CONCLUSION

On the one hand our present laws sanction the survival of an employer's labor obligations in three instances: (1) where only the form of the business enterprise, and not the real identity of the owner, changes; (2) where the transaction between the predecessor and the successor is clothed with bad faith; and (3) where there is a merger or consolidation. The last instance, however, is yet to be confirmed by the Supreme Court through a construction of Sec. 80 of the Corporation Code.

On the other hand, a *bona fide* purchaser of a business is held not to be bound by the seller's labor law obligations which he has not expressly assumed. The basis of this rule is the principle of privity of contract.

In the United States, there has been a departure from the privity of contract rule in determining successor obligations. A new doctrine has evolved - the successorship doctrine - which not only takes into account American labor policy, but also allows for more flexibility in adjusting the conflicting interests of the new owner of a business and the employees of a predecessor. The Philippine legislature may be justified in following this lead considering the constitutional mandate for the promotion of the workers' interests.

The U.S. Supreme Court developed the successorship doctrine on two levels. In the first level, said court laid down the conditions under which a successor may be required to honor the labor commitments of his predecessor. In their totality, these conditions would show substantial continuity in the business across a change of ownership. In the second, the U.S. Supreme Court determined the labor obligations which may be imposed upon a successor. In making this determination, said court was guided by two consideration: (1) whether the imposition of a particular labor obligation would further national labor policy; and (2) whether a finding of successor liability would unduly hamper free transferability of assets. Applying these two criteria in the Philippine context, it has been found that a *bona fide* successor may equitably be required to observe the following duties to predecessor employees: (1) duty to hire; (2) duty to arbitrate the extent of a successor's obligations under an existing collective bargaining agreement; (3) duty to bargain with the union recognized or certified as the employees' bargaining representative during the predecessor's incumbency; and (4) duty to remedy a predecessor's unfair labor practices.

A REVIEW: TAXATION OF FOREIGN CORPORATIONS IN THE LIGHT OF SUPREME COURT DECISIONS

EUNEY MARIE J. MATA*

Foreign investments, as generated and channeled through foreign corporations, must necessarily be subject to the sovereign supervision and regulation by the host state. Among other means, the most cognizant and ubiquitous manifestation of this regulation is taxation. The power of taxation to effectively sustain or smother business viability cannot be belabored, thus, its effectivity as an instrument of regulation. Taxation of foreign corporations traces its rationale to the state's grant of the privilege and protection of corporate existence and right of doing business within the jurisdiction of the host state. It is axiomatic, therefore, that in order to effectively regulate foreign corporations, sound and strategic taxation policies be formulated and consistently applied to induce, not retard, the influx of foreign investments.

A spate of controversial rulings in the last decade has casted the Bureau of Internal Revenue (BIR) to be more inclined to tax first and find any legal basis later, particularly vis-a-vis foreign corporations. This taxation-happy posture by the revenue agency is no doubt buoyed by the judicial affirmation subsequently stamped on these controversial rulings, albeit, in the absence of any legal basis in our tax laws or jurisprudence.

The role of the Supreme Court in interpreting the tax provisions that constitute our taxation policies is critical and cannot be overly emphasized. Supreme Court decisions on the validity of BIR rulings could very well determine or decide for the foreign investor whether to invest or not. In a series of decisions, the Supreme Court stamped its imprimatur on the strict stand adopted by the BIR in taxing as many transactions and as high a rate possible on foreign corporations, in deviation with the well-settled taxation tenet of liberal construction in favor of the taxpayer. The High Tribunal made several pronouncements which at the very least digressed from established taxation principles.

For the vacillating stance of the Supreme Court with regard taxation of foreign corporations, current tax laws are partly to blame. While the U.S. tax laws, after which our Tax Code was patterned, have since undergone several major revisions, abandoning principles deemed not beneficial, our Tax Code has indiscriminately continued to embody these

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principles. For instance, the "force of attraction principle" which the U.S. rejected in 1966, is still embodied in our Code. Such inadequacy is accentuated when the Supreme Court, in order to remedy the "anomalous" situation wherein nonbusiness income of a resident foreign corporation is taxed at a lower rate even if it is not effectively connected with its trade or business in the Philippines, ruled in Marubeni that the corporation with a branch here in the Philippines is considered a nonresident foreign corporation with respect to such income.

The Tax Code likewise does not even define the fundamental concept of what constitutes "doing business," at least as far as taxation is concerned. Thus, the author recommends that a precise definition is essential as upon this delineation hinges the basis for the crucial contradistinction between resident and nonresident foreign corporations. The present practice of using the definition under the investment laws is clearly insufficient. An express definition based and evaluated from the taxation point of view is imperative.

The objective of placing the taxation burden of the branch at par with the subsidiary has fallen short in practice. If there is a distinction as to "effectively connected" income as to branches, the same distinction should also be applied to the subsidiaries' income.

Clearly, the author opines, the inadequacy of our tax laws, as reflected in the decisions and in the manner these decisions were arrived at, calls for a thorough study and revisions of the present tax laws. The deviation and sometimes clear departure from well-reasoned dogma constitute a judicial hint to the legislature for some legislative adjustments.

I. INTRODUCTION

A. Background

William Anderson stated that "private investments play a dominant role in the operation of a private economy."[1] He said that "there is a close relation between enterprise, progress and innovation."[2] And we know that what he said is true. Progress in several countries has been attributed to a rising economy and a healthy atmosphere for investments. And this has been eluding the Philippines for years.

Congressman Margarito B. Teves, Chairman of the Committee on Economic Affairs of the House of Representatives said:

> The country needs foreign investments to supplement the shortage of domestic capital. Foreign investments provide a host of benefits which include the following: generating jobs for the unemployed, the underemployed and the new entrants to the labor force; facilitating the transfer of appropriate and modern technology; helping improve the quality of the products and eliminate monopoly through healthy competition; and expanding the economy's productive capacity and sustaining economic growth. Substantial amounts of foreign investments may even lessen our need to borrow from international financial institutions xxx.[3]

Although such observation was made in 1991, a similar statement was made sixteen years earlier by Atty. Tomas Toledo, to wit:

> There are some types of investments that the developing country, such as ours, need. So our government has encouraged the entry of foreign investments, foreign technology and know-how to supplement our domestic resources, in order that we may have a balance development both in agriculture and industry and also to give opportunities to our people to earn more money to increase the per capita income.[4]

Thus, for a developing country like ours, there is a need to enact several measures in order to encourage inflow and to maintain a healthy atmosphere for investments.

A foreign investor wishing to bring in capital to a foreign country takes into account several factors. Although taxation may not be a primary consideration, it still to a large extent influences decisions of foreign companies whether or not to invest in another country. This study will focus on taxation of foreign corporations as an instrument of encouraging foreign investments. And this will be done through an examination of our tax laws in the light of Supreme Court decisions rendered.

B. Objectives of the Study

Our laws must provide for a viable method of taxing foreign corporations so as to encourage inflow of investments. Thus, our existing income tax laws governing foreign corporations must be examined in order to evaluate their effectiveness in encouraging and regulating inflow of foreign investments.

Although the enactment of tax statutes belong to the legislature, the Supreme Court plays an important role in the application of the

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[1] W. ANDERSON, TAXATION AND THE AMERICAN ECONOMY 507 (1952).

[2] *Id.*

[3] Sponsorship speech of Congressman Margarito B. Teves of House Bill No. 32496 (An Act to Promote Foreign Investments in the Philippines), Transcript of Session Proceedings 91 (December 17, 1991).

[4] Toledo, *International Aspects of Taxation*, Lecture delivered at the 11th Annual Institute on Tax Law of the University of the Philippines Law Center (1975), PROCEEDINGS OF THE ELEVENTH ANNUAL INSTITUTE ON TAX LAW 18, 31 (1976).

tax statutes through the cases brought before them for adjudication. The manner the decisions are rendered can be indicators fo the adequacy of our laws.

This study aims to review the pertinent income tax provisions on foreign corporations in the light of the cases decided by the Supreme Court.

This study also aims to understand and highlight the role of the Supreme Court in the taxation of foreign corporation.

C. *Delimitations of the Study*

The discussion is limited to the income tax aspects and issues on dividends, branch profits, doing business and sourcing of income affecting foreign corporations. These aspects and issues were identified taking into account their significance and impact on the subject, in the light of the Supreme Court decisions. The cases are focused on the decisions enunciated by the Supreme Court particularly within the last seven years. Reference is made to American jurisprudence and laws after which our constitutional government and income tax laws are largely patterned.

II. TAXATION OF FOREIGN COPORATIONS

Although taxation has been regarded as a tool to raise revenue, taxation has been recognized to accommplish several other purposes. It can be an instrument to reduce excessive inequalities of wealth, to regulate business or to even aid in shaping the economy. Thus, taxation is no longer viewed as a fiscal instrument, "charged merely with the responsibility of raising the revenues to pay for the ordianry expenses of government."[5] It has long been recognized as a powerful government tool. According to former Finance Minister Cesar Virata:

> "Taxation is not really an end by itself. Taxation is only a national tool because the ultimate objective is — how do we improve our country and how do we distribute the earnings of the country among the people."[6]

[5] ANDERSON, *supra* note 1, at 17.

[6] Virata, *Keynote Speech*, delivered at the 11th Annual Institute on Tax Law of the University of the Philippines Law Center (1975), INTERNATIONAL ASPECTS OF TAXATION 1 (1976).

> Taxation is often referred to as the power of the sovereign to impose burdens or charges upon persons, property, or property rights for the use and support of governdmment to enable it to discharge its appropriate functions.[7] It is a power of the sovereign state to recover a contribution of money and other property in accordance with some rule of apportionment, from the property or occupations within its jurisdiction for the purpose of defraying the public expense.[8] Taxation, in its true sense, is but compensation paid by the individual for protection to the person or his property, and therefore the right of taxation is necessarily confined to the territory where the person is domiciled, or the property is situated.[9]

B. *Characteristics of Taxation*

The power of taxation is inherent in sovereignty as an incident or attribute thereof, being essential to the existence of independent government.[10] And the power of taxation is peculairly and exclusively legislative.[11] Hence, taxes can be imposed, levied, assessed and collected only under statutory authority and in the manner provided for by law, and that the power of taxing officials exists only by virtue of the statutes empowering them to act, and can be exercised only within the express authority conferred.[12]

The power to tax has not been extended to the judiciary. As long as the legislature, in imposing a tax, does not violate the applicable constitutional limitations or restrictions, the courts have no concern with the wisdom or policy of the exaction imposed, the political or other collateral motives behind it, or the amount to be raised.[13] However, where the legislature transcends its functions and violates one or more of the restrictions or limitations placed upon the taxing power by the Constitution, the judiciary has the right and duty to interpose and declare the attempted imposition invalid.[14]

[7] *Des Moines Union v. Chicago Great Western*, 186 IA. 1019, 9 ALR 1557, 177 N.W. 90 (1920).

[8] 1 COOLEY, LAW OF TAXATION 149 (4th ed., 1924).

[9] 41 WORDS AND PHRASES 269 (1968); footnotes omitted.

[10] 71 AM. JUR, *State and Local Taxation*, Sec. 871 (2nd ed., 1973)); footnotes omitted.

[11] *Id.* at Sec. 872.

[12] *Id.* at Sec. 874.

[13] *Id.* at Sec. 877.

[14] *Id.*

C. Taxability of Foreign Corporations

As a rule, a government has no jurisdiction over foreign corporations since they are juridical creations of another sovereign. The term "foreign corporation" is used generally to denote, with respect to a particualr state or country, any corporation created by, or organized under the laws of another state, government or country.[15] Strictly speaking, a corporation can have no legal existence out of the boundaries of the sovereignty by which it is created. And one state cannot confer a corporate body a corporate existence in another state or add to or diminish its powers to be exercised there.[16] However, this doctrine does not prevent recognition of such existence by other states or the exercise of the corporation's legitimate powers by its agents therein by virtue of the law of comity. And the capacity of the corporation to act in another state is governed by the laws of that sovereignty. The state in extending to foreign corproations the privilege (of doing business) may impress upon such privilege whatever conditions and restrictions it deems fit.

The protection that the government grants to said foreign corproation justifies the imposition of the tax. However, the protection received and the requirements set will depend on the nature and manner of the presence of the foreign corporation in another country.[17]

III. BRANCHES AND SUBSIDIARIES

A. Background

A foreign corporation wishing to invest in the Philippines has various alternatives.[18] First, it may incorporate and organize a subsidiary as a domestic corporation, either wholly owned by it or under its effective control.[19] In such a case, the subsidiary would be a legally independent unit and will be governed exclusively by Philippine laws.[20]

[15] 36 AM. JUR., *Foreign Corporations*, Sec. 1 (2d ed. 1968).

[16] *Id.* at Sec. 11.

[17] Santos, *Protection of Foreign Investments Under International Law*, Lecture delivered in the 8th Lawasia Conference on September 10, 1983, in 58 PHILIPPINE L. J. 291, 292 (1983).

[18] 2 CAMPOS, THE CORPORATION CODE: COMMENTS, NOTES AND SELECTED CASES 484 (1990).

