REPUBLIC OF THE PHILIPPINES
COURT OF TAX APPEALS
QUEZON CITY

FIRST DIVISION

FORTUNE TOBACCO CORPORATION, *Petitioner,*	**CTA CASE No. 9105** For: Assessment
-versus-	Members: DEL ROSARIO, P.J., *Chairperson* UY, and MINDARO-GRULLA, *JJ.*
COMMISSIONER OF INTERNAL REVENUE, *Respondent.*	Promulgated: AUG 15 2018 2:20 pm

x---x

DECISION

MINDARO-GRULLA, J.:

This is a Petition for Review[1] filed by petitioner Fortune Tobacco Corporation (FTC) on July 27, 2015, pursuant to Section 7(a)(1)[2] of Republic Act (RA) No. 1125,[3] as amended, as well as Section 3(a)(1)[4] of Rule 4 and Section

---

[1] Dockets, Vol. I, pp. 10-46.
[2] Sec. 7. Jurisdiction. - The CTA shall exercise:

(a) Exclusive appellate jurisdiction to review by appeal, as herein provided:

(1) Decisions of the Commissioner of Internal Revenue in cases involving disputed assessments, refunds of internal revenue taxes, fees or other charges, penalties in relation thereto, or other matters arising under the National Internal Revenue Code or other laws administered by the Bureau of Internal Revenue;

xxx

[3] Act Creating the Court of Tax Appeals.
[4] Sec. 3. Cases within the jurisdiction of the Court in Division.- The Court in Division shall exercise:

(a) Exclusive original over or appellate jurisdiction to review by appeal the following:

4(a)[5] of Rule 8 of the Revised Rules of the Court of Tax Appeals, as amended.

FTC prays for the reversal and setting aside of the Final Decision on Disputed Assessment (FDDA)[6] of the respondent Commissioner of Internal Revenue (CIR) on FTC's Administrative Protest/Request for Reconsideration[7] dated December 3, 2014, insofar as the said Decision imposes a deficiency "Improperly Accumulated Savings Tax" in the amount of ₱2,602,478,844.21; the setting aside and cancellation of Assessment Notice No. ELTAD-II-IE-0900004[8] dated October 28, 2014 issued by the CIR against FTC for alleged deficiency "Improperly Accumulated Earnings Tax" in the total amount of ₱2,442,651,058.87, inclusive of interest for the period January 15, 2011 to November 30, 2014; and declaring that FTC is not liable to pay the aforesaid assessment.

Respondent CIR is the head of the Bureau of Internal Revenue (BIR), with office address at the Office of the Commissioner of Internal Revenue, BIR National Office Building, Agham Road, Diliman, Quezon City, Metro Manila, where he may be served with summons and other processes of this Court.

> (1) Decisions of the Commissioner of Internal Revenue in cases involving disputed assessments, refunds of internal revenue taxes, fees or other charges, penalties in relation thereto, or other matters arising under the National Internal Revenue Code or other laws administered by the Bureau of Internal Revenue.

[5] Sec. 4. Where to appeal; mode of appeal.-

(a) An appeal from a decision or ruling or the inaction of the Commissioner of Internal Revenue on disputed assessments or claim for refund of internal revenue taxes erroneously or illegally collected, the decision or ruling of the Commissioner of Customs, the Secretary of Finance, the Secretary of Trade & Industry, the Secretary of Agriculture, and the Regional Trial Court in the exercise of their original jurisdiction, shall be taken to the Court by filing before it a petition for review as provided in Rule 42 of the Rules of Court. The Court in Division shall act on the appeal.

[6] Dockets, Vol. I, pp. 187-191.
[7] Dockets, Vol. I, pp. 146-186.
[8] Dockets, Vol. I, pp. 99-145.

L

On August 27, 2014, FTC received a Preliminary Assessment Notice (PAN)[9] dated May 19, 2014, together with the Details of Discrepancies and other attachments[10] from the CIR, stating that after investigation, there had been found due from FTC deficiency Income Tax (IT), Value-Added Tax (VAT), Expanded Withholding Tax (EWT), Final Withholding Tax-VAT (FWT-VAT), Documentary Stamp Tax (DST), and Improperly Accumulated Earnings Tax (IAET) for the calendar year 2009, all amounting to ₱3,560,809,047.91.

On September 11, 2014, or within the reglementary period of fifteen (15) days, FTC submitted its Reply[11] to the Preliminary Assessment Notice.

