiary from the sale of such goods within the Philippines.[85] Therefore, the crucial inquiry as to the taxability of such sales transactions by the Philippines is whether such goods were, legally speaking, sold within the Philippines.[86] "With respect to . . . sales of personal property, the rules on the situs of the perfection of the sales contract, shipping arrangements [such] as F.O.B., and situs as to where title on [sic] the property is transferred control the taxability of the gains or profits derived from the sale."[87]

Gross income from services (including transportation and communication services) rendered within the Philippines are also taxable at a 35 percent rate.[88] The gross income from services rendered partly within and partly without the Philippines is apportioned between Philippine and foreign sources.[89]

Interest on loans made to residents of the Philippines is taxed at 15 percent.[90] Royalty payments are taxed at 35 percent,[91] except for film rentals which are taxed at 25 percent;[93] rentals, lease and charter fees for vessels chartered by Philippine nationals (which charter or lease has been duly approved by the Maritime Industry Authority) which are subject to a 4.5 percent final withholding tax;[94] and rentals and charter fees for aircraft,

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84 *Id.*, sec. 24 (b) (1) in relation to sec. 37 (a) (6) and 37 (e).

85 *Id.*

86 *Id.*, sec. 37 (e). However, sales transactions are usually structured with the help of both American and Filipino tax lawyers, so that legally, the sales are made outside the Philippines. This only goes to show that the practice of law is really interesting, or if one is to take another viewpoint, it is in certain instances, largely a matter of semantics.

87 E. CASTANEDA, *supra* note 22, at 84-85.

88 N.I.R.C. OF 1977, *supra* note 14, sec. 24(b) (1) in relation to sec. 37(a) (3) and sec. 37 (e).

89 *Id.*, § 37 (e).

90 *Id.*, sec. (b) (1) (ii).

91 *Id.*, sec. 24 (b) (1).

92 *Id.*

93 *Id.*, sec. 24 (b) (1) (iv).

94 *Id.*, sec. 24 (b) (1) (v).

machineries and other equipment which are subject to a 7½ percent final withholding tax.[95]

Dividend income from equity investments in Philippine corporations is taxed at 15 percent, so long as the U.S. corporation's stockholding is at least 10 percent; otherwise the rate is at 35 percent of the dividends paid.[96]

2.3 INVESTMENT INCENTIVES IN THE FORM OF TAXATION MEASURES

An important body of laws of significance with respect to the tax treatment of U.S. corporations deriving income from Philippine sources are the various Philippine investment incentive laws.[97] These laws provide for tax and other incentives for qualified enterprises as well as for investors in such enterprises. They are designed to encourage investment and economic activity in what the Philippines regards as priority economic areas, which include new industrial production,[98] agriculture,[99] tourism[100] and exports of both goods and services.[101]

A perusal of these laws readily reveals that tax inventives are the incentive measures primarily used. There are tax incentives for both the corporation that is engaged in the preferred economic activity,[102] as well as for the stockholders who have invested in such corporation.[103] The tax incentives take the form of special additional deductions,[104] net operating loss carry-overs (as deductions),[105] special tax credits,[106] exemptions from various kinds of taxes,[107] duty and tax free importations of machinery and

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[95] *Id.*, sec. 24 (b) (1) (ii).

[96] *Id.*, sec. 24 (b) (1) (iii). This is because under I.R.C. § 902 (1982), a United States corporation with dividend income from foreign sources is entitled to the "deemed paid" credit for the income taxes paid by the foreign corporation in which it has an equity investment only if it holds at least 10 percent of the voting stock of the foreign corporation; see note 74.

[97] OMNIBUS INVESTMENTS CODE, Tourism Incentives Program of 1974, Pres. Decree No. 535, (1974) [hereinafter cited as Tourism Incentives Program of 1974]; Pres. Decree No. 66 (1972).

[98] *See* OMNIBUS INVESTMENTS CODE, supra note 35.

[99] *Id.*

[100] *See* Tourism Incentives Program of 1974, *supra* note 97.

[101] *See* OMNIBUS INVESTMENTS CODE, *supra* note 25; Pres. Decree No. 66 (1972).

[102] *See* OMNIBUS INVESTMENTS CODE, *supra* note 35; arts. 45-50; Tourism Incentives Program of 1974, secs. 8, 11, *supra* note 97; Pres. Decree No. 66 (1972), secs. 17, 18.

[103] OMNIBUS INVESTMENTS CODE, *supra* note 35, arts. 43-44; Tourism Incentives Program of 1974, *supra* note 97, sec. 5.

[104] OMNIBUS INVESTMENTS CODE, *supra* note 35, arts. 47(b), 47(c), 49(d), 49(f), 49(g), 50; Tourism Incentives Program of 1974, *supra* note 97, sec. 8(a).

[105] OMNIBUS INVESTMENTS CODE, *supra* note 35, arts. 45(d), 48(e); Tourism Incentives Program of 1974, *supra* note 97, sec. 8(b); Pres. Decree No. 66 (1972), sec. 18(a).

[106] OMNIBUS INVESTMENTS CODE, *supra* note 35, arts. 45(b), 45(c), 45(e), 46(a), 46(b), 48(b), 48(c), 48(d), 48(f), 48(i), 48-A(a), 48-A(c), 48-B, 49(c), 50(a); Tourism Incentives Program of 1974, *supra* note 97, secs. 8(c), 8(f).

[107] OMNIBUS INVESTMENTS CODE, *supra* note 35, arts. 43(b), 44(c), 45(a), 46(a), 46(b), 47(a), 48(a), 48(h), 48-A(b), 49(a), 49(b); Tourism Incentives Program

equipment,[108] investment allowances,[109] accelerated depreciation,[110] and tax-free zones,[111] subject to various conditions including time limitations.

However, the incentives may generally be availed of only by Philippine corporations and their stockholder-investors.[112] The exceptions are enterprises or corporations operating in areas designated as export processing zones.[113] Thus, as a general rule, a U.S. corporation may not avail of the incentives if it operates in the Philippines through a branch. It may do so only when it sets up a Philippine subsidiary which is involved in certain designated areas of economic activity, or otherwise invests in the equity of a Philippine corporation involved in such economic activity.

Under the Omnibus Investments Code and the Tourism Incentives Program of 1974, a Philippine corporation must be registered under the relevant "investment priorities plan" or "tourism priorities plan" with either the Philippine Board of Investments or the Philippine Tourism Authority in order to qualify for tax incentives.[114] Registration is not a mere ministerial process, nor is approval automatic. The two aforementioned governmental bodies must determine that the relevant statutory criteria are met, and may approve or reject the application.[115] A corporation whose registration has been approved is denominated a "registered enterprise,"[116] or "registered tourism enterprise,"[117] entitled to investment incentives including tax incentives.

As a general rule, registration is limited to Philippine corporations of which 60 percent of the capital stock outstanding and entitled to vote is owned and held by "Philippine nationals."[118] For a corporation which is a stockholder to be considered a "Philippine national," such a corporation must itself be a Philippine corporation and 60 percent of its capital stock outstanding and entitled to vote must be held by citizens of the Philippines.[119]

of 1974, *supra* note 97, secs. 8(e), 9(b); Pres. Decree No. 66 (1972), sec. 18(c); Pres. Decree No. 1716-A (1980), sec. 11.

108 OMNIBUS INVESTMENTS CODE, *supra* note 35, arts. 45(a), 46(a), 46(b), 48 (a), 50(b); Tourism Incentives Program of 1974, *supra* note 97, sec. 8(e).

109 OMNIBUS INVESTMENTS CODE, *supra* note 35, arts. 44(a), 46(c); Tourism In-Incentives Program of 1974, *supra* note 97, secs. 8(g), 9(a).

110 Pres. Decree No. 66 (1972), sec. 18(a).

111 Pres. Decree No. 66 (1972), sec. 17.

112 To be entitled to registration, a corporation must be a corporation organized under Philippine laws. *See* OMNIBUS INVESTMENTS CODE, art. 10; Tourism Incentives Program of 1974, supra note 97, sec. 6(b).

113 Pres. Decree 66 (1972), sec. 16.

114 OMNIBUS INVESTMENTS CODE, *supra* note 35, arts. 10, 18-20, 29-30, 34-41, 45-56; Tourism Incentives Program of 1974, *supra* note 97, secs. 3, 4, 6, 8, 15.

115 OMNIBUS INVESTMENTS CODE, *supra* note 35, arts. 38-41 in relation to arts. 34-47; Tourism Incentives Program of 1974, *supra* note 97, secs. 6, 15.

116 OMNIBUS INVESTMENTS CODE, *supra* note 35, arts. 10, 18-20.

117 Tourism Incentives Program of 1974, *supra* note 97, sec. 3(b).

118 OMNIBUS INVESTMENTS CODE, *supra* note 35, arts. 34-36; Tourism Incentives Program of 1974, *supra* note 97, sec. 6(b) (1).

119 OMNIBUS INVESTMENTS CODE, *supra* note 35, art. 14.

Under certain statutory exceptions though, Philippine corporations less than 60 percent of the capital stock of which is held by Philippine nationals are allowed to engage in certain areas of economic activity and avail of tax and other incentives.[120]

It will thus be seen that it is only in certain areas of economic activity that Philippine subsidiaries of U.S. corporations are allowed to engage in certain areas of economic activity and avail of tax incentives under the two laws mentioned. In the majority of cases, the subsidiary will not qualify. If a U.S. corporation wants a Philippine corporation in which it has an equity interest to qualify for incentives, the former's equity interest in the Philippine corporation generally cannot exceed 40 percent (assuming the rest of the stock is held by Philippine nationals). However, in this case, the Philippine corporation involved would no longer be its subsidiary.

2.4 THE IMPACT OF THE INCOME TAX CREDIT PROVISIONS DERIVING INCOME FROM PHILIPPINE SOURCES

We have seen that under local Philippine tax laws, U.S. corporations will be liable for Philippine income tax so long as they derive income from Philippine sources. However, their income from Philippine sources will also be subject to U.S. income tax, U.S. corporations being subject to U.S. income tax on their worldwide income. To alleviate this double tax burden, U.S. tax law provides that U.S. corporations are entitled to a credit for any Philippine income taxes that they might have paid on their income from Philippine sources, the credit to be taken against their income tax liability to the United States government.

Under § 901 of the Internal Revenue Code,[121] the U.S. income tax due from a United States corporation on its income from sources outside the United States (prior to any reduction because of foreign tax credits, hereinafter referred to as "pre-credit U.S. income tax"), is credited with the amount of any (1) income, war profits, and excess profits taxes which the corporation paid or accrued during the taxable year to a foreign country, as well as with (2) the income, war profits and excess profits taxes *it is deemed to have paid* to a foreign country.[122] Foreign taxes paid "in lieu of income, war profits or excess profits taxes" also qualify for the credit.[123]

The taxes "deemed paid" by the U.S. corporation to a foreign country are calculated under § 902[124] as follows:

> [A] domestic corporation which owns at least 10 percent of the voting stock of a foreign corporation from which it receives dividends in any

[120] *Id.*, arts. 34-47.
[121] I.R.C. § 901 (1983).
[122] The latter is often referred to as the "deemed-paid" credit.
[123] *Id.*, § 903.
[124] *Id.*, § 902.

> taxable year shall be deemed to have paid the same proportion of any income, war profits, or excess profits taxes paid or deemed to be paid by such foreign corporation to any foreign country or to any possession of the United States, on or with respect to the accumulated profits of such foreign corporation from which such dividends were paid, which the amount of such dividends (determined without regard to section 78) bears to the amount of such accumulated profits in excess of such income, war profits, and excess profits taxes (other than those deemed paid).

Whether or not a particular foreign tax qualifies as "income, war profits, or excess profits taxes" or as "taxes paid in lieu of income, war profits or excess taxes" paid or deemed paid by the U.S. corporation, and as such is creditable against U.S. income tax, would be determined by the United States Internal Revenue Service and by American courts based on American tax concepts of what are "income, war profits or excess profits taxes." The Philippine income tax paid by resident and non-resident foreign corporations should qualify as a creditable income tax.[125] Likewise, the income tax paid by Philippine subsidiaries of U.S. corporations, or by Philippine corporations in whch U.S. corporations have at least a 10 percent interest in the voting stock, should qualify as a creditable "deemed paid" tax under § 902 of the Internal Revenue Code.[126] (Further discussion of the subject of what should be the characteristics of a foreign tax for it to be creditable under the Internal Revenue Code is outside the scope of this paper.)

However, several Philippine taxes have been administratively or judicially ruled not to be creditable under the Internal Revenue Code. These include the tax on the gross income of banks doing business in the Philippines,[127] and the privilege tax on business measured by a percentage of

125 Considering the fact that the National Internal Revenue Code of the Philippines is largely of American origin, Philippine Taxes on income should qualify for the § 901 credit. For example, the American Internal Revenue Service has ruled that the tax imposed under § 24 (b) (1) of the former National Internal Revenue Code of the Philippines on non-resident foreign corporations was a creditable income tax under § 901 of the I.R.C.; the ruling took note of the fact that "The foregoing provision of the Philippine tax law relative to income tax on non-resident foreign foreign corporations is analogous to section 881 of the United States Internal Revenue Code relating to tax on foreign corporations not engaged in business in the United States. Accordingly, the tax imposed under sec. 24 (b) of the Philippine Code falls within the United Statse concept of an income tax ...", Rev. Rul. 65-66, 1966—1 C.B. 175; also *see* sec. 24 (b) (g) of the National Internal Revenue Code, Com-24 (b) (1) of the N.I.R.C. of 1977, *supra* note 14.

In Bank of America Nat'l. Trust & Savings Ass'n. v. U.S., 459 F. 2d 513, 515 (Ct. Cl. 1972), *cert. denied* 409 U.S. 949 (1972), the Court of Claims noted that the Internal Revenue Service had allowed the "Philippine Tax on Foreign Corporations" (presumably the tax imposed on resident foreign corporations under § 24 (b) (2) of the former National Internal Revenue Code, Commonwealth Act No. 466, now sec. 24 (b) (2) of the N.I.R.C. OF 1977, *supra* note 14, as a § 901 tax credit.

126 I.R.C. § 902 (1983).

127 National Internal Revenue Code, Com. Act No. 466 (1939), § 249 (as amended up to August, 1964); a similar tax on banks is still imposed under the N.I.R.C. OF 1977, *supra* note 14, sec. 20. *See* Bank of America Nat'l. Trust & Savings Ass'n. v. U.S., 459 F. 2d 513 (Ct. Cl. 1972(, *cert. denied* 409 U.S. 949 (1972); also *see* Bank America Nat'l. Thust and Savings Assn'n v. Commissioner 61 T.C. 752

the gross receipts of the business,[128] both formerly imposed under the National Internal Revenue Code.

The credit for foreign taxes is subject to a quantitative limitation. Under § 904 of the Internal Revenue Code, the foreign tax credit "shall not exceed the same proportion of the [U.S. income] tax against which such credit is taken which the taxpayer's taxable income from sources without the United States (but not in excess of the taxpayer's entire taxable income) bears to his entire taxable income for the same taxable year."[129]

For purposes of simplicity, we assume a U.S. corporation whose only income from foreign sources is from the Philippines. By virtue of the operation of §§ 901-904, if the creditable Philippine income tax is less than the pre-credit U.S. income tax collectible on the same income from Philippine sources (which would be a proportionate part of the total U.S. income tax on the corporation's income from all sources), U.S. income tax on such income from Philippine sources would still be due. The amount due as U.S. tax, which would be equivalent to the excess of the pre-credit U.S. income tax over the Philippine income tax, would still be collected from the U.S. corporation. On the other hand, if the Philippine income tax was greater than the corresponding pre-credit U.S. income tax, no credit would be given for the excess, with no U.S. income tax being collected on that part of the income of the corporation from Philippine sources.[130]

(1974), *aff'd* 538 F. 2d 334 (9th Cir. 1976). The Court of Claims, in the first *Bank of America* case ruled that:

> "[T]he term 'income tax' in § 901 (b) (1) covers all foreign income taxes designated to fall on some net gain or profit, and includes a gross income tax if, but only if, that impact is almost sure, or very likely, to reach some net gain because costs or expenses will not be so high as to offset the profit." *Id.*, at 523.

This test was cited with approval by the Tax Court in the second *Bank of America* case at 760.

128 National Internal Revenue Code, Com. Act No. 146 (1939), sec. 178 in relation to sec. 192, 195 (as amended up to August, 1956); the tax imposed by the former sec. 178 is now embodied in sec. 188 of the National Internal Revenue Code of 1977, Pres. Decree No. 1158 (1977). *See* Rev. Rul. 57-62, 1957-1 CB 241; also *see* Rev. Rul. 57-62, 1957-1 CB 241; also *see* U.S. v. Waterman Steamship Corp., 330 F. 2d 128 (5th Cir. 1964), *rehg denied* 382 U.S. 873 (1965), where the Court of Appeals for the 5th Circuit ruled that the privilege tax imposed under sec. 178 in relation to sec. 192 of the former Philippine National Internal Revenue Code was not a qualifying "in lieu of" tax under § 901 in relation to § 903 of the United States Internal Revenue Code. (In both cases, the U.S. taxpayer involved was liable for the regular Philippine income tax).

129 I.R.C. § 904 (1983). This limitation is oftentimes referred to as the "overall limitation."

130 It is in this context that Ruling No. 76-004 of the Philippine Bureau of Internal Revenue, *see* note 77, first flounders. The reduced rate of 15 percent on dividends is supposed to be applied in a situation where the incentive of the reduced rate is preserved for the investor and what occurs is not merely a flow of revenue from the Philippine to the U.S. treasury. Under the operation of the U.S. foreign income tax credit, the Philippines does in fact give up some of its tax when it applies the reduced rate. Illustrated: (a) Given (1) $100 of income or accumulated profits (before any income tax) of the subsidiary and (2) full remittance of such income (after tax); (b) at a withholding rate on dividends of 35 percent, the total

III. THE IMPACT OF THE PHILIPPINES-U.S. INCOME TAX TREATY

3.1 Higher Threshold of Economic Activity Required for the Exercise of Philippine Taxing Jurisdiction with Respect to Business Profits

One of the important, if not the most important, changes which the Philippines-U.S. income tax treaty bring about in the taxation of U.S. corporations which exploit the Philippine market is the higher threshold of economic contact with, or economic activity in the Philippines required of such corporations before they become liable for a Philippine tax on their business profits. As a result, many transactions previously taxed under the National Internal Revenue Code are no longer taxable.

The impact of the new rules on this matter in the treaty is primarily on two categories of corporations. The first category is corporations which are engaged in the *active pursuit of their business* in exploiting the Philippine market without being "engaged in trade or business in the Philippines," and therefore considered as *non-resident foreign corporations* under the National Internal Revenue Code. These would include corporations which manufacture and sell goods to Philippine residents or merely sell such goods, or lease personal property to Philippine residents, or who render services within the Philippines. Excluded from this category are non-resident banks and investment companies which are subject to the interest and dividend provisions of the treaty. The second category is those corporations (including banks and investment companies) considered as "being engaged in trade or business in the Philippines" under the National Internal Revenue Code as *resident foreign corporations* (These two categories of corporations are hereinafter referred to as "covered" corporations).

These new rules have no application to U.S. corporations which do business (again we emphasize, in an economic and business, but not in a tax sense) in the Philippines through subsidiaries.

3.11 *Partial Abandonment of the National Internal Revenue Code's "Source of Income" Taxability Concept, and even of the "Doing Business" Rule. The New Standard—Permanent Establishment.*

As we previously discussed, the minimum economic contact with the Philippines required for a U.S. corporation to be taxable under the National

Philippine tax would be $57.75 (35 percent x $100, plus 35 percent of the $65 dividend), which would be creditable under § 901. The U.S. income tax on this in-Philippine tax would would be creditable under § 901. The U.S. tax would have been $46.00, or 46 percent x $100; the present maximum U.S. corporate income tax rate being 46 percent. *See* I.R.C. § 11 (1983); and (c) At a withholding rate of 15 percent, the total Philippine tax would be $44.75 (35 percent x $100; plus 15 percent x $65), which would again be creditable. Since $44.75 is less than the maximum imposable U.S. tax of $46, the U.S. would collect $1.25, the amount of U.S. tax not wiped out by the credit. This amount is thus lost by the Philippine treasury to the U.S. treasury.

Internal Revenue Code was that it derive income from Philippine sources. Under the treaty, for a *covered* corporation (see discussion under 3.1) to be taxable by the Philippines on its business profits,[131] it must have a "permanent establishment" in the Philippines.[132] A permanent establishment ordinarily means a *fixed place of business* through which the U.S. corporation engages in its trade or business.[133] However, the corporation would also be deemed to have a permanent establishment in the Philippines when it has a *dependent* agent in the Philippines, who does, or who in its behalf has authority to do, certain specified acts.[134] In contrast, when the U.S. corporation does business through a separate Philippine subsidiary, the subsidiary will ordinarily not be considered its permanent establishment.[135]

Thus, in respect of the business profits of covered corporations, when they *merely* derive income from Philippine sources in the sense of the source rules, they will no longer be taxable on such income.[136] To this extent, the concept under the National Internal Revenue Code of a non-resident foreign corporation deriving income from Philippine sources as being a taxable entity has been eliminated.

Just as there is a distinction for purposes of the National Internal Revenue Code between the concept of "being engaged in a trade or business in the Philippines" and the setting up of a branch in the Philippines, so is there a difference between being "engaged in trade or business in the

131 The term "business profits" means income derived from any trade or business whether carried on by an individual, corporation or any other person ... including the rental of tangible personal (movable) property. Philippines — U.S. Income Tax Treaty, *supra* note 1, art. 8, par. (6).

132 Philippines-U.S. Income Tax Treaty, *supra*, note 1, art. 8, para. (1). Furthermore, under the National Internal Revenue Code, income of any kind, to the extent required by any tax treaty obligation, is exempt from Philippine income tax. Na- required by any tax treaty obligation, is exempt from Philippine income tax. N.I.R.C. OF 1977, *supra* note 14, sec. 29 (b) (6).

