REPUBLIC OF THE PHILIPPINES
COURT OF TAX APPEALS
QUEZON CITY

SMITHKLINE AND FRENCH OVERSEAS CO.,
Petitioner,

- versus -

C.T.A. CASE NO. 5048

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Promulgated:
SEP 22 1995

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DECISION

This is a case involving a refund of alleged overpaid withholding tax-at-source on royalty payments in the sum of P372,884.70.

Petitioner is a resident foreign corporation duly organized and existing under the laws of the Philippines. It is engaged in the manufacture and sale of pharmaceutical and veterinary products and consumer brands in the Philippines under a patent and technical assistance agreement with Smithkline and French International Company, a foreign corporation organized and existing under the laws of the State of Pennsylvania, United States of America which was registered and approved by the Bureau of Patents, Trademarks and Technology Transfer, Department of Trade and Industry.

In consideration of the licenses, technical expertise and information transferred and services rendered by the licensor, petitioner pays a royalty fee of 3% of net sales of pharmaceutical products.

From January 21, 1992 to September 1992, petitioner paid its licensor royalties in the total amount of P2,485,897.97 from which the amount equivalent to 10% thereof was withheld and paid the same to the Bureau of Internal Revenue as withholding tax on royalties pursuant to the "most favored nation clause" under Article 13 of the R.P.- U.S. Tax Treaty in relation to Article 12(b) of the R.P.- West Germany Tax Treaty.

On July 1, 1992 the Bureau of Internal Revenue issued Revenue Memorandum Circular No. 39-92, ruling that the phrase "under similar circumstances" requirement of the R.P.- U.S. Tax Treaty is not satisfied because the R.P.- West Germany Tax Treaty allows a matching tax credit of 20% to Germans receiving Philippine-source royalty income while the R.P.- U.S. Tax Treaty does not provide for such a credit. Hence, taxpayers who withheld only a 10% tax on royalties are deemed deficient and are required to amend their withholding tax returns and pay the deficiency without penalties on or before October 30, 1992.

On October 30, 1992, petitioner paid under protest the alleged deficiency withholding tax of P372,884.70 on royalties to the Bureau of Internal Revenue (Exh "F").

Relying on the doctrine laid down in the case of **General Electric Philippines Meter and Instrument Co., Inc. vs. Commissioner of Internal Revenue**, CTA Case No. 4158, December 5, 1991, petitioner filed on May 12, 1993 a claim for a tax credit/refund in the sum of P372,884.70 with the Bureau of Internal Revenue's Appellate Division.

Respondent did not act on said claim for refund. Hence, this appeal.

The issue is: Whether or not petitioner is entitled to the claim for refund in accordance to the "most favored nation clause" as provided in the R.P.- U.S. Tax Treaty, Art. 13(2)(iii) in relation to Article 12(2)(b) of the R.P.- West Germany Tax Treaty.

We answer in the affirmative.

In the case of General Electric Philippines, **supra**, this court ruled, thus:

> On the basis of the most favored nation clause of the RP - U.S. Tax Treaty, Art. 13 (2) (b) (ii), taken in relation to Article 12 (2) (b) of the RP - West German Tax Treaty and BIR Ruling No. 263-86, petitioner should have withheld and paid only 10% tax instead of 25% on the royalties paid by petitioner to General Electric Company in the U.S..

> Of the accrued royalties in 1984 in the amount of P15,570,208.22 paid in 1985 - 25% tax was actually paid by petitioner on May 10, 1985 by way of withholding tax in the amount of P81,743.59 (Exhs. I, K & J, pp. 53-54, CTA rec.). Since the tax due thereon is only 10%, according to the above provision of law, the sum of P54,495.73 was due and paid resulting to an overpayment of P27,247.86.
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> Of the technical service fee of P168,474.91, petitioner paid on June 10, 1985 the 15% withholding tax in the sum of P25,271.23. (Exhs. E, G, & F, pp. 50-51 CTA rec.). Since the tax due is only 10%, according to the above provision of law, the sum of P14,440.71 was due and paid resulting to an overpayment of P10,830.52.

