REPUBLIC OF THE PHILIPPINES
*Court of Tax Appeals*
QUEZON CITY

# ***EN BANC***

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| AIR NEW ZEALAND, *Petitioner,* | **C.T.A. EB NO. 230 (C.T.A. CASE NO. 6657)** |
| | Present: |
| -versus- | ACOSTA, Presiding Justice, CASTAÑEDA, JR., BAUTISTA, UY, CASANOVA, and PALANCA-ENRIQUEZ, JJ. |
| COMMISSIONER OF INTERNAL REVENUE, *Respondent.* | **Promulgated:** JUN 2 8 2007 |

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# D E C I S I O N

**PALANCA-ENRIQUEZ, J.:**

Another case involving the issue on whether or not the revenue derived by an international air carrier from sales of tickets in the Philippines for air transportation, while having no landing rights in the country, constitutes income of the said international air carrier from Philippine sources and accordingly, taxable under *Section 28 (A) (1)* of the *National Internal Revenue Code of 1997* (hereafter "*NIRC of 1997*"), as amended, is presented before the Court.

**THE CASE**

This is a Petition for Review filed by Air New Zealand (hereafter "petitioner") under *Section 11 of Republic Act No. 9282 (An Act Expanding the Jurisdiction of the Court of Tax Appeals)*, in relation to *Rule 43* of the *1997 Rules of Civil Procedure, as amended*, which seeks the reversal of the Decision dated July 11, 2006 and Resolution dated November 16, 2006 rendered by the First Division of this Court in C.T.A. Case No. 6657. The respective dispositive portions of the Decision and Resolution read as follows:

> "**IN VIEW OF ALL THE FOREGOING,** the subject Petition for Review is hereby **DENIED** for lack of merit.
>
> **SO ORDERED.**"
>
> "**WHEREFORE,** premises considered, petitioner's Motion for Reconsideration is hereby **DENIED** for lack of merit.
>
> **SO ORDERED.**"

**THE FACTS**

The antecedent facts, as culled from the records, are as follows:

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Petitioner is a foreign corporation organized and existing under the laws of the New Zealand, with principal office at ANZ Level 21, Quay Tower, 29 Customs Street, West Auckland I, New Zealand. It is an off-line international air carrier having no landing rights in the Philippines, hence does not maintain flight operations to and from the Philippines. However, it maintains off-line flights for the carriage of passengers between ports or points outside the territorial jurisdiction of the Philippines. Petitioner has a general sales agent in the Philippines, the Aerotel Limited Corporation, which, among others, sells passage documents for compensation or commission covering its off-line flights. Petitioner is not registered with the Securities and Exchange Commission as a corporation, branch office or partnership, hence, it is not licensed to do business in the Philippines.

Respondent, on the other hand, is the duly appointed Commissioner of Internal Revenue who holds office at the 5th Floor of the BIR National Office Building, located at Agham Road, Diliman, Quezon City, where he may be served with summons and other legal processes.

Believing that its off-line flights, covered by passage documents sold in the Philippines by Aerotel, were subject to income tax on Gross Philippine Billings, petitioner paid tax at the reduced rate of 1½%

pursuant to Article 8 (2) of the RP-New Zealand Tax Treaty amounting to P872,447.66.

Thereafter, petitioner filed, through its general sales agent, the following Quarterly and Annual Income Tax Returns for its gross revenues from the sale in the Philippines of passage documents for carriage of passengers during taxable year 2000 on the following dates:

| PERIOD | DATE FILED |
|---|---|
| 1st Quarter | 5/30/2000 |
| 2nd Quarter | 8/29/2000 |
| 3rd Quarter | 11/29/2000 |
| Final Adjustment Return | 4/16/2001 |

On February 5, 2003, petitioner filed a formal claim for refund with Revenue District Office No. 47 of the Bureau of Internal Revenue for the recovery of the amount of P872, 447.66, representing erroneously paid tax on Gross Philippine Billings for the taxable year 2000.

Respondent failed to act on petitioner's administrative refund, hence, on April 14, 2003 petitioner filed a Petition for Review before this Court, docketed as C.T.A. Case No. 6657.