133 Philippines-U.S. Income Tax Treaty, *supra*, note 1, art. 5, para. (1).

134 *Id.*, art. 5, para. (4).

135 See *Id.*, art. 5, para. (8). However, such a subsidiary could be regarded as giving rise to a permanent establishment, if it acts as a dependent agent for its parent corporation under *Id.*, art. 5 (4). *See* COMMITTEE ON FISCAL AFFAIRS, ORGANIZATION FOR ECONOMIC COOPERATION AND DEVELOPMENT, MODEL DOUBLE TAXATION CONVENTION ON INCOME AND ON CAPITAL, Commentary on art. 5, 39-40 (1977), a provision which is similar to art. 5 (8) of the Philippines-U.S. Income Tax Treaty [hereinafter cited as OECD Model Treaty].

136 The source rules of the Philippines-United States Income Tax Treaty, *supra* note 1, art. 4, would override the source rules in sec. 37 of the N.I.R.C. OF 1977, *supra* note 14 (amended up to January 1, 1982). The relevant source rule in the treaty re business profits states: "Notwithstanding paragraphs (1) through (4), business profits which are attributable to a permanent establishment which the recipient, a resident of one of the Contracting States has in the other Contracting State, shall be treated as income from sources within that other Contracting State." Does this mean that under the treaty, business profits of a U.S. corporation not attributable to a permanent establishment in the Philippines are not taxable by the Philippines because they would not be derived from Philippine sources? This would not seem to be the case. The language of the provision itself only states that business profits attributable to a permanent establishment within a state are derived from sources within that state; the provision is an exception to the dividend, interest, royalties, and real income source provisions in pars. 1 to 4. It *does not* state that business

Philippines" and the concept of a permanent establishment under the treaty. A corporation may "be engaged in trade or business in the Philippines" under the National Internal Revenue Code but still be considered not to have a permanent establishment under the treaty. It would therefore not be taxable by the Philippines.[137] A branch however would always qualify as a permanent establishment.[138]

The treaty enumerates several physical facilities which would qualify as a "fixed place of business" and therefore as a permanent establishment.[139] These include a building site or construction or assembly project, or supervisory activities in connection therewith continuing for a period of more than 183 days.[140] The furnishing of services, including consultancy services for a period or periods aggregating more than 183 days for the same or connected project would likewise be a "fixed place of business."[141] However, the use of facilities solely for the purposes of storage, display, or

profits not attributable to a permanent establishment within a state would no longer be considered as being derived from sources within that state (if otherwise considered derived from sources within that state according to its domestic laws.) Furthermore, under art. 4, par. 8 of the treaty the source of any item of income to which specific treaty source rules do not apply shall be determined by each of the Contracting States in accordance with its own law. Therefore, business profits of a U.S. corporation not attributable to a Philippine permanent establishment (but otherwise derived from Philippine sources according to sec. 37 of the Philippine National Internal Revenue Code) are not taxable by the Philippines under the treaty, not because they are no longer considered as being derived from Philippine sources (under art. 6 (1) of the treaty, a United States corporation may be taxed by the Philippines only on its income from Philippine sources), but because of the specific mandate of the business profits provisions (art. 8) of the treaty.

However, one could argue that one could read the source provision re business profits in the treaty (art. 4, par. 6) together with the business profits provision (art. 8) to come up with a conclusion that business profits not attributable to a permanent establishment within a state are no longer from sources within that state. This is a weak argument. The business profits provision is not a source provision. The source provision could easily have been written to reflect this viewpoint.

137 This is the interpretation as well of the Senate Foreign Relations Committee of the United States construing a similar "engaged in trade or business requirement" under the Internal Revenue Code of the United States. *See* S. Exec. Rep. No. 39, *supra* note 9 ¶ 74, 138, at 74, 190 (P-H).

138 Philippines-U.S. Income Tax Treaty, *supra* note 1, art. 5, para. (2) (b).

139 "(2) The term 'fixed place of business' includes but is not limited to:

(a) A seat of management;
(b) A branch;
(c) An office;
(d) A store or other sales outlet;
(e) A factory;
(f) A workshop;
(g) A warehouse;
(h) A mine, quarry, or other place of natural resources;
(i) A building site or construction or assembly project or supervisory activities in connection therewith, provided such site, project or activity continues for a period of more than 183 days; and
(j) The furnishing of services, including consultancy services, by a resident of one of the Contracting States through employees or other personsnel, provided activities of that nature continue (for the same or a connected project) within the other Contracting State for a period or periods aggregating more than 183 days."

140 *Id.*, art. 5, par. (2) (i).

141 *Id.*, art. 5, par. (2) (j).

occasional delivery of goods or merchandise belonging to the corporation would not give rise to a permanent establishment.[142] Neither will the maintenance by the corporation of a stock of its goods or merchandise solely for storage, display, or occasional delivery; for processing by another person; or the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise, collecting information, advertising, the supply of information, scientific research, or for similar activities which have a similar preparatory or auxiliary character.[143]

The fact that there is a dependent agent (e.g., an employee) acting on behalf of a corporation in the Philippines shall be deemed to give rise to a permanent establishment only if the agent has and habitually exercises in the Philippines an authority to conclude contracts in the name of the corporation or when the agent although without such authority, habitually maintains in the Philippines a stock of goods or merchandise from which he regularly delivers goods and merchandise on behalf of the corporation.[144] As was the rule prior to the treaty, when the corporation acts through an independent agent who is acting in the ordinary course of his business, there will be no permanent establishment.[145]

Merely participating in the management, supervision or control of a Philippine firm or corporation is not specifically included in the enumeration of a fixed place of business.[146] However, it must be remembered that the enumeration as to what is a fixed place of business in the Philippines-U.S. income tax treaty is not exclusive. If the business of the U.S. corporation is carried on by virtue of the exercise of such management, supervision or control, then there is a permanent establishment, and the persons acting on behalf of the corporation could be considered dependent agents. Moreover, the facilities utilized in order for a permanent establishment to exist need not be owned by the U.S. corporation; they may be those of a Philippine corporation.[147]

3.12 *Selling and Rental Activities as Contrasted to Licensing and Manufacturing Activities*

In our previous discussion of the alternatives available to an American manufacturing corporation which wanted to exploit the Philippine market, we noted that it had several alternatives. The first would be to set up a branch in the Philippines with manufacturing and selling (or leasing) functions or solely with selling functions. The second would be to pursue

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[142] *Id.*, art. 5, par. 3 (a).

[143] *Id.*, art. 5, par. (3) (b)-(3) (e).

[144] *Id.*, art. 5, par. (4).

[145] *Id.*, art. 5, par. (5). However, when the activities of such an agent are devoted wholly or almost wholly on behalf of that resident, he shall not be considered an agent of independent status ... if the transaction between the agent and the resident were not made under arm's length conditions. *Id.*

[146] Under the Philippine rules and regulations on the "doing business" concept in the OMNIBUS INVESTMENTS CODE, *supra* note 35, this is considered as doing business.

[147] *See* OECD Model Treaty, *supra* note 135, commentary on art. 5, ¶ 4.

these business activities by setting up a subsidiary corporation. The third alternative would be to forego setting up an active economic presence in the Philippines, and instead sell or lease its products directly to the Philippines, or merely license its technology in exchange for royalties.

Under the National Internal Revenue Code, all of the alternatives would have meant some form of Philippine taxation for the U.S. corporation involved. However, under the state of things post-treaty, a corporation which merely decides to sell or lease its products directly to the Philippines would no longer be subject to the Philippine tax. To this extent, § 24(b) (1) and especially § 24(b) (1) (v) (rentals of vessels) and § 24(b) (vii) (rentals of aircraft, machineries and other equipment) of the National Internal Revenue Code would be rendered inoperative. An exception in the case of rentals would be film rentals which would still be taxable as royalties under the treaty.[148]

3.13 *Possible Exception Re Ships and Aircraft in International Traffic*

The treaty states that:

> *Notwithstanding any other provision of this convention,* profits derived by a resident of one of the Contracting States from sources within the other Contracting State from the operation of ships in international traffic may be taxed by the Contracting States ... [T]he tax imposed by the other Contracting State ... shall not exceed, the lesser of one and a half percent of the gross revenue derived from sources in that State ...[149]
>
> Nothing in this Convention shall affect the right of a Contracting State to tax, in accordance with domestic law, 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.[150]

These provisions reflected a decision by the U.S. airline industry to be left out of the treaty when it was signed. They had preferred to be left out of it completely because there was no reciprocal exemption for shipping and airline profits in the treaty.[151]

This position was subsequently changed, and the airlines agreed to be taxed at a reduced rate under the treaty.[152] The result was the reservation made by the U.S. Senate to the effect that, "[N]otwithstanding the provisions of paragraph (2) of Article 9 of the Convention, the tax imposed

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[148] Philippines-U.S. Income Tax Treaty, *supra* note 1, art. 13, pars. (1), (3).

[149] *Id.*, art. 9, par. (1).

[150] *Id.*, par. (2).

[151] *See* Statements on proposed income tax treaties with Philippines, Korea, and the United Kingdom by Laurence N. Woodworth, *supra* note 6, ¶ 74, 133 at 74,123; *1977 Hearings, supra* note 5, at 62-63 (testimony of Norman J. Philion, Executive Vice President, Air Transport Association of America); *id.*, at 85 (prepared statement of Laurence N. Woodworth, Assistant Secretary of the Treasury for Tax Policy); *1981 Hearings, supra* note 8, at 74 (statement of John E. Chapoton, Assisttant Secretary of the Treasury, Tax Policy).

[152] *1981 Hearings, supra* note 8, at 100 (statement of William M. Hawkins, Vice President, Finance and Taxation, Air Transport Association of America); *id.*, at 69 (statement of John E. Chapoton, Assistant Secretary of the Treasury, Tax Policy).

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 may be as much as ... the lesser of one and one-half percent of the gross revenue derived from sources within that State ..."[153]

This compromise had been agreeable to the Philippine negotiators when the treaty was first being negotiated.[154] With the ratification of the treaty after the U.S. Senate had made its reservations, the reduced 1½ rate on gross Philippine revenues should therefore apply to aircraft as well as ships.

By virtue of the "notwithstanding" language, the provision on shipping companies (which would also apply to airline companies under the abovementioned reservation) could be construed to mean that shipping companies and airline companies will be subject to Philippine tax regardless of whether or not they have a permanent establishment in the Philippines. The "notwithstanding" clause could be interpreted to mean notwithstanding *all* the other provisions in the Convention, including the permanent establishment and business profits provisions. Under this construction of the provision, the phrases, "profits . . . derived from sources within the other Contracting State from the operation of ships (and aircraft) in international traffic ..." and "[G]ross revenues derived from sources in that state...", would be construed to mean profits and gross revenue so long as they are "[F]rom the operation of ships (and aircraft) in international traffic . . . derived from outgoing traffic originating in . . . [the Philippines]",[155] which is the source rule with respect to international traffic in the treaty, regardless of the existence of a permanent establishment. Thus, profits and gross revenue of airline and shipping companies, so long as they are derived from outgoing international traffic originating from the Philippines would be taxable by the Philippines, whether or not these companies had a permanent establishment in the Philippines.

Another construction of the airline and shipping provisions would make the airline and shipping companies taxable by the Philippines only when they have a permanent establishment in the Philippines. The phrases, *[P]rofits* derived from...sources within the other Contracting State from the operation of ships (and aircraft) in international traffic...", and "[G]ross revenue derived from sources in ... [the Philippines] ..." should under this constructionn, refer to *business profits* derived from Philippine

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[153] *See* Resolution of Ratificatoin (of Tax Convention with the Republic of the Philippines, 97th Cong., 1st Sess. 188 CONG. REC. S15533 (1981).

[154] *See* Statements on proposed income tax treaties with Philippines, Korea, and the United Kingdom by Laurence N. Woodworth, *supra* note 6, ¶ 74,133 at 74,123. After the 1977 hearings before the Senate Foreign Relations Committee, the U.S. Treasury tried to renegotiate for a reciprocal exemption provision. This was rejected by the Philippine government. See Statement on proposed income tax treaty with the Philippines by Donald C. Lubick, Assistant Secretary of the Treasury for Tax Policy, before the Senate Foreign Relations Committee, June 6, 1979, reprinted in (1979) 2 TAX TREATIES (P-H) ¶ 74,135, at 74,153.

[155] Philippines-United States Income Tax Treaty, *supra* note 1, art. 4, par. 7.

sources because of the use of word "profits" in the airline and shipping provision. One could then argue that under the treaty, business profits not attributable to a permanent establishment are not derived from Philippine sources,[156] and therefore not taxable by the Philippines; that the source rule on international traffic should be read together with the business profits source rule as interpreted above. As we noted earlier, this interpretation of the business profits provision is not a very plausible argument. Business profits not attributable to a Philippine permanent establishment are not taxed under the treaty not because they are considered as not being derived from Philippine sources, but because of the specific mandate of the business profits provision.[157]

As a last resort, one could cite the "savings clause" of the treaty, to the effect that a convention should not increase the tax burden on residents of the Contracting States, and therefore if the tax treatment under domestic law were more favorable than that under the treaty the taxpayer may avail of the more favorable rule.[158] It must be remembered though that under the National Internal Revenue Code, international carriers were taxable by the Philippines whether or not they were deemed as being "engaged in trade or business in the Philippines" under the Code. If an international carrier was classified as a non-resident foreign corporation under the Code, it would still have been taxable by the Philippines, although on a presumably smaller tax base and at a lower tax rate—on its gross income from that part of its transportation services performed within the Philippines.[159] At the very least then, international carriers deriving income from Philippine sources (according to the rules of the National Internal Revenue Code) would be taxed on this basis (assuming that this treatment would be more favorable than being taxed under the treaty at 1½ of gross Philippine revenues).

Although not supported by the text of the treaty itself, the second interpretation of the airline and shipping provisions seems to be the one adhered to by the U.S. Senate Foreign Relations Committee,[160] and impliedly by the U.S. Treasury.[161]

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[156] *See* note 136.

[157] Philippines-U.S. Income Tax Treaty, *supra* note 1, art. 8, par. (1).

[158] *Id.*, art. 6, par. (2).

[159] N.I.R.C. OF 1977, *supra* note 14, sec. 24 (b) (1) in relation to sec. 37 (e).

[160] S. Exec. Rep. No. 39, note 9, § 74,138, at 74,185. "General sales agents are independent brokers under Article 5 (5) of the treaty, and accordingly *are not a permanent establishment of the U.S. carriers.* Therefore, when such agents sell tickets on U.S. airlines which are not for international traffic originating in the Philippines the Philippines may not tax that sale." This was in response to a complaint of the airline industry that the Philippine government allegedly considered a general sales agent as constituting a permanent establishment, and that therefore there was Philippine source income for an airline that does not serve the Phlippines, but has a general sales agent therein. The crucial point seems to be not whether there is a permanent establishment in the Philippines but whether the international traffic is traffic "originating from the Philippines."

[161] In the technical explanation of the treaty, the U.S. Treasury states that the word "notwithstanding" refers to the non-discrimination provisions of art. 24 of the

3.2 RETENTION OF NATIONAL INTERNAL REVENUE CODE SOURCE OF INCOME TAXABILITY STANDARD WITH RESPECT TO DIVIDENDS, INTEREST, AND ROYALTIES

Generally speaking, the source of income taxability standard under the National Internal Revenue Code has been followed in the treaty with respect to passive income received by U.S. corporationns—dividends, interest, and royalties—in contrast to business profits. Thus, the minimum economic contact that a United States corporation need have with the Philippines to be taxable by it—when receiving dividends, interest and royalty income, is that such income be derived from Philippine sources, as determined under the source rules embodied in the treaty.[162]

However, there are some differences between the source rules in the National Internal Revenue Code and those in the treaty.

3.21 *Dividends*

As in the Code, the treaty provides that dividends paid by a Philippine corporation to a U.S. corporation would be derived from Philippine sources.[163] Furthermore, a proportionate part of the dividends paid by a corporation of *any state* could also be considered as derived from Philippine sources, if for the three-year period preceding the declaration of dividends (or for the period the corporation has been in existence), at least 50 percent of such corporation's gross income from all sources was business profits attributable to a permanent establishment in the Philippines.[164] Therefore if such a corporation paid dividends to an American corporation, the American corporation would be subject to Philippine tax on a proportionate part of the dividends which it received.[165] This is similar to the rule in the National Internal Revenue Code regarding foreign corporations at least 50 percent of the gross income of which was derived from Philippine sources.[166]

If 50 percent or more of the gross income of a U.S. corporation for the three-year period preceding the declaration of dividends or for the period during which it has been in existence was attributable to a permanent establishment it had in the Philippines, a proportionate part of any dividends which it declared would be considered as derived from Philippine

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treaty without any mention of the permanent establishment provision. See U.S. DEP'T OF THE TREASURY, TECHNICAL EXPLANATION OF THE PROPOSED TREATY BETWEEN THE UNITED STATES AND THE PHILIPPINES reprinted in (1961) 2 TAX TREATIES (P-H) ¶ 74,137, at 74,163-74,164 (1981), [hereinafter cited as *Technical Explanation of Philippines-U.S. Income Tax Treaty*].

162 Philippines-U.S. Income Tax Treaty, *supra* note 1, art. 4 in relation to arts. 11-13.

163 *Id.*, art. 4, par. (1) (a).

164 *Id.*, art. 4, par. (1) (b).

165 *Id.*, art. 4, par. (1) (b) in relation to art. 11, par. (1).

166 N.I.R.C. OF 1977, *supra* note 14, sec. 37 (a) (2) (B).

sources.[167] Again, if the recipient of its dividends included another U.S. corporation, that other U.S. corporation would be taxable by the Philippines on a proportionate part of the dividends which it received.[168]

3.31 *Interest*

The rules on interest are similar. A U.S. corporation will be taxable on interest which is paid to it by the Philippines or any of its political subdivisons, or by a resident of the Philippines.[169] However, there is a new source rule not found in the National Internal Revenue Code. Interest received by a U.S. corporation which is paid on indebtedness incurred in connection with a permanent establishment in the Philippines shall be deemed to be from Philippine sources.[170]

3.32 *Royalties*

The rules with respect to royalties are again similar. Royalties received by a U.S. corporation for the use of, or the right to use property or rights in the Philippines, shall be deemed to be from Philippine sources.[171] The exception to this territoriality standard is again with respect to a permanent establishment. If the liability to pay the royalty was incurred in connection with a permanent establishment in the Philippines which bears such royalty, then the royalty is deemed to be from Philippine sources.[172]

3.3 *Taxation of the Permanent Establishment Compared with the Taxation of the Philippine "Resident Foreign Corporation" Tax Entity*

Under the National Internal Revenue Code, when a U.S. corporation would set up a branch in the Philippines, it would be classified as a resident foreign corporation and would be taxable as such. Under the Philippines-U.S. income tax treaty, the branch would be considered a permanent establishment.[173] The corporation would be taxable on the business profits attributable to its permanent establishment or branch.[174]

3.31 *Tax Base*

Under the Code, a resident foreign corporation was taxed by the Philippines on its net income from Philippine sources.[175] It did not matter whether part of the net income was not attributable to the activities of the branch of the corporation. So long as the income was considered as derived from Philippine sources under Philippine source rules, such net income was

167 Philippines-U.S. Income Tax Treaty, *supra* note 1, art. 1, par. (1) (b).
168 *Id.*, arts. 1, 3, par. (3).
169 *Id.*, art. 4, par. (2).
170 *Id.*
171 *Id.*, art. 4, par. (3).
172 *Id.*
173 Philippines-U.S. Income Tax Treaty, *supra* note 1, art. 5, par. (2) (b).
174 *Id.*, art. 8, par. (1).
175 N.I.R.C. OF 1977, *supra* note 14, sec. 24 (b) (1).

subject to taxation by the Philippines. There was also a Philippine source standard—the net income had to be derived from *Philippine sources*. The branch in the Philippines could conceivably earn business profits that would be attributable to the activities of such branch, but which would not be derived from Philippine sources under the National Internal Revenue Code. Such profits would therefore not be taxable by the Philippines.

Under the treaty, only those business profits of a United States corporation which are attributable to the corporation's permanent establishment are subject to Philippine taxation.[176] The corporation may derive other business profits from the Philippines (in an economic sense and in the sense of the source rules of the National Internal Revenue Code), even similar in kind to the business profits attributable to its permanent establishment, such as from direct sales made to Philippine customers, or from the rendition of services (lasting less than 183 days). However, so long as those business profits are not "attributable to its permanent establishment," the United States corporation will not be taxable on such business profits.[177]

As such, the provision may be the subject of abuse and tax avoidance schemes.[178] In order to avoid this, the treaty states that: "There may also be attributed to . . . [the] permanent establishment the business profits derived from the sale of goods or merchandise of the same or similar kind as those sold, or from other business activities of the same or similar kind as those effected through that permanent establishment if the sale or activities had been resorted to in order to avoid taxation."[179]

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176 Philippines-U.S. Income Tax Treaty, *supra* note 1, art. 8, par. (1).

177 Construing a similar provision in the OECD model treaty, the OECD Commentary states:

> "The second and more important point is that it is laid down—in the second sentence—that when an enterprise carries on business through a permanent establishment in another State that State may tax the profits of the enterprise but only so much of them as is attributable to the permanent establishment; in other words that the right to tax does not extend to profit that the enterprise may derive from that State otherwise than through the permanent establishment .... But it is thought that it is preferable to adopt the principle contained in the second sentence of paragraph 1, namely that the test that business profits should not be taxed unless there is a permanent establishment is one that should properly be applied not to the enterprise itself but to its profits. To put the matter another way, the principle laid down in the second sentence of paragraph 1 is based on the view that in taxing the profits that a foreign enterprise derives from a particular country, the fiscal authorities of that country should look at the separate sources of profit that the enterprise derives from their country and should apply to each the permanent establishment test. This is of course without prejudice to other Articles." OECD Model Treaty, *supra* note 135, Commentary on art. 7, par. 4.

178 This abuse would arise in a situation where a corporation would "set up in a particular country a permanent establishment which made no profits, was never intended to make profits, but existed solely to supervise a trade ... that the enterprise carried on in that country through independent agents and the like ..." OECD Model Treaty, *supra* note 135, Commentary on art. 7, par. 6.

