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Tax-treaty exposure

OUR President in his State of the Nation Address (Sona) boasted that investors once found doing business in the Philippines as too risky since our country's rules constantly change. He said that now, our country has a level playing field, and transparent and consistent rules.

I say, tell this to investors who are now faced with looming tax assessments because their applications for tax-treaty relief were denied not because they are not entitled to the same, but because a mere revenue memorandum order is being implemented as if it is a law.

Section III (2) of Revenue Memorandum Order (RMO) 1-00 of the BIR (Procedures for Processing Tax Treaty Relief Application) (RMO 1-2000) provides that an application filed at the International Tax Affairs Division (ITAD) must precede any availment of tax-treaty relief (exemption from income tax or reduction of tax) at least 15 days before the intended transaction or payment of income. RMO 72-10 introduced some changes but still require an application for tax-treaty relief before the taxable transaction.

The Court of Tax Appeals in *Mirant (Philippines) Operations Corp. v. Commissioner of Internal Revenue* (CTA Case 6382 dated June 7, 2005) used the foregoing RMO in ruling that a foreign corporation wishing to avail itself of the benefits of the tax treaty should invoke the provisions of the tax treaty and prove that indeed the provisions of the tax treaty applies to it, before the benefits may be extended to such corporation. This is to prevent any erroneous interpretation and/or application of the treaty provisions with which the Philippines is a signatory to. This decision was upheld by the Supreme Court in a minute Resolution (GR 168531) dated February 18, 2008.

This year alone, many rulings have been released by the ITAD that denied applications for tax-treaty relief on the ground that the applications were not filed 15 days before the intended transaction. What does this mean in quantifiable terms? It means that if a company pays P1 million royalty to its affiliate, it will only pay 15 percent (or other applicable tax-treaty rate) if the preferential tax-treaty rate is applied. Since the application for tax-treaty rate was denied, the company should have paid the full rate as provided in the Tax Code, i.e., 30 percent. This now becomes a tax exposure of the company and will balloon to unimaginable proportions if the company was already using the preferential rate when paying royalty, but has only filed its application for tax-treaty relief with ITAD, just yesterday. In other words, the company must brace for a tax assessment for the previous taxable years.

Companies which were issued BIR rulings, partly or wholly denying their tax treaty-relief applications, are now sitting ducks waiting to be roasted. But these companies must not worry since there are still defenses available to them. Among them is questioning whether a tax ruling is really necessary. Article 26 of the Vienna Convention provides that "Every treaty in force is binding upon the parties to it and must be performed by them in good faith." This is known as the principle of *pacta sunt servanda*, which preserves the sanctity of treaties and have been one of the most fundamental principles of positive international law.

Once a treaty is ratified, it becomes part of Philippine law. It must be in force and binding. Its implementation cannot be derailed by a mere RMO. A tax-treaty relief that is secured with the BIR must only be confirmatory rather than mandatory. To require a foreign corporation that wishes to invest in the Philippines or transacts with Filipino counterparts to apply for tax-treaty relief before it invokes the use of preferential tax-treaty rates is certainly not considered a "level playing field" with the practices of other countries.

On the part of companies who have yet to file applications for tax-treaty relief, they must be wary of the rulings that were issued by ITAD recently and must learn from them. They must watch out though, because contrary to what the President said, the government is full of surprises.

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