[19] *Id.*

The foreign corporation may decide instead to open a branch or agency in the Philippines, bringing in capital and technical know-how, without organizing a legally independent unit.[21]

B. Tax Treatment

1. SUBSIDIARY

If a subsidiary is set up, the subsidiary will acquire the status of a domestic corporation and will be taxed at thrity-five percent (35%) on its net income pursuant to section 24 (a) of the National Internal Revenue Code (N.I.R.C.).[22] The parent foreign corporation will have the status of a non-resident foreign corporation if it does not actively participate in the business and operations of the subsidiary. Dividends declared and remitted by the subsidiary to the parent corporation will be subject to a thirty-five percent (35%) tax on its gross amount pursuant to section 25 (b) of the N.I.R.C. But the rate can be lower by virtue of an applicable treaty or pursuant to the tax sparing provision under section 25 (b) (5) of the N.I.R.C.

Thus, foreign corporations with subsidiaries in the Philippines are subject to a two-tier tax — the income tax imposed on the subsidiary's income and the tax on dividends declared and remitted to the parent corporation. It is the government's policy that the two-step tax is not beyond the income tax rate of the country of residence of the investor.[23] Otherwise, there would be no incentive whatsoever on the part of the foreign corporation to set up a subsidiary here in the Philippines.[24]

2. BRANCH

If the foreign corporation decides to set up a branch, the former is considered to have extended its corporate status here. Thus, in the ordinary course of business, the foreign corporation will acquire the status of a resident foreign corporation doing business in the Philippines. Branch profits, remitted by the branch to the head office, will

[20] *Id.*

[21] *Id.*

[22] THE NATIONAL INTERNAL REVENUE CODE, PRES. DECREE NO. 1158 (1977), *as amended* by EXEC. ORDER NO. 21, 22, 36, 37, 40, 72, 194, 195, 311 and 273; hereinafter cited as N.I.R.C.

[23] Virata, *supra* note 6, at 4.

[24] *Id.*

normally be subject to the fifteen percent (15%) branch profits remittance tax.[25] To be subject to the branch profits remittance tax, the branch profits must be effectively connected with the trade or business in the Philippines.

3. EQUALIZATION OF TAX TREATMENT

Taxwise, the branch enjoyed some advantages over a subsidairy prior to 1975. A subsidiary was subject to twenty-two (22) and thirty (30) percent corporate income tax on its net income from the Philippines and another thirty percent (30%) on the remittance of the dividends to the mother company. The branch, on the other hand, was subject only to the regular income tax while the remmittance to the head office was tax free.

In 1974, Presidential Decree No. 369[26] was passed, introducing the tax-sparing provision. Under said decree, the dividends received by nonresident foreign corporation can be subject to the lower rate of fifteen percent (15%) subject to the condition that the country in which the nonresident foreign corproation is domiciled shall allow a credit against the tax due from the nonresident foreign corporation, tax deemed to have been paid in the Philippines equivalent to twenty percent (20%).

In 1975, Presidential Decree No. 778[27] imposed the twenty percent (20%) branch profits tax on any profit remitted abroad by a branch office to its head office. Said tax was subsequently reduced to fifteen percent (15%)[28] to place the branch and subsidiary on equal footing.[29]

Two very significant decisions rendered by the Supreme Court affecting the branches and subsidiaries are the *Marubeni v. Commissioner of Internal Revenue*[30] and *Commissioner of Internal Revenue v. Procter & Gamble PMC*.[31]

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[25] N.I.R.C., Section 25 (a) (5).

[26] January 1, 1974.

[27] August 24, 1975.

[28] PRES. DECREE NO. 1158-A (1977).

[29] J. NOLLEDO, THE NATIONAL INTERNAL REVENUE CODE OF THE PHILIPPINES ANNOTATED 84 (1989).

[30] 177 SCRA 500 (1989).

[31] 160 SCRA 560 (1988) as subsequently set aside by the Supreme Court *en banc* in G.R. No. 66838, December 2, 1991 in resolving the motion for reconsideration.

C. The Procter & Gamble Case

1. THE FACTS

Procter and Gamble Philippines Manufacturing Corporation (hereinafter reffered to as P&G-Phil.), a corporation duly organized and existing under Philippine laws, is a wholly owned subsidiary of Procter and Gamble, U.S.A. (hereinafter referred to as P&G-USA), a non-resident foreign corporation, not engaged in trade or business in the Philippines. P&G-Phil. declared dividends in favor of its parent corporation and paid thirty-five percent (35%) tax thereon. Subsequently, it asked for a refund of the 20 percentage-point portion of the 35 percentage-point whole tax paid, invoking the tax-sparing credit provision in Section 24(b) of the N.I.R.C. The failure of the Commissioner of Internal Revenue to act on the request for refund compelled the P&G-Phil. to seek the intervention of the Court of Tax Appeals which granted the claim for refund.[32] On appeal, the Second Division of the Supreme Court denied the claim. After examining Section 902 of the U.S. Internal Revenue Code, the law governing tax credits granted to U.S. corporations on dividends received from foreing corporations, the Second Division of the Supreme Court, through Justice Paras, held:

> To our mind there is nothing in the aforecited provision that would justify tax return of the disputed 15% to the private respondent. Furthermore, as ably argued by the petitioner [CIR], the private respondent failed to meet certain conditions necessary in order that the dividends received by the non-resident parent company in the United States may be subject to the preferential 15% tax instead of 35%.[33]

The Second Division also added that among other things, private respondent failed:

> (1) to show the actual amount credited by the U.S. government against the income tax due from PMC USA on the dividends received from private respondent; (2) to present the income tax return of its mother company for 1975 when the dividends were re-ceived; and (3) to submit any duly authenticated document showing that

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[32] C.T.A. Case No. 2883 dated January 31, 1984.

[33] *Procter & Gamble*, 160 SCRA at 567.

the U.S. government credited the 20% tax deemed paid in the Philippines.[34]

The doctrine enunciated by the Second Division in *Proctor & Gamble* was extended to the case of *Marubeni Corporation v. Commisioner of Internal Revenue*[35] wherein the Court added that the tax sparing provision should be "strictly" complied with, being a tax concession in the nature of a tax exemption.[36]

The Second Division of the Supreme Court in the *Procter & Gamble* case anchored its argument on two grounds:

(1) Nothing in Section 902 of the U.S, Internal Revenue Code justifies the grant of the twenty percent (20%) tax advantage; and

(2) the failure of the subsidiary to present the required proofs that credit has been granted in the U.S.

On December 2, 1991, the Supreme Court, *en banc*, in resolving the motion for reconsideration filed by the respondent, set aside the decision of the Second Division, affirmed the decision of the Court of Tax Appeals and granted the refund.[37] The Majority's decision was written by Justice Feliciano.[38]

2. TAX-SPARING

a. *Provision*

Section 25(b) (5) (B) of the NIRC provides that:

" x x x the tax shall be 15% of the dividends received x x x subject to the condition that the country in which the nonresident foreign corporation is domiciled shall allow a credit against the tax due

[34] *Id.* at 567-568.

[35] Resolution dated March 7, 1990.

[36] *Id.* at 3.

[37] *Commissioner of Internal Revenue v. Procter & Gamble Philippines Manufacturing Corporation*, G.R. No. 66838, December 2, 1991.

[38] Of the thirteen justices who participated, five dissented. Justice Paras, the *ponente* of the decision rendered earlier by the Second Division, wrote the dissenting opinion. He was joined by Justices Melencio-Herrera, Padilla, Regalado and Davide. The rest — Justices Narvasa, Gutierrez, Bidin, Medialdea, Cruz and Grino-Aquino — joined Justice Feliciano.

from the nonresident foreign corporation, taxes deemed to have been paid in the Philippines equivalent to 20% which represents the difference between the regular tax (35%) on corporations and the tax (15%) on dividends x x x"

The said provision was introduced by Presidential Decree No. 369 in 1974 in order to encourage more capital investment for large projects and to tax dividends received by nonresident foreign corporations in the same manner as the tax imposed on foreign loans.[39] Earlier, the tax on foreign loans was reduced from thirty five percent (35%) to fifteen percent (15%) in order to attract loans from foreign countries.[40]

b. *Nature of tax sparing*

In order to understand the operations and proper application of the "tax sparing" provision, it is useful to look into its nature.

"Tax sparing" credit is one which a foreign country would allow for taxes which were not paid or which were lowered because of national policy.[41] For instance, the tax on dividends earned by non-resident foreign corporations is normally at thirty-five percent (35%). It is reduced to fifteen percent (15%) if the country of residence of the foreign corporation allows a credit of thirty-five percent (35%) against the income of the corporation when it reports the dividends earned from the Philippines.

In giving up a part of the tax in the tax sparing provision, "we want to see and we want to expect that the tax that we gave up for this particular investment is not taxed by the other country."[42] It is to encourage investors coming to the Philippines by crediting at least

[39] Pres. Decree No. 369 provides:

WHEREAS, it is imperative to adopt measures responsive to the requirements of a developing economy foremost of which is the financing of economic development programs;

WHEREAS, nonresident foreign corporations with investments in the Philippines are taxed on their earnings from dividends at the rate of 35%;

WHEREAS, in order to encourage more capital investment for large projects, an appropriate tax need be imposed on dividends received by nonresident foreign corporations in the same manner as the tax imposed on interest on foreign loans.

[40] PRES. DECREE NO. 131 (1973).

[41] Toledo, *supra* note 4, at 31.

[42] *Id.* at 18.

that portion which is so-called tax free margin insofar as the investor is concerned.[43]

c. U.S tax credits

Section 902 of the U.S. Internal Revenue Code does not really provide for a "tax spared" credit. It provides for a tax "deemed paid" or indirect tax credit.

In the U.S., both direct and indirect tax credits are available to the taxpayer.[44] Section 901 (a) of the U.S. Internal Revenue Code permits eligible taxpayers to elect the foreign tax credit for taxes which they pay directly.[45] These taxes may include withholding taxes on dividends, interests, or similar items of income where the burden of the tax rests on the taxpayer recipient.[46] However, a corporation electing the foreign tax credit is required, in addition to including its direct taxes, to include the indirect taxes it is deemed to have paid under Sections 902 and 960 of the same Code.[47] Under Section 902, a corporation which owns 10% or more of the voting stock of a foreign corporation, upon receipt of a dividend from the foreign corporation, is deemed to have paid its proportionate share of foreign taxes paid by the foreign corporation relating to the dividends.

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[43] *Id.* at 32.

[44] 12 MERTENS, LAW OF FEDERAL INCOME TAXATION, *The Foreign Tax Credit*, Section 45-4.09 (1987).

[45] U.S. INTERNAL REVENUE CODE, Section 901 provides:

SEC. 901 — *Taxes of foreign countries and possessions of the United States.*

(a) *Allowance of credit.* — If the taxpayer chooses to have the benefits of this subpart, the tax imposed by this chapter shall, subject to the applicable limitation of section 904, be credited with the amounts provided in the applicable paragraphs of subsection (b) plus, in the case of a corporation, the taxes deemed to have been paid under sections 902 and 960 x x x.

(b) *Amount allowed.* — Subject to the applicable limitation of section 904, the following amounts shall be allowed as, the credit under subsection (a):

(a) *Citizens and domestic corporations.* — In the case of a citizen of the United States and of a domestic corporation, the amount of any income, war profits, and excess profits taxes paid or accrued during the taxable year to any foreign country or to any possession of the United States x x x

[46] 12 MERTENS, *supra* note 44.

[47] *Id.* at 84.

Section 902 of the U.S. Internal Revenue Code provides as follows:

SEC. 902 — CREDIT FOR CORPORATE STOCKHOLDERS IN FOREIGN CORPORATION.

(a) Treatment of Taxes paid by Foreign Corporation — For purposes of this subject, a domestic corporation which owns at least 10 percent of the voting stock of a foreign corporation from which it receives dividends in any taxable year shall —

(1) to the extent such dividends are paid by such foreign corporation out of accumulated profits [as defined in subsection (c)(1) (a)] of a year for which such foreign corporation is not a less developed country corporation, be deemed to have paid the same proportion of any income, war profits, or excess profit taxes paid or deemed to be paid by such foreign corporation to any foreign country or to any possession of the United States on or with respect to such accumulated profits, which amount of such dividends (determined without regard to Section 78) bears to the amount of such accumulated profits in excess of such income, war profits, and excess profits taxes (other than those deemed paid); and

(2) to the extent such dividends are paid by such foreign corporation out of accumulated profits [as defined in subsection (c) (1) (b)] of a year for which such foreign corporation is a less developed country corporation, be deemed to have paid the same proportion of any income, war profits or excess profits taxes paid or deemed to be paid by such foreign corporation to any foreign corporation or to any possession of the United States on or which the amount of such dividends bears to the amount of such accumulated profits.

x x x x x x x x x

(c) Applicable Rules

(1) Accumulated profits defined. — For purposes of this section, the term 'accumulated profits' means with respect to any foreign corporation.

(A) for purposes of subsections (a) (1) and (b) (1), the amount of its gains, profits, or income computed without reduction by the amount of the income, war profits, and excess profits taxes imposed on or with respect to such profits or income by any foreign country. x x x; and

(B) for purposes of subsections (a)(2) and (b)(2), the amount of its gains, profits, or income in excess of the income, war profits, and excess of profit taxes imposed on or with respect to such profits or income.