179 Philippines-U.S. Income Tax Treaty, *supra* note 1, art. 8, par. (3).

As we previously noted, a possible exception to the permanent establishment rule could be with respect to airline and shipping profits.

Of course, if under the treaty's source rules, the U.S. corporation derived other income (not classifiable as business profits even under the "effectively connected" provision) from Philippine sources which was taxable under the treaty, then the corporation would be taxed under the relevant rate or rates applicable, whether or not this other income was attributable to the permanent establishment. This other income would include dividends,[180] interest,[181] royalties,[182] income from real property located in the Philippines,[183] capital gains from the alienation of such real property,[184] and capital gains from the alienation of tangible personal (movable) property forming part of the business property of its permanent establishment, or from the alienation of the permanent establishment itself.[185]

As we stated, the general rule is that only business profits attributable to a permanent establishment which a U.S. corporation has in the Philippines may be taxed by the Philippines. However, one should note that under the treaty, there may be business profits which are attributable to a permanent establishment although they may be profits which under the rules of the National Internal Revenue Code, would have been considered as derived from foreign sources and therefore not taxable by the Philippines, *e.g.*, services performed in a foreign country.[186] Under the treaty, these "foreign" business profits would be subject to taxation by the Philippines, whereas under the National Internal Revenue Code, they would not have been taxable.

3.32 *Tax Rates*

The tax rates that were applicable to a resident foreign corporation (25 percent and 35 percent)[187] under the Code will also be applicable to the business profits attributable to the permanent establishment. There is one important difference though. Under the Internal Revenue Code, interest and royalty income of a resident foreign corporation were taxed

180 *Id.*, art. 11.
181 *Id.*, art. 12.
182 *Id.*, art. 13.
183 *Id.*, art. 7.
184 *Id.*, art. 14, par. (2).
185 185 *Id.*, art. 14, par. (1).
186 With regard to a similar provision in the United States-United Kingdom income tax treaty, "Business profits may be attributable to a permanent establishment which an enterprise of one Contracting State has in the other Contracting State, whether from sources within or without a Contracting State. Thus, items of income described in section 864 (c) (4) (B) of the Code which are attributable to a permanent establishment situated in the United States will be subject to tax by the United States." U.S. DEP'T OF THE TREASURY, TECHNICAL EXPLANATION OF US-UK INCOME TAX TREATY, reprinted in (1977) 2 TAX TREATIES (P-H) ¶ 89,064, at 89,064.
187 N.I.R.C. OF 1977, *supra* note 14, sec. 24 (b) (2) (i) in relation to sec. 24 (a).

at the applicable 25 percent or 35 percent rate, because these were subsumed under the term "total net income derived . . . from all sources within the Philippines."[188] Under the treaty, as we shall see later, only in the situations where the interest and royalties could be classified as business profits, or where they are "effectively connected" with a permanent establishment would this still be the case. In other cases, the interest and royalty income would be taxed at the special rates provided in the treaty.

3.33 *Allowable Deductions*

The "resident foreign corporation" entity under the National Internal Revenue Code was allowed deductions only for various expenses (including interest, losses, bad debts, depreciation allowance, and depletion allowance) which were connected with its derivation of income from Philippine sources. This was because it was taxable only on such income. Under the treaty, the U.S. corporation would be subject to taxation on *all* of the business profits attributable to its Philippine permanent establishment, regardless of where the profits were earned. As a logical corollary, it is "[A]llowed as deductions ordinary and necessary expenses which are reasonably allocable to such profits, including executive and general administrative expenses, *whether incurred in the Contracting State in which the permanent establishment is situated or elsewhere.*"[189] However, to safeguard against abuses, no deductions are "[A]llowed in respect of amounts paid or payable (other than reimbursement of actual expenses) by the permanent establishment to . . . [its corporation's head office or other offices] for royalties or similar payments; commission for specific services performed, or for management; and for interest . . . except in the case of a banking institution."[190]

3.34 *Impact on the Philippine Tax on Branch Remittances of Profit*

The treaty retains the Philippine tax on the remittances of profit by a branch to its corporation's head office. With the exception of shipping and air transport profits, the Philippines may in the words of the treaty, "impos[e] on the earnings of a [U.S.] 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, provided that any such additional tax . . . shall not exceed 20 percent of the amount of such earnings which have not been subjected to such additional tax in previous taxable years."[191] This additional tax is the Philippine branch profits remittance tax of 15 percent.[192]

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[188] *Id.*, sec. 24 (b) (2) (i).
[189] Philippines-U.S. Income Tax Treaty, *supra* note 1, art. 8, par. (4).
[190] *Id.*
[191] *Id.*, art. 11, par. (6).
[192] N.I.R.C. OF 1977, *supra* note 14, sec. 24 (b) (2) (ii) (1983).

3.35 *The Non-Discrimination Provision: Its Impact on* (1) *Philippine Nationality and* (2) *Philippine Tax Incentive Rules, with Respect to Certain Areas of Economic Activity*

The treaty's non-discrimination provisions affecting U.S. corporations, the first with respect to permanent establishments,[193] and the second in respect of Philippine corporations in which American corporations have equity interests,[194] have a significant bearing on Philippine economic development. The scope of the non-discrimination provisions are very broad. They apply to Philippine taxes of every kind, not only income tax.[195] Both represent the further opening up to foreign investment of an economy which in a sense is already dominated by foreign investment (a large, if not the largest portion of which is American).

Under the treaty, a U.S. corporation's permanent establishment may not be subjected to more burdensome taxes than a Philippine corporation carrying on the same activities.[196] The only exceptions under the treaty are again with respect to airline and shipping companies, to which the non-discrimination provisions do not apply by specific provision of the treaty.[197]

The "more burdensome" language used means that it is "[p]ermissible to tax permanent establishments differently, for practical reasons from busi-

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193 Philippines-U.S. Income Tax Treaty, *supra* note 1, art. 24, par. (2).

194 *Id.*, art. 24, par. (3).

195 *Id.*, art. 24 par. (4).

196 *Id.*, art. 24, par. (2).

197 *Id.*, art. 9, par. (1). According to the U.S. Treasury, the alleged discrimination consists in"

> First, while the Philippines imposes on U.S. airlines a tax equal to 2.5 percent of their gross revenues from Philippine sources plus a corporate franchise tax of 2 percent of the same amount, the Philippine Airlines (PAL) is exempt from that 2.5 percent tax but instead pays a tax of 2 percent on its worldwide gross revenues. There is some dispute as to the actual difference in the Philippine tax burden imposed on income derived by PAL and that imposed on the U.S. airlines on their income from operating into and out of the Philippines. The U.S. airlines take the position that they are subject to a 4.5 percent tax while PAL is only subject to a 2 percent tax. *The U.S. Treasury, however, takes the position that the effective tax burden on PAL is about 4 percent (compared to the 4.5 percent burden of U.S. airlines) because the tax on PAL is computed on a broader base.* In any event, it appears that *there may be at least some discrimination,* and it is specifically permitted to continue under the treaty.
>
> A separate type of discrimination occurs with respect to U.S. shipping companies and their Philippine competitors. Under Philippine law, Philippine shipping corporations receive recurring 10-year exemptions from tax; thus, they in effect pay no Philippine tax. U.S. shippers, however, do not receive the exemptions and would be paying Philippine tax at the treaty rate of 1.5 percent of gross revenues (reduced from the statutory 2.5 percent rate). The proposed treaty also permits this discrimination to continue, although the treaty does reduce the discrimination which otherwise would exist.

With respect to U.S. airlines, the alleged discrimination would therefore not be as great as these airlines would picture it. *1977 Hearings, supra* note 5, at 55 (prepared statement of Paul Oosterhius, Legislative Counsel, and David Brockway, Legislative Attorney, Staff of the Joint Committee on Taxation).

nesses of resident persons, so long as the *result* is not less favorable to the permanent establishment."[198] The purpose of the provisions is to end all discrimination in the treatment of permanent establishments of U.S. corporations as compared with Philippine corporations belonging to the same sector of activities, with respect to taxes based on industrial and commercial activities especially taxes on business profits.[199]

We discussed earlier that under the Omnibus Investments Code and the Tourism Incentives Program of 1974, tax incentives are made available to corporations engaged in preferred areas of economic activity. We also noted that these incentives were available only to Philippine corporations which were registered under the investment priorities plans, and thereby designated as registered enterprises. Would the non-discrimination provision regarding permanent establishments mean that these tax incentives are now available to permanent establishments of U.S. corporations?

The answer is a qualified affirmative. If, prior to the treaty, the permanent establishment was already operating without incentives in a preferred area of economic activity wherein registered enterprises were entitled to incentives, it should be entitled to incentives after the treaty becomes effective. Likewise, if after the effective date of the treaty, the permanent establishment (or more accurately the U.S. corporation of which it is permanent establishment) is allowed to engage in a preferred area of economic activity then it too should be entitled to incentives just like registered enterprises. The registration requirements under the incentive laws mentioned are therefore partially dismantled.

Whether the U.S. corporation will be allowed, in the first place, to engage in the preferred area of economic activity is another matter. The Philippine Constitution[200] and various Philippine laws mandate nationality and other requirements for enterprises engaged in several sectors of the Philippine economy. Aside from this, the Omnibus Investments Code provides that before a U.S. corporation may engage in business in the Philippines, it must obtain prior government authority to do so.[201] There are again specific statutory criteria to be met, the most important of which is that the field of business or economic acivity is not one that is already being adequately exploited by Philippine nationals.[202] Within the bounds of these statutory criteria, the Board of Investments which is the Philippine governmental body which grants such authority, has a large amount of discretion. In a further extension of this policy, permanent establishments already in the Philippines are not allowed to engage in new areas of econo-

[198] *See* O'Brien, *The Non-Discrimination Article in Tax Treaties,* 10 LAW & POL'Y INT'L BUS. 568 (1978); OECD Model Treaty, *supra* note 135, Commentary on art. 24, par. 22.

[199] OECD Model Treaty, *supra* note 135, Commentary on art. 24, par. 23.

[200] CONST., (1973).

[201] OMNIBUS INVESTMENTS CODE, *supra* note 35, art. 69.

[202] *Id.*

mic activity without prior Board of Investments authority. The Philippine economic nationalistic dam may have sprung leaks, but by and large, it still holds.

3.4 TAXATION OF PHILIPPINE SUBSIDIARIES OF U.S. CORPORATIONS

The taxation by the Philippines of the Philippine subsidiaries of U.S. corporations is not very much affected by the treaty. Indeed, Philippine corporations are, as a general rule, outside the scope of the treaty. Embodying a general principle of treaty theory, the Philippines-U.S. income tax treaty states that "Notwithstanding any provisions of this convention . . . [The Philippines] may tax its residents . . . and its citizens as if . . . [the] Convention had not come into effect."[203] A Philippine corporation is a Philippine resident.[204]

The most significant treaty provision with a direct bearing on Philippine subsidiaries of U.S. corporations would be the non-discrimination provision. It provides that:[205]

> A corporation of one of the Contracting States, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other Contracting States, shall not be subjected in the first-mentioned Contracting State to any taxation or any requirement connected with taxation which is other or more burdensome than the taxation and requirements to which a corporation of the first-mentioned Contracting State carrying on the same activities, the capital of which is wholly owned or controlled by one or more residents of the first-mentioned Contracting State, is or may be subjected.

Our discussion on the effect of the non-discrimination provision on permanent establishments would also be relevant here. The repercussions of the non-discrimination provision on subsidiaries would be very similar to those on permanent establishments.

The quoted treaty provision would mean that the incentives under the Omnibus Investments Code and the Tourism Incentives Program of 1974 would become available to subsidiaries of U.S. corporation already operating without incentives in preferred areas of economic activity, and to those subsidiaries who would be allowed to operate in such areas after the treaty goes into effect. Again, however, the question of being allowed to operate in such an economic activity is another matter. In a counterpart provision to the "doing business" rule, the Omnibus Investments Code provides that an equity investment in excess of 30 percent by a U.S. corporation in a Philippine corporation would have to be authorized by the Philippine Board of Investments.[206] The most important

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203 Philippines-U.S. Income Tax Treaty, *supra* note 1, art. 6, par. 3.
204 *Id.*, art. 3, par. (1) (a).
205 *Id.*, art. 24, par. (3).
206 OMNIBUS INVESTMENTS CODE, *supra* note 35, art. 68.

consideration would also be whether the investment was being made in an enterprise engaged in an area of economic activity already being adequately exploited by Philippine nationals.[207]

The treaty does by specific provision reserve certain incentives for Philippine citizens or corporations.[208] These are (1) an investment allowance, an exemption from capital gains tax on the sale or other disposition of capital assets if the proceeds from the sale are invested in new issues of capital stock owned by foreigners in "pioneer" enterprises, and a tax exemption on the sale or other disposition of stock dividends received from a pioneer enterprise, all for Philippine nationals who invest in "pioneer" enterprises;[209] (2) a special additional income tax deduction for a "registered export producer" in an amount equivalent to the direct labor cost of the product and the local raw materials of non-traditional export products, utilized in the manufacture of its export products,[210] and (3) an investment allowance for Philippine nationals investing in registered tourism enterprises, as well as an exemption from income tax on sales or other dispositions of capital assets, if the proceeds from the sale or other disposition is used to purchase stock owned by foreigners in registered tourism enterprises.[211]

One notes that with the exception of the additional deduction for a registered export producer, the incentives that are reserved are for investors in enterprises, and not for the enterprises themselves. With respect to the incentives for investors in a Philippine corporation, the specific reservation of these incentives for Philippine citizens or corporations is not even necessary if the purpose was to preserve their availability only to Philippine nationals. The treaty does not forbid discrimination against U.S. corporations which are stockholders in Philippine corporations, only against the Philippine corporations themselves.[212] The treaty's non-discrimination provisions apply only to the tax treatment of individuals,[213] permanent establishments,[214] and Philippine corporations in which American corporations or residents (as defined under the treaty) have an equity interest.[215] These provisions do not apply, and the treaty does not prohibit,

207 *Id.*

208 Philippines-U.S. Income Tax Treaty, *supra* note 1, art. 24, par. (5).

209 *Id.*, art. 24, par. 5(a), 5(b). These incentives were formerly provided for in sec. 5 of the Investment Incentives Act, Rep. Act No. 5186, and in sec. 5 of the Export Incentives Act, Rep. Act No. 6135; they are now embodied in art. 44 of the OMNIBUS INVESTMENTS CODE.

210 Philippines-U.S. Income Tax Treaty, art. 24 par. 5(b). This incentive was formerly provided for in sec. 7(b) of the Export Incentives Act, Rep. Act No. 6135; it does not seem to be embodied in the OMNIBUS INVESTMENTS CODE.

211 Philippines- U.S. Income Tax Treaty, *supra* note 1, art. 24, par. (5) (c).

212 This is the conclusion of the OECD Commentary on a similar provision in the OECD Model Treaty. See OECD Model Treaty, *supra* note 135, Commentary on art. 24, par. 57.

213 Philippines-U.S. Income Tax Treaty, *supra* note 1, art. 24, par. (1); *See* O'Brien, *supra* note 198, at 547.

214 Philippines-U.S. Income Tax Treaty, *supra* note 1, art. 24, par. (2).

215 *Id.*, art. 24, par. (3).

tax discrimination directed against American corporations which are investors in Philippine corporations. Therefore, incentives reserved only for Philippine nationals investing in Philippine corporations under the various Philippine laws would still be denied to U.S. corporations which are also investors in such corporations, and it would not be a violation of the treaty's non-discrimination provision if laws to the same effect were enacted by the Philippines in the future.

3.5 Taxation of Dividends, Interest and Royalties; As They Dovetail With the Business Profits Provision

The treaty does not prescribe specific rates of tax on dividends, interest and royalties received by U.S. corporations from Philippine sources. Only maximum limitations are prescribed which these taxes cannot exceed.[216] So long as the rates of tax provided for in the National Internal Revenue Code on these forms of income are lower than, or equal to the maximum limits prescribed in the treaty, then the rates in the Code will be applicable. Otherwise, the tax rates applicable will be the maximum rates prescribed by the treaty.

In this respect, another rule that should be kept in mind is that an income tax convention should not increase the tax burden of the residents of the contracting states to the treaty.[217] Thus a U.S. corporation may choose between availing itself of a treaty provision or one in the National Internal Revenue Code, depending on which provision grants more favorable tax treatment.

If the dividend, interest and royalty income are classifiable as business profits, or are deemed "effectively connected" with a permanent establishment, then these forms of income will be taxed as business profits under the business profits provision, and not under the treaty provisions on dividends, interest, and royalties.[218]

3.51 *Dividends*

Under the treaty, the Philippine tax on dividends received by a U.S. corporation from Philippine sources cannot exceed 20 percent if the recipient U.S. corporation owns at least 10 percent of the stock of the Philippine corporation. In other cases, the tax cannot exceed 25 percent.[219]

Under the National Internal Revenue Code, a U.S. corporation with a permanent establishment in the Philippines would be classified as a resi-

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216 Philippines-U.S. Income Tax Treaty, *supra* note 1, art. 11-12.

217 *See* Philippines-U.S. Income Tax Treaty, *supra* note 1, art. 6, par. (3); *Technical Explanatoin of Philippines-U.S. Income Tax Treaty, supra* note 161, ex-12, par. (5), art. 13, par. (4).

218 Philippines-U.S. Income Tax Treaty, *supra* note 1, art. 11, par. (4), art. 12, par. (5); art. 13, par. (4).

219 *Id.*, art. 11, par. (2).

dent foreign corporation. The dividends it received from a Philippine corporation would have been subject to a 10 percent final intercorporate dividends tax. Since 10 percent is lower than the maximum rates allowed under the treaty, it would still be the rate after the treaty comes into effect.

A U.S. corporation without a permanent establishment in the Philippines would be classified as either a resident foreign corporation or a non-resident foreign corporation under the National Internal Revenue Code, depending on whether the Code's "engaged in business" threshold standard had been crossed. If classified as a non-resident foreign corporation, it would have been subject to tax at 15 percent on dividends it received from a Philippine corporation in which it held at least a 10 percent equity interest. Again, 15 percent is lower than 20 percent and would still be the applicable rate even post treaty. If the equity interest was less than the required 10 percent, the Philippine tax under the National Internal Revenue Code would have been 35 percent. This is higher than the 25 percent maximum prescribed under the treaty. As such, 25 percent would then be the applicable rate post-treaty.

If the U.S. corporation without a permanent establishment would have been classified as a resident foreign corporation under the Code, the applicable tax on dividends it received from a Philippine corporation will be the final 10 percent intercorporate dividends tax.

3.52 *Interest*

Under the treaty, interest received by a U.S. corporation from Philippine sources shall be taxed at a rate not to exceed 15 percent of the gross interest, with the maximum rate at 10 percent on interest from public issues of bonded indebtedness.[220]

A U.S. corporation with a permanent establishment in the Philippines would have been classified as a resident foreign corporation under the National Internal Revenue Code and taxed at 25 percent and 35 percent rates on its net income from Philippine sources. Any interest it received from Philippine sources would have been included as a part of such tax base (with the exception of interest from deposits and yield from deposit substitutes), but expenses incurred in connection with such interest income would have been deductible in computing net income (subject to the rules of the National Internal Revenue Code as to which expenses a non-resident foreign corporation may deduct). This complicates the answer to the question of what should be the tax rate on interest received by a permanent establishment, (such interest not being business profits or otherwise effectively connected with the permanent establishment) after the treaty goes into effect.

[220] *Id.*, art. 12, par. (3).

The answer will depend on whether taxing the interest at a 25 percent or 35 percent rate but allowing a deduction for qualified expenses incurred in connection with such interest income (the method under the National Internal Revenue Code), would yield a lower tax than taxing the *gross* interest at the maximum treaty rates of either 15 percent or 25 percent. If so, the first method should apply. Otherwise, the post-treaty rates will be the applicable maximum of 15 percent or 25 percent.

If the U.S. corporation involved did not have a permanent establishment, it would again have been classified under the Code as either a resident or a non-resident foreign corporation. If classifiable as a resident foreign corporation, then the above discussion would also apply to it.

A non-resident foreign corporation extending loans to Philippine residents would have been taxable on the interest it received at a rate of 15 percent under the Code. This would be the applicable rate post-treaty, since it does not exceed the treaty's maximum rates.

3.53 *Royalties*

Under the treaty, royalties derived by a U.S. corporation from Philippine sources cannot be taxed at a rate in excess of 25 percent of the gross amount of the royalties. In case the royalties are paid by an enterprise registered with the Philippine Board of Investments, the maximum rate is 15 percent. The rate may not also exceed 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.[221] Since the Philippines in its income tax treaty with Japan agreed to a maximum withholding rate of 10 percent on royalties received from enterprises registered with the Board of Investments, this should likewise be the rate on royalties received by U.S. corporations from the same enterprises.[222] Royalties include payments made for the use of, or the right to use a copyright for a cinematographic film or films or tapes used for radio or television broadcasting.[223]

Under its income tax treaty with Sweden, the Philippines agreed to tax payments from Philippine sources to Swedish residents and corporations for the use of, or the right to use, motion picture films, film or tapes for radio or television broadcasting at 10 percent of the rentals or amounts paid.[224] This will now be the applicable rate for similar royalty payments

221 *Id.*, art. 13, par. (2).

222 Convention Between the Republic of the Philippines and Japan For the Avoidance of Double Taxation and the Prevention of Fiscal Evasion With Respect to Taxes in Income. February 13, 1980, art. 12, par. (3), (available from the Tax Treaties Implementation Section, Int'l Operations Division, Bureau of Internal Revenue of the Philippines, Quezon City, Metro Manila, Philippines) [hereinafter cited as Philippines-Japan Income Tax Treaties].

223 Philippines-U.S. Income Tax Treaty, *supra* note 1, art. 13, par. (3).

224 Convention Between the Republic of the Philippines and the Kingdom of Sweden for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital, April 12, 1966, art. 8, par. (1) [here-

made to U.S. corporations after the treaty goes into effect. This would also seem to be the applicable rate regardless of whether or not these particular royalties are effectively connected with a permanent establishment.

