REPUBLIC OF THE PHILIPPINES
COURT OF TAX APPEALS
QUEZON CITY

ARMCO-MARSTEEL ALLOY CORPORATION,
Petitioner,

- versus -

C.T.A. CASE NO. 5115

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Promulgated:
FEB 06 1996

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DECISION

This is a judicial claim for the refund of alleged overpaid withholding tax on royalties made by the petitioner from the period starting July of 1992 to October of 1993 in the amount of P769,579.68.

Petitioner is a domestic corporation organized and existing under and by virtue of the laws of the Philippines and is registered with the Board of Investments as a preferred pioneer enterprise engaged in the production and manufacture of grinding balls.

Under a Technical Aid Agreement, which was initially executed in 1972 and extended several times to cover the present claim for refund, ARMCO, Inc. a corporation duly organized under the laws of Ohio, USA, granted petitioner a non-exclusive license to manufacture and sell grinding balls using its trademark. In addition, ARMCO, Inc. (USA) in pursuance to such an agreement, shall provide technical assistance and know-how to petitioner which are essential in the continued manufacture and sale of its products.

In consideration of the licenses granted as well as the technical assistance it will receive under the agreement, petitioner agreed to pay ARMCO, Inc. royalty payments at the rate of two and one-half percent of its net sales of the licensed products. This agreement was registered with the Bureau of Patents, Trademarks and Technology Transfer evidenced by a certificate of registration dated November 9, 1992 (Exhibit "T").

The petition alleges that it paid 15% withholding tax on the royalty payments it remitted to its licensor, ARMCO, Inc. (USA) from the period beginning July, 1992 to October 1993 pursuant to Revenue Memorandum Circular No. 39-92 which provides that a 15% tax rate is imposed on royalty payments made by BOI-registered pioneer enterprise as the payments made to German and U.S. residents are not made "under similar circumstances". However, because of the decision rendered by this Court in the case entitled **IBM Philippines, Inc. vs. Commissioner of Internal Revenue,** CTA Case No. 4308, March 31, 1993, where we upheld the 10% tax rate instead of the 15% earlier imposed, petitioner filed a claim for refund/tax credit in the sum of P769,579.68 representing the difference between the 15% tax rate it had already withheld and the 10% rate that should have been paid.

This claim for refund which was dated December 6, 1993 and received by respondent on December 8, 1993 was not acted upon, hence petitioner filed a petition for review with this Court on June 1, 1994.

Respondent expressed its resistance to the claim by the following Special and Affirmative Defenses in her answer, thus:

SPECIAL AND AFFIRMATIVE DEFENSES

> 8. Petitioner's claim for refund of alleged overpaid withholding tax on royalty payments is still under investigation/ examination by the BIR;
>
> 9. Petitioner should be taxed at the rate of 25% withholding tax on royalties under Article 13(2)(b)(i) or 15% of the gross amount of royalties (Art. 13(2)(b)(ii) if petitioner is registered with the Philippine Board of Investments and engaged in preferred areas of activities and <u>not 10%</u> withholding tax on royalties in accordance with Article 12(2)(b) of the RP-West Germany Tax Treaty;
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> 10. Petitioner is not entitled to the most favored nation rate of 10% because under Article 13(2)(b)(iii) of the RP-US Tax Treaty said rate maybe availed on only <u>if paid under similar circumstances to a resident of a Third State</u>, thus:
>
> > "(iii) 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."

The "most favored nation: tax rate on royalties is 10% as provided in the RP-Germany Tax Treaty, quoted as follows:

> "2. However, such royalties may also be taxed in the contracting State in which they arise, and according to the law of that State, but the so charged shall not exceed:
>
> xxx xxx xxx
>
> "(b) 10 per cent of the gross amount of royalties arising from the use of, or the right to use, any patent, trade mark, design or model, plan, secret formula or process, or from the use of, or the right to use, industrial, commercial or scientific equipment, or for information concerning industrial, commercial or scientific experience" (Article 12, Section 2(b)."

However, in relation to the foregoing provisions, the said treaty further provides:

> "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

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

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. (underlining supplied)

From the foregoing provisions, it is evident that Article 13(2)(b)(iii) of the RP-US Tax Treaty is not applicable in this case. According to said Article, the tax imposable on royalties derived by a third State 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. Although Article 12(2)(b) of the RP-West Germany tax treaty imposes a lower rate of 10% royalties derived from sources within the Philippines, said rate cannot be availed of because the payment of such tax is not under similar credit granted by the United States.

11. Article 24 (Relief from Double Taxation of the RP-West Germany Tax Treaty) grants 20% for royalties whereas a perusal of Article 23 (Relief from Double Taxation of the RP-US Tax Treaty) shows no provision for such tax credit. Petitioner is, therefore, not entitled to the preferential rate of 10% on royalty remittance because their payment is not under similar circumstance;

12. Rulings previously issued by the respondent's Bureau allowing the availment of the benefits of the "most favored nation" clause on payments of royalties to recipients

in the United States have already been revoked effective January 21, 1992, under RMC No. 39-92 dated July 1, 1992;

13. The taxes sought to be refunded in this case was collected in accordance with law and applicable BIR Rulings and regulations;

14. The claim for tax refund, being in the nature of an exemption from taxation must be construed strictly against petitioner Insular Lumber Co. vs. Court of Tax Appeals, 104 SCRA 710 (1984).