The operation of Section 901 and 902 of the U.S. tax code was graphically illustrated in BIR Ruling No. 76-004,[48] rendered by then Acting Commissioner of Internal Revenue Efren I. Planas. In said ruling the BIR upheld the application of the tax sparing provision on dividends remitted by a Philippine subsidiary to its U.S. parent corporation on the strength of Section 902, as follows:

> Thus, if a Philippine corporation wholly owned by a U.S. corporation has a net income of ₱100,000, it will pay ₱25,000 [now ₱35,000 based on 35% corporate income tax] Philippine income tax thereon in accordance with Section 24(a) of the Tax Code. The net income, after income tax, which is ₱75,000, will then be declared as dividend to the U.S. corporation and 15% tax, or ₱11,250 will be withheld therefrom. Under the aforementioned sections [Sections 901 and 902] of the U.S. Internal Revenue Code, U.S. corporation receiving the dividend can utilize as credit against its U.S. tax payable on said dividends the amount ₱30,000 composed of:
>
> (1) The tax "deemed" or indirectly paid on the dividend arrived at as follows:
>
> ₱75,000 X ₱25,000 = ₱18,750
>
> (2) The amount of 15% of ₱75,000 withheld = 11,250
>
> ₱30,000
>
> The amount of ₱18,759 deemed paid and to be credited against the U.S. tax on the dividends received by the U.S. corporation from a Philippine subsidiary is cleary more than the 20% requirement of Presidential Decree No. 369 as 20% of ₱75,000.00, the dividends to be remitted under the above example, amounts to ₱15,000.00 only.

BIR Ruling No. 76-004 was reitereated in BIR Ruling dated 22 July 1981 addressed to Basic Foods Corporation and BIR Ruling dated 20 October 1987 addressed to Castillo Laman, Tan and Associates.

[48] BIR Ruling No. 76-004 (July 19, 1976) modifying BIR Ruling No. 75005 (September 10, 1975).

BIR Ruling No. 76-004 was based on the premise that the Philippines is a less-developed country and adopted the ruling in the *American Chicle* case.[49]

Under the *American Chicle* case, only the net amount of the dividend paid by the foreign corporation was included in the income of the U.S. corporate recipient and the amount of foreign taxes deemed paid by the recipient corporation was accordingly reduced by a fraction.[50] The foreign tax in effect is deducted in that the dividends, on which the domestic corporation pays a tax, do not include the portion of the earnings of the foreign corporations used to pay the foreign tax. Thus, it "shaves" the amount of creditable tax deemed paid by the recipient corporation.[52]

The U.S. Revenue Act of 1962 added a limited gross-up to the Code.[53] It required the U.S. corporate recipient of a dividend to gross up the amount of the dividend to include the appropriate portion of the foreign taxes paid by the foreign subsidiary. It then allowed the U.S. corporation full credit for the entire amount of foreign taxes paid with respect to the grossed-up dividends.[54] This rule was subsequently extended to less-developed countries in 1976, this eliminating the last vestiges of the *American Chicle* rule.[55]

[49] *American Chicle Co. v. U.S.*, 316 U.S. 450 (1942).

[50] Dale, *The Reformed Foreign Tax Credit*, 33 TAX LAW REVIEW 175, 176-177 (1978).

[51] 5 MERTENS, LAW OF FEDERAL INCOME TAXATION, *Credit for Foreign Taxes*, Section 33.14 (1980).

[52] Dale, *supra* note 50.

[53] 5 MERTENS, *supra* note 51.

[54] Now, the formula in computing the tax "deemed paid" is as follows:

$$\text{Foreign tax on year's total profits} \times \frac{\text{Dividends received out of year's profits}}{\text{The "accumulated profits"}} = \text{Taxes deemed to have been paid on the dividends}$$

The definition of "accumulated profits" had to be changed under the 1976 Tax Reform Act. It means, with respect to any foreign corporation, the amount of gains, profits of income computed *without reduction by the amount of income, war profits, and excess profits taxes imposed on or with respect to such profits or income* by any foreign country or by any possession of the United States; see 5 MERTENS, *supra* note 51.

[55] The U.S. Congress believed that the failure to "gross-up" the dividend from a less-developed country corporation by the amount of foreign taxes deemed paid resulted in a double allowance for foreign taxes, in the amount paid in foreign taxes was not only allowed as a credit in computing United States tax, but was also allowed as a deduction since dividends were paid from the income remaining after the payment of the foreign taxes. Dale, *supra* note 50 at 177-179; also 5 MERTENS, *supra* note 51, Section 33.14.

Mathematically, the computation in BIR Ruling No. 76-004 is still correct even if the distinctions as to the operation of the U.S. tax credit provisions on less developed and developed country subsidiaries no longer exist because the deemed-paid credit under the gross-up requirement is even greater than the one previously applicable to less developed country corporations.[56]

d. Conceptual difficulty

However, in the *Procter & Gamble* case, the Second Division through Justice Paras concluded that "there is nothing in the aforecited provision [Section 902] that would justify tax return of the disputed 15% to the private respondent."

There is indeed a "conceptual difficulty"[57] in applying the tax sparing provision on the strength of Section 902 of the U.S. Internal Revenue Code. The said provision does not categorically provide for a "tax spared" credit. It provides for an indirect or "deemed paid" credit.

The "tax spared" is technically distinct from a "tax credit." Normally, a tax credit refers to the taxpayer's right to deduct from income tax payable the tax he has paid to a foreign country subject to limitation.[58] It can be allowed as a deduction from gross income or a deduction from the tax due.

In international taxation, the tax credit is designed to avoid the possibility of double taxation on the same income.[59] Since a taxpayer may be taxed on worldwide income, it is possible that income derived from operations in a foreign jurisdiction has already been taxed therein. For instance, if ABC Co., a resident of country A, earns dividends from another company in country B, that dividend in the source country is usually taxed via withholding taxes most of the time.[60] When that dividend is remitted to the country of taxpayer the country of residence imposes a tax.[61] If there is no coordination between the country of source and the country of residence, it is very possible that the tax

[56] Medalla, *The Income Tax Treaty Between the Philippines and the United States*, 58 PHILIPPINE L. J. 301, 314 n. 77 (1983).

[57] *Id.*

[58] NOLLEDO, *supra* note 29 at 163.

[59] 12 MERTENS, *supra* note 44, Section 45-4.02 (1987).

[60] Toledo, *supra* note 4, at 18.

[61] *Id.*

burden to be shouldered by the taxpayer may even wipe out the entire income.[62]

The tax sparing provision is not really an instrument against double taxation. "We give up a part of the tax and we want to see and we want to expect that the tax we gave up for this particular investment is not taxed by the other country."[63] It is purely an incentive measure wherein the government foregoes a portion of the tax. Hence, a "tax spared" credit is not exactly the same as a "tax deemed paid" credit.

e. Substantial compliance

Section 25 (b) (5) (B) of our Tax Code requires that the "country in which the nonresident foreign corporation is domiciled shall allow a credit against the tax due from the nonresident foreign corporation, taxes deemed to have been paid in the Philippines equivalent to 20% x x x." The provision merely provides that an equivalent credit should exist. It does not strictly specify the form of this credit. And as pointed out by Justice Feliciano in the *en banc* decision, the law merely provided that the country of domicile of the foreign stockholder corporation "shall allow" such foreign corporation a tax credit for "taxes deemed paid in the Philippines."[64]

The amount of the taxes "deemed paid" credit pursuant to Section 902 clearly exceeds the 20 percentage-point requirement in the N.I.R.C. representing the tax spared. And the taxes "deemed paid" by the U.S. parent corporation are not really "ghost" or "phantom" taxes.[65] It is a portion of the subsidiary's income tax paid here in the Philippines which the U.S. laws allow as a credit against the parent corporation's income tax. Under Section 902, the U.S. Internal Revenue Code creates a "fiction"— as if it was the parent corporation which paid the income tax of the subsidiary here in the Philippines.

And this was recognized by the Supreme Court in the *en banc* decision when it stated that:

> Since ₱29.75 is much higher than ₱13.00 (the amount of dividend tax waived by the Philippine government), Section 902, US Tax

[62] *Id.*

[63] *Id.*

[64] *Procter & Gamble*, G.R. No. 66838 at 10-11.

[65] *Procter & Gamble*, G.R. No. 66838 at 22.

> Code, specifically and clearly complies with the requirements of Section 24 (b) (1), N.I.R.C.[66]

In countries where dividends are not subject to tax, the requirement is deemed satisfied.[67] The Supreme Court, in *Commissioner of Internal Revenue v. Wander Phil.*, Inc.,[68] ruled:

> While it may be true that claims for refund are construed strictly against the claimant, nevertheless, the afct that Switzerland does not impose any tax or (sic) the dividends received by Glaro from the Philippines should be considered as a full satisfaction of the given conditions.

3. REPORTING REQUIREMENTS

The second reason laid down by the Second Division of the Supreme Court in denying the claim was the failure on the part of respondent to comply with the following reporting requirements:

(1) to show the actual amount credited by the U.S. government against the income tax due from P&G-U.S.A. on the dividends received from private respndent;

(2) to prevent the income tax return of its mother company for 1975 when the dividends were received; and

(3) to submit any duly authenticated document showing that the U.S. government credited the 20% tax deemed paid in the Philippines.

The Court in the December 2, 1991 decision rejected the requirements set by the Second Division,. It distinguished between "the legal question" from questions of administrative implementation arising after the legal question has been answered.[69] The Court *en banc* held that details relating to administrative implementation should belong to the BIR and not to the Supreme Court.[70] It also pointed out that the requirement set by the Second Division was impractical. This is

[66] *Id.* at 18.

[67] BIR Ruling No. 178-85, October 4, 1985.

[68] *Commissioner of Internal Revenue v. Wander Phil.*, Inc., 160 SCRA 573 (1988).

[69] *Procter & Gamble*, G.R. No. 66838 at 24.

[70] *Id.* at 26.

so, considering that the tax credit cannot be given in the U.S., which means that the Philippine dividend tax, at the rate here applicable was actually imposed.[71] And to require respondent to show documentary proof of its parent corporation having actually received the "demand part" tax credit from the proper tax authorities, would be like putting the "cart before the horse."[72]

In setting up the said requirements, the Second Division also failed to take into account certain provisions of the U.S. Internal Revenue Code relating to tax credits. Section 904 (c) of the U.S. Internal Revenue Code provides that "unused" credits, which cannot be claimed for the taxable year because of certain limitations, may be carried back to two preceding years and forward to five succeeding years. "Unused" credits may arise sine Section 904 (a) of the same code provides for an "over-all limitation."[73]

Furthermore, if an amount otherwise constituting gross income for the taxable year from sources outside the United States is not includible in the income for that year because of monetary, exchange or other restrictions imposed by the foreign country, the foreign tax credits may be taken proportionately in a later year in which the amount or portion thereof is includible in gross income.[74]

Thus, in effect the Second Division made the compliance with the sparing provision very difficult, if not impossible. This *en banc* decision is clearly more reasonable, practical and beneficial to investors.

4. BENEFITS OF TAX SPARING

The lowered rate on dividends was indeed an attraction for U.S. investors. The effective tax rate on the dividends declared remitted after the thirty five percent (35%) corporate income tax and the fifteen percent (15%) tax on dividends remitted to the parent company is 44.75% [35% x ₱100; plus 15% x ₱65].

However, in countries where no credit equivalent to at least twenty percent (20%) is given, representing the difference between the regular tax and lowered rate, the effective tax rate will be very much higher,

[71] *Id.* at 24.

[72] *Procter & Gamble*, G.R. No. 66838, concurring opinion written by Justice Bidin, at 3.

[73] The "per-country" limitation, which was added to the "over-all" limitation in 1932 was eliminated in 1976, thus bringing back to the original "over-all" limitation; Dale, *supra* note 50, at 180.

[74] 5 MERTENS, *supra* note 51, at Section 33.08.

if there are no tax treaties providing for lower rates. The effective tax rate will be 57.75% [35% x ₱100; plus 35% x ₱65].

The effective tax rate on the dividends pursuant to the tax-sparing provisions was definitely lower than the U.S. regular corporate income tax rate of forty-six percent (46%) then existing. However, the U.S. regular corporate income tax rate was lowered to thirty-four percent (34%). Thus, even with the application of the tax-sparing provision, the effective tax rate of the dividends remitted by the Philippine subsidiaries will now be much higher than the regular corporate income tax in the U.S.

5. STATUS OF AGENT

An issue which was belatedly raised by the BIR for the first time before the Supreme Court was the capacity of P&G-Phil. to claim for refund on behalf of P&G-USA, its mother corporation. The Second Division ruled that P&G-Phil., being a mere withholding agent, cannot claim the refund.

Ironically, on the same date, the Third Division of the Court, in the case of *Commissioner of Internal Revenue v. Wander Philippines, Inc.*,[75] held the contrary. Justice Bidin, writing for the division, held that the Wander Philippines, a wholly owned subsidiary, being a witholding agent of the government, is the proper entity who shall claim for the refund or credit, even without express authority from the parent company.

The Court also resloved this issue in the December 2, 1991 decision. The Court held that "a person liable for tax", such as a witholding agent, is a "person subject to tax" and properly considered a "taxpayer."[76] And by reasonable standard, such a person should be regarded as a party in interest, or as a person having sufficient legal interest, to bring a suit for refund of taxes he believes were illegally colected from him.[77] The Court also held that there is an implied authority on P&G-Phil., considering that it is a wholly-owned subsidiary under the effective control of the parent stockholder.

This later position of the Supreme Court is definitely more beneficial to the foreign corporation.