On November 3, 2014, FTC received from the respondent CIR a Formal Letter of Demand (FLD)[12] dated October 28, 2014, together with Assessment Notice No. ELTAD-II-IE-09-00004 for IAET[13] and other Assessment Notices for IT,[14] VAT,[15] EWT,[16] FWT-VAT,[17] and DST,[18] all dated October 28, 2014, and the Details of Discrepancies and other attachments,[19] issued to FTC by the CIR.

The assessments for taxable year 2009 had an aggregate amount of ₱3,730,024,871.21 inclusive of surcharges and interests. The CIR requested FTC to pay the same on or before December 3, 2014. The computation of the alleged deficiency IAET of ₱2,442,651,058.87 is detailed in the FLD.

---

[9] Dockets, Vol. I, pp. 47-51.
[10] Dockets, Vol. I, pp. 52-80.
[11] Dockets, Vol. I, pp. 81-97.
[12] Dockets, Vol. I, pp. 99-102.
[13] Dockets, Vol. I, p. 108.
[14] Dockets, Vol. I, p. 103.
[15] Dockets, Vol. I, p. 105.
[16] Dockets, Vol. I, p. 106.
[17] Dockets, Vol. I, p. 104.
[18] Dockets, Vol. I, p. 107.
[19] Dockets, Vol. I, pp. 109-145.

L

Within the reglementary period of thirty (30) days, or on December 3, 2014, FTC filed on the aforesaid FLD an Administrative Protest/Request for Reconsideration.[20]

On June 29, 2015, FTC received the FDDA[21] dated June 9, 2015 of the CIR on its Administrative Protest/Request for Reconsideration dated December 3, 2014, stating that its Administrative Protest/Request for Reconsideration "is hereby denied for lack of factual and legal basis".

On June 30, 2015, FTC paid the IT in the amount of ₱34,684,986.33, inclusive of interest;[22] the VAT in the amount of ₱12,833,363.65, interest included;[23] the EWT in the amount of ₱5,827,024.25, inclusive of increments;[24] for DST in the amount of ₱168,352.43, interest included;[25] and the Miscellaneous Tax in the amount of ₱140,000.00.[26]

With respect to the alleged deficiency IAET, in support thereof, it is stated in the FDDA, among other things, that "The rationale is that if the earnings and profits were distributed, the shareholders would then be liable to income tax thereon"; that "a tax is being imposed in the nature of penalty to the corporation xxx as a form of deterrent to the avoidance of tax upon shareholders who are supposed to pay dividends tax on the earnings distributed to them by the corporation"; and that "if there is a determination that a corporation has accumulated income beyond the reasonable needs of the business, the 10% improperly accumulated earnings tax shall be imposed". It is further stated that the CIR questions the propriety of the appropriation amounting to ₱14.3 Billion as of year-end 2009 in the audited financial statements because two months after the close of the taxable year 2009, FTC entered into a "business combination" with Philip Morris Phils. Inc. (PMPI) where FTC would be earning passive income only; and that the case filed by the Republic of the Philippines against FTC in the

---

[20] *Supra,* note 7.
[21] Dockets, Vol. I, pp. 187-197.
[22] Dockets, Vol. I, pp. 198-201.
[23] Dockets, Vol. I, pp. 202-205.
[24] Dockets, Vol. I, pp. 206-209.
[25] Dockets, Vol. I, pp. 210-213.
[26] Dockets, Vol. I, pp. 214-217.

Sandiganbayan[27] (Civil Case No. 0005) should not be a reason for not declaring dividends for taxable year 2009 since FTC had paid dividends in 2013.

On July 27, 2015, the subject Petition for Review was filed by FTC.

On November 9, 2015, Answer[28] was filed by the CIR. The CIR's Pre-Trial Brief[29] was filed on February 11, 2016; while FTC's Pre-Trial Brief[30] was filed on February 15, 2016.

The parties filed their Joint Stipulation of Facts and Issues (JSFI)[31] on March 11, 2016, which was approved by the Court *via* Resolution[32] dated March 23, 2016.

FTC presented witnesses Nestor C. Mendones on May 17, 2016,[33] Lt. Gen. Salvador M. Miso and Mrs. Juanita Tan Lee on July 26, 2016,[34] and Ms. Evita Panteleon on August 23, 2016,[35]

On September 20, 2016, FTC filed its Formal Offer of Evidence[36] offering Exhibits "P", "P-1", "P-2", "P-2-a", "P-2-b", "P-2-c", "P-2-d", "P-2-e", "P-2-f", "P-2-g", "P-2-h", "P-2-i", "P-2-j", "P-2-k", "P-2-l", "P-2-m", "P-2-n", "P-2-o", "P-2-p", "P-2-q", "P-2-r", "P-3", "P-2-s", "P-2-t", "P-2-u", "P-17", "P-17-a", "P-4", "P-5", "P-5-a", "P-5-b", "P-6", "P-16", "P-16-a", "P-15", "P-15-a", "P-8", "P-9", "P-9-a", "P-9-b", "P-10", "P-12", "P-14", "P-11", "P-13", "P-18", "P-18-a", "P-7", "P-1-a", as its documentary evidence. The CIR filed his Comment (Re: Petitioner's Formal Offer of Evidence)[37] on September 29, 2016.

