

GUIDELINES TO IMPLEMENT THE "MOST FAVORED NATION CLAUSE"; PROVIDED IN ARTICLE 13, 2(B) (III) OF THE PHILIPPINES-UNITED STATES TAX TREATY

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The undersigned's memorandum decision dated January 21, 1992 denied the claim of the IBM WORLD TRADE CORPORATION and INTERNATIONAL BUSINESS MACHINES CORPORATION for refund of alleged overpaid taxes on royalty income derived from the Philippines. As ruled, Article 13, 2 (b), (iii) of the Philippines-United States Tax Treaty, otherwise known as the "most favored nation" clause, shall not apply in the particular case. Pursuant to said clause, 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 (underscoring supplied). In correlation to this, Article 12, 2 (b) of the Philippines-Germany Tax Treaty explicitly states that royalties arising in the Philippines and paid to a resident of Germany may also be taxed in the Philippines, but the tax so charged shall not exceed 10% of the gross amount of said royalties. Furthermore, Article 24 (b), (dd) and (c) (cc) of the same treaty provides for Germany to allow a matching credit of 20% for royalties arising in the Philippines. Accordingly, a resident of a third State (in the particular IBM case, the United States) is not entitled to the most "favored nation" tax rate of 10% on royalty income derived from the Philippines because the payment of such tax is not under similar circumstances since there is a matching credit in Germany (20% for royalties), while there is no such similar credit granted by the United States.

In consonance therefore with the abovementioned ruling, hereunder are the guidelines in the treatment of cases relative to the application of the "most favored nation" tax rate on royalties paid to United States residents:

1. Rulings previously issued by the BIR allowing the availment of the benefits of the "most favored nation" clause on payments of royalties to recipients in the United States are revoked effective January 21, 1992 pursuant to the IBM memorandum decision. It is to be noted that this revocation is not given retroactive application because of the provisions of Section 246 of the Tax Code which prohibits such retroactive application if such will be prejudicial to the interest of the taxpayer. But beginning January 21, 1992, the tax liabilities which accrue or become payable on royalty payments shall be determined at the correct tax rate (either 15% if royalties are paid by corporations registered with the Board of Investments and engaged in preferred areas of activities or 25%, for all other cases) and paid under the conditions as provided for in the following paragraphs.
2. Taxpayers who have relied on such rulings, but are not the recipients of such rulings directly providing for the "most favored nation" tax rate of 10% on their royalty payments, and accordingly have failed to withhold the correct taxes on royalties paid to recipients in the United States are deemed to be deficient in their tax payments beginning from such date that they have started paying the incorrect amount of taxes of 10%. These taxpayers cannot claim that they have a vested right to such "most favored nation" tax treatment which cannot be given retroactive application. As such, these taxpayers are given not later than October 30, 1992 to amend their withholding tax returns and pay the corresponding taxes, without the penalties. This policy of leniency on the imposition of penalties is being pursued because of the confusion arising from the aforementioned errors in

interpretation. But after the lapse of the October 30 deadline, taxpayers who have not amended their returns will be assessed the additional amount of taxes with the corresponding penalties. The same conditions and procedures presented in this order shall apply to taxpayers whose rulings have been revoked effective January 21, 1992 pursuant to the preceding paragraph and who have not been able to pay the correct taxes thereafter.

3. The International Tax Affairs Division shall be responsible for monitoring compliance hereof and shall institute a verification program to identify taxpayers who have not paid the correct taxes on royalties paid to recipients in the United States. Taxpayers who will be paying before October 30, 1992 shall furnish a copy of the evidence of payment, including the withholding tax returns to the International Tax Affairs Division, not later than five (5) working days from date of payment.

4. Claims of taxpayers for tax credits/refunds bearing on this "most favored nation" issue and involving payments of royalties to United States residents and pending as of the date of this circular shall automatically be denied.

Adopted: 1 July 1992

(SGD.) JOSE U. ONG

Commissioner of Internal Revenue

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