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[75] 160 SCRA 573 (1988).

[76] *Procter & Gamble*, G.R. No. 66838 at 7.

[77] *Id.* at 8.

D. The Marubeni Case

1. FACTS

In the case of *Marubeni Corporation v. Commissioner of Internal Revenue*,[78] Marubeni Corporation, a foreign corporation organized under the laws of Japan and licensed to engage in business under the Philippine laws through its branch in Manila, sought for the refund or tax credit of branch profits tax it allegedly overpaid.

Marubeni Corporation has equity investments in AG&P of Manila. AG&P declared and paid cash dividends to Marubeni Corporation and withheld the corresponding ten percent (10%) final intercorporate dividend tax thereon.[79] And when AG&P remitted the dividends of the petiotioner's head office in Japan, it witheld the fifteen percent (15%) branch profit remittance tax on the amount. Marubeni now claims refund for the fifteen percent (15%) profit remittance tax contending that the dividends are not subject to the branch profits remittance tax since they are not effectively connected with the conduct of its business in the Philippines.[80] The BIR admitted that the income is not effectively connected with Marubeni Corporation's branch operations and is not subject to branch profits remittance tax.[81] But still it denied the refund on the ground that the dividends are taxed as income recived by nonresident foreign corporation subject to the 25% (instead of the normal 35%) tax pursuant to Article 10 (2) (b) of the RP-Japan Tax Treaty.[82] The Court of Tax Appeals affirmed the denial and held:

> admittedly, the dividends under consideration were earned by Marubeni Corporation of Japan, and hence, taxable to said Corporation. While it is true that the Marubeni Corporation Philippine Branch is duly licensed to engage in business under the Philippine laws, such dividends are not the income of the Philippine Branch and are not taxable to said Philippine branch. We see no significance thereto in the identity concept or principal-agent relationship theory of petitioner because such dividends are the income of and taxable to the Japanese corporation in Japan and not to the Philippine Branch.[83]

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[78] 177 SCRA 500 (1989).

[79] Since 1986, intercorporate dividends are not subject to tax pursuant to EXECUTIVE ORDER NO. 37 (1986).

[80] N.I.R.C., Section 24 (b) (2) as amended by PRESIDENTIAL DECREES NOS. 1705 and 1773.

[81] BIR Ruling No. 157-81, July 13, 1981.

[82] February 13, 1980.

[83] C.T.A. Case No. 3605, February 12, 1986.

The Supreme Court upheld the position of the respondents and ruled that:

> There can be no other logical conclusion considering the undisputed fact that the investment x x x was made for purposes peculiarly germane to the conduct of the corporate affairs of Marubeni, Japan, but certainly not of the branch in the Philippines. It is thus clear that petitioner, having made this independent investment attributable only to the head office, cannot now claim the increments as ordinary consequences of its trade or business in the Philippines and avail itself of the lower tax rate of 10%.[84]

The Supreme Court adopted the Solicitor General's argument, as follows:

> The general rule that a foreign corporation is the same juridical entity as its branch office in the Philippines cannot apply here. This rule is based on the premise that the business of the foreign corporation is conducted through its branch office, following the principal-agent relationship theory. It is understood that the branch becomes its agent here. So that when the foreign corporation transacts business in the Philippines independently of its branch, the principal-agent relationship is set aside. The transaction becomes one of the foreign corporation, not of the branch. Consequently, the taxpayer is the foreign corporation, not the branch or the resident foreign corporation.[85]

Thus, the Supreme Court's decision was based on two premises:

(1) that the dividend income is not effectively connected with the branch's operation here in the Philippines;

(2) that since the transaction was entered into by the parent company, Marubeni Japan, independently of its branch, the parent-agent relationship is set-aside; consequently, Marubeni Japan should be taxed on the dividends received as a non-resident foreign corporation.

2. LEGISLATIVE HISTORY

a. Philippine Laws

Our Internal Revenue Code was originally copied from the United States tax laws. The Philippine Income Tax law, or Act No. 2833, enacted

[84] *Marubeni*, 177 SCRA at 509.

[85] *Id.*

by the Philippine Legislature in 1919, was patterned after the United States Congressional Act of 1916.[86] Later, the National Assembly, in order to obtain greater revenues for the government, passed Commonwealth Act No. 117 which took effect on November 3, 1936.[87] In 1939, Commonwealth Act No. 466, otherwise known as the National Internal Revenue Code was enacted.

Like Act No. 2833, Commonwealth Act No. 117 and Commonwealth Act No. 466, taxed corporations organized, authorized, or existing under the laws of any foreign country in the same manner as domestic corporations on their income from Philippine Sources.[88] They were taxed on the net basis.

In 1959, Republic Act No. 2343 was enacted significantly changing the manner foreign corporations are taxed. Foreigncorporations were classified into resident and nonresident foreign corporation. Those engaged in trade or business in the Philippines were considered resident corporations and taxed on a net basis just like domestic corporations on income from within the Philippines.[89] Foreign corporations not engaged in trade or business were taxed at thirty percent (30%) of the gross income from Philippine sources.[90] Up to this date, this is the basis for the classification of foreign corporations in our Tax Code.[91]

There are reasons in imposing a higher tax on nonresident foreign corporations. As elaborated by Atty. Tomas Toledo:[92]

> The first and important reason is that principle upholding the right of the state of source (of income) the primary right to tax the income. The second reason is that it is our established preference to have businesses stay in out country rather than stay outside and operate their businesses outside the Philippines. It is better control on the conduct of business and disposition of assets and profits of the corporation.

[86] C. REY, TAX CODE ANNOTATED 36 (1964).

[87] *Id.* at 37.

[88] ACT NO. 2833, Section 10 (a) (1919); COMMONWEALTH ACT NO. 117, Section 5 (1936); N.I.R.C., COMMONWEALTH ACT NO. 466, Section 24 (1939).

[89] N.I.R.C., Section 24 (b) (2) *as amended* by Republic Act No. 2343 (1959).

[90] *Id.*, Section 24 (b) (1).

[91] N.I.R.C., Sections 25 (a) (1) & 25 (b) (1) (1988).

[92] Toledo, *International Aspects of Taxation*, Open Forum conducted during the 5th Annual Institute on Tax Law of the University of the Philippines Law Center (1968), FIFTH ANNUAL INSTITUTE ON TAX LAW 64, 97 (1969).

b. U.S. Laws

A similar pattern took place in the United States prior to 1966. The 1909 corporation tax in the U.S., which was an excise tax measured by income, applied to foreign corporations to the extent of their net income from "business transacted and capital invested within the United States."[93] The 1913 act continued to tax foreign corporations on this basis. The basic overhaul of the statutory provisions took place in 1936 under the Roosevelt administration.[94] The basic change was to tax foreign persons who were not "engaged in trade or business" or who had no "office or place of business" within the United States, at a flat rate of ten percent (10%) on gross amounts of interest, dividends, rents, salries, and other items of "fixed or determinable annual or periodical gains, profits and income."[95] Foreign persons engaged in trade or business or with an office or place of business within the United States were subject to tax on their net income from United States sources at the rates applicable to citizens or domestic corporations.[96] The stated purpose of the 1936 changes was to provide for a scheme of taxation that would be "productive of substantial amounts of additional revenue."[97]

This manner of classification introduced in the 1936 U.S. Revenue Act was premised on the principle of "force of attraction."[98] This system attracted all U.S.-source income into the taxing web, whether or not there existed any actual connection between the business being conducted and the income in question.[99] Thus, if the nonresident alien was engaged in trade or business in the United States, he would be subject to tax at the regular rates on all his taxable income from United States sources, whether or not such income was connected with the trade or business carried on in the U.S.[100] If the nonresident alien was not engaged in trade or business in the U.S., a flat thirty percent (30%) rate (or lower

[93] Ross, *United States Taxation of Aliens and Foreign Corporations*, 22 TAX LAW REVIEW 279, 280 (1967).

[94] *Id.* at 282.

[95] *Id.*

[96] *Id.*

[97] *Id.*

[98] S. ROBERTS & W. WARREN, FOREGIN INVESTORS TAX ACT 7-1 (1967).

[99] Dale, *Effectively Connected Income*, 42 TAX LAW REVIEW 689, 690 (1987).

[100] ROBERTS, *supra* note 98, at 7-2.

treaty rate) is applied to income from United States sources.[101] The Philippines adopted the same method in 1959 with the enactment of Republic Act No. 2343.

The United States government, however, realized that this method of taxation led to anomalous results in that investment income of a foreigner derived from the United States was taxed at one rate if he was engaged in a business in the United States but was taxed at another rate where he did not have such a United States business, even though in either case the business had no relation or connection with the investment income.[102] To address this problem, the U.S. Congress introduced the concept of income which is "effectively connected with the conduct of trade or business within the U.S." with the enactment of the Foreign Investor's Tax Act in 1966.

The primary objective of said Act was the equitable treatment by the U.S. of nonresident aliens and foreign corporations and to correct inequities favorable to foreign taxpayers by taxing foreign income that ought to be taxed by the United States.[103] Upon recommendation by the Fowler Task Force,[104] it abandoned the "force of attraction principle[105] and introduced the separation, for purposes of computing United States tax, of income derived from engaging in trade or business within the United States from nonbusiness or investment income.[106] Business income (if engaged in trade or business) is taxed on a net income basis, and at the rates applicable to a citizen or resident of the United States in the case of a nonresident alien individual and at the rates applicable to a domestic corporation in the case of a foreign corporation. Investment or nonbusiness income[107] is taxed on a gross income basis and at a flat rate of 30 per cent under the statute.

[101] 8 MERTENS, LAW OF FEDERAL INCOME TAXATION, Section 45.20a (1978).

[102] *Id.*

[103] ROBERTS, *supra* note 98, at 2-1.

[104] A group appointed by Pres. Kennedy in 1963 in order to consider ways of reducing the growing adverse balance of payments position of the U.S. in the early 60's; *see* Dale, *supra* note 99, at 691; also *see* Roberts, *id.*

[105] At the time the U.S. abandoned the "force of attraction system" other countries — especially in Europe — have for a long time followed a pattern of separate taxation of business and investment income; *see* Ross, *supra* note 93, at 295.

[106] *Ross, supra* note 93, at 292.

[107] But the release of the force of attraction for such income is not automatic — it depends upon the application of two tests: The business-activities test and the asset-use test. Dale, *supra* note 99, at 692.

In the words of Harvey Dale:

> x x x, the ECI [effectively-connected income] rules are a substitute for the prior indiscriminate but jurisdictionally limited monopole magnet. Instead, they create a more subtle but more powerful bipolar magnet, which repels from the net-progressive rate regime some types of previously attracted U.S.-source income, but attracts to it certain foreign-source income which was previously beyond its forced field.[108]

Thus, the taxation of nonresident aliens and foreign corporations in the U.S. was made to depend upon three factors: (1) whether the entity is engaged in a United States trade or business, (2) whether its income is United States foreign source, and (3) whether its income is "effectively connected" with the conduct of a United States trade or business.[109]

c. *Current Philippine Scenario*

The substantial change in the pattern of taxing foreign corporations here in the Philippines as introduced by Republic Act No. 2343 in 1959 adopted the "force of attraction" principle already existing in the United States since 1936. Although said principle escaped congressional discussion during the enactment of said law, in justifying the higher rates of taxes the bill sought to impose upon individuals and corporations, the proponents constantly referred to the tax law of the United States.[110]

However, unlike the United States, which abandoned the said principle way back in 1966, we have continued to adopt the same manner of taxing foreign corporations. Our Tax Code still taxes foreign corporations on the basis of (1) whether the entity is engaged in a Philippine trade or business, and (2) whether its income is Philippine or foreign source. It does not distinguish whether the income of the foreign corporation is effectively connected or not in the pursuit of its business in the Philippines. Thus, the "anomalous" situation wherein

[108] Dale, supra note 99 at 692.

[109] 12 MERTENS, LAW OF FEDERAL INCOME TAXATION, Section 45.09 (1990).

[110] 1 HOUSE CONGRESSIONAL RECORD 2335-43; 2362-69; 2626-55 (April 1958); Comment, *Taxation of Foreign Corporations: A Commentary on Marubeni v. Commissioner of Internal Revenue*, 35 ATENEO L. J. 95, 106 (1991).

the "investment income of a foreigner" derived from the Philippines was "taxed at one rate if he was engaged in a business" in the Philippines but was "taxed at another rate" where he did not have such a Philippine business, even though in either case the business had no relations or connection with the investment income was bound to arise.[111]

3. MARUBENI PROBLEM

a. *Status of agent*

Prior to the *Marubeni* case, a foreign corporation which established a branch here in the Philippines was deemed to have acquired an active economic presence in the country. It was considered being "engaged in trade or business" and was classified as a "resident foreign corporation."[112] As a "resident foreign corporation" it would have been subject to the ten percent (10%) (now 0%) intercorporate dividend tax on dividends received from a domestic corporation. However, *Marubeni* substantially altered this.

The Supreme Court, setting aside the principal-agent relationship, considered the parent corporation a separate taxable entity from the branch established in the Philippines. The proposition is at once false and misleading.[113] It is false because it assumes that a branch has a personality.[114]. A branch is defined as "an offshoot, lateral extension, or subdivisions. Any member or part of a body or system; a department."[115] It cannot have a distinct personality from its "parent" corporation. The head office and the branch are one and the same. Thus, the branch cannot be rightfully be considered an agent of itself.