---

[27] Dockets, Vol. I, pp. 499-539.
[28] Dockets, Vol. I, pp. 252-274.
[29] Dockets, Vol. I, pp. 283-289.
[30] Dockets, Vol. II, pp. 705-716.
[31] Dockets, Vol. II, pp. 741-761.
[32] Dockets, Vol. II, p. 778.
[33] Minutes of the hearing dated May 17, 2016, Dockets, Vol. II, pp. 801-802.
[34] Minutes of the hearing dated May 17, 2016, Dockets, Vol. II, pp. 812-813.
[35] Minutes of the hearing dated May 17, 2016, Dockets, Vol. II, pp. 820-821.
[36] Dockets, Vol. II, pp. 828-845.
[37] Dockets, Vol. II, pp. 972-975.

ℒ

In the Resolution[38] dated November 24, 2016, the Court admitted Exhibits "P", "P-1", "P-2", "P-2-a", "P-2-b", "P-2-c", "P-2-d", "P-2-e", "P-2-f", "P-2-g", "P-2-h", "P-2-i", "P-2-j", "P-2-k", "P-2-l", "P-2-m", "P-2-n", "P-2-o", "P-2-p", "P-2-q", "P-2-r", "P-3", "P-2-s", "P-2-t", "P-2-u", "P-17", "P-17-a", "P-4", "P-5", "P-5-a", "P-5-b", "P-6", "P-16", "P-16-a", "P-15", "P-15-a", "P-8", "P-9", "P-9-a", "P-9-b", "P-10", "P-12", "P-14", "P-11", "P-13", "P-18", "P-18-a", "P-7" but denied the admission of Exhibit "P-1-a".

FTC filed a Motion for Reconsideration[39] on December 14, 2016 *sans* comment from the CIR. The Court granted FTC's Motion for Reconsideration and admitted Exhibit "P-1-a" in the Resolution[40] dated February 23, 2017.

FTC's documentary exhibits are as follows:

Exhibit:	Description:
P	General Information Sheet of FTC dated October 9, 2009
P-1	General Information Sheet of FTC dated April 30, 2010
P-2 P-2-a to P-2-r	Entries in the Stock and Transfer Book of FTC.
P-2-s P-2-t and P-2-u	Cover and inside page of the Stock and Transfer Book of FTC from which the entries marked as P-2, P-2-a to P-2-r were taken
P-3	Amended Articles of Incorporation of Shareholdings, Inc.
P-4	Memorandum dated January 15, 2010 to the FTC Board of Directors thru Lt. Gen. Salvador M. Mison
P-5 P-5-a and P-5-b	"Syndicated Loan Agreement" dated February 5, 2008, with its attachments, consisting of 34 pages excluding the attachments
P-6	Secretary's Certificate of the Board Resolution adopted by the Board of Directors of FTC on January 18, 2010
P-7	Audited Financial Statements of FTC for the taxable year 2009

[38] Dockets, Vol. II, pp. 986-987.
[39] Dockets, Vol. II, pp. 990-992.
[40] Dockets, Vol. II, pp. 1002-1005.