The same problem which we encountered in our discussion of interest received by a U.S. corporation with a permanent establishment in the Philippines would also result when royalties are received by such a corporation. The corporation would again have been classifiable as a resident foreign corporation under the National Internal Revenue Code. Therefore the tax post-treaty on royalties received by such a corporation (not considered business profits or "effectively connected" income) would be the lower of that which will result from applying two alternative methods: 25 percent or 35 percent multiplied by (royalties minus expenses deductible under the National Internal Revenue Code incurred in connection with such royalty income), or 25 percent, 15 percent or 10 percent (whichever is applicable) of gross royalties. As was the case with interest, this discussion will also apply to a U.S. corporation without a permanent establishment in the Philippines, but classifiable under the National Internal Revenue Code as a resident foreign corporation.

Lastly, a U.S. corporation classifiable as a non-resident foreign corporation under the Code would have been taxable at 35 percent of the gross income (including the royalties) it received from Philippine sources, with the tax at 25 percent if the royalties were considered film rentals. In this case, the post-treaty rates on the royalties received would again be either 25 percent, 15 percent, or 10 percent.

3.54 *The Effectively Connected Provisions*

Dividends, interest and royalty income received by a permanent establishment in the Philippine could themselves be business profits. This would be the case, for example, if the U.S. corporation involved were an investment company, a bank or lending institution, or a technology research and licensing firm. In these situations, and in others where the dividend, interest and royalty income was otherwise "effectively connected" with the permanent establishment, the dividend, royalty or interest income would not come under the coverage of the maximum rates prescribed under the treaty's dividend, interest, and royalty provisions. Instead they would be taxed as business profits, under the business profits provision.[225]

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inafter cited as Philippines-Sweden Income Tax Treaty]; reprinted in U.N. DEP'T OF ECONOMIC AND SOCIAL AFFAIRS, 9 SECOND PART A, INTERNATIONAL TAX AGREEMENTS, General Agreements on Income and Fortune Taxes No. 161, U.N. Doc. ST/ECA/SER C/9 (the first series of treaties in the compilation was published in 1958).

[225] Philippines-U.S. Income Tax Treaty, *supra* note 1, art. 1, par. (4), art. 12, par. (5), art 13, par. (4), in relation to art. 8; also *see* OECD Model Treaty, *supra* note 135, Commentary on art. 10, par. 30, art. 12, par. 15, construing similar provisions in the OECD Model Treaty.

This would mean being taxed at the Philippine corporate income tax rates of 25 percent and 35 percent, with the rest of the business profits income attributable to the permanent establishment. The exception would be with respect to dividends effectively connected with a permanent establishment. Under the National Internal Revenue Code, dividends received by a resident foreign corporation (which includes a U.S. corporation with a Philippine permanent establishment) from a Philippine corporation would have been subject to a final 10 percent intercorporate dividends withholding tax instead of the 25 percent or 35 percent rate and would not have been includible in computing the net income of the U.S. corporation from Philippine sources.[226] This should still be the rate after the treaty goes into effect. Otherwise, we would run afoul of the "savings clause" of the treaty,[227] the National Internal Revenue Code,[228] and possibly of the discrimination provision as it operates with respect to permanent establishments.[229]

What is meant by the term "effectively connected"? The U.S. Internal Revenue Code uses the same term in connection with income "effectively connected with the conduct of a trade or business within the United States."[230] The concept of "effectively connected" in the treaty was probably intended to be the same as that in the U.S. Internal Revenue Code.[231]

Transposing the "effectively connected" concept of the U.S. Code onto the treaty, dividend, interest and royalty income would be considered as being effectively connected with a permanent establishment if these income were derived from assets used in or held for use in the conduct of the trade or business of the permanent establishment.[232] For example, was the stock that gave rise to the dividend, or the receivable giving rise to the interest, used or held for use in the conduct of the permanent establishment's trade or business? Likewise, the enumerated forms of income would also be considered as "effectively connected" income if the activities of the permanent establishment were a material factor in their realization.[233] This would be the case among others, when the U.S. corporation involved

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226 N.I.R.C. OF 1977, *supra* note 14, sec. 24(c).

227 Philippines-U.S. Income Tax Treaty, *supra* note 1, art. 6, par. (2).

228 N.I.R.C. OF 1977, *supra* note 14, sec. 24(c).

229 Philippines-U.S. Income Tax Treaty, *supra* note 1, art. 24, par. (2). This would happen if the Philippine National Internal Revenue Code was amended so that resident foreign corporations receiving dividends from Philippine corporations would no longer be subject to the final 10 percent intercorporate dividends tax, but instead let us say, to the regular corporate rates of 25 percent and 35 percent. *See* OECD Model Treaty, *supra* note 135, Commentary on art. 24, par. 31-33.

230 I.R.C. § 882 in relation to § 864 (c) (1983).

231 Technical Explanation of Philippines-U.S. Income Tax Treaty, *supra* note 161, ¶ 74,137, at 74,163.

232 *See* I.R.C., § 864 (c) (2) (1983); also OECD Model Treaty, *supra* note 135, Commentary on art. 10 par. 30, Commentary on art. 11, par. 22, Commentary on art. 12, par. 15, construing similar provisions in the OECD Model Treaty.

233 *Id.*

were an investment company, a lending institution, or a technology research and licensing firm.

Ordinarily an asset will be treated as used in, or held for use in, the trade or business of the permanent establishment if the asset is held for the principal purpose of promoting the present conduct of the business, *e.g.*, where stock is acquired or held to assure a constant source of supply; or the asset is acquired and held in the ordinary course of the business, *e.g.*, in the case of an account receivable arising from the business; or otherwise held in a direct relationship to the business.[234] In determining whether an asset is "held in a direct relationship to a business," principal consideration is given to whether the asset is needed in the business.[235]

On the other hand, the business activities test would be satisfied if, for example, dividends or interest are derived by a dealer in stocks or securities, or when royalties are derived in actively conducting a business consisting of the licensing of patents or similar intangible property.[236]

Even dividend, royalty and interest income which would have been considered as income from foreign sources and therefore not taxable under the Philippine National Internal Revenue Code could be considered as effectively connected with a permanent establishment, and subject to taxation by the Philippines.[237] Thus the Philippines could tax a U.S. corporation on dividends, interest and royalties the U.S. corporation received from foreign corporations and even from other U.S. corporations if such dividends, interest and royalties were effectively connected with the trade or business of the U.S. corporation's Philippine permanent establishment.[238]

3.6 TAXATION OF SHIPS AND AIRCRAFT IN INTERNATIONAL TRAFFIC

Under the National Internal Revenue Code of the Philippines, international carriers (both shipping and airline companies) which were classified as non-resident foreign corporations, were subject to tax at 35 percent of their gross income from Philippine sources (to the extent that the transportation services were rendered within the Philippines). As we noted earlier, if an international carrier did not have a permanent establishment in the Philippines, but was otherwise classifiable as a non-resident foreign corporation under the Code, it could opt for this form of taxation if it was more favorable than the gross revenue tax in the treaty.

On the other hand, an international carrier classified as a resident foreign corporation was taxed at a rate of 2½ percent of "gross Philippine billings."

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[234] *See* Treas. Reg. § 1.864-4 (c) (2) (ii).
[235] *See* Treas. Reg. § 1.864-4 (c) (2) (iii).
[236] *See* Treas. Reg. § 1.864-4 (c) (3) (i).
[237] *See* I.R.C., § 864 (c) (4) (1983).
[238] Philippines-U.S. Income Tax Treaty, *supra* note 1, art. 4, par. (6), art. 8, par. (1), art. 11, par. (3) (b), in relation to each other.

Under the treaty, the tax on international carriers that may be imposed by the Philippines from the operation of ships and aircraft in international traffic cannot exceed the lesser of 1½ percent of gross revenue derived from Philippine sources, or the lowest rate of Philippine tax on profits of the same kind derived under similar circumstances by a resident of a third country.[239] Therefore, after the treaty comes into effect, the effective and applicable tax rate would be the maximum allowed under the treaty—1½ percent of gross revenue derived from Philippine sources.

International traffic is defined by the treaty as "any transport by a ship or aircraft operated by a resident of . . . (the United States or the Philippines), except where such transport is confined solely to places within . . . [either] state."[240] Thus if a ship operated by a U.S. corporation transports goods from Taiwan to the Philippines, leaving some of the goods in Manila and the remainder in Bacolod City (another city in the Philippines), the portion of the voyage between Manila and Bacolod City is international traffic.[241]

The treaty provides that gross revenues from the operation of ships in international traffic shall be treated as being from sources within the Philippines to the extent they are derived from *outgoing traffic originating in the Philippines*.[242] This definition is quite problematic, especially with respect to aircraft (in comparison with ships) and passengers (in comparison to mail or cargo).

When is the gross revenue of an international carrier to be regarded as gross revenue from outgoing traffic originating in the Philippines? For cargo or mail, it would seem that the standard should be that the Philippines be the first port of shipment. In the case of passengers, it would seem that a substantially continuous journey of passengers who first boarded the plane in New York, had a brief stop-over or plane change in the Philippines, then continued on to China would not be outgoing traffic originating from the Philippines. However, what if the passengers who came from New York stayed in the Philippines for three months, before going to China, but the passage documents for the whole journey from New York to China had been sold in New York? Does the journey from the Philippines to China originate from the Philippines? One test we could resort to in situations like this could be where the passage documents were sold, a test embodied in the National Internal Revenue Code. Or should the test in this situation be the final destination stated in the passage documents when the passage documents were sold? In this case, if the passage documents when sold indicated the final destination to be China although part of the journey was to the Philippines, then there will

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239 *Id.*, art. 9, par. (1).

240 *Id.*, art. 2, par. (h).

241 *See* Technical Explanation of Philippines-U.S. Income Tax Treaty, *supra* note 161, explanation of art. 2, 74,137, at 74,155.

242 Philippines-U.S. Income Tax Treaty, *supra* note 1, art. 4, par. (7).

have been no international traffic which had its origin in the Philippines. This solution, however, is not without a small amount of administrative difficulty.

The amount to be regarded as gross revenue derived from Philippine sources will still pose problems even after the problem of origin has been solved. The crucial question in this regard is—up to what part of the sea voyage or airline trip will the revenues realized be deemed as being from Philippine sources? For cargo or mail the answer seems to be clear. If the cargo or mail were first loaded onto the carrier in a Philippine port, then gross revenue derived fom Philippine sources should be up to their point of final destination. However, with respect to passengers, we come up with the same difficulties we encountered in our previous discussion. In an airline journey originating from the Philippines with a stop-over in Honolulu, then a continuation of the journey to San Francisco, would the Honolulu to San Francisco leg of the journey still be gross revenue derived from Philippine sources? The position of the U.S. Treasury seems to be in the negative.[243]

The need for more detailed rules on these matters is evident.

3.7 IMPACT ON U.S. FOREIGN INCOME TAX CREDIT

The treaty has little effect on the operation of the U.S. credit provision. It will operate as it is now embodied in the U.S. Internal Revenue Code and remain primarily a matter of U.S. internal tax law. Later unilateral U.S. amendments with regard to it will automatically become part of the U.S. tax credit as it operates within the context of the treaty.[244]

> [The treaty provision on the U.S. tax credit] does not require the United States to provide a per-country or overall limitation in the future so long as the general principle of a foreign tax credit remains in effect. For the purpose of applying the United States credit in relation to taxes paid or accrued to the Philippines, the rules set forth in Article 4 (Source of Income) will be applied to determine the source of income and the taxes referred to in paragraphs (1) (b) and 2 of Article 1 (Taxes Covered) will be considered to be income taxes.[245]

The important changes then are with respect to what will be considered to be net income from Philippine sources for purposes of the tax credit's overall limitation, and what Philippine taxes will be considered creditable income taxes. To this extent, the U.S. Internal Revenue Code's source and credit provisions are overriden.

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[243] *See* Technical Explanation of Philippines-U.S. Income Tax Treaty, *supra* note 161, explanation of art. 4, ¶ 74,137, at 74,159.

[244] Philippines-U.S. Income Tax Treaty, *supra* note 1, art. 23, par. (1).

[245] Technical Explanation of Philippines-U.S. Income Tax Treaty, *supra* note 161, explanation of art. 23, ¶ 74,137, at 74,174.

Of course there will be the important revenue effects for the Philippine Treasury and the U.S. Treasury. To the extent that the Philippines has foregone taxes on, and has reduced its income taxes with respect to U.S. corporations, then to that extent there are less Philippine income taxes eligible for the U.S. foreign income tax credit. This means more revenue for the U.S. Treasury and/or tax savings for U.S. corporations.

IV. THE TREATY AS A RESPONSE TO THE FELT NEEDS OF THE PHILIPPINES

In attempting to evaluate the Philippine-U.S. income tax treaty from the Philippine viewpoint, the foremost thing that should be kept in mind is that countries enter into treaties of this nature not just for the sake of it, or for some reason like international amity. They do so because they will derive (or think so, anyway) some economic advantage from it. Of course, it goes without saying that each country will negotiate so as to be able to obtain the maximum economic advantage for itself, each having its own interest to protect. Concessions will have to be made in the give and take process.

Thus, the Philippines-U.S. income tax treaty can be adjudged a fair treaty if upon examination we find that both countries yielded mutually equal economic concessions to each other, from the viewpoint of each country's own particular national economic interests. From the Philippine perspective at least, equality is or should be enough, and the derivation of a better bargain is not necessary.

4.1 THE TAX TREATY CONCERNS OF A DEVELOPING COUNTRY LIKE THE PHILIPPINES

4.11 *Loss of Revenue*

As is usual in contemporary income tax treaties,[246] the main thrust of the Philippines-U.S. income tax treaty has been the elimination of the reduction of the income taxes imposed by the "source country" (the country of the source of income) on income received by residents of the other treaty country (the "country of residence"). This has been attained primarily by the adoption of the permanent establishment concept with regard to business profits, the reduction of withholding rates on passive income, the alteration of source rules, as well as by provisions to the effect that income heretofore taxed by both states party to the treaty will be taxable only by the country where the taxpayer resides.

Whether or not this scheme of things is the right system for the governance of tax relations between countries can be subject of much

[246] The OECD Model Treaty, *supra* note 135, being the prime example; *See id.*, at 21.

debate. Convincing arguments can be made on both sides as to whether it is the country of source or the country where the taxpayer resides which has the primary right to tax certain kinds of income. In the final analysis, a good argument or theory can almost always be found in support of one's own economic interests; what ultimately determines the shape of tax treaties is not some abstract principle, but what each country is willing to give for what it wants to get in return. For example, under the domestic law of many developed countries, the situs of a debt for taxation purposes is usually considered to be the state of the debtor, and these countries often impose a high withholding tax on interest payments made by their residents to foreign lenders. Yet, when it comes to tax treaties, these very same countries take the opposite viewpoint.[247]

Likewise, the concept of "permanent establishment" is in theory anchored on the "principle" that before the business profits of an enterprise may be subject to taxation by a state, the enterprise must have some substantial economic contacts with that state. It is often said that such an enterprise should be subject to a particular state's taxing jurisdiction only if it has participated in some substantial degree in the economic life of the latter, and this degree of substantiality is only attained when the enterprise has a fixed place of business within that state.[248] Again, however, principles only mask the economic interests on which they are really based. As one commentator has pointed out, in this day and age when international communications and transport are so well-developed, oftentimes only telephone conversations and telex messages are necessary to consummate transactions. Fixed places of business are in many instances thus rendered superfluous.[249] Furthermore the "business profits attributable to a permanent establishment" standard is subject to being abused via elaborate tax avoidance schemes where the object is to structure transactions so as to derive profits without the "attributable" nexus.[250]

Be that as it may, the Philippines-U.S. income tax treaty is structured the way it is, and basically adheres to the principles we stated as being the thrust of contemporary income tax treaties. However, it is not only interesting, but also instructional to note that the primary advocates of these predominant principles are the developed countries of the world (the United States included), while the authors of the arguments against these principles are the developing countries.

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[247] *See* U.N. DEP'T OF ECONOMIC AND SOCIAL AFFAIRS, TAX TREATIES BETWEEN DEVELOPED & DEVELOPING COUNTRIES—FOURTH REPORT 46, U.N. Doc. ST/ECA/188 (1973).

[248] *See id.*, at 12, 59; OECD Model Treaties, *supra* note 135, Commentary on art. 7, par. 3.

[249] Atchabian, *Some Aspects of International Double Taxation Between Developed and Developing Countries*, 25 BULL FOR INT'L FISCAL DOCUMENTATION 451, 458 (1971).

[250] *See* U.N. DEP'T OF ECONOMIC AND SOCIAL AFFAIRS, TAX TREATIES BETWEEN DEVELOPING COUNTRIES—FOURTH REPORT 46, *supra* note 247.

The reason for this phenomenon is not hard to fathom. If the reciprocal investment and income flows between the United States and the Philippines were substantially equal, both countries would not realize any substantial increase or loss in tax revenues. The loss in tax revenue to the Philippines because certain types of income of U.S. residents (especially U.S. corporations) have ceased to be subject to Philippine taxation or are now subject to reduced rates, is offset by an increase in the Philippines' own tax collections from Philippine residents as a result of a similar exemption from, or reduction in U.S. tax on Philippine residents deriving income from U.S. sources, both countries being on the tax credit method. In much the same way, the loss in tax revenue to the United States with respect to Philippine residents would be offset by an increase in tax revenue with respect to its own residents.

It doesn't exactly work out this way though, in fact far from it. The Philippines is a developing, basically agricultural Southeast Asian country. On the other hand, the United States is *the* superpower of the world economy. Due to the great inequality of income and capital flows from one country to the other (in the Philippine case, capital flows almost exclusively from the United States to the Philippines,[251] while the income flow to the United States from the Philippines greatly exceeds that which occurs the other way round), the Philippines will end up with a lot less tax revenue than it used to have prior to the treaty. The United States outflow. Moreover, what may be a very substantial loss in tax revenue Treasury or U.S. corporations will be the recipients of this tax revenue to the Philippines may not be of so much consequence to the United States, considering the enormous amounts of tax revenues the latter collects.

The effects of this loss of revenue is especially vital to a developing country like the Philippines. The Philippine government as a result of a current shift in Philippine economic policy has assumed the role of the primary entrepreneur in Philippine society, hoping to be the catalytic agent that will finally spur the Philippines to a respectable degree of economic development. In order to achieve this, it needs all the tax revenue it can lays its hands on; it has, in fact, been chastised for the alleged shortfall in its revenue collections. The loss in tax revenue brought by the treaty could aggravate this problem, and the solution that may have to be resorted to would be to increase the tax burden on Filipino taxpayers.

The loss in revenue assumes even more significance (and would be substantial) when we take account of the fact that in the Philippines foreign investment and enterprise (of course including American investment and enterprise) assume a very important and significant role in the Philippine economy and in the exploitation of the Philippine market for goods and

[251] Although there have been some interesting developments as of late, notably investments by wealthy Filipinos in U.S. real estate, but that's another story. These are basically illegal and unrecorded capital flows.

services. A large portion of the taxable income in the Philippine economy is earned by foreign enterprises.

4.12 *The Concessions in the Discrimination Provision*

The other, maybe equally important, economic concession that the Philippines has made in the treaty has been its almost blanket extension of the tax incentives formerly reserved only for Philippine nationals and contained in its investment incentive laws, to U.S. permanent establishments and subsidiaries. Of course, we noted that this will not mean the opening up of large areas of the Philippine economy to foreign control by virtue of the legal barriers imposed by the Philippine Constitution and Philippine laws prescribing nationality qualifications for entry into enumerated sectors of the Philippine economy, especially the need for prior authority before a foreign enterprise may engage in trade or business.

Nevertheless, this is the first income tax treaty with a developed industrialized state wherein the Philippines has agreed to provisions of this kind. In income tax treaties in force with Sweden,[252] Denmark,[253] Canada,[254] France,[255] the United Kingdom,[256] Belgium[257] and Japan,[258]

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[252] Philippines-Sweden Income Tax Treaty, *supra* note 224.

[253] Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital, December 16, 1966, Philippines-Denmark, [hereinafter cited as Philippines-Denmark Income Tax Treaty]; reprinted in U.N. DEP'T OF ECONOMIC AND SOCIAL AFFAIRS, 9 SECOND PART A, INTERNATIONAL TAX AGREEMENTS, General Agreements on Income and Fortune No. 171, U.N. Doc. ST/ECA/SER. C/9 (the first series of treaties in the compilation was published in 1958).

[254] Convention Between the Philippines and Canada for the Avoidance of Double Taxation and the Pervention of Fiscal Evasion with Respect to Taxes on Income, March 11, 1976 [hereinafter cited as Philippines-Canada Income Tax Treaty]; reprinted in U.N. DEP'T OF ECONOMIC AND SOCIAL AFFAIRS, 9 SECOND PART .C, INTERNATIONAL TAX AGREEMENTS, General Agreements on Income and Fortune Taxes No. 402, U.N. Doc ST/ECA/SER C/9 (the first series of treaties in the compialtion was published in 1958).

[255] Convention Between the Government of the Republic of the Philippines and the Government of the French Republic for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, June 10, 1976 (available from the Tax Treaties Implementation Section, Int'l Operations Division, Bureau of International Revenue of the Philippines, Quezon City, Metro Manila, Philippines) [hereinafter cited as Philippines-France Income Tax Treaty].

[256] Convention Between the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of the Republic of the Philippines for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital Gains, June 10, 1976 [hereinafter cited as Philippines-U.K. Income Tax Treaty]; reprinted in U.N. DEP'T OF ECONOMIC AND SOCIAL AFFAIRS, 9 SECOND PART C, INTERNATIONAL TAX AGREEMENTS, General Agreements on Income and Fortune Taxes No. 368, U.N. DOC ST/ECA/SER C/9 (the first series of treaties in the compilation was published in 1958).