The fate of the present petition depends entirely on the resolution of two issues, thus:

1) Whether or not the royalty payments remitted by petitioner to its licensor in the USA are subject to the 10% withholding tax;

2) Whether or not petitioner is entitled to the refund of P769,579.68 representing alleged overpaid withholding tax on royalties.

The foregoing issues are far from unique as they have been comprehensively passed upon in a number of cases decided by this Court, some of which are hereinbelow mentioned, thus:

1) Kimberly-Clark Corporation (USA) and Kimberly-Clark Philippines vs. Commissioner of Internal Revenue, CTA Case No. 4288, January 30, 1992;

2) General Electric Philippines Meter and Instrument Company vs. Commissioner of Internal Revenue, CTA Case No. 4158, December 5, 1991;

3) IBM Philippines, Inc. vs. Commissioner of Internal Revenue, CTA Case No. 4308, March 31, 1993; and the most recent,

4) Smith-Kline and French Overseas Company vs. Commissioner of Internal Revenue, CTA Case No. 5048, September 22, 1995.

In all of the cases aforecited, this Court subscribed to the view pronounced by the then Commissioner of Internal Revenue Bienvenido Tan, Jr. in BIR Ruling No. 456-88 to the effect 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 correct 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. This correct rate mentioned in the R.P.-U.S. Tax Treaty can be found under Article 12, paragraph 2(b) of the R.P.-West Germany Tax Treaty which 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 <u>shall not exceed 10% of the gross amount of royalties</u>. This treaty also provides that the 10% tax rate shall apply as long as the contract giving rise to such royalties has been approved by Philippine competent authorities.

In the instant case the agreements entered into between petitioner and ARMCO, Inc., USA is registered with the Technology Transfer Board of the Department of Trade and Industry (Exhibit "T") thus, it follows that by virtue of such approval, the royalties arising from such an agreement should be taxed at the rate of 10% and not 15% as opined by respondent.

To further seal its case against the claim for refund, respondent proposed the theory that the petitioner is not entitled to the most favored nation rate of 10% because said rate may be availed of only if paid under similar circumstances to a resident of a third state. This theory was a result of the correlation made by respondent between Article 13(1)(iii) of the R.P.-U.S. Tax Treaty with several provisions of the R.P.-West Germany Tax Treaty. Article B(1)(iii) of the R.P.-U.S. Tax Treaty provides the following:

> Article 13. xxx xxx xxx
>
> (1) xxx
>
> (iii) 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.

Under the provisions of the German Tax Treaty, there is a matching credit in Germany of 15% and 20% and that there is allegedly no such credit in the United States, thus the phrase "under similar circumstances" provided for in the aforequoted provision of the US Tax Treaty does not apply making the 10% rate not applicable in the instant case.

Again, the argument propounded by the respondent is not novel as such argument was already raised in a Motion for Reconsideration in the IBM case and duly disposed of in our 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:
>
>> "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.

As to the factual basis of petitioner's claim, We find that it has successfully established the amount sought to be refunded.

Petitioner formally offered the monthly remittance returns (Form No. 1743 W) covering the period July, 1992 to October, 1993 (Exhibits "A" tp "P", pages 60 to 75, CTA records). The amounts so verified are listed below, thus:

	Exhibit	Royalty Fee	Tax Withheld (15%)	Should Be (10%)	Overpayment
July, 1992	"A"	704,926.65	105,738.99	70,492.66	35,246.33
August	"B"	1,024,118.80	153,617.82	102,411.88	51,205.94
September	"C"	1,166,612.60	174,991.89	116,661.26	58,330.63
October	"D"	995,949.73	149,392.46	99,594.97	49,797.49
November	"E"	1,046,269.27	156,940.39	104,626.93	52,313.46
December	"F"	690,627.73	103,594.16	69,062.77	34,531.39
January, 1993	"G"	992,136.20	148,820.43	99,213.62	49,606.81

February	"H"	680,601.40	102,090.21	68,060.14	34,030.07
March	"I"	1,046,890.47	157,033.57	104,689.05	52,344.52
April	"J"	599,709.93	89,956.49	59,970.99	29,985.50
May	"K"	975,390.53	146,308.58	97,539.05	48,769.53
June	"L"	1,165,862.27	174,879.34	116,586.23	58,293.11
July	"M"	1,148,920.27	172,338.04	114,892.03	57,446.01
August	"N"	883,564.33	132,534.65	88,356.43	44,178.22
September	"O"	1,749,132.40	262,369.86	174,913.24	87,456.62
October	"P"	520,881.00	78,132.15	52,088.10	26,044.05
TOTAL		15,391,593.58	2,308,739.03	1,539,159.35	769,579.68

WHEREFORE, in view of the foregoing, respondent is hereby ordered to issue a TAX CREDIT CERTIFICATE in the amount of P769,579.68 in favor of petitioner.

SO ORDERED.

ERNESTO D. ACOSTA
Presiding Judge

WE CONCUR:

MANUEL K. GRUBA
Associate Judge

RAMON O. DE VEYRA
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