The proposition is also misleading because by emphasizing the nominal term "status" it overshadows the existing determinant of the taxability of foreign corporation, i.e., the fact of doing business.[116]

[111] 8 MERTENS, *supra* note 101.

[112] Medalla, *supra* note 56 at 307.

[113] Comment, *Taxation of Foreign Corporations: A Commentary on Marubeni v. Commissioner of Internal Revenue*, 35 ATENEO L. J. 95, 102 (1991).

[114] *Id.*

[115] BLACK'S LAW DICTIONARY 245 (3rd ed. 1933).

[116] Comment, *supra* note 113.

b. Investment income

The dividend arising from the investment in AG&P is clearly not income "effectively connected"[117] with the conduct of trade or business in the Philippines of the Marubeni Corporation, Philippine branch. Thus, it is not subject to the fifteen percent (15%) branch profits remittance tax imposed by Section 25 (a) (5) of the Tax Code.

The Tax Code also exempts from tax dividends received by a domestic or resident foreign corporation from a domestic corporation.[119] Prior to 1986[120] these dividends were taxed at ten percent (10%). But dividends received by a nonresident foreign corporation from a domestic corporation are subject to a thirty-five percent (35%) tax.[121] The disparity in tax rates is very significant.

The position of the BIR and the Supreme Court in *Marubeni* is understandable. They do not want foreign corporations with branches in the Philippines to avail the benefits of resident foreign corporation with regard to its investment income which are not effectively connected with their Philippine operations. They want to tax such income at the higher rate imposed on nonresident foreign corporations. Because it is indeed "anomalous" for such investment income to be taxed at the lower rate considering that it is not connected with the conduct of trade or business of the branch here in the Philippines.

However, the bases of classifying and taxing foreign corporations in our Tax Code are still as follows: (1) whether they are doing business in the Philippines or not; and (2) whether income is Philippine or foreign source.

Unlike the U.S., we have not added the third criterion of being "effectively connected." And the Supreme Court in splitting the status of the head office and the branch where the income is not effectively connected with the business operations of the branch in effect, added a criterion which is not found in our law.

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[117] The BIR has adopted the "business activities" test. It ruled that to be "effectively connected" [in relation to branch profits remittance tax] it is not necessary that the income be derived from the actual operation of taxpayer-corporation's trade or business; it is sufficient that the income arises from the business activity in which the corporation is engaged. BIR Ruling No. 157-81 dated July 13, 1981.

[118] BIR Ruling No. 157-81 dated July 13, 1981.

[119] N.I.R.C., Section24 (e) (4); Section 25(a) (6) (D).

[120] EXECUTIVE ORDER NO. 37, July 31, 1986

[121] *Id.*, Section 25 (b) (1).

The *Marubeni* decision is just a manifestation of the inadequacy of our tax laws. Thus, it is about time that we abandon the "force of attraction" principle long embodied in our Tax Code. There should be a distinction between income earned by a branch from the conduct of its business in the Philippines and those that are not connected therewith.

E. Equalization: Truth or Myth

It has been the policy of the government to equalize the treatment of branches and subsidiaries. However, such equalization has not exactly been achieved.

The income of a subsidiary is subject to the thirty five percent (35%) regular corporate income tax. When such income is declared as dividends to the parent corporation, it is subject to the thirty five percent (35%) or fifteen percent (15%) subject to the requirements set in SEction 25 (b) (5) of the N.I.R.C. There is no distinction as to whether or not the income earned by the subsidiary is "effectively connected" with its business operations in the Philippines.

The income of a branch from its business operations is also subject to the regular corporate income tax. When the income is remitted to the head office, it will be subject to the fifteen percent (15%) branch profits remittance tax under Section 25 (a) (5) of the N.I.R.C. And enterprises registered with the Export Processing Zone are exempt and those authorized to engage in petroleum operations in the Philippines are subject to tax at seven and half percent (7 1/2%) only.

But the income or profits of the branch will be subject to the branch profits remittance tax only if they are "effectively connected" with the conduct of its trade or business in the Philippines. And the non-business income of the branch is not subject to the remittance tax.

It seems that the branch has some tax advantage over a subsidiary since it it definitely subject only to fifteen percent (15%) branch profits remittance tax on income effectively connected with its business operations. And some enterprises, like those registered with the EPZA and those engaged in petroleum operations are subject to lower rates. On the other hand, a parent corporation still runs the risk of being subjected to the thirty five percent (35%) tax on dividends declared by its subsidiary if it fails to meet the requirements set in the tax sparing provisions. And this happened initially to P&G-USA.

IV. ENGAGED IN TRADE OR BUSINESS

A. Tax Provision

The notable change introduced by Republic Act No. 2343 in 1959 is the distinction between resident and nonresident foreign corporations. A resident foreign corporation is a corporation organized, authorized, or existing under the laws of any foreign[122] country,engaged in trade or business within the Philippines. The nonresident foreign corporation, on the other hand, is a foreign corporation not engaged in trade or business in the[123] Philippines.

The distinction is important since resident foreign corporations are subject to a thirty five percent (35%) tax on its net income from sources within the Philippines computed in the same manner as domestic corporations while nonresident foreign corporations are subject to a thirty five percent (35%) tax on gross income.

B. Policy Considerations

The power to tax is based on the cost of protection the state accords to a taxpayer. However, a nonresident foreign corporation is taxed at a higher rate than a resident foreign corporation. The first and important reason for the higher rate imposed on nonresident corporations is that principle upholding the right of the state of source (of income) the primary right to[124] tax the income. The second reason is that it is our established preference to have businesses stay in our country rather than stay outside and operate their business outside the Philippines. It is better for our government and it can effect a better control on the conduct of businesses and disposition of[125] assets and profits of the corporations.

C. Capacity to Sue

The distinction is also significant in determining the foreign corporation's capacity to sue. Section 133 of the 126 Corporation Law provides as follows:

[122] N.I.R.C., Section 25 (a).

[123] *Id.*, Section 25 (b).

[124] Toledo, *supra* note 92, at 97.

[125] *Id.*

> No foreign corporation transacting business in the Philippines without a license, or its successors or assigns, shall be permitted to maintain or intervene in any action, suit or proceeding in any court or administrative agency of the Philippines; but such corporation may be sued or proceeded against before Philippine courts or administrative tribunals on any valid cause of action recognized under Philippine laws.

Thus, if a foreign corporation does business in the Philippines without a license, it can not sue before Philippine[127] courts. But it can be sued before Philippine courts whether[128] it has a license to do business or not.

But if a foreign corporation is not doing business in the Philippines, it can not be sued here because Philippine courts can not acquire jurisdiction over it. On the other hand, it needs no license to sue before Philippine courts on isolated[129] transaction, for infringement of trademark and unfair[130] competition, or on a cause of action entirely independent of[131] any business transaction. The object of the statute is not to prevent the foreign corporation from performing single acts, but to prevent it from acquiring a domicile for the purpose of business without taking the steps necessary to render it amenable[132] to suit in the local courts.

D. Definition of "Engaged in Trade or Business"

What constitutes doing business is often a troublesome question, and generally the character of the business done by a foreign corporation must be determined from the facts of a particular case.[133] Generally

[126] BATAS PAMBANSA BLG. 68 (1980).

[127] *Mentholatum Co. Inc. v. Manaliman*, 72 Phil. 524 (1941).

[128] *General Corporation of the Philippines et al v. Union Insurance Society of Canton Ltd.*, 87 Phil. 313 (1950).

[129] *Eastboard Navigation Ltd. v. Juan Ismael & Co. Inc.*, 102 Phil. 1 (1957); Aetna Casualty & Surety Co. v. Pacific Star Lines, 80 SCRA 635 (1977); *Facilities Management Corp. v. de la Osa*, 89 SCRA 131 (1979).

[130] *Western Equipment & Supply Co. v. Reyes*, 51 Phil. 115 (1927); but see *Leviton Industries v. Salvador*, 115 SCRA 420 (1982).

[131] *Dampschiefs Renderei Union v. La Compania Transatlantica*, 8 Phil. 766 (1907).

[132] *Marshall-Wells Co. v. Henry W. Elser & Co.*, 46 Phil. 71 (1924).

[133] 18A FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS, Section 6814.1 (1977).

speaking, the terms "trade" and "business" have the same meaning and comprehend "that which occupies the time, attention, and labor of men for the purpose of a livelihood or profit."[134] And this expression "engaged in trade or business" is held to convey the notion of progression, continuity, or sustained activity.[135] The U.S. Tax Courts have consistently held that before a taxpayer can be found to be "engaged in trade or business in the United States" it must, during some substantial portion of the taxable year, have been regularly and continuously transacting a substantial portion of its ordinary business in the country.[136]

The N.I.R.C. does not define or set the parameters when a corporation is deemed "engaged in" or "doing" trade or business in the Philippines for tax purposes. But "doing business" under the tax laws has been given the same meaning and interpretation as under the investments laws and jurisdictional statutes.

The first case which attempted to lay down the definition of "doing business" was *Mentholatum Co., Inc. v. Anacleto Mangaliman.*[137] Quoting American jurisprudence, the Supreme Court held that: "No general rule or governing principle can be laid downas to what constitute "doing" or "engaging in" or "transacting" business. Indeed, each case must be judged in the light of its peculiar environmental circumstances. The true test, however, seems to be whether the foreign corporation is continuing the body or substance of the business or enterprise for which it was organized or whether it has substantially retired from it and turned it over to another. (*Traction Cos. v. Collectors of Int. Revenue* [C.C.A. Ohio]. 223 F. 984, 987). The term implies a continuity of commercial dealings and arrangements, and contemplates, to that extent, the performance of acts or works or the exercise of some of the functions normally incident to, and in progressive prosecution of, the purpose and object of its organization. (*Griffin v. Implement Dealers' Mut. Fire Ins.* Col, 241 N. W. 75, 77; *Pauline Oil & Gas Col. v. Mutual Tank Line* Col, 246 P. 851, 852, 118 Okl. 111; *Automotive Material Co. v. American Standard Metal Products Corp.*, 158 N.E. 698, 703, 327 111. 367.)"[138]

[134] 8 MERTENS, *supra* note 101, Section 45.20.

[135] *Id.* at Section 45.25.

[136] *Id.*

[137] 72 Phil. 524 (1941).

[138] *Id.*, at 528-29 (italics supplied).

In 1968, Republic Act 5455[139] was enacted codifying the definition enunciated in Mentholatum as follows:

> x x x the phrase "doing business" shall include soliciting orders, purchases, service contracts, opening offices, whether called "liaison" offices or branches; appointing representatives or distributors who are domiciled in the Philippines or who in any calendar year stay in the Philippines for a period or periods totalling one hundred eighty (180) days or more; participating in the management, supervision or control of any domestic business firm, entity or corporation in the Philippines; and any other act or acts that imply a continuity of commercial dealings or arrangments, and contemplate to that extent the performance of acts or works, or the exercise of some of the functions normally incident to, and in progressive prosecution of, commercial gain or of the purpose and object of the business organizatio.[140]

The same definition was adopted in Pres. Decree No.1789[141] and Executive Order No. 226.[142]

In 1991, or twenty three years after Republic Act 5455 codified the definition set in *Mentholatum*, Republic Act No. 7042, otherwise known as the Foreign Investment Act of 1991 was enacted. The said act substantially retained the definition in the prior investment acts but added a proviso which provides:

> That the phrase "doing business" shall not be deemed to include mere investment as a shareholder by a foreign entity in domestic corporations duly registered to do business, and/or the exercise of rights as such investor; not having a nominee director or officer to represent its interests in such corporation; nor appoint a representative or distributor domiciled in the Philippines which transacts business in its own name and for its own account.[143]

The act of making "purchases" was also removed from the definition of doing business.

The Implementing Rules and Regulations of R.A. 7042 subsequently passed by the Board of Investments did away with the expanded

[139] FOREIGN BUSINESS REGULATIONS ACT, September 30, 1968.

[140] *Id.*, Section 1; italics supplied.

[141] OMNIBUS INVESTMENTS CODE, Article 65 (1981).

[142] OMNIBUS INVESTMENTS CODE, Article 44 (1987).

[143] REPUBLIC ACT NO. 7042, Section 3 (d) (1991).

enumeration of the earlier rules and regulations. It substantially adopted the words of the law.[144]

E. Doctrines

The Supreme Court has admitted that no general rule or governing principle can be laid down as to what constitutes "doing" or "engaging in" or "transacting" business.[145] However, it should imply a "continuity" of commercial dealings and arrangements and contemplate the "performance of acts or works or the exercise of some of the functions normally incident to, and in progressive prosecution of, the purpose and object of its organization."[146]

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[144] Implementing Rules and Regulations, Section 1 (f) (1991) provides as follows:

f. Doing business shall include soliciting orders, service contracts, opening office, whether liaison offices or branches; appointing representatives or distributors, operating under full control of the foreign corporation, domiciled in the Philippines or who in any calendar year stay in the country for a period or periods totaling one hundred eighty (180) days or more; participating in the management, supervision or control of any domestic business, firm, entity or corporation in the Philippines; and any other act or acts that imply a continuity of commercial dealings or arrangements and contemplate to that extent the performance of acts or works, or the exercise of some of the functions normally incident to and in progressive prosecution of commercial gain or of the purpose and object of the business organization. The following acts shall not be deemed "doing business" in the Philippines:

(1) Mere investment as a shareholder by a foreign entity in domestic corporations duly registered to do business, and/or the exercise of rights as such investor;

(2) Having a nominee director or officer to represent its interests in such corporation;

(3) Appointing a representative or distributor domiciled in the Philippines which transacts business in the representative's or distributor's own name and account;

(4) The publication of a general advertisement through any print or broadcast media;

(5) Maintaining a stock of goods in the Philippines solely for the purpose of having the same processed by another entity in the Philippines;

(6) consignment by a foreign entity of equipment with a local company to be sued in the processing of products for export;

(7) Collecting information in the Philippines; and

(8) Performing services auxiliary to an existing isolated contract of sale which are not on a continuing basis, such as installing in the Philippines machinery it has manufactured or exported to the Philippines, servicing the same, training domestic workers to operate it, and similar incidental services.