[257] Agreement Between the Kingdom of Belgium and the Republic of the Philippines for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, October 2, 1976, [hereinafter cited as Philippines-Belgium Income Tax Treaty]; reprinted in U.N. DEP'T OF ECONOMIC AND SOCIAL AFFAIRS 9 SECOND PART A, INTERNATIONAL TAX AGREEMENTS, General Agreements on Income and Fortune Taxes No. 428, U.N. Doc. ST/ECA/SER. C/9 (the first series of treaties in the compilation was published in 1958).

[258] Philippines-Japan Income Tax Treaty, *supra* note 222.

there has always been a proviso in the non-discrimination article to the effect that tax incentives may be reserved by the Philippines for its own nationals.[259] Now that the floodgates have been opened, the countries mentioned will probably seek to have the benefit of these incentives themselves by seeking an amendment of their respective income tax treaties with the Philippines.

If one adheres to the notion that meaningful economic development requires among other things that the economic benefits from the exploitation of the economic patrimony of a nation should primarily accrue to its own citizens and nationals, and that this can be assured by reserving certain areas of the national economy only for such citizens and nationals, then this development is disturbing. However, it is not unexpected. The definite trend for some time in contemporary Philippine economic policy has been to all but relegate the principle of economic nationalism to the dustbin of the many unfulfilled aspirations of the Filipino people.[260]

4.13 *The Necessary Quid Pro Quo—Increased Investment, Debt Capital, and Technology Inflow*

There must be a *quid pro quo* for these valuable concessions. In contemporary income tax treaty practice, this *quid pro quo* has usually been the structuring of the provisions of the income tax treaty so as to encourage the inflow of investment from the developed to the developing country. Also sought to be encouraged would be the transfer of technology, and in certain cases the inflow of debt-capital (to use a more understandable word, "loans") from the developed to the developing countries. All these would generate new economic activity which in turn would generate new tax revenue that could theoretically offset the earlier expected loss in tax revenue.

Of course, the pursuit of the objectives presupposes a model of economic development wherein foreign investment and foreign loans play an important, if not major role in filling the capital formation needs of the developing country, and wherein foreign technology is used to speed up the process of transforming indigenous labor and capital into economic prosperity.[261] Many will argue against this economic development model,

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[259] *See* Philippines-Sweden Income Tax Treaty, *supra* note 224, art. 19, par. (3); Philippines-Denmark Income Tax Treaty, *supra* note 253, art. 26. par. (5); Philippines-Canada Income Tax Treaty, *supra* note 254, art. 23, par. (6); Philippines-France Income Tax Treaty, *supra* note 255, art. 24, par. (5); Philippines-Belgium Income Tax Treaty, *supra* note 257, art. 24, par. (7); Philippines-Japan Income Tax Treaty, *supra* note 222, art. 24, par. (6).

[260] *See* Medalla, *Law and Philippine Nationhood,* 53 PHIL. L.J. 287, 302-307, 323-325, 329-330.

[261] *See* U.N. DEP'T. OF INT'L. ECONOMIC AND SOCIAL AFFAIRS, UNITED NATIONS MODEL DOUBLE TAXATION CONVENTION BETWEEN DEVELOPED AND DEVELOPING COUNTRIES 1, U.N. Doc. ST/ESA/102 (1980) [hereinafter cited as U.N. Model Double Taxation Convention].

opting instead for a more nationalistic and self-sufficient approach.[262] Nevertheless, this model of economic development reflects the hope and the aspiration that foreign investment and loans, if channeled into specified areas in the economy, can be a positive factor for meaningful economic development, and not merely a device for the continuing exploitation of the under-developed by the developed world. The latter would be a scenario wherein the national economies of the third world are controlled by foreign interests, its economic markets and national resources swiftly exploited for quick profits without any meaningful structural economic change; and wherein the third world nations are burdened by an ever-increasing foreign debt and are mired in a repetitive pattern of dependency on foreign technology, technology which might not even meet the real needs of its people.

If the necessity for more foreign investment inflows for the purpose of economic development is accepted as a valid proposition, then one may argue that the treaty's provision on non-discrimination was a change for the better. However, one should then note that at least from a Philippine national policy perspective, meaningful economic development does not, and cannot mean completely opening up the Philippine economy to foreign interests and investments. In certain vital and important economic sectors, the Filipino individual and corporate investor must still be preferred over his foreign counterpart.

4.131 *Internal Measures and Treaty Provisions*

The encouragement of the inflows mentioned starts with internal Philippine law.

The primary concern of a foreign corporate entrepreneur is of course the rate of return on its investment, whether that investment be in its branch or subsidiary in the Philippines, in the technology it licenses to a Philippine company, or in the loan it extends to a Philippine debtor. If its net after-tax rate of return is not at least equal to its rate of return in a similar utilization of capital or technology in its home country or in another foreign country, there is no incentive for it to venture into the Philippine market. Obviously, the relevant Philippine tax rate on the income concerned would enter into the computation of this after-tax rate of return. Assuming an equal pre-tax rate of return on the same kind of investment in its own country and in the Philippines, there is no point in the investor making the investment in the Philippines if the Philippine rate of tax is higher than that of its own country (assuming the same tax base is used).

Therefore, the first step is to see to it that Philippine tax rates are competitive with those of the investor's own country. Translated, this would mean that Philippine tax rates should not exceed the tax rates in the investor's home country on comparable investments.

[262] *See* Medalla, *supra* note 242, at 324-325.

If necessary to obtain this parity, tax rates should be reduced. This can be done by amending the National Internal Revenue Code, or by providing in an income tax treaty for the reduction of rates.

The primary Philippine tax rates with which we are concerned are the corporate income tax rates which are applicable to subsidiaries and permanent establishments, the branch profits remittance tax, the withholding tax on dividends, the tax on royalties, the tax on foreign loans, and to a certain extent the Philippine tax on international carriers. For the reasons we discussed, these taxes would have to be less than or equal to the maximum U.S. tax on the same kind of income which in most cases would be the maximum corporate tax rate of 46 percent on net income.[263]

The effective rate of Philippine tax on a U.S. corporation operating through a Philippine subsidiary, or branch or permanent establishment, or receiving dividend income from a Philippine corporation in which it has at least a 10 percent interest would be 44.75 percent of net income.[264] This is less than 46 percent.[265] All things being equal, there would be no need for a reduction here.

It is with regard to the taxes based on gross income where we encounter problems. The Philippine tax on royalties, on foreign loans and on international carriers are all taxes on gross income. In order to have the desired parity, these gross income tax rates should be at such a level so that the amount of tax which is produced when these rates are multiplied by their income base would at least equal the amount of tax produced when 46 percent is multiplied by the same kinds of income computed on a net income basis.

The tax rate on gross royalties seemed to have been too high at 35 percent.[266] Therefore, the reduction of the rate in the treaty to either 25 percent or 15 percent brought the rate to more realistic levels.[267]

The 2½ percent of gross Philippine billings tax on international carriers did not seem to be excessive.[268] With its reduction to 1½ percent

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263 I.R.C., § 11 (1983).

264 On $100 of income, (1) Subsidiary: 35 percent x $100 = $35 (corporate income tax). 15 percent x $65 = $9.75. (Dividends withholding tax). Total = $44.75. (2) Branch: 35 percent x $100 = $35 (corporate income tax). 15 percent x $65 = $9.75 (Branch profits remittance tax). Total = $44.75.

265 The policy of the Philippines is in fact to see to it that the two-step tax (either subsidiary — dividend, or branch — remittance) is not greater than the income tax rate of the country of residence of the investor. See Keynote Speech by Minister of Finance Cesar Virata *supra* note 79, at 4.

266 *See* U.N. Model Double Taxation Convention, *supra* note 261, Commentary on art. 12, General Considerations.

267 But *see id.*, Commentary on art. 12, pars. 1 and 2. The members from the developing countries of the Group of Experts observed that patents and processes were usually licensed to developing countries after they had been fully exploited elsewhere, when the expenses incurred in connection with their development had already been largely recouped.

268 The theory behind the 2½ percent gross Philippines billings tax is that the assumed rate of return is 10 percent. The lower regular rate of Philippine cor-

of gross revenue in the treaty, all the more the desired parity seemed to have been maintained.

Although there may be numerical parity between the effective tax burden in a developing country and the tax burden in the investor's own country, one scholar notes that due to special risk factors present in the developing countries but not in the developed ones, including those pertaining to political stability and foreign exchange restrictions, this numerical parity is not enough. What is required is that the investor's after-tax rate of return from an investment in a developing country must be higher than that for a similar investment in a developed country to compensate for these risk factors.[269] Viewed from this perspective, this would mean that effective tax rates in underdeveloped countries should be lower than those for developed countries for parity actually to exist.

The value of the various tax incentives contained in the Philippine investment incentive laws will thus be appreciated. Through various devices which can generally be grouped into either exemption from tax, reduction of the tax rate, or a shrinkage of the tax base, the investor's rate of return (after Philippine tax) from his Philippine investment is further increased.

However, as we shall see, the U.S. tax credit system will tend to destroy the efficacy of these incentives.

4.132 *The U.S. Tax Credit System and the Need for Relief at the Treaty Level*

The U.S. tax credit system operates to equalize the combined/total tax burden (U.S. and/or foreign tax) on currently taxable income of U.S. corporations, whether the income be from foreign or U.S. sources. In any given taxable year, the effective combined tax rate will equal or be greater than the U.S. tax rate, but can never be less than it. Thus tax neutrality, to the extent that it can be effected by American internal law, is maintained between domesic and foreign income and investment. Given the same pre-tax (Philippine tax plus U.S. tax) rate of return on similar investments of a U.S. corporation in the U.S. and in the Philippines, the tax credit will operate in such a manner so that the rate of return *after tax* (Philippine and U.S. tax) on the Philippine investment can only be less than or equal but not greater than that on the U.S. investment.

Under this system, if we have a U.S. corporation which derives income from foreign sources (we assume that such a corporation is not in an excess *overall* foreign tax credit position), such a corporation will be

porate income tax is 25 percent. Therefore the tax on airlines and shipping companies would be 25 percent x 10 percent or 2 1/2 percent, *See* Keynote Speech by Minister of Finance Cesar Virata, *supra* note 79, at 6.

269 *See* Stikker, The Role of Private Enterprise in Investment and Promotion in Developing Countries, Chapter IV of a report to the United Nations Secretariat, reprinted in 22 BULL. FOR INT'L. FISCAL DOCUMENTATION 383, 386 (1968).

allowed a credit for qualifying foreign taxes against the pre-credit U.S. income tax due on its foreign source income only to the extent of the amount of such pre-credit U.S. income tax. If the total foreign taxes are less than the corresponding pre-credit U.S. income tax, then U.S. tax in the amount of the difference (this will be the U.S. income tax that will be actually collected after the pre-credit U.S. income tax has been reduced by the foreign tax credits, hereinafter referred to as "post-credit U.S. income tax") will be collected from the U.S. corporation involved. By virtue of the operation of the Internal Revenue Code's overall limitation provision, if the foreign taxes for the current taxable year exceed the corresponding pre-credit U.S. income tax on the same income (the income from foreign sources), the excess will not be allowed as a credit in that year. However, the excess may still be availed of as a foreign tax credit in prior or succeeding taxable years.[270]

This system will in many instances negate Philippine tax incentives if the avowed purpose of such incentives is to reduce the tax cost of investing in the Philippines and to therefore encourage such investment. These will be in situations where by virtue of the Philippine tax incentive, the effective Philippine income tax is reduced to less than the corresponding pre-credit U.S. income tax, with the U.S. corporation not being in an excess overall foreign tax credit position. In these situations, the reduction of the Philippine income tax on the Philippine source income of a U.S. corporation which is not in an excess overall foreign tax credit position, or the exemption of such income from Philippine tax will not result in any tax savings for the corporation involved, but only in added tax revenue for the U.S. Treasury.[271] Even shrinking the corporation's Philippine taxable base by the device of additional or special deductions will be ineffectual. The worldwide taxable income of a U.S. corporation as well as its taxable income from foreign sources will *for U.S. tax purposes* be determined solely by reference to U.S. tax law and its standards, rules and concepts. The Philippine calculation, for *Philippine tax purposes,* of the corporation's taxable income from Philippine sources is irrelevant.

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270 Foreign taxes that are not utilized as credits in a taxable year may be used as such in the two prior taxable years and in the five succeeding taxable years, subject to the limitation discussed above respecting the amount of foreign tax that may be allowed as a credit as applied to those prior or succeeding taxable years. I.R.C. § 904(c) (1983).

271 In Situation 1, assume a U.S. corporation which derives foreign source income from the Philippines and another country, Country X. It has $2,000 of foreign-source income, $1,000 each from the Philippines and from Country X. The U.S. income tax rate is 46%; assume that the effective Philippine rate is also 46%; that of X is 20%. The pre-credit U.S. tax woull be $920 (46% of $2,000). The total foreign tax on the $2,000 would be $660 — Philippine tax of $460 (46% of $1,000) and Country X tax of $200 (20% of $1,000), which would be creditable against the pre-credit U.S. tax of $920. The post-credit U.S. tax to be collected would therefore be $260 ($920-$660). The combined U.S. and foreign tax would be $920.

In Situation 2, assume a reduction in Philippine tax from 46% to 20% as a result of a subsequently enacted Philippine tax incentive. The pre-credit U.S. tax would still be $920. The total foreign tax would be $400—Philippine tax of $200

If the American corporation is in a situation where *overall* it has excess foreign tax credits[272] (*i.e.*, its creditable foreign taxes exceed its overall foreign tax credit limitation), then the exemption from, or reduction of Philippine tax will result in real tax savings and not merely in additional U.S. tax revenue. The total tax on its foreign source income will be reduced by virtue of the exemption or reduction, and a real tax benefit will accrue to the corporation.[273]

It should be noted though that this tax benefit does not operate to reduce the tax cost of investing in the Philippines *per se* if the effective rate of Philippine tax prior to reduction or exemption was lower than or at least equal to the effective U.S. rate on the same income. In this situation, the Philippine tax incentive's actual effect is to reduce the tax cost of the corporation's investment in another country which generated the excess tax credit by virtue of an effective rate of tax higher than the U.S. rate (the corporation deriving foreign source income from several countries). However, the corporation's investment decisions are affected not only by individual country tax considerations but also by its calculation of the overall tax cost of its foreign operations. To the extent that the Philippine tax incentive reduces that overall tax cost and insofar as this is a factor in the corporation's decisions as to where to invest its capital, investment in the Philippines will have been encouraged.

The only real escape from the system, and one in which a Philippine tax incentive directly operates to reduce the tax cost of investing in the Philippines *per se* is when the U.S. corporations operate through Philippinc subsidiaries or invest in Philippine corporations. The fiction of a separate corporate entity will be respected for U.S. tax purposes. The U.S. corpora-

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and Country X tax of $200. The post-credit U.S. tax would increase from $260 previously to $520 ($920-$400). The combined U.S. and foreign tax would still be $920, but the U.S. share of this total would increase by $260, an increase which is equivalent to the reduction in Philippine tax — (46% minus 20%) of $1,000 equals $260.

272 This is primarily due to the corporation's operating in countries which have an effective rate of tax greater than the U.S. rate. The excess foreign tax credits for a taxable year are either generated currently or may be due to carrybacks and carryovers fom other years.

273 In Situation 1, assume a U.S. corporation which derives foreign source income from the Philippines and another country, Country X. It has $2,000 of foreign source income, $1,000 each from the Philippines and from Country X. The U.S. income tax is 46%; assume that the effect Philippine rate is also 46%; that X is 50%. The pre-credit U.S. tax would be $920 (46% of $2,000). The total foreign tax on the $2,000 would be $960 — Philippine tax of $460 (46% of $1,000) and Country X tax of $500 (50% of $1,000), only $920 of which can be credited against the the pre-credit U.S. tax (of $920), the difference of $40 being an excess foreign tax credit. There would be no post-credit U.S. tax to be collected. The combined U.S. and foreign tax load would be equivalent to $960, the total foreign tax.

In Situation 2, assume a reduction in Philippine tax from 46% to 42% as a result of a subsequently enacted Philippine tax incentive. The pre-credit U.S. tax would remain at $920, but the total foreign tax on the $2,000 would be reduced from $960 to $920, which would again mean that there would be no post-credit U.S. tax collectible. However, the combined U.S. and foreign tax load would be reduced from $960 to $920, a $40 reduction which is equivalent to the reduction in Philippine tax — (46% minus 42%) of $1,000 equals $40.

tion will be subject to U.S. income tax on its share of the income of the Philippine corporation only upon its receipt of dividends from the latter, although even this rule has been substantially eroded by certain provisions in the Internal Revenue Code, notably the provisions on controlled foreign corporations.[274] To the extent that the U.S. taxation of such income is deferred, the goal of channelling the tax savings generated by Philippine tax incentives to the American investor instead of merely enriching the U.S. Treasury will have been achieved. Furthermore, the tax savings result in additional funds being available to the American corporation for possible reinvestment in the Philippines.

It must be recognized though that all these is true only prior to the declaration of dividends.[275] At the point of dividend declaration, the amount of U.S. tax due from the U.S. corporation will be determined solely according to American tax law. The amount of Philippine taxes that have been foregone because of Philippine tax incentives will not be considered at all; it is the amount of Philippine tax *actually* paid or accrued that will be allowed as a foreign tax credit. Philippine tax concepts and measurements of income will again be inapplicable. As in the case of a U.S. corporation directly doing business in the Philippines, even a Philippine tax incentive the effect of which is to shrink the taxable base of the Philippine subsidiary or other corporation from which the U.S. corporation receives dividends, through special deductions that reduce taxable income and therefore earnings and profits for Philippine taxation purposes, will be of no avail. The determination for U.S. income tax purposes of whether and how much of the money or other property received by the U.S. corporation from the Philippine corporation is a taxable dividend[276] will be made solely according to American tax concepts and measurements of how much the taxable income (and consequently the earnings and profits) of the Philippine corporation is.[277]

If the U.S. corporation receiving dividends is in an overall foreign tax credit position, the reduction of Philippine taxes by virtue of Philippine

[274] Under the U.S. Internal Revenue Code, U.S. stockholders of certain foreign corporations are required to include in their gross income certain kinds of income of these foreign corporations even prior to the receipt of dividends; these corporations are what are termed under the I.R.C. as "controlled foreign corporations," I.R.C. § 951-964 (1983), and "foreign personal holding companies," I.R.C. § 551-558 (1983); the "controlled foreign corporations" provisions were specifically enacted to deal with the abuse of the legal concept that a U.S. parent corporation and its foreign subsidiary are separate entities for U.S. tax purposes.

[275] See Crokett, *"Tax Sparing": A Legend Finally Reaches Print*, 11 NAT'L. TAX J. 146, 147 (1958); U.N. DEP'T. OF ECONOMIC AND SOCIAL AFFAIRS, TAX TREATIES BETWEEN DEVELOPED AND DEVELOPING COUNTRIES — THIRD REPORT 91, U.N. Doc. ST/ECA/166 (1972).

[276] A taxable dividend for U.S. tax law purposes, which depends on the earnings and profits of the corporation declaring the dividend, is different from a dividend for purposes of corporation law, which is determined by the corporation's retained earnings.

[277] *See* Treas. Reg. § 1.902-1(a) (3) (ii) (6) (T.D. 7481, 4-15-77. *Amended* by T.D. 7490, 6-10-77 and T.D. 7649, 10-17-79); also *see* Rev. Rul. 59-71, 1959-1 C.B. 194; Rev. Rul. 74-387, 1974-2 C.B. 207.

tax incentives will reduce the total tax on the corporation's foreign source income. It should be noted though that U.S. multinationals operating through subsidiaries are oftentimes able to manage their overall foreign tax credit position so as to obviate an overall excess credit situation, by repatriating (through dividends) only so much income from their low-taxed foreign subsidiaries (i.e., subject to an effective foreign tax rate lower than the comparable U.S. tax rate) as can be sheltered by excess tax credits from their higher taxed foreign operations (i.e., subject to an effective foreign tax rate greater than the comparable U.S. tax rate).[278] In this situation, there are two scenarios. If prior to the reduction or elimination of Philippine taxes, the Philippine subsidiary was a higher-taxed foreign subsidiary, (i.e., subject to an effective pre-incentive Philippine tax rate higher than the comparable U.S. tax rate), then such reduction or elimination will result in the U.S. corporation concerned being able to repatriate less income from its low-taxed foreign subsidiaries. It can thus take advantage of the deferral of U.S. tax on more foreign-source income. However, if prior to the reduction or elimination, the effective pre-incentive Philippine tax rate was lower than or at least equal to the comparable U.S. tax rate, then the reduction or elimination will enable the U.S. corporation to realize more after-tax (i.e., Philippine tax) income from its Philippine subsidiary, the U.S. income tax on which can be effectively deferred while at the same time utilizing all foreign tax credits.

The need for relief on a treaty level is therefore evident. The primary method used to achieve this would be to incorporate a "tax sparing" provision in the treaty. A tax exemption provision could also be utilized to the same effect.[279]

In tax sparing, a country like the United States which utilizes the tax credit system would give a credit not only for the Philippine income taxes actually paid by the U.S. corporation, but also for Philippine income tax that would have been paid if it were not for tax incentives measures.[280] The "spared" taxes which could be allowed for credit purposes may include taxes foregone due to a reduction of withholding rates on passive income below the regular rates, or because of a reduction of the corporate income tax rates for certain corporations, or due to special deductions and exemptions reducing taxable income. It may even include those taxes spared due to the grant of tax incentives not to the U.S. corporation itself, but to its Philippine subsidiary. The taxes subject to the tax sparing clause can vary,

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[278] It should be remembered though that the availability of excess foreign tax credits is only one of the factors which affect a corporation's decision with regard to whether to repatriate or reinvest the profits from its investment in a foreign country.

[279] *See* U.N. Model Double Taxation Convention, *supra* note 261, Commentary on art. 23, General Considerations.

[280] *See* COMMITTEE ON FISCAL AFFAIRS, ORGANIZATION FOR ECONOMIC COOPERATION AND DEVELOPMENT, *supra* note 135, at 15.

depending on the agreements reached between the two states concerned, and on administrative feasibility.

