REPUBLIC OF THE PHILIPPINES
Court Of Tax Appeals
QUEZON CITY

SECOND DIVISION

HEUNG-A SHIPPING CO., represented by WALLEM PHILIPPINES SHIPPING, INC.,
Petitioner,

-versus-

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

C.T.A. CASE NO. 6672

Members:

CASTAÑEDA, JR., Chairman
UY, and
PALANCA-ENRIQUEZ, JJ.

Promulgated:

OCT 28 2005

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DECISION

PALANCA-ENRIQUEZ, J.:

THE CASE

This is a Petition For Review filed on April 15, 2003 by Heung-A Shipping Co., represented by Wallem Philippines Shipping, Inc. (hereafter "petitioner"), which seeks the refund or the issuance of a tax credit certificate in the aggregate amount of P3,260,198.69 representing erroneously paid income taxes on Gross Philippine Billings covering the taxable years 2000, 2001 and 2002.

240

THE FACTS

In their "Joint Stipulation of Facts and Issues", the parties stipulated as follows:

"1.0 Respondent is the Commissioner of the Bureau of Internal Revenue, vested with the power to decide, approve, and grant refunds or tax credits of overpaid internal revenue taxes as provided by law, and holds office and may be served with summons, orders, pleadings, and other processes at the BIR National Office, BIR Building, Agham Road, Diliman, Quezon City;

2.0 Article 8 (3) of the '*Convention between the Government of the Republic of South Korea for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income*' (hereinafter referred to as the '*RP-Korea Treaty*') provides:

'**Article 8**

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3. 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 the lesser of:

241

a) one and one-half percent of the gross revenues derived from sources in that State; and

b) the lowest rate of Philippine tax that may be imposed on profits of the same kind derived under similar circumstances by a resident of third State.'

3.0 Soon after the execution of the RP-Korea Tax Treaty the Philippine government signed the '*The Agreement Between the Government of the Republic of the Philippines and the Government of the Republic of Cyprus on Merchant Shipping dated September 7, 1984, which entered into force on June 6, 1985*, providing as follows:

'Article 12

'(1) Profits from the operation of shipping enterprise, registered under the laws and regulations of either of the Contracting Parties, in international traffic, including profits derived from its participation in a pool, a joint business or in an international operation agency, shall be taxable only in the Contracting Party where the registered office of the enterprise is situated.'

4.0 On April 14, 2003, Petitioner filed an administrative claim for refund on behalf of Heung-A Shipping Co. in the aggregate amount of Three Million Two Hundred Sixty Thousand One Hundred Ninety Eight and 69/100 Pesos (P3,260,198.69) which to date remains pending with the International Tax Affairs Division (ITAD) of the Bureau of International Revenue-Main Building." aul

242

From the above stipulated facts, the following facts appear undisputed:

Petitioner Heung-A Shipping Co. is a foreign corporation duly organized and existing under the laws of South Korea. It is engaged in business as an international shipping carrier and represented in the Philippines by its duly designated shipping agent, Wallem Philippines Shipping, Inc. (hereafter "Wallem"), a domestic corporation.

Generally, international carriers are subject to Philippine income tax at the rate of 2 ½% on their Gross Philippine Billings, pursuant to *Section 28(A)(3) of the National Internal Revenue Code (hereafter "NIRC") of 1997, as amended.* However, in conformity with the *RP-South Korea Tax Treaty* petitioner enjoys a preferential tax rate of 1 ½ % of its Gross Philippine Billings, instead of the standard 2½% tax rate. The *RP-South Korea Tax Treaty*, in pertinent part, provides as follows:

"**RP-South Korea Tax Treaty**

"**Article 8**
Shipping and Air Transport

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3. Notwithstanding the provisions of paragraph 1, profits from sources within the Contracting State derived by

243

> 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 the lesser of:
>
> > a.) **one and one-half percent of the gross revenues derived from sources in that State**; and
> >
> > b.) 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." *(Emphasis supplied)*

Thus, prior to the instant claim for refund, Wallem, believing that the income payment falls under the above *Article 8, Section 3(a)*, withheld 1 ½ % tax rate on the Gross Philippine Billings from its remittances to petitioner Heung-A.