[145] *Mentholatum*, 72 Phil. at 528.

[146] *Id.*

Thus, when a foreign corporation undertakes several transactions which imply continuity of commercial dealings and arrangements, it is considered doing business in the Philippines.[147]

Single or isolated acts, contracts, or transactions of foreign corporations in the state will not ordinarily be regarded as doing or carrying on of business therein.[148]

However in *Far East Int'l Import and Export Corp. v. Nankai Kogyo Co., Ltd.*[149] the Supreme Court held that where a single act or transaction of a foreign corporation is not merely incidental or casual, but is of such character as distinctly to indicate a purpose on the part of the corporation to do other business in the state, and to make the state a basis of the operation for the conduct of a part of the corporation's ordinary business, such act or transaction constitutes doing business.

Even if a foreign corporation enters into subsequent transactions but if such transactions are shown to have been entered for the purpose of carrying out the isolated original agreement, the corporation can not be considered as doing business here in the Philippines.[150]

A foreign corporation may choose to act through agents. If the agent, who conducts trade or business here in the Philippines, has no independent status, the corporation is deemed to have extended its presence here and thus, is deemed to be engaged in trade or business. This is premised on the basic rule in agency that the agent is a mere extension of the principal and that the acts of the former are deemed acts of the latter. But if the "agent" has an independent status of its own i.e. indentor or broker, the foreign corporation can not be considered to have extended its presence through the "agent." However, even if the "agent" is possessed of independent status, if the "agency" is exclusive or restrictive, the Supreme Court has considered the "agent" an extension of the principal.

In *Mentholatum Co.,Inc. v. Mangaliman*[151] the Philippine-American Drug Co., Inc., was the exclusive distributing agent of Mentholatum

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[147] *General Corporation of the Phil., v. Union Insurance Society of Canton, Ltd.*, 87 SCRA 313 (1950); *Wang Laboratories, Inc. v. Mendoza*, 156 SCRA 44 (1987); *Granger Associates v. Microwave Systems, Inc.*, 189 SCRA 631 (1990).

[148] *Pacific Micronesian Line, Inc. v. Del Rosario and Pelingon*, 96 Phil. 23 (1954); *Facilities Management corporation v. De la Osa*, 89 SCRA 131 (1979); *Aetna Casualty & Surety company v. Pacific Star Line*, 80 SCRA 636 (1977); *Eastboard Navigation Ltd., v. Juan Ysmael & Co, Inc.*, 102 Phil. 1 (1957); *N.V. Reederij "Amsterdam" v. Commissioner of Internal Revenue*, 132 SCRA 487 (1988).

[149] *Far East International Import and Export Corporation v. Nankai Kogyo Co., Ltd.*, 6 SCRA 725 (1962).

[150] *Antam Consolidated, Inc, v. Court of Appeals*, 143 SCRA 288 (1986).

[151] *Mentholatum*, 72 Phil. 524.

Co.Inc., a Kansas corporation. The Court ruled that "whatever transactions the Philippine-American Drug Co.,Inc., had executed in view of the law, the Mentholatum Co., Inc., did it itself."

This rule was reiterated in the case of *Top-Weld Manufacturing, Inc. v. ECED, S. A.*[152] In said case, Top-Weld Manufacturing, Inc., a domestic corporation, entered into a "license and technical agreement" with IRTI, S.A. a corporation organized under the laws of Switzerland. It also entered into a "distributor agreement" with ECED, S.A. a Panamanian corporation. Both agreements were highly restrictive. Although Top-Weld appeared to have maintained an independent status, the Supreme Court ruled that "in essence it merely extends to the Philippines the business of the foreign corporation."

The mere ownership or control by a foreign corporation of the stock of another corporation which is doing business within a state has been held not to constitute the doing of business, so as to subject it to the state's regulatory power.[153]

But in *Granger Associates v.Microwave Systems, Inc.*[154], the Supreme Court held that Granger is deemed doing business here in the Philippines for its 30% investment in MSI despite the BOI regulations stating that mere investment in a local company by a foreign corporation should not be construed as doing business in the Philippines. The Court noted as follows:

> x x x the investment of Granger in MSI is quite substantial, enabling it to participate in the actual management and control of MSI. In fact, it appointed a representative in the board of directors to protect its interests, and this director was so influential that, at his request, the regular board meeting was converted into an annual stockholder's meeting to take advantage of his presence.[155]

Close on the heels of the Granger decision was the case of *Marubeni Nederland B.V. v. Tensuan,*[156] penned by then Chief Justice Fernan. In said case D.B. Teodoro Development Corporation (DBT) entered into a contract where Marubeni Nederland B.V., a Japanese corporation agreed to supply the former all the necessary equipment, machinery,

[152] 138 SCRA 118 (1985).

[153] 36 AM. JUR., *Foreign Corporations*, Section 246, 349 (2d ed 1973).

[154] 189 SCRA 631 (1990).

[155] *Id.*

[156] G.R. No. 61950, Sept. 28, 1990.

materials, technical know-how and the general design of the construction of DBT's lime plant. DBT sued Marubeni Nederland for breach of contract and the latter interposed the defense that it is a corporation not doing business in the Philippines, and thus, no jurisdiction can be acquired over its person. It further alleged that the sale and purchase of the machineries and equipment for the Guimaras lime plant were isolated contracts and in no way indicated a purpose to engage in business and that services performed in the Philippines were merely auxiliary to the said isolated transaction.

The Supreme Court ruled that the Marubeni Nederland can be sued on two premises. First, that Marubeni Nederland is not a separate business entity from Marubeni Corporation, Japan, which took an active part in the negotiation of the contract. And since Marubeni Corporation, Japan, has a branch here in the Philippines and is considered doing business here. And second, that even assuming that Marubeni Nederland is a separate entity from Marubeni Japan, it had effectively solicited "orders, purchases (sales) or service contracts" as well as constituted Marubeni Corporation, Japan and its Manila Branch as its representative in the Philippines. The Court held that:

> These circumstances, taken singly or in combination, constitute "doing business in the Philippines" within the contemplation of law.

F. Case Analysis

Despite the definition set by the law on what acts constitute doing business, the question is still highly disputable and indeed "troublesome."

The Implementing Rules of the prior Omnibus Investment Codes[157] attempted to elaborate on these acts and circumstances that constitute "doing business." But the Supreme Court did not always adopt the elaboration. And this was shown in *Granger* where the Court held that "the administrative regulation, which is intended only to supplement the law, can not prevail against the law itself as the Court has interpreted it." The existing Rules then explicitly provided that "[m]ere investment in a domestic enterprise which has a distinct legal personality and duly licensed to transact business in the Philippines and/or the exercise of the rights as such investor, shall not constitute doing business therein." But the court did not apply such rule in *Granger*.

[157] PRES. DECREE 1789 (1981); EXECUTIVE ORDER NO. 226 (1987).

The *Granger* decision caused a lot of controversy and furor in the business world. And it led to a lot of other developments.

The definition of "doing business" in Republic Act 5455 did not explicitly state that "mere investment" is not doing business. However, the debates and discussion in the Senate during the deliberation of said Act disclosed that the framers of the law distinguished between two forms of investment: (1) making investments and (2) actually doing business.[158] The act of "making investments" which means "equity investment" was not included in the definition of "doing business"[159] Furthermore, the act of making investments can not be considered transacting a substantial portion of the ordinary business of the foreign corporation.

That particular ambiguity in *Granger* is now obviated under the Foreign Investments Act of 1991.[160] The said act added a proviso explicitly excluding mere investment as a shareholder by a foreign entity in a domestic corporation and/or the exercise of rights as such investor from the definition of "doing business." It even went further to exclude "having a nominee director or officer to represent its interests" in such corporation from the said definition.

It is worthy to note that when Senate Bill No. 1678 and House Bill No. 32496,[161] the bases of the 1991 Foreign Investments Act, were passed by the respective houses, both bills adopted *in toto* the definition of "doing business" under R.A. 5455. It was the same definition adopted by Pres. Decree 1789 and E.O. 226, the prior investment laws. However, the Conference Committee Report[162] consolidating and harmonizing both bills incorporated the proviso modifying the definition. The modification was suggested by Sycip, Gorres, Velayo & Co. thru its partner, Mr. Rizalino Navarro, in a letter dated April 19, 1991 addressed to Senator Vicente Paterno. In said letter, Mr. Navarro said:

> The *Granger* decision and other court decisions have been sending the wrong signals to foreign investors. The decision implies that a foreign investor must first get a license from the SEC before he can be considered as "doing business" and therefore able to sue in the Philippine courts. The act of obtaining a license makes the foreign entity subject to various reportorial requirements of government agencies, filing of tax returns, and securing permits and licenses from local governments these constitute deterrents to foreign entities which merely want to purchase capital stock of domestic companies.

Thus, for a foreign corporation which merely wants to purchase stock, the various reportorial requirements which are required for any foreign corporation to engage in trade or business in the Philippines constitute deterrents. On the other hand, if mere investment constitutes doing business, then the foreign corporation will be able to avail of the exemption from tax on intercorporate dividends received by resident foreign corporations[163] even if in reality, it has not extended its trade or business in the Philippines. However, the *Marubeni*[164] decision might result in the investor corporation being considered a nonresident in respect to its equity investment. In *Marubeni Nederland* the Supreme Court rejected the contention that the services performed by the petitioner were mere auxiliary to the principal contract to construct DBT's lime plant. Instead, it considered that Marubeni Nederland has no distinct personality from Marubeni Corporation, Japan because the latter took an active part in the initial stages of the negotiation. However, the mere fact that one or more corporations are owned and controlled by a single stockholder is not of itself sufficient ground for disregarding separate corporate entities.[165] It is disregarded only when the corporation is the mere alter ego or business conduit of another corporation as shown by dominance and interlacing of activities.[166] Such facts are not shown by mere active participation in the negotiations of a contract.

While it is true that "soliciting orders" is one of those acts enumerated which indicate "doing business," such act must still imply "continuity." The business done in the state had to be more than a mere solicitation of business.[167] The casual and occasional soliciting and taking of orders for goods[168] should not be considered as "doing business."

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[158] 3 SENATE CONGRESSIONAL RECORD 259-260 (July 1968).

[159] *Id.* at 255.

[160] REPUBLIC ACT NO. 7042.

[161] AN ACT TO PROMOTE AND ATTRACT FOREIGN INVESTMENTS, PRESCRIBE THE PROCEDURES FOR REGISTERING ENTERPRISES DOING BUSINESS IN THE PHILIPPINES, REPUBLIC ACT 7042, Section 2 (d) (1991).

[162] Section 3 (d).

[163] N.I.R.C., Section 25 (a) (6) (D).

[164] 177 SCRA 500 (1989).

[165] 3 AGBAYANI, COMMENTARIES AND JURISPRUDENCE ON THE COMMERCIAL LAWS OF THE PHILIPPINES, 35 (1980).

[166] Azcuna, *The Doctrine of Piercing the Veil of Corporation Fiction*, 18 ATENEO L. J. 10, 34 (1970).

[167] 18 FLETCHER, *supra* note 133, at Section 8718.

[168] *Id.*

The Supreme Court was also inclined to construe exclusive or "restrictive" licensing agreements as an agency arrangement, making the licensee here in the Philippines an agent of the licensor foreign corporation even if the former possesses independent status.[169] Restrictive license agreements prohibit the licensor from engaging directly or indirectly in the business of selling similar products. It is just a protection accorded by the parties to the licensor against unfair competition. It does not really constitute the licensee as an "extension" of the licensor's personality.

The Court failed to consider that it is the licensee who is independently engaged in commercial transactions in the Philippines. What the licensor does is just transfer technology or know-how to the licensee. In most cases, it does not participate in the conduct of the trade and business here.

Republic Act No. 7942 now explicitly provides that to appoint a "representative or distributor domiciled in the Philippines which transacts business in its own name and for its own account" is not doing business here in the Philippines. But the law does not expressly provide whether an exclusive or restrictive licensing agreement constitutes an "agency" so as to make the licensee an extension of the licensor.

