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CLARIFYING THE IMPLICATION OF ARTICLE 12(2)(B) ON ROYALTIES OF THE RP-CHINA TAX TREATY, IN RELATION TO ARTICLE 13(2)(B)(III), OTHERWISE KNOWN AS THE “MOST-FAVORED-NATION” CLAUSE...

REVENUE MEMORANDUM CIRCULAR NO. 46-2002, SEPTEMBER 2, 2002, September 02, 2002

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With the effectivity of the RP-China tax treaty on January 1, 2002, it is necessary to clarify the implication of its Article 12(2)(b) insofar as it provides that the tax charged shall not exceed ten per cent (10%) 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, in relation to Article 13(2)(b)(iii), also known as the "most-favored-nation" clause, of the RP-US tax treaty.

Article 13 of the RP-US tax treaty provides as follows:

"Article 13

> "ROYALTIES
>
> "1. Royalties derived by a resident of one of the Contracting States from sources within the other Contracting State may be taxed by both Contracting States.
>
> "2. However, the tax imposed by that other Contracting State shall not exceed —
>
> a) In the case of the United States, 15 percent of the gross amount of the royalties, and
>
> b) In the case of the Philippines, the least of:
>
> (i) 25 percent of the gross amount of the royalties,
>
> (ii) 15 percent of the gross amount of the royalties, where the royalties are paid by a corporation registered with the Philippine Board of Investments and engaged in preferred areas of activities, and
>
> (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.

3. The Term 'royalties' as used in this Article means payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work, including cinematographic films or films or tapes used for radio or television broadcasting, any patent, trade mark, design or model, plan, secret formula or process, or other like right or property, or for information concerning industrial, commercial or scientific experience. The term 'royalties' also Includes gains derived from the sale, exchange or other disposition of any such right or property which are contingent on the productivity, use, or disposition thereof.

"xxx xxx xxx"

Article 13(2)(b)(iii) of the RP-US tax treaty speaks of 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." This is known as the "most-favored-nation" clause of the RP-US tax treaty. The purpose of the "most-favored-nation" clause is to grant to the other Contracting State a tax treatment that is no less favorable than that which is granted to the "most favored" among other countries. Therefore, the tax treatment of royalty payments to a US entity must be taken in relation to other tax treaties what provide for a lower rate of tax on the same type of income.

In this regard, Article 12 of the RP-China tax treaty provides as follows:

"Article 12
"ROYALTIES

> "1. Royalties arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other State.
>
> "2. However, such royalties may also be taxed in the Contracting State in which they arise and according to the laws of that State, but if the recipient is the beneficial owner of the royalties, the tax so charged shall not exceed:
>
> a) 15 per cent of the gross amount of royalties arising from the use of, or the right to use, any copyright of literary, artistic or scientific work including cinematograph films or tapes for television or broadcasting, or
>
> 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.
>
> For as long as the transfer of technology, under Philippine law, is subject to approval, the limitation of the tax rate mentioned under (b) shall, in the case of royalties arising in the Republic of the Philippines, only apply if the contract giving rise to such royalties has been approved by the Philippine competes authorities.
>
> "3. The term 'royalties' as used in this Article means payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work including cinematography films, or films or tapes for radio or television broadcasting, any patent, trade mark, design or model, plan, secret formula or process, or for the use of, or the right to use, industrial, commercial, or scientific equipment, or for information concerning industrial, commercial or scientific experience.
>
> "xxx xxx xxx"

In the case of Commissioner of Internal Revenue vs. S.C. Johnson and Son., Inc. and Court of Appeals (G.R. No. 127105, June 25, 1999), 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 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.

On the other hand, the RP-China tax treaty does not contain a "matching credit" provision similar to that found in the RP-Germany tax treaty. Thus, the tax on royalty payments to residents of US and China can be considered paid under similar circumstances.

Article 23 of the RP-US tax treaty reads:

"Article 23
"RELIEF FROM DOUBLE TAXATION

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> "Double taxation of income shall be avoided in the following manner:
>
> "1. In accordance with the provisions and subject to the limitations of the law of the United States (as it may be amended from time to time without changing the general principle hereof), the United States shall allow to a citizen or resident of the United States as a credit against the United States tax the appropriate amount of taxes paid or accrued to the Philippines and, in the case of a United States corporation owning at least 10 percent of the voting stock of a Philippine corporation from which it receives dividends in any taxable year, shall allow credit for the appropriate amount of taxes paid or accrued to the Philippines by the Philippine corporation paying such dividends with respect to the profits out of which such dividends are paid. Such appropriate amount shall be based upon the amount of tax paid or accrued to the Philippines, but the credit shall not exceed the limitations (for the purpose of limiting the credit to the United States tax on income from sources within the Philippines or on income from sources outside the United States) provided by United States law or the taxable year x x x"

On the other hand, Article 23 of the RP-China tax treaty provides, viz:

"Article 23
"METHODS FOR THE ELIMINATION OF DOUBLE TAXATION

> "I, In China, double taxation shall be eliminated as follows:
>
> Where a resident of China derives income from the Philippines the amount of tax on that income payable in the Philippines in accordance with the provisions of this Agreement, may be credited against the Chinese tax imposed on that resident. The amount of the credit, however, shall not exceed the amount of the Chinese tax on that income computed in accordance with the taxation laws and regulations of China.
>
> "xxx xxx xxx"

Article 23 of the RP-US tax treaty and Article 23 of the RP-China tax treaty, though differently worded, plainly reveal a similarity in the provisions on relief from or avoidance of double taxation to their respective residents. Thus, the tax on royalty payments to residents of US and China are paid under similar circumstances, i.e., the amount of royalty income tax paid or accrued to the Philippines under the respective tax treaties is available as tax credit against the income tax payable in their respective countries. US residents may, therefore, invoke the preferential tax rate of 10% on royalties, accruing beginning January 1, 2002, arising in the Philippines "from the use of, or the right to use, any patent, trademark, design or model, plan, secret formula or process, x x x, or for information concerning industrial, commercial or scientific experience" under the RP-China tax treaty, pursuant to the "most-favored-nation" clause of the RP-US tax treaty.

It bears stressing, however, that there are two important requirements that should be complied with before the 10% rate of withholding tax on royalties remitted to a resident of US and China may be availed of, to wit:

1. It is necessary that there be an agreement or a contract whereby the royalties paid to the US must originate 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, or the right to use, industrial, commercial or scientific experience; and

2. For as long as the contract or agreement is subject to approval under Philippine law, the same must be duly approved by the Philippine competent authorities.

All internal revenue officers, employees and others concerned are enjoined to give this Circular the widest publicity possible.

Adopted: 2 Sept. 2002

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(SGD.) GUILLERMO L. PARAYNO, JR.
Commissioner of Internal Revenue

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