In his Answer, respondent alleged by way of special and affirmative defenses:

> "5. He reiterates and repleads the preceding paragraph of this answer as part of his Special and Affirmative Defenses;
>
> 6. Petitioner's alleged claim for refund is subject to administrative routinary investigation/examination by the Bureau;
>
> 7. The amount of P3,260,198.69 being claimed by petitioner as alleged erroneously collected income taxes on Gross Philippine Billings for the taxable

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244

years 2000, 2001 & 2002 was not properly documented;

8. In an action for refund, the burden of proof is on the taxpayer to establish its right to refund, and failure to sustain the burden is fatal to the claim for refund/credit;

9. Petitioner must show that it has complied with the provisions of Sections 204 (C) and 229 of the Tax Code on the prescriptive period for claiming tax refund/credit; and

10. Claims for refund are construed strictly against the claimant for the same partake the nature of exemption from taxation (*Commissioner of Internal Revenue vs Ledesma, 31 SCRA 95)* and as such, they are looked upon with disfavor *(Western Minolco Corp. vs Commissioner of Internal Revenue, 124 SCRA 1211).*"

Petitioner presented Ma. Catherine Ragamit and Dennis Fajardo, as witnesses, and submitted documentary evidence, marked as *Exhibits "A'* to *"TT"*, including their respective submarkings.

On the other hand, respondent submitted the case for decision, without presenting any evidence.

Thereafter, both parties were ordered to file their respective memoranda, within thirty (30) days. Both parties having complied thereto, the case was deemed submitted for decision on July 11, 2005.

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245

ISSUES

As stipulated upon by the parties, the following are the issues for the consideration of this Court:

I

> Whether or not petitioner erroneously paid income taxes on the Gross Philippine Billings of Heung-A Shipping Co. in the amount of Three Million Two Hundred Sixty Thousand One Hundred Ninety Eight and 69/100 Pesos (P3,260,198.69).

II

> Whether or not the petitioner has factual and legal basis to be refunded the above amount of erroneously paid taxes.

The two issues raised by both parties boil down to the principal issue of whether petitioner, a Korean corporation, is entitled to the "most favored nation clause" under *Article 8(3)(b) of the RP-South Korea Tax Treaty,* in relation to *Article 12(1) of the RP-Cyprus Shipping Agreement.*

THE RULING OF THE COURT

We deny the petition.

Basis of Petitioner's Claim For Refund

Petitioner argues that it had erroneously and improperly paid its income taxes on the Gross Philippine Billings at 1½ % tax rate, invoking the provision of the "most favored nation clause" under *Article 8, Section 3 (b) of the RP-South Korea Tax Treaty* which states that the Philippine income tax so charged shall not exceed 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." According to petitioner, the residents of the Republic of Cyprus are exempt from the payment of Philippine income taxes under *Article 12 (1) of the "Agreement between the Government of the Republic of the Philippines and the Government of the Republic of Cyprus on Merchant Shipping"*, which provides as follows:

> "Article 12
>
> (1) Profits from the operation of shipping enterprise, registered under the laws and regulations of either of the Contracting Parties, in international traffic, including profits derived from its participation in a pool, a joint business or in an international operation agency, shall be taxable only in the Contracting Party where the registered office of the enterprise is situated." (*Original Docket of C.T.A Case No. 6672, p. 144*)

Therefore, pursuant to the "most favored nation clause" as found in *Article 8, Section 3(b)* of the *RP-South Korea Tax Treaty*, petitioner claims that the profits from its shipping operation in the Philippines

247

should not also be taxable, an exemption clearly enjoyed by the residents of the Republic of Cyprus.