In his Answer filed on June 4, 2003, respondent alleged by way of special and affirmative defenses that the instant case is analogous to the cases of British Overseas Airways Corp., Air India, American Airlines, and Japan Airlines, hence, petitioner is liable to the two and one-half per cent (2.5%) Gross Philippines Billings Tax under Section 28 (A) (3) (a) of the Tax Code; Section 3 of Revenue Regulations No. 15-2002 cited by petitioner does not apply to the instant case in view of the non-retroactivity of rules and regulations; in an action for tax refund/credit, the taxpayer has the burden to establish its right to refund and failure to sustain the burden is fatal to the claim for refund; and well-established is the rule that refunds/tax credits are construed strictly against taxpayer as they partake of the nature of exemption from tax.

After trial on the merits, on July 11, 2006 the First Division rendered the assailed Decision denying the Petition for Review.

Not satisfied, petitioner filed a "Motion for Reconsideration", which was denied by the First Division in a Resolution dated November 16, 2006.

On December 8, 2006, petitioner filed the instant Petition for Review.

On January 10, 2007, We required respondent to file his comment on the petition, within ten (10) days from notice.

On January 24, 2007, respondent filed his "Motion to Admit Comment", which the Court granted in its Resolution dated February 8, 2007, and respondent's Comment was admitted.

Hence, the petition is now deemed submitted for decision.

**ISSUES**

Petitioner raised the following issues for the Court En Banc's consideration:

I

WHETHER OR NOT PETITIONER, AS AN OFF-LINE INTERNATIONAL CARRIER SELLING PASSAGE DOCUMENTS THROUGH AN INDEPENDENT SALES AGENT IN THE PHILIPPINES, IS ENGAGED IN TRADE OR BUSINESS IN THE PHILIPPINES SUBJECT TO THE 32% INCOME TAX IMPOSED BY SECTION 28 (A)(1) OF THE 1997 NIRC.

II

WHETHER OR NOT THE INCOME DERIVED BY PETITIONER FROM THE SALE OF PASSAGE DOCUMENTS COVERING PETITIONER'S OFF-LINE FLIGHTS IS PHILIPPINE-SOURCE INCOME SUBJECT TO PHILIPPINE INCOME TAX.

III

WHETHER OR NOT THE HONORABLE COURT ERRED IN DENYING PETITIONER'S CLAIM FOR REFUND OF ERRONEOUSLY PAID TAX ON GROSS PHILIPPINE BILLINGS FOR TAXABLE YEAR 2000 DESPITE FINDING THAT PETITIONER IS NOT

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SUBJECT TO 2 ½% TAX ON GROSS PHILIPPINE BILLINGS.

IV

WHETHER OR NOT PETITIONER IS ENTITLED TO THE REFUND OF ERRONEOUSLY PAID TAX ON GROSS PHILIPPINE BILLINGS FOR TAXABLE YEAR 2000 IN THE AMOUNT OF P872,447.66.

***Decisive Issue***

The decisive issue posed for resolution by the Court *En Banc* is whether or not the income derived by petitioner from the sales of passage documents in the Philippines for air transportation, while having no landing rights here, constitutes income of petitioner from Philippine sources, and accordingly, taxable.

**THE COURT *EN BANC'S* RULING**

The petition is bereft of merit.

*Decisive Issue*
*Had been*
*Previously Ruled by*
*The Supreme Court*
*In the Affirmative*

There is nothing novel in this case, as the decisive issue raised herein had, in a number or so of cases, been previously ruled by the Supreme Court in the affirmative.

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In the case of *Commissioner of Internal Revenue vs. British Overseas Airways Corporation (149 SCRA 395)*, the Supreme Court ruled:

> "The Tax Code defines 'gross income' thus:
>
> 'Gross income' includes gains, profits, and income derived from salaries, wages or compensation for personal service of whatever kind and in whatever form paid, or from profession, vocations, trades, business, commerce, sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interests, rents, dividends, securities, or the transactions of any business carried on for gain or profit, or gains, profits, and income derived from any source whatever' (Sec. 29[3]; Italics supplied)
>
> The definition is broad and comprehensive to include proceeds from sales of transport documents. 'The words 'income from any source whatever' disclose a legislative policy to include all income not expressly exempted within the class of taxable income under our laws.' Income means 'cash received or its equivalent'; it is the amount of money coming to a person within a specific time x x x; it means something distinct from principal or capital. For, while capital is a fund, income is a flow. As used in our income tax law, 'income' refers to the flow of wealth.
>
> The records show that the Philippine gross income of BOAC for the fiscal years 1968-69 to 1970-71 amounted to P10,428,368.00.
>
> Did such 'flow of wealth' come from 'sources within the Philippines'?
>
> The source of an income is the property, activity or service that produced the income. For the source of income to be considered as coming from the Philippines, it is sufficient that the income is derived from activity within the

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Philippines. In BOAC's case, the sale of tickets in the Philippines is the activity that produces the income. The tickets exchanged hands here and payments for fares were also made here in Philippine currency. The situs of the source of payments is the Philippines. The flow of wealth proceeded from, and occurred within, Philippine territory, enjoying the protection accorded by the Philippine government. In consideration of such protection, the flow of wealth should share the burden of supporting the government.

A transportation ticket is not a mere piece of paper. When issued by a common carrier, it constitutes the contract between the ticket-holder and the carrier. It gives rise to the obligation of the purchaser of the ticket to pay the fare and the corresponding obligation of the carrier to transport the passenger upon the terms and conditions set forth thereon. The ordinary ticket issued to members of the travelling public in general embraces within its terms all the elements to constitute it a valid contract, binding upon the parties entering into the relationship.

True, Section 37 (a) of the Tax Code, which enumerates items of gross income from sources within the Philippines, namely: (1) interest, (2) dividends, (3) service, (4) rentals and royalties, (5) sale of real property, and (6) sale of personal property, does not mention income from the sale of tickets for international transportation. However, that does not render it less an income from sources within the Philippines. Section 37, by its language, does not intend the enumeration to be exclusive. It merely directs that the types of income listed therein be treated as income from sources within the Philippines. A cursory reading of the section will show that it does not state that it is an all-inclusive enumeration, and that no other kind of income may be so considered."

The Supreme Court reiterated the above ruling in the subsequent case of *Commissioner of Internal Revenue vs. Air India (157 SCRA 648)*, as follows:

> "On the basis of the doctrine announced in *British Overseas Airways Corporation*, the revenue derived by the private respondent Air India from the sales of airplane tickets through its agent Philippine Air Lines, Inc., here in the Philippines, must be considered taxable income. As correctly assessed by the petitioner, such income is subject to a 2.5% tax pursuant to Presidential Decree No. 1355, amending Section 24(b)(2) of the tax code. The total Philippine billings of the private respondent for the taxable year in question amounts to P2,968,156.00. 2.5% of this amount or P74,203.90 constitutes the income tax due from the private respondent."

Then, in the case of *Commissioner of Internal Revenue vs. American Airlines, Inc. (180 SCRA 274)*, the Supreme Court adopted the same ruling and ruled:

> "The controversy is now before this Court, elevated by petitioner on the issue of whether or not respondent American Airlines, Inc., which is an off-line international carrier without flight operations in this country but rendering ticketing services herein, is liable to pay the 2-1/2% tax on its gross Philippine billings pursuant to Section 24(b)(2), as amended, of the tax code.
>
> We have already had the occasion to rule on this issue in two previous cases involving the British Overseas Airways Corporation and Air India, generated by similar factual backgrounds although of different taxable periods.

In said cases, foreign airline companies which sold tickets in the Philippines through their local agents, whether called liaison offices, agencies or branches, were considered resident foreign corporations engaged in trade or business in the country. Such activities show continuity of commercial dealings or arrangements and performance of acts or works or the exercise of some functions normally incident to and in progressive prosecution of commercial gain or for the purpose and object of the business organization.