Said decision became final after the Court of Appeals denied petitioner's (herein, respondent) Petition for Review. (**Commissioner of Internal Revenue vs. General Electric Philippines Meter and Instrument Co., Inc.** C.A. G.R.-No. 30674) The Entry of Judgment was issued on January 26, 1994.

In a latter case, this Court reiterated the above ruling, thus:

> On the second issue, whether or not petitioner should be taxed at the reduced rate of 10% withholding tax on royalties in accordance with Article 12 (2) (b) of the R.P.- West Germany Tax Treaty and not 25% withholding tax on royalties under Articles 13 (2) (b) (iii) of the R.P.- U.S. Tax Treaty.
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> This Court is of the persuasion that petitioner's stand is correct and concurs with the opinion rendered by then Commissioner of Internal Revenue, Bienvenido Tan, (BIR Ruling No. 456-88, supra., that under the most favored nation provision of the R.P.- U.S. Tax Treaty

(Article 13 paragraph 2 (b) (iii), the tax imposable on royalties derived by a resident of the United States from sources within the Philippines shall be the lowest rate of Philippine tax that may be imposed on royalties of the same kind paid under similar circumstances to a resident of a third state. Article 12, paragraph 2 (b) of the R.P.- West Germany Tax Treaty, provides that royalties arising in the Philippines and paid to a resident of West Germany may also be taxed in the Philippines, but the tax so charged shall not exceed 10% of the gross amount of royalties. Said treaty also provides that for as long as the transfer of technology under Philippine law, is subject to approval, the limitation of the tax rate in case of royalties arising in the Philippines, apply if the contract giving rise to such royalties has been approved by Philippine competent authorities.

Thus, inasmuch as the Agreement between World Trade and IBM Phils. as well as the Agreement between IBM and IBM Phils. had been approved by the Central Bank of the Philippines, royalties arising in the Philippines and payable to World Trade as well as to IBM by IBM Phils. should be taxed at the rate of 10% because said rate is indicated in the R.P.- West Germany Tax Treaty and pursuant to Article 13, paragraph 2 (b) (iii), of the RP - US Tax Treaty.

(**IBM Philippines Inc. vs. Commissioner of Internal Revenue**, CTA Case No. 4308, March 31, 1993 pp. 10-12)

In her Answer, Respondent raised as one of her Special and Affirmative Defenses that Petitioner is not entitled to the application of the "most favored nation clause" since under the "provisions of the German Tax Treaty, there is 'matching credit' in Germany of 15% and 20%" while there is allegedly no such credit in the

United States. Hence, according to her, "their payment is not under similar circumstances" and should not therefore be entitled to the "most favored nation clause".

The above-cited argument is not of first impression. In fact, such argument was already raised in a Motion for Reconsideration filed by the same Respondent in the above-cited IBM case, supra, and has been accordingly resolved by this Court in a Resolution dated July 21, 1993, thus:

> It is claimed by the respondent that this Court erred in granting the refund since "petitioner is not entitled to the 'most favored tax rate' on royalties." (Motion, C.T.A. Records, p.345)
>
> The applicable provision of the R.P.-U.S. Tax Treaty provides:
>
> > "Art. 13(2)(b)(iii). xxx (T)he tax imposed by that other Contracting State shall not exceed the lowest rate of Philippine tax that may be imposed on royalties of the same kind <u>paid under similar circumstances</u> to a resident of a third state." (Underscoring supplied)
>
> Respondent advanced his argument on the premise that the R.P.-Germany Tax Treaty, which provides for a 10% tax on royalties, does not apply in the case under consideration. He argued that:
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> > "Under the xxx provisions of the German Tax Treaty, there is a 'matching credit' in Germany of 15% and 20%. A perusal of Article 23

(Relief from Double Taxation of the R.P.-U.S. Tax Treaty), there is no such tax credit so that the IBM WORLD TRADE CORPORATION AND INTERNATIONAL BUSINESS MACHINES CORPORATION are not entitled to the 'most favored nation' tax rate on royalties (10%) because their payment of the tax is not under similar circumstances i.e., there is 'matching credit' in Germany (20% for royalties), while there is no such credit in the U.S. xxx.) (Motion, C.T.A. Records, p.348)