G. The Amended Definition

The other change in the definition of "doing business" embodies in Republic Act No. 7042 was the deletion of the word "purchases." This was another modification suggested by Sycip, Gorres, Velayo & Company for the following reasons:

1) the presence of the word "purchases" may be interpreted by the licensing agencies of the government, and even by the courts, to mean that a foreign buyer/corporation can buy goods from the Philippine suppliers or exporters *only upon securing a license from the SEC;*

2) if this is the case, such a foreign buyer/corporation would instead prefer to buy from other countries which do not impose the crippling reporting requirements that go with the license;

3) such a possible misinterpretation should be avoided from the start. Republic Act No. 7042 was enacted fifty years after the

[169] *Top-weld*, 138 SCRA 118.

first attempt to define what constitutes "doing business" in the *Mentholatum* case and twenty years after Republic Act No. 5455 first codified the definition. It took the legislature such a long time to realize that the definition has not been clear enough.

Furthermore, the definition was amended in an "afterthought" manner. It came out only in the Conference Committee Report and it was never deliberated upon by the Senate or House of Representatives. Although beneficial the amendments may seem, it is possible that there has been no sufficient study prior to its incorporation.

V. SOURCE RULES

Foreign corporations whether engaged in trade or business in the Philippines or not, are taxable only on income from sources within the Philippines. The N.I.R.C. has provided for rules in determining the source of certain types of income.[170]

A. Commissioner of Internal Revenue vs. BOAC

In 1987, the Supreme Court en banc promulgated the case *Commissioner of Internal Revenue v. British Overseas Airways Corporation (BOAC)*.[171]

BOAC, which is engaged in the international airline business, was a 100% British Government-owned corporation. It had no landing rights for traffic purposes in the Philippines but it maintained a general sales agent here which was responsible for selling tickets covering passengers and cargoes. The Commissioner of Internal Revenue (CIR) assessed BOAC income taxes which the latter paid under protest. BOAC claimed for a refund but was denied by the CIR. On appeal, the Court of Tax Appeals (CTA) reversed the CIRand granted the claim for refund.[172] The CTA held that the proceeds of sales of BOAC passage tickets in the Philippines do not constitute income from Philippine sources "since

[170] N.I.R.C., Section 36 (1988).

[171] 149 SCRA 395 (1987).

[172] *British Overseas Airways Corporation v. Commissioner of Internal Revenue*, CTA Case No. 2372 (1982) & CTA Case No. 2562 (1983).

no service or carriage of passengers or freight was performed by BOAC within the Philippines." It was the CTA's position that the income from transportation is income from services so that the place where services are rendered determines the source.

In the petition for review on certiorari, the Supreme Court reversed the CTA's position and upheld the CIR. The Supreme Court first concluded that BOAC is deemed doing business in the Philippines for maintaining a general sales agent whose "activities" were in the exercise of the functions which are normally incident to, and are in progressive pursuit of the purpose and object of its organization as an international air carrier." Then, it ruled that the proceeds from the sale of airline tickets are deemed income from Philippine sources, to wit:

> The source of an income is the property, activity or service that produced the income. For the source of income to be considered as coming from the Philippines, it is sufficient that the income is derived from activity within the Philippines. In BOAC's case, the sale of tickets in the Philippines is the activity that produces the income. x x x The situs of the source of payments is the Philippines. The flow of wealth proceeded from, and occurred within Philippine territory, enjoying the protection accorded by the Philippine government.[173]

The Supreme Court went further to say that the transportation ticket is "not a mere piece of paper."[174]

It stated that it is a contract which gives rise to the obligation of the purchaser to pay the fare and the corresponding obligation of the carrier to transport the passenger upon the terms and conditions set forth thereon.

Justice Feliciano wrote a lengthy dissenting opinion. He agreed with the Court of Tax Appeals that the proceeds from the sale of the tickets are not income from Philippine source since the transportation service was not rendered here in the Philippines. He said that the "source of income" relates not to the physical sourcing of a flow of money or the physical situs of payments but rather to the "property, activity or service which produced the income."[175] He traced the concept

[173] *Commissioner*, 149 SCRA at 407; italics supplied.

[174] *Id.*

[175] Citing *Howden and Col, Ltd. v. Collector of Internal Revenue*, 13 SCRA 601 (1965); *id.* at 414.

of "source of income" for purposes of taxation to the United States income tax system as introduced in 1916 and subsequently embodied in the 1939 U.S. Tax Code from which our Tax Code (Commonwealth Act 466, as amended) was patterned. He pointed out that our Tax Code under Section 37(e)[176] and the Income Tax Regulations implicitly recognized transportation as a service income. He even went further to state that the airline ticket in and of itself has no monetary value, even a scrap of paper. It was merely the "evidence of the contract of carriage" entered into between BOAC and the passenger.

The Supreme Court reiterated the ruling in BOAC in the subsequent cases of *CIR vs. Air India*[177], CIR vs. *American Airlines*[178] and in the very recent case of *CIR vs. Japan Air Lines.*[179] The first case was decided by the first division, the second case by the second division and the last case was decided by the Supreme Court *en banc*. In the *JAL* case, Justice Feliciano reiterated his dissent.

B. Basic Concept of Source of Income

1. JURISDICTION

No state may tax anything not within its jurisdiction without violating the due process clause of the constitution. The taxing power of a state does not extend beyond its territorial limits, but within such limits it may tax persons, property, income of business.[180] This is just fair since taxation, in its true sense, is but compensation paid by the individual for protection to the person or his property.[181]

[176] (e) *Income from sources partly within and partly without the Philippines.* — Items of gross income, expenses, losses and deductions, other than those specified in subsections (a) and (c) of this section shall be allocated or apportioned to sources within or without the Philippines, under the rules and regulations prescribed by the Secretary of Finance. x x x Gains, profits, *and income from (1) transportation or other services rendered partly without the Philippines, x x x shall be treated as derived from sources within and partly from sources without the Philippines.* (italics supplied)

[177] 157 SCRA 648 (1988).

[178] 180 SCRA 274 (1989).

[179] G.R. No. 60714, October 4, 1991.

[180] *Manila Gas Corporation v. Collector of Internal Revenue*, 62 Phil. 895 (1936).

[181] 12 MERTENS, *supra* note 59, Section 45-3.04; footnotes omitted.

2. SOURCE

A "source" is that from which anything comes forth, regarded as its cause or origin.[182] It is the "first cause; origin that which gives rise to anything; the first producer; one who or that which originates..."[183] The word "source," therefore, conveys one essential idea that of origin.[184]

3. INCOME

"Income" is the return in money from one's business, labor, or capital invested; gains, profit, or private revenue.[185] It is something derived from property labor, skill, ingenuity, or sound judgment, from two or more in combination, and it is not commonly thought of as property but as gain derived from property or some other productive source.[186]

Income taxes are based on income, gross or net.[187] Thus, income is the "test of faculty" as distinguished from capital.

> Income as contrasted with capital or property is to be the test. The essential difference between capital and income is that capital is fund; income is flow. A fund of property existing at an instant time is called capital. A flow of services rendered by that capital by the payment of money from it or any other benefit rendered by a fund of capital in relation to such fund through a period of time is called income. Capital is wealth, while income is service of wealth.[188]

The U.S. Supreme Court has said that income may be derived from three possible sources only: (1) capital and/or (2) labor and/or (3) the sale of capital assets.[189] While the three elements of this definition need not be accepted as all-inclusive, they serve as useful guides in an

[182] 39 WORDS AND PHRASES 57 (1968).

[183] 12 MERTENS, *supra* note 59 at 10.

[184] *Id.*

[185] 20A WORDS AND PHRASES 166 (1968).

[186] *Id.*, at 167.

[187] 71 AM. JUR. 2d., *State and Local Taxation*, Section 443 (1973).

[188] *Marigal & Paterno v. Rafferty & Concepcion*, 38 Phil. 414 (1918); italics supplied.

[189] 12 MERTENS, *supra* note 59 at 11.

inquiry into whether a particular item is from "sources within the Philippines" and suggest an investigation into the nature and location of the activity or property which produces the income.[190] In determining the "source" of income, it is helpful to observe whether it was derived from capital, labor, or a sale of assets, and then to ascertain where these activities took place.[191] And the key to understanding the source of an item of gross income is focusing on the appropriate sourcing criteria.[192]

C. *Characterization*

The Supreme Court in *BOAC* first ruled on the issue of whether or not the airlines are doing business in the Philippines. However, such issue is actually irrelevant, as correctly pointed out by Justice Feliciano in his dissent. Under the Tax Code, a foreign corporation, whether doing business or not in the Philippines, is taxable only on its income from Philippine sources.[193] And since BOAC is a British corporation, it is taxable only on its income from within the Philippines, whether it be considered a resident or non-resident foreign corporation. Thus, the real issue in the cases is the source and necessarily, the characterization of the income generated from the "sale of the airline tickets."

1. SIGNIFICANCE

Characterization of the income is very important because different source rules apply to different kinds of income.

For instance, income from service is considered income from the place where the service is performed.[194]

Sale of personal property is generally considered income in the place where the property is sold.[195] Income from interest is deemed income in the place of residence of the obligors.[196]

[190] *Id.*

[191] *Id.*, Section 45-3.02.

[192] *Id.*, Section 45-3.03.

[193] N.I.R.C., Sections 25 (a) & (b) (1988).

[194] N.I.R.C., Sections 36 (a) (3) & (c) (3) (1988).

[195] N.I.R.C., Section 36 (e).

[196] N.I.R.C., Section 36 (a) (1) & (c) (1).

Thus, for income from labor or performance of services, the important factor which determines the source of income is not the residence of the payor, or the place where the contract for service is entered into, or the place of payment.[197] It is the place where the services are actually rendered.[198]

2. AIRLINE AS A COMMON CARRIER

The Supreme Court failed to consider that an airline has long been regarded as a common carrier and is thus engaged in the performance of service.

A carrier of passengers is one who undertakes to transport persons from place to place, gratuitously or for hire.[199] Art. 1732[200] of the Civil Code provides that common carriers are persons, corporations, firms or associations engaged in the business of carrying or transporting passengers or goods or both, by land, water, or air, for compensation, offering their services to the public. In consideration of the payment of the fare demanded, a contract for the carriage of passengers imports that the carrier will use all possible care and diligence in transporting and delivering the passenger safely and promptly at the place of destination.[201]

In the case of *Alitalia Airways vs. Court of Appeals*,[202] the Court had the occasion to state that "common carriers, like commercial airlines, are in the business of rendering service, which is the primary reason for their recognition in our law." In fact, in several Supreme Court decisions, airlines were subjected to the obligations and liabilities of a common carrier.[203]

Since a common carrier is engaged in the performance of service, then an airline company, like BOAC, is primarily engaged in rendering transportation services to the public.

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[197] 8 MERTENS, *supra* note 101, Section 45.33.

[198] *Id.*

[199] 14 AM. JUR., *Carriers*, 218 (2d ed. 1973); footnotes omitted.

[200] REPUBLIC ACT 386 (1949).

[201] 14 AM. JUR., *supra*, Section 737.

[202] 187 SCRA 263 (1990).

[203] *Shewaran v. Philippine Air Lines, Inc.*, 17 SCRA 606 (1966); *Davila v. Philippine Air Lines, Inc.*, 49 SCRA 496 (1973); *Abeto v. Philippine Air Lines, Inc.*, 115 SCRA 489 (1982); *KLM Royal Dutch Air Lines v. Court of Appeals*, 65 SCRA 237 (1975).

3. TRANSPORTATION INCOME

Transportation income means any income derived from or in connection with the use of a vessel or aircraft or the performance of services directly relating to such a vessel or aircraft.[204] In understanding the sourcing rules relating to transportation income, it should be kept in mind that vessels or aircraft for use between countries are the focus of attention.[205]

4. U.S. LAWS

There was introduced in the 1921 Tax Law of the U.S., which was later brought in to the 1939 code, the basis for our Tax Code (CA 466), a provision that "gains, profits, and income" from "transportation or other services rendered partly within and partly without the United States... shall be treated as derived partly from sources within and partly from sources without the United States."[206] This was based upon a recognition of the fact that transportation was a service and that the source of income derived therefrom was to be treated as being the place where the service of transportation was rendered.[207] It was the intention of Congress under the 1921 law to place the taxation of transportation companies upon sounder and more scientific basis, and so the principle was adopted of considering income derived from transportation to be income for service, and thus the place where the services were rendered determined the source.[208] The result was income from sources partly within and partly without the U.S.[209]

Under the U.S. Tax Reform Act of 1984, transportation income earned from transportation that begins and ends in the U.S. is treated as U.S. income.[210] Transportation income earned from transportation that begins in the U.S. and ends in a U.S. possession (or vice versa) is treated as 50% United States source income.[211]

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[204] 12 MERTENS, *supra* note 59, at Section 45-3.20.

[205] *Id.*

[206] 8 MERTENS, *supra* note 101, Section 45.43.

[207] *Id.*

[208] *Id.* (italics supplied).

[209] *Id.*

[210] 12 MERTENS, *supra* note 59, at Section 45-3.20; U.S. I.R.C., Section 863 (c).

[211] U.S. I.R.C., Section 863 (c) (2) (A).

This was still based upon a recognition of the fact that transportation was a service.[212]

Thus, if point of origin and point of destination are both within the United States, the income is all U.S. source income.[213] On the other hand, if the point of origin and the point of destination are both outside the United States, the income is foreign source income.[214] If the point of origin or the point of destination is within the United States, but not both, the income is sourced 50 percent United States and 50 percent foreign.[215]

D. *Analysis*

In the *BOAC* case, the Supreme Court did not consider the income of BOAC as income from performance of transportation services. It referred to the definition of "gross income" in the Tax Code[216] and concluded that the definition is "broad and comprehensive enough to include proceeds from sales of transport documents." It also referred to the enumeration of gross income from sources within the Philippines under Section 37 (a) [now Section 36 (a)],[217] of the Tax Code and held that the enumeration "does not mention income from the sale of tickets for international transportation." And thereafter concluded that the enumeration is not "all-inclusive" and merely "directs" that

[212] 12 MERTENS, *supra* note 181, at Section 45-3.20.