It was likewise declared that for the source of income to be considered as coming from the Philippines, it is sufficient that the income is derived from activities within the country. In the case of these airline companies, the absence of flight operations within Philippine territory cannot alter the fact that the income was derived from activity within this jurisdiction for, as lucidly explained by Mme. Justice Melencio-Herrera in the *British Overseas Airways Corporation* case:

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In the recent case of *Commissioner of Internal Revenue vs. Baier-Nickel (500 SCRA 87)*, the Supreme Court again applied the ruling when it cited the case of *Commissioner of Internal Revenue vs. British Airways Corporation, supra*, to wit:

"In *Commissioner of Internal Revenue v. British Overseas Airways Corporation (BOAC)*, the issue was whether BOAC, a foreign airline company which does not maintain any flight to and from the Philippines is liable for Philippine income taxation in respect of sales of air tickets in the Philippines, through a general sales agent relating to the carriage of passengers and cargo between two points both outside the Philippines. Ruling in the affirmative, the Court applied the case of *Alexander Howden & Co., Ltd. v.*

*Collector of Internal Revenue*, and reiterated the rule that the source of income is that 'activity' which produced the income. It was held that the 'sale of tickets' in the Philippines is the 'activity' that produced the income and therefore BOAC should pay income tax in the Philippines because it undertook an income producing activity in the country.

Both the petitioner and respondent cited the case of *Commissioner of Internal Revenue v. British Overseas Airways Corporation* in support of their arguments, but the correct interpretation of the said case favors the theory of respondent that it is the *situs* of the activity that determines whether such income is taxable in the Philippines. The conflict between the majority and the dissenting opinion in the said case has nothing to do with the underlying principle of the law on sourcing of income. In fact, both applied the case of *Alexander Howden & Co., Ltd. v. Collector of Internal Revenue*. The divergence in opinion centered on whether the sale of tickets in the Philippines is to be construed as the 'activity' that produced the income, as viewed by the majority, or merely the physical source of income, as ratiocinated by Justice Florentino P. Feliciano in his dissent. The majority through Justice Ameurfina Melencio-Herrera, as *ponente*, interpreted the sale of tickets as a business activity that gave rise to the income of BOAC. Petitioner cannot therefore invoke said case to support its view that source of income is the physical source of the money earned. If such was the interpretation of the majority, the Court would have simply stated that source of income is not the business activity of BOAC but the place where the person or entity disbursing the income is located or where BOAC physically received the same. But such was not the import of the ruling of the Court. It even explained in detail the **business activity** undertaken by BOAC in the Philippines to pinpoint the taxable activity and to justify its conclusion that BOAC is subject to Philippine income taxation. Thus-

*Cea*

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Pursuant to the aforequoted decisions of the Supreme Court, We affirm the First Division's ruling that the petitioner is a resident foreign corporation doing business in the Philippines and the income earned from its flight operations outside the Philippines is subject to income tax. Judicial decisions of the Supreme Court applying and interpreting the law shall form part of the legal system of the Philippines *(Article 8, New Civil Code).* Equally settled is the rule that decisions of the Supreme Court are authoritative and precedent setting. And it bears stressing that the BOAC decision has not been reversed, superceded nor modified by the Supreme Court and was again applied by the Supreme Court in the recent case of *Commissioner of Internal Revenue vs. Baier-Nickel (500 SCRA 87)*, promulgated on August 29, 2006. Indeed, it is the duty of the judges to apply the law as interpreted by the Supreme Court *(Secretary of Justice vs. Catolico, 68 SCRA 62; Albert vs. CFI, 23 SCRA 968).*

*Pursuant to the*
*RP-New Zealand Tax Treaty*
*the applicable rate is 1 ½%*
*of its gross revenues*

Pursuant to *Section 28 (A) (1) of the NIRC of 1997*, as amended, a resident foreign corporation like herein petitioner, shall be subject to 32%

corporate income tax. However, with the existence of a tax treaty between the Philippines and New Zealand, petitioner is liable only to 1½% tax of its gross revenues derived from sources within the Philippines arising from the "operation in international traffic of ships or aircraft", pursuant to *Article 8* of the RP-New Zealand Tax Treaty, to wit:

> "ARTICLE 8
> SHIPPING AND AIR TRANSPORT
>
> 1. Profits derived by an enterprise of a Contracting State from the operation in international traffic of ships or aircraft shall be taxable in that State.
> 2. Notwithstanding the provisions of paragraph 1, profits from sources within a Contracting State derived by an enterprise of the other Contracting State from the operation of ships or aircraft in international traffic may be taxed in the first-mentioned State but the tax so charged shall not exceed one and one-half percent of the gross revenues derived from sources in that State.
> 3. The provisions of paragraphs 1 and 2 shall also apply to profits derived from the participation in a pool, a joint business or an international operating agency."

