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Tax sparing, alternative to treaty relief

THE requirement that availing of tax exemption or preferential tax rates provided under tax treaties must be preceded by an application for tax treaty relief is causing headaches to many taxpayers. The application process itself is already a deterrent to the enjoyment of tax treaty rates. The fact that there are many denied or partially denied applications for tax treaty relief on mere failure to observe procedural requirement is a testament to this.

Sadly, the Court of Tax Appeals had affirmed this requirement in a number of cases. Thus, this will be a continuing challenge unless the BIR itself stops or modifies its requirements. That may not happen soon. And the failure to enjoy lower tax rates clearly available under a tax treaty is sometimes a disincentive to cross border transactions.

If the recipient of income is not entitled to the benefits of tax treaty provisions, its income will be taxed in the Philippines in accordance with the National Internal Revenue Code. This means that the gross amount of income received from sources within the Philippines by the non-resident will, as a rule, be subject to 30-percent tax (other rates are applicable to some types of income and to individuals). This is substantially higher than the tax rates imposed under tax treaties—usually 25 percent, 20 percent, 15 percent, 10 percent or even exempt depending on the nature of the income and other peculiarities of the parties and the transaction.

With respect, however, to dividends received by a non-resident foreign corporation, our Tax Code imposes 15-percent tax if the country in which the foreign corporation is domiciled allows a credit against its taxes due taxes deemed to have been paid in the Philippines equivalent to 15 percent. The tax due of 30 percent which should otherwise be imposed on dividends could be reduced to 15 percent, subject to the condition that the country of residence of the recipient of the dividends allows a credit of 15 percent (representing the difference between the 30-percent regular tax and the 15-percent tax) against the tax due in its home country. This is referred to as the tax sparing provision.

In the case of Commissioner of Internal Revenue v. Wander Philippines Inc. (GR 68375, April 15, 1988), the Supreme Court ruled that if the home country (Switzerland) of the recipient of the dividend does not impose any tax on the dividends paid by a Philippine company, the condition is also deemed complied with. The fact that Switzerland does not impose any tax on the dividends received from the Philippines should be considered as full satisfaction of the condition.

Similarly, in GR 66838, December 2, 1991, the Supreme Court also upheld the application of 15-percent tax on dividend income paid to a resident of the United States. In that case, the Court emphasized that for the 15-percent tax rate to apply, our Tax Code does not require that the US must give a deemed paid tax credit for the dividend tax waived by the Philippines. The law only requires that the US shall allow a "deemed paid" tax credit in an amount equivalent to (at that time) 20 percentage points waived by the Philippines.

Tax on dividend is therefore entitled to a reduction to 15 percent if the country of residence of a corporate stockholder (a) allows a credit of 15-percent tax deemed to have been paid in the Philippines against the tax due on the dividends or (b) does not impose any tax on the dividends. Unlike the availment of the preferential treaty rate, which requires the application for tax treaty relief, no application for tax relief is required for the availment of the 15-percent tax under the Tax Code. This was the ruling of the Court of Tax Appeals in the CTA Case 7796, February 21, 2011.

Thus, if a taxpayer is denied the benefit of the preferential tax treaty rates, it may still avail of the 15-percent preferential tax rate under the Tax Code if its home country does not impose tax on the dividends received from the Philippines or allows as credit the 15-percent tax waived by the Philippine government. The BIR cannot automatically impose the 30-percent tax on dividends if no application for tax relief is made or if the application is denied. A reference should be made to the provision of the Tax Code, and if the condition for availing the of 15-percent tax is present, this rate should be applied.

Unfortunately, the tax sparing provision applies only to dividends. For other types of income, taxpayers are encouraged to comply with application procedures for tax treaty relief to avoid the denial of the benefits provided under tax treaties.

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