Under the tax exemption method, all income, or certain kinds of income received from foreign sources is exempted from tax in the state of residence of the investor. The effective overall tax rate and the rate of return on investment will thus be determined solely by the country where the income has its source.[281]

Under both these methods, the integrity of the tax incentive system of a developing country like the Philippines is fully preserved. A half-way method that could also be used would be the deferral of U.S. taxation of income from Philippine sources by treaty mandate.

The policy of the Philippines is, or has been to seek the incorporation of tax sparing provisions in its income tax treaties, to complement the tax incentive program of its investment incentive laws.[282] In the income tax treaties of the Philippines with industrialized developed countries which are in force, tax sparing provisions are a feature of the treaties with Sweden, Denmark, France, Belgium and Japan,[283] but not in the treaties with the United Kingdom and with Canada (the provisions in the treaties with France, Belgium and Japan are really for matching credits).[284] The tax sparing provisions in these treaties complement the reduction of tax rates on dividends, interest, and royalties received by foreign investors from enterprises in preferred areas of investment.[285]

Other investment incentives which could be incorporated in a treaty include investment credits or investment allowances to be given by the developed country for investments in the underdeveloped country.

4.14 *The Investment Environment*

Independent of any tax incentive measures in a treaty or any tax sparing or tax exemption provisions intended to preserve the tax incentives granted by the internal law of developing countries, it has been said that the existence of the treaty in itself is an incentive to investment. Basically,

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[281] *Id.*, at 13-14.

[282] *See* T. Toledo, *supra* note 77, at 31-32.

[283] Philippines-Sweden Income Tax Treaty, *supra* note 224, art. 6, par. (2), art. 7, par. (5), art. 18, par. (5); Philippines-Denmark Income Tax Treaty, *supra* note 253, art. 6, par. (6), art. 7, par. (6), art. 8, par. (7), art. 23, par. (5); Philippines-France Income Tax Treaty, *supra* note 255; art. 23, par. (2); Philippines-Belgium Income Tax Treaty, *supra* note 257, art. 23; Philippines-Japan Income Tax Treaty, *supra* note 222, art. 23, par. (3).

[284] A matching credit is a credit calculated at a *fixed percentage* of the pre-credit income, regardless of the tax rate imposed by the developing country. *See* U.N. DEP'T. OF ECONOMIC AND SOCIAL AFFAIRS, *supra* note 275, at 78.

[285] Philippines-Sweden Income Tax Treaty, *supra* note 224, art. 6, par. (2), art. 7, par. (3); Philippines-Denmark Income Tax Treaty, *supra* note 253, art. 6, par. (2), art. 7, par. (2), art. 8, par. (3); Philippines-France Income Tax Treaty, *supra* note 255, art. 12, par. (2); Philippines-Japan Income Tax Treaty, *supra* note 222, art. 10, par. (2), art. 11, par. (3); art. 12, par. (3).

the contention is that the fact that there is a tax treaty with the country where he intends to invest enables the potential investor to calculate the tax costs associated with, and the rate of return on his investment with more certainty. Consequently, the attractiveness of investment in the country concerned is enhanced. The adverse effects of another "risk factor" in the total investment environment is reduced. The International Chamber of Commerce has stated that: "Evaluation of an investment and its likely success demand that reliable figures be used, including the taxes in the host country . . ."[286] Tax treaties "[P]rovides [(or are supposed to)] a reasonable element of legal and fiscal certainty as a framework within which international operations can be carried on."[287]

The Fiscal Committee of the Organization for Economic Cooperation and Development (OECD) observed:

> [A]part from the solution of concrete tax problems relating to international trade and investment, tax conventions [for the prevention or elimination of double taxation] can provide an improvement in the general tax atmosphere by offering re-assurance to investors and businessmen that there exists a mechanism for the settlement of tax grievances that may arise. The mere fact of a tax treaty having been agreed to, even if it provides no formal procedures for the settlement of differences, conveys a sense of co-operation between the authorities of the two countries which instills confidence that potential disputes can be settled on reasonable terms. In addition, however, tax treaties may provide authorization for specific procedures, for mutual agreement in the settlement of differences.[288]

Maybe even more important than this is the fact that a tax treaty substantially reduces the incidence of double taxation, defined as the "[I]mposition of comparable taxes in two (or more) States on the same taxpayer in respect of the same subject matter and for identical periods, [as the result of the overlapping tax claims of those states],"[289] an objec-

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[286] THE INTERNATIONAL CHAMBER OF COMMERCE, COMMENTS ON THE U.N. MODEL TAX CONVENTION BETWEEN DEVELOPED AND DEVELOPING COUNTRIES, ICC Doc. No. 180/206 Rev. 2 reprinted in 35 BULL FOR IN'TL. FISCAL DOCUMENTATION 309, 312 (1981).

[287] U.N. Model Double Taxation Convention, *supra* note 261, at 1.

[288] ORGANIZATION FOR ECONOMIC COOPERATION AND DEVELOPMENT, FISCAL INCENTIVES FOR PRIVATE INVESTMENT IN DEVELOPING COUNTRIES: REPORT OF THE FISCAL COMMITTEE (Paris, 1965), par. 166, quoted in UNITED NATIONS, MANUAL FOR THE NEGOTIATION OF BILATERAL TAX TREATIES BETWEEN DEVELOPED AND DEVELOPING COUNTRIES 1, U.N. Doc. ST/ESA/94 (1979).

[289] *See* OECD Model Treaty, *supra* note 135, at 7, 12; U.N. Model Double Taxation Convention, *supra* note 261, at 1.

The following reasons were given for this cumulation of taxes:

> "1. Two States may tax a person (individual or company) on his world-wide income or capital because of his personal link with the States (domicile, residence, nationality, place of incorporation or management): so-called concurrent full liability to tax;
>
> 2. One State taxes a person on his world-wide income or capital, because he is resident (fully liable to tax) there, and the other State taxes the same person on income he derives from that State or on capital situated therein (so-called limited liability to tax); that is, the conflict of residence against source or situs;

tive which in the first instance is the primary purpose (or at the least, was originally the primary purpose) of international tax treaties.[290] If not alleviated, the double taxation problem leads to an overall tax burden on foreign investment that would in many instances, prevent such investment from ever being made. In the case of the U.S. corporation doing business in the Philippines, double taxation would be the result of the interaction between the U.S. tax system which taxes U.S. corporations doing business in the Philippines on their worldwide income,[291] and the Philippine tax system which subjects the income derived by U.S. corporations from Philippine sources to Philippine taxes.

Relief can of course be given unilaterally in the internal revenue laws of countries through tax credit or tax exemption provisions with respect to income received by residents from foreign sources. The relevant example would be the tax credit provisions of the United States Internal Revenue Code. However, due to differences in national concepts, among others, of taxable income, the characteristics of a creditable tax, the source of income (whether domestic or foreign), and the allocation of deductions to domestic or foreign source income, these unilateral relief provisions have to be supplemented by provisions in a bilateral income tax treaty.[292]

To the extent that the Philippines-U.S. income tax treaty more clearly delineates and binds the two states to agreement on what taxes qualify for each other's income tax credit, on what are allowable deductions, on where income has its source, and to a mutual agreement procedure for the settlement of whatever disagreements or differences in interpretation may arise,[293] the problem of double taxation is substantially alleviated. The International Chamber of Commerce states that: "[E]nterprises prefer to invest in a country with which a treaty exists with clear provisions for the avoidance of double taxation."[294]

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3. A person is subjected to limited liability to tax in two States; main example: an enterprise of State A having a permanent establishment in State B which derives income from State C: case of concurrent limited liability to tax in States B and C.."

OECD Model Treaty, *supra* note 135, at 12.

290 *See* COMMITTEE ON FISCAL AFFAIRS, ORGANIZATION FOR ECONOMIC COOPERATION AND DEVELOPMENT, *supra* note 135, at 7-21; U.N. Model Double Taxation Convention, *supra* note 261, at 1-12.

291 *See* I.R.C. §§ 61 and 63, in relation to § 11 (1983).

292 *See* Statement on the U.S.-Thai Income Tax Convention by Stanley S. Surrey, Assistant Secretary of the Treasury, before the Subcommittee on Tax Conventions of the Senate Committee on Foreign Relations, August 11, 1965, reprinted in (1965) 2 TAX TREATIES (P-H) ¶ 84,132, at 84,121-84,123; U.N. DEP'T. OF ECONOMIC AND SOCIAL AFFAIRS, *supra* not 247, at 37; UNITED NATIONS, MANUAL FOR THE NEGOTIATION OF BILATERAL TAX TREATIES BETWEEN DEVELOPED AND DEVELOPING COUNTRIES 3, U.N. Doc. ST/ESA/94 (1979).

293 Philippines-U.S. Income Tax Treaty, *supra* note 1, art. 25.

294 THE INTERNATIONAL CHAMBER OF COMMERCE, *supra* note 286, at 312.

4.2 THE U.S. RESPONSE TO PHILIPPINE NEEDS AND HOW THIS IS REFLECTED IN THE TREATY

4.21 *Revenue*

The treaty's provisions reveal that the United States has made several concessions to the Philippines in recognition of the latter's status as a developing country which will suffer a substantial revenue loss due to the limiting effects of the treaty on the reach and scope of the latter's taxing jurisdiction. These concessions, as embodied in the treaty's provisions, are departures from U.S. practice in its treaties with other developed countries, and can be best illustrated by a comparison of the provisions of the Philippines-U.S. income tax treaty with those of the U.S. Model Income Tax Treaty.[295] The primary concessionary provisions include: (1) higher withholding tax rates on passive income derived from Philippine sources, (2) lower thresholds of economic activity required for a permanent establishment to exist in the Philippines, and (3) Philippine taxation of U.S. airline and shipping companies engaged in international traffic. All three concessions result in a reduction of what otherwise would be a greater loss in tax revenue for the Philippines as a result of the treaty.

The first and second set of concessions are concessions that the United States under its current practice, usually gives when it concludes treaties with developing countries.[296] When negotiating treaties with developing countries (as against developed countries), the U.S. policy on withholding tax rates applicable to passive income is merely to seek the reduction of developing country rates so that the effective overall tax burden on U.S. foreign investment or income does not exceed the U.S. tax burden on domestic investment and income solely from U.S. sources.[297] The lower thresholds of economic activity required for a permanent establishment to exist are the result of the influence of the U.N. Model Treaty.[298]

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[295] U.S. Model Income Tax Treaty of May 17, 1977, reprinted in [1977] 1 TAX TREATIES (P-H), ¶ 1019 (hereinafter cited as U.S. Model Treaty).

[296] *1981 Hearings, supra* note 8, at 11 (statement of John E. Chapoton, Assistant Secretary of the Treasury, Tax Policy); *Id.*, at 83-84 (statement of Richard A. Gordon, International Tax Counsel, Joint Committee on Taxation); *Income Tax Treaties Hearings Before the Subcommittee on Oversight of the Committee on Ways and Means,* House of Representatives, 96th Cong., 2nd Sess. (1980) (prepared statement of David Rosenbloom, International Tax Counsel, Department of the Treasury) (available 1981 on Congressional Information Service microfiche, CIS Accession No. H781-2) [hereinafter cited as *Income Tax Treaties Hearings*]; *1977 Hearings, supra* note 5, at 28 (prepared statement of Laurence N. Woodworth, Assistant Secretary of the Treasury).

[297] *See* Statement on the U.S.-Thai Income Tax Conventions by Stanley S. Surrey, *supra* note 292, at 84,123-84,124; *Income Tax Treaties Hearing, supra* note 296, at 75 (prepared statement of David Rosenbloom, International Tax Counsel, Department of the Treasury); *1977 Hearings, supra* note 5, at 28-29 (prepared statement of Laurence N. Woodworth, Assistant Secretary of the Treasury).

[298] U.N. Model Double Taxation Convention, *supra* note 261. The U.N. Model Treaty was drafted percisely to serve as a model for income tax treaties between developed and developing countries, since "the traditional tax conventions have not commended themselves to developing countries." *See Id.*, at 2; these traditional con-

With respect to the taxation of airline and shipping companies, the Philippines-U.S. income tax treaty would be the first U.S. income tax treaty that did not provide for a reciprocal exemption for airline and shipping income.[299]

4.211 *Higher Withholding Rates*

The concessions on this point can be best illustrated by a tabular comparison of the withholding tax that the Philippines can impose on the dividend, interest and royalty income derived by U.S. residents from Philippine sources under the Philippines-U.S. income tax treaty, with the withholding taxes that may be imposed by the source country on the same kinds of income under the U.S. Model Income Tax Treaty, and in the treaty recently concluded by the United States with Egypt,[300] another developing country like the Philippines. See Table I, following page.

Our comparison reveals that the Philippines-U.S. income tax treaty has the highest rates. In fact, these rates are among the highest that have been allowed by U.S. negotiators.[301]

However, these concessions can be viewed from another perspective—that of the developing countries. With respect to interest, developing countries whose residents are the debtors argue that they (the developing countries) should have "[T]he exclusive, or at least the primary, right to tax interest, . . . [that] it . . . [is] incumbent on the developed countries to prevent double taxation of that income through exemption, credit or other relief measures, . . . [and] that interest should be taxed where it was earned, that is, where the capital was put to use."[302] A similar position is taken with respect to dividends and royalties.[303] With respect to royalties,

ventions include the OECD Model Treaty and the U.S. Model Treaty which is substantially influenced by the OECD Model Treaty, *See 1977 Hearings, supra* note 5, at 28 (prepared statement of Laurence N. Woodworth, Assistant Secretary of the Treasury; Also *see* S. Exec. Rep. No. 39, *supra* note 10, at 74,188; *1981 Hearings, supra* note 8, at 11 (statement of John Chapoton, Assistant Secretary of the Treasury, Tax Policy); *Id.,* at 83-84 (statement of Richard A. Gordon, International Tax Counsel, Joint Committee on Taxation).

299 *See* S. Exec. Rep. No. 39, *supra* note 9, at 74,180, 74,183; *1977 Hearings, supra* note 5, at 47 (prepared statement of Paul Oosterhuis, Legislative Counsel and David Brockway. Legislation Attorney, staff of the Joint Committee on Taxation); STAFF OF THE JOINT COMMITTEE ON TAXATION, 95th CONG., 1st SESS., ISSUES RELATING TO PROPOSED INCOME TAX TREATIES WITH THE UNITED KINGDOM, THE PHILIPPINES AND KOREA 7 (Comm. Print 1977) (available 1977, on Congressional Information Service, Inc. microfiche, CIS Accession No. S862-60).

300 Convention Between the Government of the United States of America and the Government of the Arab Republic of Egypt for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, August 24, 1980, reprinted in [1982] 2 TAX TREATIES (CCH) ¶ 8005- ¶ 8037 [hereinafter cited as Egyptian Treaty].

301 *See* S. Exec. Rep. No. 39, *supra* note 9, at 74,181; *1981 Hearings, supra* note 8, at 84 (statement of Richard A. Gordon, International Tax Counsel, Joint Committee on Taxation).

302 *See* U.N. Model Double Taxation Convention, *supra* note 261, Commentary on art. 11, par. (2).

303 *Id.,* commentary on art. 10, par. (2), art. 12, par. (1) and (2).

TABLE 1

	U.S. Model Income Tax Treaty	*U.S. Income Tax Treaty with Egypt*	*Philippines-U.S. Income Tax Treaty*
Dividends	(1) cannot exceed 5% (if recipient is a U.S. corporation paying the dividends) (2) cannot exceed 15% in other cases [304]	(1) cannot exceed 5% (same condition) (2) cannot exceed 15% in other cases [305]	(1) cannot exceed 20% (same condition) (2) cannot exceed 25% in other cases [306]
Interest	No withholding tax [307]	No withholding tax [308]	(1) cannot exceed 15% of gross amount of interest (2) cannot exceed 10% with respect to public issues of bonded indebtedness [309]
Royalties	No withholding tax [310]	Cannot exceed 15% of the gross amount of the royalty [311]	(1) cannot exceed 25% of gross amount of royalty [312] (2) cannot exceed 15% if paid by Philippine corporation registered with Board of Investments and engaged in preferred areas of activity (effectively 10% because U.S. is granted most favored nation status and Philippines-Japan income tax treaty provides a 10% rate) [313]

[304] U.S. Model Treaty, *supra* note 295, art. 10, par. (2).
[305] Egyptian Treaty, *supra* note 300, art. 11, par. (2).
[306] Philippines-U.S. Income Tax Treaty, *supra* note 1, art. 11, par. (2).
[307] U.S. Model Treaty, *supra* note 295, art .11, par. (1).
[308] Egyptian Treaty, *supra* note 300, art. 12, par. (1).
[309] Philippines-U.S. Income Tax Treaty, *supra* note 1, art. 12, par. (2).
[310] U.S. Model Treaty, *supra* note 295, art. 12, par. (2).
[311] Egyptian Treaty, *supra* note 300, art. 13, par. (1).
[312] Philippines-U.S. Income Tax Treaty, *supra* note 1, art. 13, par. (2) (b).
[313] *See* Philippines-U.S. Income Tax Treaty, *supra* note 1, art. 13, par. (2) (b) (ii); Philippines-Japan Income Tax Treaty, *supra* note 222, art. 12, par. (3).

developing countries have observed that patents and processes were usually licensed to developing countries after they had been fully exploited, and the expenses incurred in connection with their development had already been largely recouped.[314]

When tempered by these observations, the concessions made by the U.S. on withholding tax rates would still be meaningful, but not as significant as they would appear upon initial analysis.

However, without these concessions, the Philippine revenue loss could have been considerably more. Examining Philippine rates on dividends, interest and royalties (not effectively connected with a permanent establishment) prior to, and after the treaty, we find:

	Pre-Treaty	*Comparable Post-Treaty Rate*
I. Dividends	(1) 10% on dividends received by a branch (resident foreign corporation)	(1) 10% (with a permanent establishment, but not effectively connected income)
	(2) 15% on dividends received by a non-resident foreign corporation not doing business in the Philippines, if it holds a 10% equity interest in the Philippine corporation paying the dividends	(2) same (without a permanent establishment and not otherwise classifiable as a resident foreign corporation)
	(3) 35% on portfolio dividends and other dividends	(3) 25%
II. Interest	(1) interest (with the exception of interest on savings deposits—15%; interest on time deposits—20%) is included as part of net income from Philippine sources, with net income taxable at 25% and 35% corporate rates (resident foreign corporation)	(1) either pre-treaty treatment or if more favorable, the maximum rates under the treaty of either 15% or 10% of gross interest (with a permanent establishment but not effectively connected income)
	(2) 15% of gross interest on foreign loans made by a non-resident foreign corporation	(2) same
III. Royalties	(1) royalties included as part of net income from Philippine sources with net income taxable at 25% or 35% corporate rates (resident foreign corporation)	(1) either pre-treaty treatment, or if more favorable, the maximum rates under the treaty of either 15% or 10% of the gross royalties (with a permanent establishment but not effectively connected income)

[314] *Id.*, commentary on art. 12, pars. (1) and (2).

Pre-Treaty	*Comparable Post-Treaty Rate*
(2) 25% of gross film rentals	(2) 10% if film rentals classifiable as royalties
(3) 35% of gross royalties in other cases	(3) 10% of gross royalties, (a) from B.O.I. registered enterprises engaged in preferred pioneer area of investment and (b) if they relate to copyrights for the use of motion picture films, films or tapes for radio or television broadcasting; 25% in other cases

(See discussion at 3.51 to 3.53)

Thus, the revenue losses would probably come from the lower tax rates with respect to portfolio dividends and royalties. These post-treaty rates are really lower than the rates in effect prior to the treaty.

4.212 *Permanent Establishment*

In the Philippines-U.S. Income Tax Treaty, a building site or construction or assembly project constitutes a permanent establishment if the site, project or activity continues for a period of more than 183 days.[315] In the U.S. Model Income Tax Treaty, similar activities have to last for more than 24 months for there to be a permanent establishment.[316] The U.S.-Egypt income tax treaty, though, also requires a time period of only six months.[317] The U.N. Model Double Taxation Convention also provides for a six-month period.[318]

The furnishing of services, including consultancy services within the Philippines by a resident of the United States through employees or other personnel for a period or periods aggregating more than 183 days will also constitute a permanent establishment under the Philippines-U.S. treaty.[319] There is no similar provision in either the U.S. Model Income Tax Treaty or in the Egyptian treaty. However, a provision similar to that in the Philippine treaty is found in the U.N. Model Treaty.[320]

Under both the U.S. model income tax treaty and the U.S. treaty with Egypt, the maintenance of a stock of goods or merchandise for the purpose of delivery will not constitute a permanent establishment.[321]

315 Philippines-U.S. Income Tax Treaty, *supra* note 1, art. 5, par. (2) (i).
316 U.S. Model Treaty, *supra* note 295, art. 5, par. (3).
317 Egyptian Treaty, *supra* note 300, art. (1).
318 *See* U.N. Model Double Taxation Convention, *supra* note 261, art. 5, par. 3.
319 Philippines-U.S. Income Tax Treaty, *supra* note 1, art. 5, par. (2) (j).
320 *See* U.N. Model Double Taxation Convention, *supra* note 261, art. 5, par. 3.
321 *See* U.S. Model Treaty, *supra* note 295, art. 5, par. (4) (a); Egyptian Treaty, *supra* note 300, art. 5, par. (3) (b).