A comprehensive scrutiny of the provisions of the treaty readily reveals that the state of residence and the state of source are both permitted to tax profits derived by corporations engaged in shipping and air transport in the operation of its ship and/or air transport in international traffic, with a limitation on the extent of the tax that may be collected, which is the ceiling of 1½% of the gross revenues derived from the state of source. A further perusal of the RP-New Zealand Tax Treaty shows that the tax rates fixed by *Article 8* are the maximum rates, as reflected in the phrase "shall not exceed". This means that any tax imposable by the contracting states concerned regarding the operation of ships or air transport in international traffic should not exceed the 1½% limitation and that said rate would apply only if the tax imposed by our laws exceeds the same.

It is well to note that the RP-New Zealand Tax Treaty does not specifically refer to Gross Philippine Billings, but of whatever profits derived by a resident of one of the Contracting States from sources within the other Contracting State. As defined in the BOAC case, "gross income" includes gains, profits and income derived from whatever source. In the case at bar, the activity that produced the income which is petitioner's sale of tickets through its local agent was conducted in the Philippines, hence, the same should be considered as taxable income within the Philippines, as this income clearly falls *Article 8 (par. 2)* of the RP-New Zealand Tax Treaty which provides that "sources within a Contracting State derived by an enterprise of the other Contracting State from the operation of ships or aircraft in international traffic".

The RP-New Zealand Tax Treaty is just one of a number of bilateral treaties which the Philippines had entered into for the avoidance of double taxation. International agreements are entered with the intention to reconcile the national fiscal legislations of the contracting parties in order to help the taxpayer avoid simultaneous taxation in two different jurisdictions. More precisely, the tax conventions are drafted with a view towards the elimination of *international juridical double taxation,* which is defined as the imposition of comparable taxes in two or more states on the same taxpayer in respect of the same subject matter and for identical periods. The rationale for doing away with double taxation is to encourage the free flow of goods and services and the movement of capital, technology and persons between countries, conditions deemed vital in creating robust and dynamic economies. Foreign investments will only thrive in a fairly predictable and reasonable international investment climate and the protection against double taxation is crucial in creating such a climate *(Commissioner of Internal Revenue vs. S.C. Johnson and Son, Inc. and Court of Appeals, 309 SCRA 87).*

In sum, petitioner is not liable to pay tax on Gross Philippine Billings under *Section 28 (A)(3) of the NIRC of 1997, as* amended. However, it is still liable for income tax on the profits it derived from sources within the Philippines at the rate of 1½%, pursuant to *Article 8* of the RP-New Zealand Tax Treaty. Considering that petitioner paid its income tax liability on Gross Philippine Billings at the rate of 1½%, for which it is not liable, said payment should be credited as payment to petitioner's tax liability for the income it derived from sources within the Philippines at the rate of 1½% pursuant to *Section 8 of the RP-New Zealand Treaty* and the excess thereof, if any, should be refunded to petitioner.

**WHEREFORE**, premises considered, the instant petition is hereby **DENIED DUE COURSE**, and accordingly, **DISMISSED** for lack of merit. With the above modification, the Decision dated July 11, 2006 and Resolution dated November 16, 2006 rendered by the First Division are hereby **AFFIRMED** in all other respects.

SO ORDERED.

**OLGA PALANCA-ENRIQUEZ**
Associate Justice

**WE CONCUR:**

**ERNESTO D. ACOSTA**
Presiding Justice

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**(Inhibited)**
**JUANITO C. CASTAÑEDA, JR.**
Associate Justice

**LOVELL R. BAUTISTA**
Associate Justice

**ERLINDA P. UY**
Associate Justice

**CAESAR A. CASANOVA**
Associate Justice

# CERTIFICATION

Pursuant to Section 13, Article VIII of the Constitution, it is hereby certified that the above Decision has been reached in consultation with the members of the Court *En Banc* before the case was assigned to the writer of the opinion of the Court.

**ERNESTO D. ACOSTA**
Presiding Justice

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