REPUBLIC OF THE PHILIPPINES
Court of Tax Appeals
QUEZON CITY

EN BANC

UNITED AIRLINES, INC., *Petitioner,*	**C.T.A. EB NO. 297** **(C.T.A. CASE NO. 6641)**
	Present:
-versus-	ACOSTA, Presiding Justice, CASTAÑEDA, JR., BAUTISTA, UY, CASANOVA, and PALANCA-ENRIQUEZ, JJ.
COMMISSIONER OF INTERNAL REVENUE, *Respondent.*	**Promulgated:** JAN 15 2008

x --- x

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 United Airlines, Inc. (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 *Revised Rules of Court*, which seeks the reversal of the Decision dated February 22, 2007 and Resolution dated June 26, 2007 rendered by the First Division of this Court in C.T.A. Case No. 6641. The respective dispositive portions of the Decision and Resolution read as follows:

> "**WHEREFORE,** premises considered, the Petition for Review is hereby **DENIED.**
>
> **SO ORDERED.**"
>
> "**WHEREFORE,** finding no cogent reason to reverse or set aside the assailed Decision, the instant Motion is hereby **DENIED** for lack of merit.
>
> **SO ORDERED.**"

THE FACTS

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

Petitioner is a foreign corporation organized and existing under the laws of the State of Delaware, United States of America. It is licensed to establish and operate a branch in the Philippines and to "open an office as an off-line carrier" under Securities and Exchange Commission (hereafter "SEC") License No. 1094, dated June 7, 1984.

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 she may be served with summons and other legal processes.

On June 2, 1986, the said SEC License of petitioner was amended, allowing it to act as an "on-line carrier of persons, property and mail between the United States and the Philippines". In its letter on January 23, 1998, petitioner informed the Civil Aeronautics Board (hereafter "CAB") that it will discontinue its passenger flights to and from Manila after February 20, 1998, but will continue its freighter (cargo) flights three times a week from Osaka and the US, as previously approved by the CAB.

Thereafter, on April 1, 1998 petitioner appointed a general sales agent in the Philippines, the Aerotel Limited Corporation, which was renewed on April 1, 2000 and May 1, 2000. Its functions include solicitation, promotion and sale of petitioner's air passenger and cargo transportation services.

Petitioner allegedly continued to pay tax at the reduced rate of 1½%, pursuant to *Article 9 (1)* of the *Convention Between the Government of the Republic of the Philippines and the Government of the United States of America with Respect to Income Taxes* (hereafter "RP-US Tax Treaty") on revenues from tickets/passage documents sold in the Philippines covering passenger/cargo flights originating outside of the Philippines despite its allegation that it ceased its passenger and cargo flights to and from the Philippines effective February 21, 1998 and January 31, 2001.

Thereafter, petitioner filed, through its general sales agent, its Quarterly and Annual Income Tax Returns and paid the corresponding income taxes during taxable years 2000 and 2001. A Gross Philippine Billing (hereafter "GPB") amounting to P1,365,067,866.43 with related 1.5% GPB tax due of P20,476,018.00, was reflected in its 2000 Annual Income Tax Return filed on April 6, 2001. In the same manner, in its 2001 Annual Income Tax Return filed on February 22, 2002, petitioner declared a GPB amounting to P390,560,599.68, with related 1.5% GPB tax due of P5,858,409.00.

On April 12, 2002, petitioner filed an administrative claim for refund with the Bureau of Internal Revenue (hereafter "BIR") for the recovery of the amount of P15,916,680.69, representing erroneously paid tax on Gross Philippine Billings for the taxable years 1999 to 2001, pursuant to *Section 28 (A) (3) (a) of the NIRC of 1997, as amended,* in relation to *Article 4 (7) of the RP-US Tax Treaty.*

Respondent failed to act on petitioner's administrative refund, hence, on April 4, 2003 petitioner filed a Petition for Review before this Court, docketed as C.T.A. Case No. 6641, with respect to the refund for taxable years 2000 and 2001.

After trial on the merits, on February 22, 2007 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 June 26, 2007.

On August 3, 2007, petitioner filed the instant Petition for Review before the Court *En Banc*.

On September 4, 2007, without necessarily giving due course to the petition, We required respondent to file her comment on the petition, within ten (10) days from notice.

On September 14, 2007, respondent filed her Comment.

Hence, the petition is now deemed submitted for decision.