Likewise, if an agent maintained such a stock of goods or merchandise only for the purpose of delivery, there would also be no permanent establishment.[322] However, under the Philippine income tax treaty, the stock of goods or merchandise may be maintained only for purposes of *occasional* delivery. Otherwise, a permanent establishment exists.[323] This is also the rule under the U.N. Model Treaty.[324]

The Philippine treaty provides that when the activities of an agent are "devoted wholly or almost wholly on behalf of a . . . resident (of one of the Contracting States), he shall not be considered an agent of independent status . . . if the transactions between the agent and the resident were not made under arm's length condiions."[325] As such, there would be a permanent establishment in the situation covered by this provision. Again, the U.S. Model Income Tax Treaty and the U.S. treaty with Egypt do not contain this provision. The U.N. Model Treaty contains an even stricter standard in this respect, without the qualifying provision that the transactions carried on are not made under arm's length conditions.[326]

The Philippine treaty contains another provision enlarging the permanent establishment concept which is also not found in either the U.S. model treaty or in the U.S.-Egypt income tax treaty. This provision states that:

> There may also be attributed to that permanent establishment the business profits derived from the sale of goods or merchandise of the same or similar kind as those sold, or form other business activities of the same or similar kind as those affected, through that permanent establishment *if the sale or activities had been resorted to in order to avoid taxation.*[327]

A provision in the U.N. Model Treaty has the same effect, although it is even wider in scope since it does not contain the tax avoidance qualification.[328]

Lastly, the Philippines-U.S. income tax treaty includes under the definition of royalties, payments received for the use of, or the right to use, any copyright of cinematographic films or tapes used for radio or television broadcasting.[329] Rentals for these films or tapes could be classified as royalties and taxable as such. Under the U.S. model treaty and the Egyptian treaty, these rentals would be business profits, and would have to be attributable to a permanent establishment to be taxable.[330]

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322 *See* U.S. Model Treaty, *supra* note 295, art. 5, par. (5).
323 Philippines-U.S. Income Tax Treaty, *supra* note 1, art. 5, par. (3) (b).
324 U.N. Model Double Taxation Convention, *supra* note 261, art. 5, par. 5 (e).
325 Philippines-U.S. Income Tax Treaty, *supra* note 1, art. 5, par. (5).
326 U.N. Model Double Taxation Convention, *supra* note 261, art. 5, par. 7.
327 Philippines-U.S. Income Tax Treaty, *supra* note 1, art. 8, par. (3).
328 U.N. Model Double Taxation Convention, *supra* note 261, art. 7, par. (3).
329 Philippines-U.S. Income Tax Treaty, *supra* note 1, art. 13, par. (3).
330 U.S. Model Treaty, *supra* note 295, art. 7, par. (7); Egyptian Treaty, *supra* note 300, art. 8, par. (5).

4.213 *Airline and Shipping Profits*

The Philippines-U.S. income tax treaty is, as we have previously stated, the first U.S. income tax treaty without a reciprocal exemption for airline and shipping profits.[331]

During the hearings on the treaty, the position of the U.S. airline industry was that approval of the Philippines-U.S. income tax treaty would set a precedent against the consistent U.S. policy of insisting on such a reciprocal exemption.[332] Furthermore, it was their view that the Philippine position was contrary to international practice.[333] Indeed, both the OECD Model Treaty and the U.N. Model Double Taxation Convention contain a reciprocal exemption provison for airline and shipping profits.[334]

However, the other side of the coin reveals that the Philippines has also followed a consistent practice of insisting on the provision that airline and shipping companies in international traffic which derive income from Philippine sources should be subject to Philippine tax and had never agreed to an exemption provision in its income tax treaties.[335]

It would seem that the reciprocal exemption provision is based not on any concern for double or excess taxation, but on the administrative convenience of taxing the shipping or airline company in the country where it is incorporated and usually has its seat of management.[336] During the hearings no complaints were made that the 2½ percent "gross Philippine billings" tax was excessive. (As we tried to show, this Philippine tax would even seem to be reasonable in amount, and has now even been further reduced by the treaty.) Excessiveness was not an issue. In fact, one of the reasons which finally led the U.S. airlines to change their position on the reciprocal exemption provision was the fact that in the Philippine income tax treaty with Japan, another major trading partner of the Philippines, there was also no reciprocal exemption provision, and under the Philippines

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331 Philippines-U.S. Income Tax Treaty, *supra* note 1, art. 9.

332 *See* S. Exec. Rep. No. 39, *supra* note 9, at 74,188; the concern expressed was "[t]hat other developing countries would rely on the Philippine treaty as a precedent in attempting to negotiate tax treaties with the United States which do not provide the reciprocal exemption to shipping and air transport income," *See 1977 hearings, supra* note 5, at 54 (prepared statement of Paul Oosterhius, Legislative Counsel, and David Brockway, Legislation Attorney Staff of the Joint Committee on Taxation); *Id.*, at 58, 59, 62 (statement of Norman J. Philion, Executive Vice President, Air Transport Association of America).

333 Indeed both the OECD Model Treaty and the U.N. Model Double Taxation Convention contain reciprocal exemptions for shipping and air transport. *See* U.N. Model Double Taxation Convention, *supra* note 261, art. 8; OECD Model Treaty, *supra* note 135, art. 8.

334 *Id.*

335 *See* Statements on proposed income tax treaty wtih Philippines, Korea, and the United Kingdom by Laurence N. Woodworth, *supra* note 6, at 74,125. The author's own survey of Philippine income tax treaties reveals no reciprocal exemption in the Philippine income tax treaties with Sweden, Denmark, Singapore, Canada, France, the United Kingodm, Japan and Belgium.

336 *See* OECD Model Treaty, *supra* note 135, commentary on art. 8, par. 1-6.

U.S. income tax treaty, the U.S. would have "most favored nation" status with regard to airline and shipping profits.[337] Furthermore, the Philippine gross billings tax is in any case creditable against the airlines' U.S. income tax, and to that extent there are no adverse effects on them because of the Philippine tax.

The staff of the Joint Committee on Taxation observed:

> The following arguments are made in favor of the treaty:
>
> (1) It is not unreasonable for a country to tax foreign airlines on income earned from sources within that country; the U.S. taxes the U.S. source income of foreign airlines from countries not providing a reciprocal exemption to U.S. airlines. Thus, while 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 airline operating in its commerce.
>
> (2) The willingness of the United States to accept the Philippine treaty without a reciprocal exemption is not likely to serve as a precedent for other countries to insist in treaty negotiations with the United States on retaining the right to tax U.S. airlines. The OECD treaty provides for reciprocal exemption, and it is the treaty policy of most countries. Moreover, those countries which impose any significant tax on foreign airlines are not likely to eliminate their tax because of a refusal of the United States to enter into tax treaties which do not reciprocally exempt airlines. . . . (4) *The Philippine tax paid by U.S. airlines will not result in any actual increase in aggregate taxes they pay (U.S. and foreign) to the extent they are allowed as foreign tax credits.*[338]

One can also see that the airlines' argument that the Philippine taxation of international carriers is contrary to international practice, is not a very viable argument in the context of the sharing of tax revenue between the United States and the Philippines. All kinds of treaty practice, international or not, are based on some consideration, economic or otherwise, found mutually acceptable by both countries who are parties to a treaty. The practice providing for a reciprocal exemption of shipping and airline income was initially adopted by the developed countries. The compelling consideration was most probably that of more efficient tax administration, a consideration which was considered more important than any loss of revenue that would result due to the exemption from taxation of foreign international carriers. This seeming disregard for this loss of revenue was probably due to the near equality of reciprocal income flows with respect to international carriers between developed countries.[339] However, this

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[337] *See* S. Exec. Rep. No. 39,, *supra* note 9, at 74,183; *1981 Hearings, supra* note 8, at 100 (statement of William M. Hawkins, Vice President, Finance and Taxation, Air Transport Association of America).

[338] STAFF OF THE JOINT COMMITTEE ON TAXATION, *supra* note 299, at 8.

[339] *See 1977 Hearings, supra* note 5, at 46 (statement of David Brockway, legislation attorney, Joint Committee on Taxation).

equality would not seem to exist with respect to developing countries, and with it the basis for the practice. Furthermore, the Philippine tax is not excessive at all, and it would seem that the Philippines had solved the tax administration problem by imposing a gross billings tax (previously the tax was on a net basis).[340] Rather than being deprecated for this, the Philippines should be emulated.

4.214 *Still a Philippine Loss and a U.S. Gain*

Despite all these concessions, one thing still stands out—the Philippines will lose tax revenue. This means either added revenue for the U.S. Treasury or tax savings for U.S. corporations.[341] Philippine taxes on three quarters of a billion dollars (as of 1977) of U.S. investment in the Philippines,[342] taxes which in the first place were generally reasonable and not excessive, will be reduced, resulting in more U.S. tax revenues or in tax savings for U.S. corporations. The estimated savings were enough to make U.S. Treasury officials argue in favor of ratification of the treaty over the U.S. airline industry's objections,[343] and have representatives from the U.S. shipping industry (which one would expect would take common cause with the airlines on the necessity for reciprocal exemption of airline and shipping profits) berating the U.S. airline industry for its intransigence, an intransigence which would deny other U.S. industries (including the shipping industry) a reduction of their Philippine taxes.[344]

Indeed, one oft he reasons why the U.S. vigorously pursues a tax treaty program is that as a result of its treaties, the U.S. Treasury is almost always expected to come out with a net gain in revenue.[345] Unfortunately for the Philippines, the gains of the U.S. Treasury and the tax savings of U.S. corporations are its losses.

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340 *See* Keynote Speech of Minister of Finance Cesar Virata, *supra* note 79, at 5-6.

341 The U.S. Senator who championed the airline's cause in tht Senate Foreign Relations Committee was Sen. Rudy Moschwitz of Minnesota, where Northwest Airlines is based. According to TAX NOTES, November 16, 1981, at 1198, "[H]is office ... obtained from the Treasury Department, but [did] not release the estimated tax savings for U.S. firms under the proposed [Philippines-U.S.] treaty." also *see 1981 Hearings, supra* note 8, at 69 (statement of John E. Chapoton, Assistant Secretary of the Treasury, Tax Policy); Statements on proposed income tax treaty with Philippines, Korea, and the United Kingdom by Laurence N. Woodworth, *supra* note 6, at 74, 126.

342 *See 1977 Hearings, supra* note 5, at 84 (statement of Laurence N. Woodworth Assistant Secretary for Tax Policy, Department of the Treasury).

343 *See* Statements on proposed income tax treaty with Philippines, Korea, and the United Kingdom by Laurence N. Woodworth, *supra* note 6, at 74,125; Statement on proposed income tax treaty with the Philippines by Donald C. Lubick, *supra* note 154, at 74,153.

344 *1981 Hearings, supra* note 8, at 102-104 (statement of Peter J. Finnerty, Vice-President, Public Affairs, Sea-Land Industries, Inc.).

345 *1981 Hearings, supra* note 8, at 9-10 (prepared statement of John E. Chapoton, Assistant Secretary of the Treasury, Tax Policy); Brockway (International Tax Counsel, Joint Congressional Committee on Taxation), *The U.S. Tax Treaty Programs: Major Issues and Options*, in TAX NOTES, November 10, 1980, at 907, 909.

4.22 *Incentives for Investment*

We stated that the *quid pro quo* for the Philippines' loss of revenue should be the incorporation of provisions in the treaty which would preserve the efficacy of the tax incentives program of the Philippines, as well as provisions which would grant specific investment incentives. We pointed out that these provisions even became more necessary with the potential extension of Philippine incentives to U.S. corporations having permanent establishments or branches in the Philippines as to which deferral of the payment of U.S. taxes was not available.

However, even the most detailed inspection of the treaty will reveal no such provisions—neither tax sparing, tax exemption, investment credits, investment allowances, reduction of the tax on income received from foreign sources or any other investment incentive. Why?

4.221 *Rationale and History of the U.S. Position*

The United States government is adamantly opposed to the incorporation of any tax-sparing provisions in its income tax treaties. This has been its position from the late 1950s to the present time.[346] As a result of this policy, not one of its income tax treaties which were ratified and went into effect contained such a provision with the exception of a treaty concluded with Pakistan in 1957.[347]

During the Eisenhower administration and for some years thereafter, there was some official sentiment in favor of thre incorporation of tax sparing provisions in U.S. income tax treaties with developing countries as a method of extending economic aid to the latter.[348] A tax sparing provision was incorporated in the proposed income tax treaty with Pakistan, and also in proposed income tax treaties negotiated with India, Israel and the United Arab Republic.[349]

The opponents of tax sparing of which Stanley S. Surrey (formerly Harvard Law Professor, later Assistant Secretary of the Treasury) was (and would still seem to be) the primary ideologue and theorist, quickly shot down these treaties.[350] The Pakistan treaty was ratified only after the

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[346] *1981 Hearings*, *supra* sote 8, at 10 (statement of John E. Chapoton, Assistant Secretary of the Treasury, Tax Policy).

[347] The treaty with Pakistan was ratified because the Pakistan statute providing for the tax exemption on which the tax-sparing provision had been based expired after the treaty was signed. *See* U.N. DEP'T. OF ECONOMIC AND SOCIAL AFFAIRS, *supra* note 275, at 75.

[348] Eisenhower himself endorsed tax sparing. *See* Hollman, *The pros and cons of tax sparing for waived foreign taxes*, 9 J. TAX'N. 152,152-153; *See* Brockway, *supra* note 345, at 913; Statement on tre U.S.-Trai Income Tax Convention by Stanley S. Surrey, *supra* note 292, at 84,125.

[349] *See* Brockway, *supra* note 345, at 913; Statement on the U.S.-Thai Income Tax Convention by Stanley S. Surrey, *supra* note 292, at 84,125; U.N. DEP'T. OF ECONOMIC AND SOCIAL AFFAIRS, *supra* note 275, at 75.

[350] *See* Statement on the U.S.-Thai Income Tax Convention by Stanley S. Surrey, *supra* note 292, at 84,125; also *see* U.N. DEP'T. OF ECONOMIC AND SOCIAL AFFAIRS; *supra* note 275, at 75.

tax sparing provision became ineffective by virtue of the expiration of the Pakistani incentive law on which it was based. The other treaties were never ratified by the U.S.[351]

To this day, Surrey's position on tax sparing, and the arguments he used against it, are the position of, and the arguments used by the United States on the matter.[352] Surrey argued that tax sparing would be ineffective as a tool to aid the economic development of underdeveloped countries because it would only lead to the premature repatriation of profits by the U.S. investor during the period during which both tax-sparing and the tax incentives granted by the developing country were available (the desired goal being that these profits should instead be reinvested in the enterprise in the developing country).[353]

However, his primary argument was one of national policy—he argued that tax sparing would be contrary to the intent of the U.S. Congress in enacting the tax credit provisions of the Interal Revenue Code, which intent was to maintain tax neutrality between American domestic investment and American investments in foreign countries.[354] To allow tax sparing and thus to give effect to the tax incentive program of the developing countries would encourage American business to invest abroad (which is precisely the point of tax sparing) rather than in the U.S.,[355] with adverse effects on American domestic industrial development, and on the American labor force.

This perceived need for the neutrality of U.S. tax measures with respect to domestic as against foreign investment has spilled over beyond the arena of the tax-sparing controversy into the general tax policy area with respect to whether or not to grant investment incentives at all in an income tax treaty. As a result, the policy of the United States is almost not to grant any form at all of tax incentives for investment purposes in its income tax treaties, whether as a complement to the tax incentive measures of developing countries, or as an independent investment in-

[351] *See* U.N. DEP'T. OF ECONOMIC AND SOCIAL AFFAIRS, *supra* note 275, at 75.

[352] *See* Brockway, *supra* note 345, at 913.

[353] *See* Statement on the U.S.-Thai Income Tax Convention by Stanley S. Surrey, *supra* note 292, at 84,125; Surrey, *The Pakistan Tax Treaty and "Tax Sparing"* 11 NAT'L. TAX J. 156, 160 (1958); *also* Brockway, *supra* note 345, at 913.

[354] This is the second point on which Philippine B.I.R. ruling 76-004, (see discussion, note 74) flounders — the "deemed paid credit" under § 902 of the I.R.C. is not given for tax sparing considerations; whether or not the Philippines reduces its taxes, the "deemed paid credit" is always available to a qualified U.S. corporation.

[355] *See* Statement on the U.S.-Thai Income Tax Convention by Stanley S. Surrey, *supra* note 294, at 84,125; Surrey, *supra* note 319, at 158; *also* Brockway, *supra* note 345, at 913; *Income Tax Treaties Hearing, supra* note 296, at 74 (statement of David Rosenbloom, International Tax Counsel, Department of the Treasury); also *see* Ecker-Racz. *Tax Stimulants to Foreign Investment,* 1949 Proceedings of the Forty-Second Annual Conference on Taxation, National Tax Association 142, 144, 146 (1950), wherein he made the point that the basic policy of American federal income tax law has been one of neutrality between foreign and domestic investments, based on the principle of tax equity that taxpayers similarly situated should have substantially the same tax burden.

centives.[356] Even proposed treaties negotiated with developing countries by the U.S. Treasury during the Kennedy administration which provided for an investment tax credit for investments by U.S. companies in the developing country, and to which the theoretical arguments against tax-sparing would not have applied, were not approved by the U.S. Senate.[357] Likewise, provisions for tax deferral on stock received in exchange for technical assistance in the developing country in proposed treaties were also rejected.[358]

This has been the consistent U.S. policy in the past and would still seem to be the policy at present.

As a matter of fact, present U.S. tax laws even favor domestic over foreign investment. An investment credit is presently available for amounts spent on machinery and equipment for use in the United States. However, if the said machinery and equipment is to be used outside the United States, the credit is generally no longer available.[359]

The other argument often advanced against tax sparing is that it would only lead to ruinous competition among developing countries in the granting of tax incentives.[360]

4.222 *A Response to the U.S. Position*

Surrey's arguments regarding the effectiveness of tax sparing as an aid to economic development can be met both at the experiential and theoretical level. However, his argument on the need to maintain tax neutrality between American domestic and foreign investment is not so easily countered, for it is an argument of national policy, of what is best from the point of view of American national interest. Only Americans can answer that.

However, initially, one might say that since the developed countries have recognized the right of the developing countries to tax income or

365 *1981 Hearings, supra* note 8, at 10 (Statement of John E. Chapoton, Assistant Secretary of the Treasury, Tax Policy); Brockway, *supra* note 311, at 913; *Income Tax Treaties Hearings, supra* note 296, at 92 (statement of Robert J. Patrick, Jr., Senior Tax Counsel, Exxon Corp.); *see* U.N. DEP'T. OF ECONOMIC AND SOCIAL AFFAIRS, *supra* note 275, at 75.

357 *See* Brockway, *supra* note 345, at 913. The proposed treaties with an investment credit provision were those with Brazil, Israel and Thailand; *see* U.N. DEP'T. OF ECONOMIC AND SOCIAL AFFAIRS, *supra* note 275, at 75; Professor Stanley S. Surrey is himself in favor of granting an investment credit for investment in foreign countries in U.S. income tax treaties in certain circumstances; *see* Statement on U.S.-Thai Income Tax Convention by Stanley S. Surrey, *supra* note 292, at 84,127 84,127.

358 The proposed tax treaties with provisions for tax deferral for technical assistance were the treaties with Israel, Thailand, and Trinidad and Tobago, *See* U.N. DEP'T. OF ECONOMIC AND SOCIAL AFFAIRS, *supra* note 275, at 75. For an example of this particular tax incentive, *see* Tuggle, Bean and Seifman, *The United States Treaty Program with Developing Countries*, 2 J.L. & ECON. DEV. 230, 234, 248-250 (1967).

359 I.R.C. § 38 in relation to §§ 46, 48(a) (2) (A) (1983).

360 *See* Brockway, *supra* note 345, at 913.

capital, then that right should also be recognized when the developing country chooses to forego part of the tax.

> [T]he investor should be enabled to operate in the developing country under the tax system prevailing in that country. It is therefore considered the prerogative of the developing country to fix the terms of tax advantages under which the enterprise may operate. Whether it is a good idea to offer these incentives to investment should not be a matter for the judgment of the industrialized country but should be left to the host country's policy.[361]

On an experiential level, one finds that tax sparing is widely accepted in international tax relations and practice as an aid to inducing foreign investment in developing countries.[362] Many of the world's developed countries, among them the United Kingdom, France, Italy, Germany, Sweden, Canada, the Netherlands, Norway, and Japan, incorporate tax sparing provisions in their income tax treaties with developing countries.[363] The overwhelming consensus among the developing countries, supported by many of the developed countries is that tax sparing is a desirable and effective complement to the former's investment incentive programs.[364] For example, one advantage it has over the investment credit, another investment incentive, is that it allows the developing country to channel investments into what it considers are desired areas of investment according to its own development programs and goals.

There is even a conviction among some sectors in the developed countries that it is a duty on the part of the developed countries to adopt measures such as tax-sparing and tax exemption on foreign source income, to complement the investment incentives of developing countries. The International Chamber of Commerce has put it in these words:

> The duty of the capital-exporting countries is to match the reliefs granted at the source, whether such reliefs arise from general restraint such as low rates of tax, or special measures such as pioneer exemptions, investment allowances or accelerated depreciation.[365]

However, lest we be accused of the logical fallacy that a proposition is true merely because the majority thinks it is, the arguments against tax sparing can also be met on a theoretical level.

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361 THE INTERNATIONAL CHAMBER OF COMMERCE, *supra* note 286, at 311.

362 *See* THE INTERNATIONAL CHAMBER OF COMMERCE, *supra* note 286, at 310, 311; also *see Income Tax Treaties Hearing*, *supra* note 296, at 100 (prepared statement of Robert J. Patrick, Jr., Senior Tax Counsel, Exxon Corp.); OECD Model Convention, *supra* note 135, at 15; U.N. DEP'T. OF ECONOMIC AND SOCIAL AFFAIRS, *supra* note 247, at 45, 46, 166.

363 *See* Statement on the U.S.-Thai Income Tax Convention by Stanley S. Surrey, *supra* note 292, at 84,125; *Income Tax Treaties Hearing*, *supra* note 296, at 100 (prepared statement of Robert J. Patrick, Jr., Senior Tax Counsel, Exxon Corp.); *also* U.N. DEP'T. OF ECONOMIC AND SOCIAL AFFAIRS, *supra* note 275, at 83, 89; OECD Model Convention, *supra* note 135, at 15; U.N. DEP'T. OF ECONOMIC AND SOCIAL AFFAIRS, *supra* note 247, at 45, 46, 166.

364 *See* U.N. DEP'T. OF ECONOMIC AND SOCIAL AFFAIRS, *supra* note 275 at 98.