[213] *Id.*

[214] *Id.*

[215] *Id.*

[216] 'Gross income' includes gains, profits, and income derived from salaries, wages or compensation for personal service of whatever kind and in whatever form paid, or from profession, vocations, trades, business, commerce, sales, or dealings in property, whether real or personal, growing out of ownership or use of or interest in such property; also from interests, rents, dividends, securities, or the transactions of any business carried on for gain or profits, or gains, profits, and income derived from any source whatever. [Sec. 29 (3)].

[217] Section 36 — The following items of gross income shall be treated as gross income from sources within the Philippines:

(1) Interest. xxx.

(2) Dividends. xxx.

(3) Services. xxx.

(4) Rentals & Royalties. xxx.

(5) Sale of Real Property. xxx.

(6) Sale of Personal Property. xxx.

the types of income listed therein be treated as income from sources within the Philippines.

It would seem that the Supreme Court tried to impress in its decision that the sale of transportation tickets is not among those specifically enumerated as items of gross income or income from sources within the Philippines but is a special class of income which can be included in the enumeration under its "catch all" provision or under the theory that the enumeration is not exclusive. The Supreme Court did not even try to characterize the sale of transport tickets as any of those items enumerated. It did not even categorically state that it is a sale of personal property. More so, it did not even consider, or perhaps even chose to ignore, the transaction as a contract for services.

The theory of the Supreme Court hinged on its conclusion hat "the sale of tickets in the Philippines is the activity that produces the income." Was it trying to say that the "sale" is the service performed or was it trying to say that the "sale of the tickets" is akin to a sale of personal property wherein the place of sale is the decisive point? With these questions in mind it would be noteworthy to take a closer look at the nature of an airline ticket.

As Justice Feliciano stated "the phrase sale of airline tickets,' while widely used in popular parlance, does not appear to be correct as a matter of tax law.[218] The transportation ticket has been viewed either as a mere receipt for the money paid or as a contract between the ticket holder and the common carrier which embraces the entire agreement between the parties.[219] Under the first view, the ticket itself does not constitute a contract between the parties, but is merely the evidence of the right to transportation in consequence of a contract to carry.[220] Under the second view, the ticket embraces within its terms all the elements necessary to constitute a valid contract, binding upon the parties entering into the relation of carrier and passenger.[221] In our jurisdiction, we have adopted the latter view. In *Shewaram vs. Philippine Air Lines, Inc.*[222], the Supreme Court has impliedly recognized the airline ticket as a contract and applied the provisions of

[218] *Commissioner*, 149 SCRA at 421.

[219] 14 AM. JUR., *supra* note 199, at Section 811.

[220] *Id.*, Section 812.

[221] *Id.*, Section 813.

[222] 17 SCRA 606 (1966).

Article 1750[223] of the Civil Code in determining the liability of the airline. In fact, in the *BOAC* case itself, the Supreme Court recognized the airline ticket as a contract when it stated that:

> A transportation ticket is not a mere piece of paper. When issued by a common carrier, it constitutes the contract between the ticket-holder and the carrier. It gives rise to the obligation of the purchaser of the ticket to pay the fare and the corresponding obligation of the carrier to transport the passenger upon the terms and conditions set forth thereon.[224]

But as Justice Feliciano held in his dissenting opinion:

> The airline ticket in and of itself has no monetary value, even as scrap paper. The value of the ticket lies wholly in the right acquired by the `purchaser' — the passenger — to demand a prestation from the BOAC, which prestation consists of the carriage of the "purchaser: or the passenger from one point o another outside the Philippines. The ticket is really the evidence of the contract of carriage entered into between BOAC and the passenger.[225].

A document evidencing the contract of the parties remains a contract notwithstanding any provision or stipulation the parties may agree to incorporate therein. It is a mere piece of evidence, a mere piece of paper. So is an airline ticket. The fact remains that the real object or subject matter therein is the obligation of the carrier to transport he passenger to the point of destination.

Furthermore, as pointed out by Justice Feliciano in his dissenting opinion in the *JAL* case, the tax involved here is the tax on income: we are not concerned with a sales tax nor with an excise or privilege tax. Income taxes are based on income while excise or privilege taxes are imposed upon the performance of an act, the enjoyment of a privilege, or the engaging in an occupation.[226] Thus, the emphasis should not be on the sale of tickets" but on the consideration for such sale — the right to be transported — which gave rise to realization of income.

[223] Article 1750 provides that "[a] contract fixing the sum that may be recovered by the owner or shipper for the loss, destruction, or deterioration of the goods is valid, if it is reasonable and just under the circumstances, and has been fairly and freely agreed upon."

[224] *Commissioner*, 149 SCRA at 407; italics supplied.

[225] *Id.*, at 421.

[226] 71 AM. JUR., *State and Local Taxation*, Sec. 29 (2nd ed. 1973).

E. International Carrier's Tax

The *BOAC* case was significant only to the income earned prior to Novermber 24, 1972. On said date, Pres. Decree No. 69 was promulgated imposing the 2-1/2 carriers tax, as follows:

> x x x Provided, however, that international carriers shall pay a tax of 2-1/2 percent on their gross Philippine billings.[227].

The said tax was applicable only to international carriers doing business in the Philippines.[228] Pres. Decree No. 1355, promulgated on April 21, 1978, defined the term "gross Philippine billings" as follows:

> x x x `Gross Philippine billings' includes gross revenue realized from the uplifts anywhere in the world by any international carrier doing business in the philippines of passage documents sold therein, whether for passenger, excess baggage or mail, provided the cargo or mail originates from the Philippines. x x x

The said provision prodided for a simplified way of taxing international carriers. Prior to such time, the BIR encountered difficulties in verifying the allocation of income of international carriers earned in the Philippines and expenses attributable thereto in relation to their world income.[229]

F. Effect Of BOAC

In a ruling dated February 2, 1978, the BIR ruled that income diverted from the purchase and sale of Reader's Digest Magazine, is income derived from the place in which it is sold. And since the acceptance of the subscription order or the consummation of the sale took place in Hong Kong, the income from subscriptions are deemed income from without the Philippines pursuant to the "passage of title" test.

Subsequently, the BIR ruled that income earned by the publishers of foreign magazines are considered income from sources without the Philippines, since the same constitute compensation for labor or personal services without the Philippines.[230] The situs is the place where

[227] N.I.R.C., Section 25 (a) (2).

[228] *Id.*

[229] Toledo, *supra* note 4, at 32-33.

[230] BIR ruling No. 312-87 (October 8, 1987); BIR Ruling NO. 278-88 (June 28, 1988).

the editing, programming, printing and publication of the magazines took place, which is outside the Philippines.

However, in the light of the *BOAC* ruling, the BIR reversed its position. BIR Commissioner Jose Ong ruled that the *filling up of the subscription form* by the Philippine subscriber is the activity that produced the income constituting of the subscription payments.[231] And since the subscription forms were filled here in the Philippines, the income therefrom constitutes income from Philippine sources.

Since the disputed income in the *BOAC* case was earned prior to the promulgation of Pres. Decree 69, the Supreme Court might have really thought it iniquitous for the proceeds from the sales of the tickets to escape income taxation considering that the payments were made here. But in so doing, the significantly circumvented the principles behind sourcing of income and expenses for taxation purposes. If they can do it with the publishing companies, they can also do it to other industries.

Thus, while the *BOAC* case itself may not be significant anymore for international carriers with the advent of the 2 1/2 international carrier's tax, it can still have rippling effects on other lines of business.

VI. CONCLUSION

The regulation of foreign investments can take many forms. And one of these government tools is the power of taxation. The present system of taxing foreign corporations, to a large extent, influences the decisions of the foreign investors to bring in their capital to the Philippines. However, taxation can only be an effective tool if the policy of the government, as embodied in the laws, is coherent and strategic.

The role of the Supreme Court in interpreting and applying the tax provisions in the adjudication of the cases is also very important. As seen from the cases discussed, the Court made several pronouncements on and even departure from existing tax principles embodied in the Tax Code. In *Marubeni Corporation v. Commissioner of Internal Revenue*, it treated the head office as a nonresident foreign corporation in relation to its income from investments made in the Philippines which are not

[231] BIR Ruling No. 95-90 (May 28, 1990); BIR Ruling No. 96-90 (May 28, 1990); BIR Ruling No. 97-90 (May 28, 1990).

effectively connected with the business operations of the Philippine branch. However, in the case of *Marubeni Nederland B.V. v. Tensuan*, it considered Marubeni Corporation, Japan, who has a branch here in the Philippines, and Marubeni Nederland, a subsidiary of the former, as one and the same entity in order to consider the latter as engaged in trade or business in the Philippines. In *Commissioner of Internal Revenue v. Procter & Gamble PMC*, the Court initially refused to apply the tax sparing provision to a U.S. parent corporation. In *Commissioner v. BOAC*, the Supreme Court considered the "sale of the tickets" as the activity which produced the income of an international airline company. And finally, in *Granger Associates v. Microwave Systems, Inc.*, the Court considered the act of making investments as doing business in the Philippines.

The tax laws are not entirely blameless. The basic pattern of our Tax Code was copied from the United States tax laws. While the U.S. laws have several times been overhauled, abandoning old principles which are not deemed beneficial, our tax code as continued to embody these principles. For instance, the "force of attraction principle" which the U.C. rejected in 1966 is still embodied in our code. And the Supreme Court, in order to correct the "anomalous" situation wherein non-business income of the resident foreign corporation is taxed at a lower rate even if it is not effectively connected with its trade or business in the Philippines, ruled in *Marubeni* that the corporation with a branch here in the Philippines be considered a non-resident foreign corporation with respect to such income.

The tax-sparing provision which was incorporated in the Tax Code is designed to encourage foreign investments. It is not really an instrument against double taxation like the tax credits. It is a purely incentive measure. The Second Division of the Supreme Court denied its application to *Proctor & Gamble-U.S.A.* since the U.S. laws provide for an indirect or "deemed paid" tax credit and not a "tax-spare" credit. Hence, there was a "conceptual difficulty" in applying the tax sparing provision. But subsequently, the Court *en banc* considered that the U.S. laws complied with the requirements set in our code since mathematically, the amount of indirect tax credit that will be allowed in the U.S. will be much higher than the twenty percent (20%) tax which the Philippine government forgoes. The Court *en banc* also set aside the reporting requirements laid down earlier by the Second Division.

Although it has been the policy of the government to equalize the treatment of branches and subsidiaries, such equalization has not exactly been achieved. The dividends declared by subsidiaries of non-resident foreign corporations are subject to the thirty five percent (35%)

tax or to lower fifteen percent (15%) tax, regardless of whether or not such income is effectively connected with the subsidiaries' operations here in the Philippines. On the other hand, branch profits are subject to the fifteen percent (15%) branch profits remittance tax if they are effectively connected with the business of the Philippine branch.

The Tax Code does not set the parameters of what constitutes "doing business", the basis for the distinction between resident and nonresident foreign corporations. The concept of "doing business" under the Tax Code is the same concept under the investment laws and jurisdictional statutes. But the concept is for from settled. And it has never been evaluated from the taxation point of view.

It is important to note that Justice Florentino Feliciano, an expert in international law, wrote the dissenting opinions in the *BOAC* and *JAL* cases. And he was the *ponente* of the *en banc* decision reversing the decision of the Second Division in *Proctor & Gamble.*

Thus, it can be seen that the adequacy of our tax laws and the decisions of the Supreme Court shape the manner of taxing foreign corporations. Supreme Court decisions, which enunciated some departure from existing principles, may be indications that there are some inadequacies in our tax laws. They can also be indications of the Supreme Court's strict posture towards foreign corporations.

Our laws have been amended too, but in a patchwork and incoherent manner. As a result, we have a diluted and muddled tax policy regarding foreign corporations.

VII. RECOMMENDATIONS

This study showed that there is a need for the government to review the positions of branches and subsidiaries from a taxation point of view if it is indeed the policy to place both at par. If there is a distinction as to "effectively connected" income as to branches, the same distinction should also be applied to the subsidiaries' income.

It is high time to abandon the "force of attraction" principle governing resident foreign corporations. Without splitting the status of a branch and head office, there should be further distinction as to the business and nonbusiness income generated by resident foreign corporations. The latter income should be subject to a higher tax.

The concept of "doing business" under the tax statutes should be reviewed and made clear. The concept adopted by the investment laws which is also used for tax purposes has not really provided the clear distinction that is demanded for stability.

Although it is very obvious or elementary, perhaps a clear definition as to what constitutes a "contract" and what constitutes the appropriate "activity" which is the source of income, should be incorporated in our Tax Code. This will obviate the confusion caused by the Supreme Court's decisions regarding the airline companies.

Obviously, there is so much that can be done. It is just about time that the government look into the adequacy and soundness of the tax provisions affecting foreign corporations in a thorough and wholistic manner and make clear the policy towards them. This will solve a lot of problems and perhaps leave little room for policy decisions.