Republic of the Philippines
DEPARTMENT OF FINANCE
Roxas Boulevard Corner Pablo Ocampo, Sr. Street
Manila 1004

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DOF Opinion No. 003 . 2019

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CENTRAL RECORDS MGNT. DIVISION

MS. RUBINA B. AQUINO
Senior Director, Tax Services
SyCip Gorres Velayo & Co.
6760 Ayala Avenue
Makati City, Philippines

SUBJECT: Request for Review of Bureau of Internal Revenue Ruling No. ITAD 140-12

Dear **Ms. Aquino**:

This refers to the subject letter dated 11 May 2012 ("Request for Review") which you filed with this Department on behalf of Sumitomo Corporation – Tokyo Head Office ("Sumitomo Tokyo") to request for review of Bureau of Internal Revenue ("BIR") Ruling No. ITAD 140-12 dated 28 March 2012, which ruled on the income tax liability of Sumitomo Tokyo on the dividends paid by First Philippine Industrial Park, Inc. ("FPIPI") to the company.

In particular, the Request for Review prays for the reversal of the BIR's findings that the dividends paid on the 10% FPIPI shares shall be included in the taxable income of Sumitomo Corporation – Manila Branch ("Sumitomo Manila"), subject to a 30% income tax rate under Section 28(A) of the National Internal Revenue Code ("NIRC"), as amended. Thus, it provided that the dividends are subject to income tax as follows:

a. The dividends on the 90% of the shares are subject to the preferential 10% income tax rate, pursuant to paragraph 2(a) of Article 10 of the Philippines-Japan Tax Treaty;

b. The dividends on the 10% shares (recorded in the name of Sumitomo Manila) are effectively connected with Sumitomo Manila, and therefore, shall be included in its taxable income, subject to income tax at the rate of 30% under Section 28(A) of the NIRC, as amended.

BIR Ruling No. ITAD 140-12 subjected the transaction to income tax at the rate of 30% under Section 28(A) of the NIRC, as amended on the premise that the reduced rates of income tax under the Philippine-Japan Tax Treaty does not apply to the 10% FPIPI shares of Sumitomo Tokyo ("subject shares"), which shares are effectively connected with Sumitomo Manila, a permanent establishment of Sumitomo Tokyo in the Philippines.

To support the above conclusion, BIR cites the provision under paragraph 5, Artclie 10 of the Japan-Philippine Tax Treaty, which provides:

"5. The provisions of paragraph 1,2 and 3 shall not apply if the beneficial owner of the dividends, being a resident of a Contracting State, carries on business in the other Contracting State of which the company paying the dividends is a resident, **through a permanent establishment situated**

therein, or performs in that other Contracting State independent personal services from a fixed base situated therein, **and the holding in respect of which the dividend are paid is effectively connected with such permanent establishment or fixed base**. In such case the provisions of Article 7 or Article 14, as the case may be, shall apply." (Emphasis supplied)

On the specific issue on the dividends being effectively connected with a permanent establishment, the BIR referred to the Organisation for Economic Co-operation and Development (OECD) Model Tax Convention on Income and on Capital which states that dividends are effectively connected if they are paid in respect of holdings forming part of the assets of the permanent establishment or otherwise effectively connected with that establishment, thus:

> **"Paragraph 4**
> 31. Certain States consider that dividends, interest and royalties arising from sources in their territory and payable to individuals or legal persons who are residents of other States fall outside the scope of the arrangement made to prevent them from being taxed both in the State of source and in the State of the beneficiary's residence when the beneficiary has a permanent establishment in the former State. Paragraph 4 is not based on such a conception which is sometimes referred to as "the force of attraction of the permanent establishment". It does not stipulate that dividends flowing to a resident of a Contracting State from a source situated in the other State must, by a kind of legal presumption, or fiction even, be related to a permanent establishment which that resident may have in the latter State, so that the said State would not be obliged to limit its taxation in such a case. The paragraph merely provides that **in the State of source the dividends are taxable as part of the profits of the permanent establishment there owned by the beneficiary which is a resident of the other State, if they are paid in respect of holdings forming part of the assets of the permanent establishment or otherwise effectively connected with that establishment**. In that case, paragraph 4 relieves the State of source of the dividends from any limitations under the Article. The foregoing explanations accord with those in the Commentary on Article 7. (Page 193)" (Emphasis supplied)