Respondent's Counter-Arguments

On the other hand, respondent counter-argues that the *Philippines-Cyprus Shipping Agreement* is valid and binding only with respect to the provisions not related to tax exemption. In other words, *Article 12 (1)* of the Agreement, which provides for source-state exemption of profits from operation of ships in international traffic, does not have a legal and binding effect on the Philippine government for lack of legislative concurrence. He submits that pursuant to *Section 28(4) of Article VI of the 1987 Philippine Constitution*, "no law granting any tax exemption shall be passed without the concurrence of a majority of all the Members of the Congress." He further asseverates that the Philippine-Cyprus Shipping Agreement is not an international treaty or agreement in the name of national welfare, in view of the fact that *Section 15 of Article XIV of the 1973 Philippine Constitution* specifically provides that international treaties and agreements in the name of national welfare and interest refer only to those treaties and agreements entered into for the purpose of implementing the pertinent provisions on national economy

248

and patrimony, under *Sections 1 to 14 of Article XIV of the 1973 Philippine Constitution.* And a perusal of the aforementioned sections reveals nothing about the grant of tax exemptions as being the duty or the prerogative of the Prime Minister that maybe pursued in the name of national welfare and interest. Therefore, according to respondent, said agreement requires the required legislative concurrence in order for *Article 12 (1)* thereof to have legal and binding effect on the Philippine government.

In applying the doctrine or principle of the "most favored nation clause", the Supreme Court in the case of *Commissioner of Internal Revenue vs. S.C. Johnson & Son, Inc., 309 SCRA 100*, laid down the condition precedent for the entitlement of the "most favored nation clause" and ruled as follows:

> "As stated earlier, the ultimate reason for avoiding double taxation is to encourage foreign investors to invest in the Philippines – a crucial economic goal for developing countries. The goal of double taxation conventions would be thwarted if such treaties did not provide for effective measures to minimize, if not completely eliminate, the tax burden laid upon the income or capital of the investor. Thus, if the rates of tax are lowered by the state of source, in this case, by the Philippines, there should be a concomitant commitment on the part of the state of residence to grant some form of tax relief, whether this be in the form of a tax

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249

credit or exemption. Otherwise, the tax which could have been collected by the Philippine government will simply be collected by another state, defeating the object of the tax treaty since the tax burden imposed upon the investor would remain unrelieved. If the state of residence does not grant some form of tax relief to the investor, no benefit would redound to the Philippines, *i.e.,* increased investment resulting from a favorable tax regime, should it impose a lower tax rate on the royalty earnings of the investor, and it would be better to impose the regular rate rather than lose much-needed revenues to another country.

At the same time, the intention behind the adoption of the provision on 'relief from double taxation' in the two tax treaties in question should be considered in light of the purpose behind the most favored nation clause.

The purpose of a most favored nation clause is to grant to the contracting party treatment not less favorable than that which has been or may be granted to the 'most favored' among other countries. The most favored nation clause is intended to establish the principle of equality of international treatment by providing that the citizens or subjects of the contracting nations may enjoy the privileges accorded by either party to those of the most favored nation. The essence of the principle is to allow the taxpayer in one state to avail of more liberal provisions granted in another tax treaty to which the country of residence of such taxpayer is also a party provided that the subject matter of taxation, in this case royalty income, is the same as that in the tax treaty under which the taxpayer is liable. Both Article 13 of the RP-US Tax Treaty and Article 12 (2) (b) of the RP-West Germany Tax Treaty, above-quoted, speaks of tax on royalties for the use of trademark, patent, and technology. The entitlement of the 10% rate by U.S. firms despite the absence of a matching credit (20% for royalties) would derogate from the design behind the most favored nation

250

> clause to grant equality of international treatment since the tax burden laid upon the income of the investor is not the same in the two countries. The similarity in the circumstances of payment of taxes is a condition for the enjoyment of most favored nation treatment precisely to underscore the need for equality of treatment.
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> We accordingly agree with petitioner that since the RP-US Tax Treaty does not give a matching tax credit of 20 percent for the taxes paid to the Philippines on royalties as allowed under the RP-West Germany Tax Treaty, private respondent cannot be deemed entitled to the 10 percent rate granted under the latter treaty for the reason that there is no payment of taxes on royalties under similar circumstances."