Quoted below is the pertinent provisions of the R.P.-Germany Tax Treaty which reads:

"Article 24

Relief from Double Taxation

1. Tax shall be determined in the case of a resident of the Federal Republic of Germany as follows:

xxx xxx xxx

b) Subject to the provisions of German tax law regarding credit for foreign tax, there shall be allowed as a credit against German income and corporation tax payable in respect of the following items of income arising in the Republic of the Philippines, the tax paid under the laws of the Philippines and in accordance with this Agreement on:

xxx xxx xxx

dd) royalties, as defined in paragraph 3 of Article 12;

xxx xxx xxx

c) For the purpose of credit referred to in subparagraph (b), the Philippine tax shall be deemed to be xxx xxx xxx

> cc) in the case of royalties for which the tax is reduced to 10 or 15 per cent according to paragraph 2 of Article 12, 20 per cent of the gross amount of such royalties."

To settle once and for all the legal issue involved in this case, this Court deems it wise to decide on the proper interpretation of the phrase "paid under similar circumstances". Does the phrase refer to tax paid as claimed by respondent or does it refer to royalties paid as advanced by petitioner?

A cursory perusal of the provision makes this Court to agree with the petitioner's interpretation. The phrase "paid under similar circumstances" is followed by the phrase "to a resident of a third state". It is clear that what is paid to a resident of a third state is royalty and not tax.

Petitioner succinctly put in its "Opposition to Motion for Reconsideration" that:

"Respondent is in effect amending the provision of the R.P.-U.S. tax treaty. Article 13(2)(b)(iii) speaks of 'royalties of the same kind paid under similar circumstances to a resident of third state'. Nowhere does it speak, whether express or implied, of tax paid under similar circumstances. Respondent is reading into the R.P.-U.S. tax treaty something that is clearly not there.

> The requirement of 'similar circumstances' is in relation to the payment of royalty, not payment of the tax. Thus, for instance, the royalty in question paid to a U.S. resident by petitioner (which is neither BOI-registered enterprise nor engaged in a preferred-pioneer activity) is not paid under similar

> circumstances as a royalty paid to an Austrian resident by a Philippine company that is BOI-registered and engaged in a preferred-pioneer activity. Also, a royalty paid to a resident of Denmark or Sweden in respect of motion picture films and tapes is not paid under similar circumstances as the royalty herein paid by petitioner to its U.S. licensors. Clearly, the phrase 'similar circumstances' is used in reference to the payment of the royalty, and not in reference to the payment of tax." (Opposition, C.T.A. Records, pp. 363-364)
>
> **IN VIEW OF THE FOREGOING, THIS COURT HEREBY** resolves to DENY the respondent's "Motion for Reconsideration", for lack of merit.

The Entry of Judgment on said case was issued on December 15, 1993 after the Court of Appeals granted petitioner's (herein respondent) withdrawal of the case. (**Commissioner of Internal Revenue vs. IBM Philippines, Inc.**, C.A. G.R.-SP No. 31791)

We do not intend to depart from the wisdom of the said rulings and thus, the same should be applied in the case at bar.

Prescinding from the above discussions, records of the case reveal that petitioner indeed overpaid its payment on royalties in the amount of P372,884.70 (Exh. F) and thus, should be entitled to the refund of said amount.

WHEREFORE, in all the foregoing, respondent is hereby **ORDERED** to **ISSUE** a **TAX CREDIT CERTIFICATE** in the amount of P372,884.70 in favor of the petitioner.

SO ORDERED.

RAMON O. DE VEYRA
Associate Judge

WE CONCUR:

ERNESTO D. ACOSTA
Presiding Judge

MANUEL K. GRUBA
Associate Judge

CERTIFICATION

I hereby certify that this decision was reached after due consultation among the members of the Court of Tax Appeals in accordance with Section 13 Article VIII of the Constitution.

ERNESTO D. ACOSTA
Presiding Judge
Court of Tax Appeals