Sumitomo Tokyo, however, countered and submitted that the discussion in the immediately succeeding section of the OECD Commentaries (Section 32) is equally important and should be taken into consideration. Thus:

> "32. It has been suggested that the paragraph could give rise to abuses through the transfer of shares to permanent establishments set up solely for that purpose in countries that offer preferential treatment to dividend income. Apart from the fact that such abusive transactions might trigger the application of domestic anti-abuse rules, it must be recognised that **a particular location can only constitute a permanent establishment if a business is carried on therein and**, as explained below, **that the requirement that a shareholding be "effectively connected" to such a location requires more than merely recording the shareholding in the books of the permanent establishment for accounting purposes**.

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32.1 A holding in respect of which dividends are paid will be effectively connected with a permanent establishment, and will therefore form part of its business assets, **if the "economic" ownership of the holding is allocated to that permanent establishment** under the principles developed in the Committee's report entitled Attribution of Profits to Permanent Establishments(see in particular paragraphs 72-97 of Part I of the report) for the purposes of the application of paragraph 2 of Article 7. In the context of that paragraph, the **"economic" ownership of a holding means the equivalent of ownership for income tax purposes by a separate enterprise, with the attendant benefits and burdens** (e.g. the right to the dividends attributable to the ownership of the holding and the potential exposure to gains or losses from the appreciation or depreciation of the holding)." (Emphasis supplied)

After reviewing the facts and the laws presented, we agree with Sumitomo Tokyo that the dividends paid on the 10% FPIPI shares should be subject to the preferential rate of 10% of the gross amount pursuant to the Article 10(2)(a) of the Philippine-Japan Tax Treaty.

In determining the proper treatment of the dividends attributable to the subject shares, it is imperative to consider not just a single fact or a particular circumstance but determine the entirety of the underlying arrangement.

First off, the right to receive the dividends attributable to the subject shares is exercised by Sumitomo Tokyo. This is evidenced by the fact that the stock certificates covering the said shares are in the name of Sumitomo Tokyo. Also, the General Information Sheet (GIS) of FPIPI lists Sumitomo Tokyo as the owner of the subject shares. Thus, FPIPI has consistently considered Sumitomo Tokyo as the owner of the subject shares and any dividend declared by the former is remitted directly to the latter. Sumitomo Manila, on the other hand, did not receive any amount of the dividend declared and paid by FPIPI.

In addition, Sumitomo Tokyo declared in its sworn request for review that the business activities that gave rise to the dividends issued by FPIPI were not conducted through Sumitomo Manila. Sumitomo Manila does not use or hold for use any share of stock of FPIPI in the conduct of its trade or business, and it is not a material factor in the realization of Sumitomo Tokyo of the dividends.

Conversely, aside from the single fact that the subject shares of Sumitomo Tokyo is recorded in the books of Sumitomo Manila, the BIR was unable to establish any other circumstance supporting its conclusion that the subject shares should be considered effectively connected with Sumitomo Manila.

As provided in the OECD Commentaries on the specific matter, the requirement for a shareholding to be "effectively connected" to such a location requires more than merely recording the shareholding in the books of the permanent establishment for accounting purposes. Moreover, "economic" ownership of a holding means the equivalent of ownership for income tax purposes by a separate enterprise, with the attendant benefits and burdens (e.g. the right to the dividends attributable to the ownership of the holding and the potential exposure to gains or losses from the appreciation or depreciation of the holding).

In line with the foregoing, we hold that Sumitomo Tokyo has economic ownership over all the FPIPI shares, bearing the rights and obligations associated therewith. Consequently, it is subject to the preferential rate of 10% of the gross amount pursuant to Article 10(2)(a) of the Philippine-Japan Tax Treaty.

This ruling is being issued on the basis of the foregoing facts as represented. However, if upon investigation, it will be disclosed that the facts are different, then this ruling shall be considered as null and void.

Thank you.

Sincerely yours,

CARLOS G. DOMINGUEZ
Secretary of Finance
JAN 14 2019

CC **Commissioner Caesar R. Dulay**
Bureau of Internal Revenue 1/22