In the aforecited case, the Supreme Court interpreted the phrase "paid under similar circumstances" under the most favored nation clause of the *RP-US Tax Treaty* as referring to the payment of taxes and not royalties. The Supreme Court did not allow the application of the lower rate of 10% under the *RP-Germany Tax Treaty* for royalties paid to US residents because the *RP-US Tax Treaty* contains no "matching credit" provision similar to that found in *Article 24 of the RP-Germany Tax Treaty*.

Pursuant to the above ruling of the Supreme Court, for the taxpayer in one state to avail of more liberal provisions granted in another tax treaty to which the country of residence of such taxpayer is also a party, it

251

is a condition precedent that the subject matter is the same as that in the tax treaty under which the taxpayer is liable.

A resolution of this issue requires an examination and comparison of two agreements, the *RP-South Korea Tax Treaty* and the *RP-Cyprus Shipping Agreement.*

The RP-South Korea Tax Treaty

The *RP-South Korea Tax Treaty*, which was signed on February 21, 1984 and took effect on January 1, 1987, was entered into by the Republic of the Philippines and the Republic of South Korea for the purpose of concluding a Convention for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income (*Philippine Tax Treaties, 1998 ed., Ordoño, p. 324*).

Thus, in the case of *Commissioner of Internal Revenue vs. S.C. Johnson and Son, Inc., supra* (hereafter "Johnson case"), the Supreme Court has had the occasion to say:

> "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

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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.

Double taxation usually takes place when a person is resident of a contracting state and derives from, or owns capital in, the other contracting state and both states impose tax on that income or capital. In order to eliminate double taxation, a tax treaty resorts to several methods. First, it sets out the respective rights to tax of the state of source or situs and of the state of residence with regard to certain classes of income or capital. In some cases, an exclusive right to tax is conferred on one of the contracting states; however, for other items or income or capital, both states are given the right to tax, although the amount of tax that may be imposed by the state of source is limited."

The *RP-South-Korea Tax Treaty* evidently was executed by the parties for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income.

The RP-Cyprus Shipping Agreement

On the other hand, the *RP-Cyprus Shipping Agreement* is the Agreement between the Government of the Republic of the Philippines and the Government of the Republic of Cyprus on the field of merchant shipping. *Paragraph 1 of the Agreement* states:

> "The Government of the Republic of the Philippines, and the Government of the Republic of Cyprus hereinafter referred to as the "Contracting Parties",
>
> Desiring to strengthen the friendly relations between the two countries and to intensify their economic relations;
>
> Aiming to develop and promote cooperation between the Republic of the Philippines and the Republic of Cyprus in the field of merchant shipping on a mutually advantageous position in accordance with their respective needs and objectives for economic development;"
>
> Hence agreed as follows:
>
> "ARTICLE I
>
> The Contracting Parties agree to cooperate on the basis of equal rights, mutual benefit and the principle of freedom of merchant shipping in order to develop the relations between the Republic of the Philippines and the Republic of Cyprus in the field of merchant shipping." (*Original docket of C.T.A. Case No. 6672, p. 138*)

Pursuant to the above provision, the *RP-Cyprus Shipping Agreement* refers to the agreement entered into by the Philippines and the

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274

Republic of Cyprus for the purpose of strengthening and intensifying its friendly and economic relations. Likewise, the Agreement was executed to develop and promote cooperation between the Philippines and Cyprus in the field of merchant shipping, on a mutually advantageous basis in accordance with their respective needs and objectives for economic development.