ISSUES

The following are the grounds relied upon by petitioner in support of its petition:

I

THE FIRST DIVISION OF THE HONORABLE COURT ERRED IN HOLDING THAT PETITIONER IS SUBJECT TO THE REGULAR CORPORATE INCOME TAX, UNDER SECTION 28 (A) (1) OF THE NATIONAL INTERNAL REVENUE CODE ("NIRC").

II

THE FIRST DIVISION OF THE HONORABLE COURT ERRED IN RULING THAT PETITIONER IS NOT ENTITLED TO REFUND OF INCOME TAX PAID ON PASSENGER REVENUE FOR THE TAXABLE YEAR 2000 AND PASSENGER AND CARGO REVENUE FOR THE TAXABLE YEAR 2001 ON THE GROUND THAT PETITIONER IS SUBJECT TO THE REGULAR CORPORATE INCOME TAX UNDER SECTION 28 (A)(1) OF THE NIRC. IN SO RULING, THE HONORABLE COURT EFFECTIVELY OFFSET ONE TAX LIABILITY AGAINST ANOTHER, CONTRARY TO THE WELL-SETTLED RULE THAT

OFFSETTING OF TAX LIABILITIES IS NOT ALLOWED.

III

THE FIRST DIVISION OF THE HONORABLE COURT ACTED OUTSIDE ITS JURISDICTION WHEN IT DENIED THE CLAIM FOR REFUND ON THE GROUND THAT PETITIONER IS LIABLE TO THE 32% CORPORATE INCOME TAX BUT REDUCED TO 1 1/12% UNDER THE RP-US TAX TREATY, ON SALE OF PASSAGE DOCUMENTS HERE IN THE PHILIPPINES FOR TAXABLE YEARS 2000 AND 2001. IN SO DOING, THE HONORABLE COURT EFFECTIVELY ASSESSED PETITIONER FOR DEFICIENCY INCOME TAX FOR TAXABLE YEARS 2000 AND 2001, BEYOND THE PERIOD ALLOWED BY LAW FOR MAKING SUCH ASSESSMENTS.

IV

THE FIRST DIVISION OF THE HONORABLE COURT ERRED IN RULING THAT DISCREPANCIES BETWEEN PETITIONER'S REPORTED REVENUES AND SUMMARY OF GROSS REVENUES PER CARGO MANIFEST REDUCED THE ALLOWABLE REFUNDABLE AMOUNT OF ERRONEOUSLY PAID GPB TAX ON PASSENGER REVENUES FOR TAX YEAR 2000 TO ONLY PHP2,565,640.58.

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.

<u>THE COURT *EN BANC'S* RULING</u>

The petition is bereft of merit.

There is nothing novel in this case, as the issues raised herein had, in a catena of cases, been previously ruled by the Supreme Court in the affirmative.

At the outset, We adhere to the findings of the First Division that petitioner cannot be made liable to pay the income tax on Gross Philippine Billings since its carriage of persons, excess baggage, cargo and mail does not originate from the Philippines in a continuous and uninterrupted flight.

Nevertheless, considering the nature of its business being duly licensed to engage in trade or business in the Philippines as an off-line carrier and appointing a General Sales Agent to manage its passenger and cargo services in the country, petitioner is still liable for payment of its income taxes as a resident foreign corporation doing business in the Philippines, pursuant to the following decisions of the Supreme Court.

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 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, adopting the same ruling, 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:

xxx xxx."

In the recent case of *Commissioner of Internal Revenue vs. Baier-Nickel (500 SCRA 87)*, the Supreme Court citing the case of *Commissioner of Internal Revenue vs. British Airways Corporation,* again applied the ruling, as follows:

"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-xxx xxx."

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. 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).*

Considering, therefore, that petitioner is a resident foreign corporation doing business in the Philippines, pursuant to the aforequoted decisions of the Supreme Court, it shall be subject to an income tax equivalent to 32% of the taxable income derived from its sale of tickets here in the Philippines. Having received income while engaged in business and utilizing the resources available to it within the Philippines, and considering that it is not a tax exempt corporation, petitioner cannot claim that it is not liable to the regular income tax of 32% of its taxable income here. It cannot escape tax liability from the clear provisions of the law. However, in view of the existence of the RP-US Tax Treaty, the applicable tax rate is reduced to 1½% of its gross revenues.