365 ICC Document No. 180/100 of 29 March 1966, quoted in Stikker, *supra* note 269, at 384.

Tax sparing provisions can be designed so as to encourage reinvestment and discourage the premature repatriation of profits. This can be done, for example, with respect to tax sparing in connection with a reduced withholding tax on dividends, by a program (1) which makes tax sparing and reduced withholding rates available only after a required period of time has elapsed after the reinvestment was initially made, and (2) which provides for special deductions that reduce taxable income (if any) and free funds for reinvestment, prior to the lapse of such required time period.[366]

Furthermore, experience has not confirmed Surrey's fears on this point, and would seem to point to the opposite conclusion.

The report of the Secretary General to the *Ad Hoc* Group of Experts at its 4th meeting (on the problem of tax treaties between developed and developing countries), had this to state:

> Most members from both developed and developing countries agreed that it was not possible to give a precise answer to the question whether the tax-sparing credit encourages repatriation of earnings or, conversely, the reinvestment thereof in the developing countries. The replies pointed out that many other factors entered into the investment decision, such as opportunities to expand the business of the investor in the developing country, reinvesting the earnings in some other buisness in that country, or financing operations elsewhere. Moreover, the financial situation of the enterprise might permit reinvestment or dictate repatriation of profits. One reply from a member from a major developed country stated that the tax-sparing credit was neutral as far as this problem is concerned. Most members from developing countries agreed that the tax-sparing credit made investments more meaningful and attractive and was likely to influence the investor's choice of the situs of operations. Conversely, a member from one of these countries pointed out that the credit would encourage them to look to the developed countries which provided this incentive for their capital needs, because taxes were an important element of the cost of an investment.
>
> While it was obviously difficult if not impossible to trace imports of capital to specific incentives because of their interaction with other factors, a member from one developing country reported that increased imports of capital, plant and machinery which it received from a major capital-exporting country could be shown to be the direct result of the tax-sparing credit incorporated in the tax convention between the two countries.
>
> *Notwithstanding the absence of adequate quantitative estimates in this area, it was interesting to note that not one of the replies reported a massive repatriation of profits from the developing countries to the capital-exporting countries as a consequence of applicable tax-sparing credits. While it was recognized that only a limited number of replies had been*

366 *See* U.N. DEP'T. OF ECONOMIC AND SOCIAL AFFAIRS, *supra* note 275, at 95, 98-99. This would also help answer the observation that during the initial period of the investment, there might be no or not much profits anyway, so that a reduced withholding rate on dividends would not be very helpful tax-wise, because there are no dividends to remit, or whatever profits there are, are plowed back and reinvested.

> *received to date, it would seem that the fears concerning this point had not been confirmed.*[367]

Tax sparing is also oftentimes only a secondary factor in the decision whether to invest or to repatriate, depending on the circumstances.

> In focusing on tax considerations, there is a tendency to overlook the problem that most foreign investors are less sure of the security of their investments in developing countries that of the investments they make at home. Investors often seek to minimize the amount at risk abroad by recovering their investment as rapidly as possible. Unless they can be reassured as to the security of their investments, the effect of tax considerations on reinvestment decisions is likely to be minimal.[368]

At the very least, tax sparing combined with tax incentives probably attracts new investment.[369]

With respect to the argument that tax sparing only leads to ruinous competition among developing countries with regard to granting of tax incentives, one possible way to avoid this would be to fix the tax sparing credit at a percentage of the income tax against which the tax sparing credit is to be taken, regardless of the actual amount of the taxes actually spared. This would eliminate competition.

As we pointed out, it is the sovereign prerogative of the developing country whether or not to grant tax incentives, and what form these incentives should take. There is no doubt that tax costs are an important part of the overall investment environment. The lower the taxes, the higher the after-tax rate of return. This consideration becomes even more important when we take account of the opinion, probably correct, that investors need to obtain a higher rate of return in developing countries (as against in a developed country like the U.S.). Tax incentives are therefore a necessary equalizer. If we followed the argument on ruinous competition to its logical end, developing countries should not grant any tax incentives at all, with the optimum world tax system being one where developing country tax rates should not exceed, but on the other hand, should not otherwise be below U.S. levels. This only points to the primary significance of the tax incentive to the investor—the tax burden in the developing country concerned versus that in his home country.

Furthermore, there is no evidence that tax sparing policies have indeed led to ruinous competition in the granting of tax incentives by developing countries.

4.223 *In Relation to Philippine Income Tax Treaties with Tax Sparing Provisions*

Since the Philippine-U.S. income tax treaty does not contain a tax-sparing provision, we might expect that its withholding tax rates on divi-

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[367] U.N. DEP'T. OF ECONOMIC AND SOCIAL AFFAIRS, *supra* note 247, at 159.
[368] U.N. DEP'T. OF ECONOMIC AND SOCIAL AFFAIRS, *supra* note 275, at 103.
[369] *Id.*, at 98.

dends, interest and royalties would be higher than in the treaties the Philippines has concluded with Sweden, Denmark, France, Belgium and Japan which do have tax-sparing provisions (assuming lower withholding rates should be a *quid pro quo* for tax sparing). An analysis of these several treaties reveal that differences between them and the Philippines-U.S. income tax treaty in this respect are not very significant, with the U.S. even coming out ahead in certain instances as a result of most-favored nation clauses. An exception is with respect to dividend income in the Philippines-Japan income tax treaty, where the withholding rates are not allowed to exceed 10 percent when the paying Philippine corporation is an enterprise registered with the Board of Investments and engaged in a preferred pioneer area of investment, and when the Japanese corporation receiving the dividends owns at least 25 percent of the voting shares of the Philippine corporation paying the dividends.[370] See Table 2 following.

A more incongruent situation is that whereas permanent establishments of U.S. corporations may avail of tax incentives granted under Philippine investment incentive laws by virtue of the non-discrimination provision in the Philippines-U.S. income tax treaty, the same treatment is not extended to permanent establishments of the corporations of those enumerated countries who have agreed to tax sparing. Proportionality would dictate that if these tax incentives should be granted at all to permanent establishments of foreign corporations, it should be to those corporations whose home countries have agreed to tax sparing in their treaties with the Philippines. Tax sparing provisions would seem to be all the more necessary in order to preserve the effectiveness of the tax incentives involved, since tax incentives heretofore reserved for Philippine corporations are extended to foreign corporations. However, as we pointed out, the licensing laws and regulations of the Philippines with respect to the doing of business and investment in the Philippines can act as an effective barrier to this anomaly (depending on the implication of these laws).

4.23 *The Total Tax-Investment Environment*

4.231 *The Philippine Tax and Investment Environment*

This leaves us with the proposition that the existence of a treaty is in itself an important element of a favorable investment environment. Extending this proposition could lead us to the conclusion that this reason is enough by itself to justify entering into an income tax treaty. However, its significance is diluted by the peculiar relationship between U.S. tax law and Philippine tax law in particular, and between the United States and the Philipplnes in general.

370 Philippines-Japan Income Tax Treaty, *supra* note 222, art. 10, pars. (2) and (3).

TABLE 2

	(A) Dividends	(B) Interest	(C) Royalties
I. Treaty with U.S.	Not in excess of:	Not in excess of:	Not in excess of:
	(1) 20% (if recipient is a corporation owning at least 10% of the voting stock of the paying corporation)	(1) 15% on gross amount of interest	(1) 25% of gross amount of royalties
	(2) 25% in other cases[371]	(2) 10% with respect to public issues of bonded indebtedness[372]	(2) 10% if paid by B.O.I. registered enterprise (due to most favored nation clause)
			(3) 10% if paid for copyright to films or tapes for motion pictures, radio or television (due to the most favored nation clause)[373]
II. Treaty with Sweden	(1) either 35% or 15% under the National Internal Revenue Code	(1) 10% under National Internal Revenue Code	(1) 35% under the National Internal Revenue Code
	(2) regular tax may be reduced by 1/3, if paid by B.O.I. registered enterprise[374]	(2) regular tax may be reduced by 1/3, if paid by B.O.I. registered enterprise[375]	(2) 10% for use of motion picture films, films or tapes for radio or television broadcasting[376]

371 Philippines-U.S. Income Tax Treaty, *supra* note 1, 11, par. (2).
372 *Id.*, art. 12, pars. (2), (3).
373 *Id.*, art. 13, par. (2).
374 Philippines-Sweden Income Tax Treaty, *supra* note 224, art. 6, pars. (1), (2).
375 *Id.*, art. 7, pars. (1), (3).
376 *Id.*, art. 8, par. (1).

	(A) Dividends	(B) Interest	(C) Royalties
III. Treaty with Denmark	Same as with Sweden[377]	Same as with Sweden[378]	(1) Same as with Sweden[379]
			(2) regular tax may be reduced by 1/3, if paid by B.O.I. registered enterprise
IV. Treaty with France	Not in excess of:	Not in excess of:	Not in excess of:
	(1) 15% (if recipient is a corporation owning at least 10% of the voting stock of the paying corporation)	(1) 15% on gross amount of interest	(1) 25% of gross amount of royalties
	(2) 25% in other cases[380]	(2) 10% with respect to public issues of bonds, debentures[381]	(2) 15% if paid by B.O.I. registered enterprises, and if paid in respect of cinematographic films and works recorded for television broadcasting[382]
V. Treaty with Belgium	Not in excess of:	Not in excess of:	Not in excess of:
	(1) 15% if the dividends are exempt from tax in Belgium	(1) 15% of gross amount of interest	(1) 25% of gross amount on royalties

377 Philippines-Denmark Income Tax Treaty, note 253, art. 6, pars. (1) and (2).and (2),
378 *Id.*, art. 7, pars. (1), (3).
379 *Id.*, art. 8, pars. (1), (3), art. 9, par. (1).
380 Philippines-France Income Tax Treaty, *supra* note 255, art. 10, par. (2).
381 *Id.*, art. 11, pars. (2) and (3).
382 *Id.*, art. 12, par. (2).

	(A) *Dividends*	(B) *Interest*	(C) *Royalties*
	(2) 20% in other cases[383]	(2) 10% on public issues of bonds, debentures or similar obligations[384]	(2) 15% if royalties are paid by a B.O.I. registered enterprise, or are royalties in respect of cinematographic films or tapes for television and broadcasting[385]
VI. Treaty with Japan	Not in excess of:	Not in excess of:	Not in excess of:
	(1) 10% (if recipient is a corporation owning at least 25% of the voting shares of the paying corporation	(1) 15% of gross amount of interest	(1) 25% of gross amount of royalties.
	(2) 10% if paying corporation is a B.O.I. registered enterprise engaged in a preferred pioneer area of investment	(2) 10% on government securities, bonds, or debentures[387]	(2) 25% of gross amount of royalties relate to the use of cinematograph films and films or tapes for radio or television broadcasting
	(3) 25% in other cases[386]		(3) 10% if paying corporation is a B.O.I. registered enterprise in a preferred pioneer area of investment[388]

383 Philippines-Belgium Income Tax Treaty, *supra* note 257, art. 10, par. (2).
384 *Id.*, art. 11, pars. (2), (3).
385 *Id.*, art. 12, par. (2).
386 Philippines-Japan Income Tax Treaty, *supra* note 222, art. 10, par. (2).
387 *Id.*, art. 11, pars. (2), (3).
388 *Id.*, art. 12, pars. (2), (3).

We start with the premise that by and large, present Philippine taxes (unmodified by the treaty) are not unreasonable or excessive, and from the perspective of the American corporation (taking into account the American tax credit system),[389] do not constitute a tax burden that by itself constituted an impediment to investment.

In the first place, if clarity and certainty in the tax aspect of the Philippine investment environment is the desired end, then one can say that American investors should find little difficulty in this regard, because Philippine tax law is based upon, and even today adheres primarily to U.S. tax concepts. Trends in Philippine tax law (as in other fields of Philippine law) follow American trends. American authorities are freely cited in the Philippines; developments in U.S. tax law followed. Whether or not all these results in a legal system which meets the needs of the Filipino people is another matter; many Filipinos have always been classic imitators, and Filipino lawmakers and judges in particular are well known for their extraordinary ability to graft American legal concepts and laws which were formulated in answer to peculiar American problems at different points in American history, onto sometimes radically different Filipino situational milieus, either because of a deliberate design to achieve desired objectives, or because of a plain lack of original thinking. Needless to say, American tax lawyers would not feel lost in the world of Philippine tax concepts.

Furthermore, if we consider things from the viewpoint of the total business and investment environment (versus a solely tax point of view), one must remember that the Philippines has had a long history of economic, political and cultural relations with the United States. Prior to Philippine independence, American business dominated the Philippine economy and Washington had the final word in the government of the Philippines. Today, American business interests are still a very economically important (maybe even still the most important) part of the Philippine economy, and speak with a voice that the Philippine government, given present Philippine economic policy, has to listen to in the formulation of Philippine national policy, economic and otherwise. The United States is one of the two primary (if not *the* primary) trading partner of the Philippines, the other being Japan. To finally drive home the point, although many present-day Americans may not even know where the Philippines is, the Philippines is a country in the world (maybe one of the few left) whose people still speak of Filipino and American blood being spilled together in a common cause in places like Bataan and Corregidor against what was then believed to be a common enemy; where seeking American statehood is still *seriously*

[389] Surrey's evaluation: "While these (income tax) treaties are called treaties for 'the avoidance of double taxation,' for the most part as far as the United States is concerned, our Internal Revenue Code's use of the foreign tax credit effectively prevents double taxation for our citizens and corporation"; *See* Surrey, *supra* note 353 at 156.

discussed by some Filipinos as a sure-fire (if unlikely) solution to the Philippines' economic woes.

If the "investment environment" is the crucial consideration, then it can be said with certainty that the Philippine business environment is not one which is alien to the American businessman. Even without a tax treaty, American corporations have invested, are investing, and from all indications will continue to invest in the Philippines. As was pointed out during the hearings before the Senate Foreign Relations Committee, as of 1977 there were already three quarters of a billion dollars of U.S. investment in the Philippines. One is almost tempted to say that if the improvement of the Philippine investment environment for the American investor is the goal, then as far as the American investor is concerned, the mere conclusion of an income tax treaty between the Philippines and the United States, without anything more, will have a marginal effect.

In this respect, a less costly (tax-revenue wise) and equally viable alternative would be the reform of internal Philippine law and administration so as to improve the tax component of the Philippine investment environment. These could be done along the following lines: (1) seeing to it that Philippine tax rates are not excessive, i.e., produce a tax burden that acts as a deterrent to investment. Consultations could be made with the foreign business sector (in the Philippines) as to what their peculiar Philippine tax problems are, e.g., excessive Philippine tax rates, deficiencies in the administration of Philippine tax law. (In connection with this, one wonders whether prior to embarking on negotiations with the United States, the Philippines undertook to consult with and make a survey of American corporations in the Philippines with regard to their excess and double taxation concerns; something which hopefully was, or should have been done). The U.S. Treasury on its part made estimates of the tax savings for U.S. corporations that would come about as a result of the treaty;[390] (2) consistency and clarity in Philippine tax policy, and in the interpretation of Philippine tax law as it applies to taxpayers in general, and to foreign corporations in particular; (3) more efficient administration and implementation of Philippine tax laws, including tax collection (what comes to mind would be a situation in 1981 wherein after several American corporations had paid their income taxes to banks which had been officially designated by the Bureau of Internal Revenue as collection agents, bank officials absconded to the United States with the taxes collected and the Commissioner of Internal Revenue took the position that the American corporations were still liable for payment of their income taxes); and (4) the elimination of graft and corruption in the administration of Philippine tax laws, and in the collection of taxes.

[390] *See* TAX NOTES, November 16, 1981 at 1198.

One cannot escape making the comment that a tax treaty represents almost the ultimate development in the administration of tax laws; one can almost predict the effects when it is co-joined with a domestic tax system long on rules, but short on administration and implementation.

4.32 *Effect of American Treaty System on American Overseas Investment*

Even more convincing, in relation to our discussion of the importance of an income tax treaty to the total investment environment, than the arguments heretofore discussed is the appraisal by a U.S. official that American income tax treaties have not been a meaningful factor in inducing American business to invest abroad. In response to questions by the Committee on Ways and Means of the House of Representatives of the U.S. Congress, the International Tax Counsel of the Joint Committee on Taxation gave the following revealing answer:

> Mr. GIBBONS. Have tax treaties encouraged American manufacturing business to go overseas?
>
> Mr. BROCKWAY. *I wouldn't think so realistically.* Only insofar as our code structure does and obviously there is a big debate as to whether one thinks our code rules do or do not.
>
> The principal issues, I think, in these debates *as to whether our tax system results in operating overseas, is deferral, and the treaties do not grant anything additional along those lines.*
>
> The other major item in these debates is the foreign tax credit. There are some recent treaties that clearly provide that covered taxes qualify for the foreign tax credit. There is some question under some of the earlier treaties as to whether the treaties add a great deal, but in either case, the taxes covered by the treaties in almost all situations are taxes that qualify for foreign tax credit under the statute, so again the code and treaty rules tend to parallel.
>
> So, if the treaty rules encourage investment overseas I would assume the code rules do also. My guess is that treaties are fairly neutral.[391]

Therefore, with respect to American investment, it would seem that the mere entry into an income tax treaty with the United States, without anything more, adds very little to a developing country's efforts to attract foreign investment.

CONCLUDING COMMENTS

The Philippines-U.S. income tax treaty now governs the taxation aspect of the economic relations between the two countries. In evaluating its merits, one then has to do so from an economic viewpoint. The question to ask is: do its provisions reflect a rough parity in the economic give-and-take that had to take place, such that the national economic interests of

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[391] *Income Tax Treaties Hearing, supra* note 296, at 17-18 (statement of David H. Brockway, International Tax Counsel, Joint Committee on Taxation).

both nations have been furthered by the treaty? After all, by some form of economic synergism, an income tax treaty is supposed to be a whole which is more than the sum of its parts, which parts consist essentially of the economic concessions that each undertook to give to the other.

There is no doubt that concessions were given on both sides.

The limitation of the Philippines' taxing jurisdiction and the potential extension of Philippine tax incentives directly to American corporations due to the non-discrimination article are concessions of substance that produce real economic effects as far as the Philippines is concerned. There will be a real loss of Philippine tax revenue, and a further erosion of the policy of Philippine economic nationalism.

The concessions that the U.S. has given in the treaty would seem to be very real too, at least from an American tax policy perspective. The U.S. finally gave in on the controversial issue of the taxation of U.S. airline and shipping companies by the Philippines, but only after some amount of discussion, with the resultant delay in favorable action on the treaty. The Philippine treaty will after all be the first U.S. income tax treaty which will not have a reciprocal exemption for shipping and airline income. Likewise, there are the equally important concessions to source basis taxation—the lowering of economic thresholds in respect of the permanent establishment concept, and higher withholding rates on passive income.

However, all concessions are relative, in the sense that it all depends on where one defines the threshold point to be, the point after which changes in bargaining position are already deemed to be concessions. In the case of United States, that starting point was the U.S. Model Income Tax Treaty. When one considers that this model treaty is designed to govern tax relations between the United States and developed countries, and the Philippines is a developing country, should the more reasonable point of departure not have been the U.S. model treaty as *already* modified by the lowering of economic thresholds with respect to the permanent establishment concept and the incorporation of higher withholding rates on passive income? From this viewpoint, the alleged concessions can be seen as only being eqaulizers, placing a developing country in the same position as a developed country would be when it *initially* begins to negotiate an income tax treaty with the United States.

This might all be semantics though—hairsplitting wordplay. One has to find a more accurate gauge of what one started to measure in the first place, which was whether there is a rough parity in the economic concession that both nations gave to each other. This better gauge would seem to be a comparison of the situation that each country was in prior to the treaty's taking effect, with that in which it will find itself now that the treaty has gone into effect.

The fact that cannot be denied is that the Philippines will suffer a loss of revenue as a result of the treaty. Prior to the treaty, the tax incentives in Philippine investment laws were reserved only for Philippine corporations. With the treaty, these incentives will not be available to permanent establishments of U.S. corporations.

There are no benefits which sufficiently counterbalance these concessions. The treaty does not provide additional incentives for investment in the Philippines. On the other hand, one finds that the adverse effects of the U.S. tax credit system on the Philippine tax incentive program are still present, virtually unchanged, even heightened by the effect of the non-discrimination provisions with respect to permanent establishments. There would be the fact of the mere existence of the treaty in itself. We pointed out though, that its value in improving the Philippine investment environment is probably marginal as far as the American investor is concerned. The mere existence of the treaty would therefore be insufficient as a counterweight to the expected loss of Philippine revenue and the extension of investment incentives to Philippine permanent establishments of U.S. corporations.

On the other side, we find that the United States will probably not lose any revenue at all as a result of the treaty. Its tax credit system will remain largely unaffected. Its corporations will end up with tax savings, and together with their subsidiaries, may now avail of equal treatment in the availment of Philippine tax incentives. Its airline and shipping companies will be subject to a reduced rate of Philippine tax. In a very concrete sense, on the part of the United States, there have been no real losses; no real concessions have been made.

One wanders off to related questions, the best answers for which would really be empirical data, and not theoretical speculation. What is the relative importance of the tax incentive in the decision of a foreign enterprise to invest in the Philippines? Does the Philippine taxation system and the nature of Philippine taxes lead to a double taxation situation for foreign investors? Even if the answer is in the affirmative, does the fact of, and the amount of, double taxation that exists play a significant role in the investment decision of the foreign investors? If it does, could an imperfect but reasonable solution be the reform of Philippine tax law to substantially eliminate this problem, as against entering into an income tax treaty which would entail a substantial loss of Philippine revenue without substantial counterbalancing benefits?

If an income tax treaty only results in a loss of Philippine revenue, without significantly contributing to the attraction of foreign investment to Philippine shores, there is no point in having entered into it, especially in the light of an honest assessment by an American tax official that the American income tax treaty program is not really a factor in inducing

American business to invest abroad. The better alternative for the Philippines would just have been to keep the revenue rather than enter into the treaty and to build up and improve on the other elements that make up the Philippine investment environment. This would include a more efficient and politically stable government; improved infrastructure and the upgrading of the industrial skills of the Philippine work force. If the investor's rate of return is his primary concern, and he needs a higher rate of return in developing countries because of risk factors not present in the developed countries, then an eminently reasonable course of action should be to eliminate those risk factors, increasing the rate of return *before* tax, as well as after it.

There are no easy solutions, only difficult problems.