A careful comparison, therefore, of the *RP-South Korea Tax Treaty* and the *RP-Cyprus Shipping Agreement* does not reveal any similarity on their subject matter. The *RP-South Korea Tax Treaty* is a treaty for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income, with provisions relating solely to tax liabilities and exemptions. On the other hand, the *RP-Cyprus Shipping Agreement* refers to provisions relating to the field of merchant shipping. The two (2) agreements have no similar provisions on taxation, nor on the manner or payment of any tax. In fact, the two international agreements pertain to two different issues and fields.

A cursory reading of the provisions of both international agreements would illustrate entirely different subject matters. Thus, *Article 8 of the RP-South Korea Tax Treaty* reads:

"Article 8
Shipping and air transport

1. Profits of an enterprise of a Contracting State from the operation of ships or aircraft in international traffic shall be taxable only in that State.

2. The provisions of paragraph 1 shall also apply to profits derived from the participation in a pool, a joint business or an international operating agency.

3. 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 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 profits of the same kind derived under similar circumstances by a resident of a third State." (*Philippine Tax Treaties, 1998 ed., Ordoño, p. 331*)

While *Article 12 of the RP-Cyprus Shipping Agreement* states:

"Article 12

(1) Profits from the operation of a shipping enterprise, registered under the laws and regulations of either of the Contracting Parties, in international traffic, including profits derived from its participation in a pool, a joint business or in an international operation agency, shall be taxable only in

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276

> the Contracting Party where the registered office of the enterprise is situated.
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> (2) Earnings of seamen or seafarers who are citizens of either Contracting Party shall be taxed in accordance with the national laws of the Contracting Parties." (*Original Docket of C.T.A. Case No. 6672, p. 144*)

From the aforequoted provisions of the two (2) agreements, it is clear that *Article 8* of the *RP-South Korea Tax Treaty* pertains to Shipping and Air Transport, while *Article 12 of the RP-Cyprus Shipping Agreement* pertains to Merchant Shipping. Hence, the condition precedent for the entitlement of the "most favored nation clause", as elucidated by the Supreme Court in the *Johnson case*, is absent in this case. Petitioner, therefore, cannot invoke the "most favored nation clause", and is therefore not entitled to tax exemption granted under the *RP-South Korea Tax Treaty*, in relation to the *RP-Cyprus Shipping Agreement.*

Laws Granting Tax Exemption are Construed
Stricticissimi Against the Taxpayer;
Liberally in Favor of the Taxing Authority.

The cardinal rule in taxation is laws granting tax exemption are construed *stricticissimi juris* against the taxpayer and liberally in favor of the taxing authority. The tax exemption cannot arise by mere implication

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257

and any doubt whether the exemption exists is strictly construed against the taxpayer in favor of the taxing authority.

The burden of proof is upon him who claims the exemption in his favor and he must be able to justify his claim by the clearest grant of organic or statute law (*Wonder Mechanical Engineering Corp. vs. CTA, 64 SCRA 555; Commissioner of Internal Revenue vs. S.C. Johnson & Son, Inc., supra*).

There being no factual and legal basis for petitioner's claim for a tax refund or credit, the Court is left with no recourse, but to dismiss the petition.

WHEREFORE, premises considered, the present Petition For Review is hereby **DISMISSED**.

SO ORDERED.

OLGA PALANCA-ENRIQUEZ
Associate Justice

WE CONCUR:

JUANITO C. CASTAÑEDA, JR.
Associate Justice

ERLINDA P. UY
Associate Justice

228

ATTESTATION

I attest that the conclusions in the above Decision were reached in consultation before the cases were assigned to the writer of the opinion of the Court's Division.

Juanito C. Castañeda, Jr.
JUANITO C. CASTAÑEDA, JR.
Associate Justice
Chairman, Second Division

CERTIFICATION

Pursuant to Article VIII, Section 13 of the Constitution, and the Division Chairman's Attestation, it is hereby certified that the conclusions in the above Decision were reached in consultation before the cases were assigned to the writer of the opinion of the Court's Division.

ERNESTO D. ACOSTA
Presiding Justice

279