As aptly ruled by the First Division:

> "Thus, while petitioner, as a resident foreign corporation engaged in trade or business in the Philippines, is not liable to pay tax on its Gross Philippine Billings as provided in Section 28 (A) (3) (a) of the Tax Code, it is nonetheless liable to pay corporate income tax on its taxable income derived from its sale of passage documents here in the Philippines.
>
> Generally, under Section 28 (A) (1) of the 1997 Tax Code, 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 the United States, petitioner is liable only to 1 1/2% tax of its gross revenues derived from sources within the Philippines arising from the "operation of ships in international traffic" as provided in Article 9 (1) (A) of the RP-US Tax Treaty, viz:
>
> 'ARTICLE 9
> SHIPPING AND AIR TRANSPORT
>
> 1) 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 both Contracting States; however, the tax imposed by the other Contracting State may be as much as, but shall not exceed, the lesser of —
>
> a) one and one-half per cent of the gross revenues derived from sources in that State; and
>
> b) the lowest rate of Philippine tax that may be imposed on profit of the same kind under similar circumstances by a resident of a third State.
>
> xxx xxx'

Based on the foregoing, 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 restraint on the tax that may be collected by the state of source. The restraint here being, instead of holding petitioner liable to pay corporate income tax at the rate of 32%, it is liable only to the extent of 1 1/2% of the gross revenues derived from sources in this State. This is due to the fact that a closer look at the RP-US Tax Treaty shows that the tax rates fixed by Article 9 are the maximum rates as reflected in the phrase 'shall not exceed, the lesser of xxx'. This means that any tax imposable by the contracting states concerned, with respect only to the operation of ships or air transport in international traffic, should not exceed the 1 1/2% limitation and that said rate would apply only if the tax imposed by our laws exceed the same.

Simply put, profits derived by a resident of one of the Contracting States from operation of ships/air transport in international traffic shall be taxable at the rate of whatever is lesser between 1 1/2% of the gross revenues and the lowest rate of the Philippine tax on profits of the same kind by a resident of a third State.

It is important to note that the RP-US Tax Treaty does not mention of Gross Philippine Billings but of whatever

> profits derived by a resident of one of the Contracting States from sources within the other Contracting States. And as already discussed above, 'gross income' includes gains, profits and income derived from whatever source. In the present case, the activity that produced income, i.e., 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 easily falls under the phrase 'sources within the other Contracting State from the operation of ships in international traffic'.
>
> The RP-US Tax Treaty is just one of a number of bilateral treaties which the Philippines has entered into for the avoidance of double taxation. The purpose of these international agreements is 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 apparent 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."

To reiterate, petitioner is not liable to pay tax on Gross Philippine Billings under *Section 28 (A)(3)(a) of the NIRC of 1997, as amended.* However, it is still liable for income tax on the profits it derived from

W

sources within the Philippines at the rate of 1½%, pursuant to *Article 9* of the RP-US Tax Treaty. Taking into account 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 9 of the RP-US Tax Treaty* and the excess thereof, if any, should be refunded to petitioner.

We cannot sustain petitioner's argument that the First Division made an assessment against it. What the First Division did was only to determine whether the petitioner, on the basis of the evidence presented, was entitled to its claimed refund. In the process, the Court had to determine the nature and character of petitioner's business and the taxes which it has paid, and by necessity, to determine whether the taxes paid are correct. The First Division did not issue an assessment, but only limited its findings on the merit of the claim for refund.

Neither is there merit in petitioner's contention that there was an off-setting of tax liabilities. The rule is that internal revenue taxes cannot be the subject of set-off or compensation for the reason that the government and taxpayer are not mutually "creditors and debtors of each other" under *Article 1278* of the *New Civil Code*, since a claim for taxes is not such a debt, demand, contract or judgment which is allowed to be set-off. In the instances where the Supreme Court allowed legal compensation or set-off of taxes, such taxes were already due and demandable, thus compensation under *Article 1279* of the *New Civil Code*, took place by operation of law.

Pursuant to settled law and jurisprudence and finding no reversible error in the assailed Decision dated February 22, 2007 and Resolution dated June 26, 2007, We affirmed the First Division.

WHEREFORE, premises considered, the instant petition is hereby **DENIED DUE COURSE**, and accordingly, **DISMISSED** for lack of merit.

SO ORDERED.

OLGA PALANCA-ENRIQUEZ
Associate Justice

WE CONCUR:

ERNESTO D. ACOSTA
Presiding Justice

Inhibited
Juanito C. Castañeda, Jr.
JUANITO C. CASTANEDA, 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