L

P-8	Second Amended Complaint dated September 5, 1991 in Civil Case No. 0005, entitled "Republic of the Philippines vs. Lucio C. Tan, et. al.", Sandiganbayan
P-9	Electronic originals of BIR Payment Confirmation Receipt, stating that BIR eFPS (e-Filing and Payment System) received the payment confirmation from Philippine National Bank (PNB) on November 27, 2009 for Income Tax; Filing Reference No.; PNB Acknowledgement Receipt of Instruction to Debit; and Payment Forms (BIR Form No. 0605)
P-9-a	Electronic originals of BIR Payment Confirmation Receipt, stating that BIR eFPS received the payment confirmation from PNB on November 27, 2009 for Expanded Withholding Tax; Filing Reference No.; PNB Acknowledgement Receipt of Instructioin to Debit; and Payment Forms (BIR Form No. 0605)
P-9-b	Electronic originals of BIR Payment Confirmation Receipt, stating that BIR eFPS received the payment confirmation from PNB on November 27, 2009 for the Value-Added Tax; Filing Reference No.; PNB Acknowledgement Receipt of Instruction to Debit; and Payment Forms (BIR Form No. 0605)
P-10	"Preliminary Assessment Notice" dated May 19, 2014, together with the Details of Discrepancies and other attachments
P-11	Reply dated September 11, 2014, without its attachments, of FTC to the Preliminary Assessment Notice,
P-12	"Formal Letter of Demand dated October 28, 2014, of the Commissioner of Internal Revenue, together with Assessment Notice No. ECTAD-IIIE-09-00004 for Improperly Accumulated Earnings Tax and other Assessment Notices
P-13	FTC's Administrative Protest/Request for Reconsideration dated December 3, 2014, without its attachments
P-14	"Final Decision on Disputed Assessments" dated June 9, 2015, with its annexes, which is attached to the Petition as Annex "E"
P-15	Judicial Affidavit of Mr. Nestor C. Mendones dated February 11, 2016
P-15-a	Signature on page 10 of Judicial Affidavit

l

P-16	Judicial Affidavit of Gen. Salvador M. Mison dated February 11, 2016
P-16-a	Signature on page 5 of the Judicial Affidavit
P-17	Judicial Affidavit of Ms. Juanita Tan Lee dated February 11, 2016
P-17-a	Signature on page 5 of the Judicial Affidavit
P-18	Judicial Affidavit of Ms. Evita M. Pantaleon dated February 11, 2016
P-18-a	Signature on page 11 of the Judicial Affidavit

The CIR presented his lone witness, Revenue Officer Dominic M. Morales, on June 13, 2017.[41]

On June 30, 2017, the CIR filed his Formal Offer of Evidence[42] offering Exhibits "R-1", "R-2", "R-3", "R-4", "R-5", "R-6", "R-7", "R-8", "R-9", "R-10", "R-11", "R-12", "R-12-a", "R-12-b", "R-12-c", "R-12-d", "R-12-e", "R-13" and "R-14" as his documentary exhibits. FTC filed its Comment[43] on July 28, 2017.

In the Resolution[44] dated September 14, 2017, the Court admitted Exhibits "R-1", "R-2", "R-3", "R-4", "R-5", "R-6", "R-7", "R-8", "R-9", "R-10", "R-11", "R-12", "R-12-a", "R-12-b", "R-12-c", "R-12-d", "R-12-e", "R-13" and "R-14" as CIR's evidence.

The CIR's documentary exhibits are as follows:

Exhibit:	Description:
R-1	Letter of Authority (LOA) No. LOA-124-2010-00000031 dated 14 May 2010
R-2	Checklist of Requirements dated 21 May 2010 composed of two (2) pages
R-3	Final Notice dated 08 June 2010
R-4	Waiver of the Statute of Limitations under the National Internal Revenue Code executed on 23 January 2012

[41] Dockets, Vol. II, pp. 1010-1011.
[42] Dockets, Vol. II, pp. 1018-1024.
[43] Dockets, Vol. II, pp. 1032-1034.
[44] Dockets, Vol. II, pp. 1040-1041.

L

R-5	Waiver of the Statute of Limitations under the National Internal Revenue Code executed on 27 September 2012
R-6	Waiver of Statute of Limitations under the National Internal Revenue Code executed on 24 May 2013
R-7	Waiver of Statute of Limitations under the National Internal Revenue Code executed on 26 March 2014
R-8	Memorandum, dated 19 May 2014, recommending the issuance of the Preliminary Assessment Notice (PAN)
R-9	Preliminary Assessment Notice (PAN) dated 19 May 2014 with attached Details of Discrepancies
R-10	Memorandum, dated 02 October 2014, recommending the issuance of the Formal Letter of Demand (FLD)
R-11	Formal Letter of Demand (FLD) with attached Details of Discrepancies dated 28 October 2014
R-12, R-12-a, R-12-b, R-12-c, R-12-d and R-12-e	Audit Result/Assessment Notice (BIR Forms 0401) Nos. ELTAD-II-IT-09-0026, ELTAD-II-WF-09-0008, ELTAD-II-VT-09-0022, ELTAD-II-DS-09-0021 and ELTAD-II-IE-09-00004
R-13	Memorandum, dated 09 June 2015, recommending the issuance of the Final Decision on Disputed Assessment (FDDA)
R-14	Final Decision on Disputed Assessments (FDDA) with attached Summary of Deficiency Taxes dated 09 June 2015

The Memorandum[45] for the CIR was filed on October 19, 2017; while the Memorandum[46] for the FTC was filed on October 26, 2017. Hence, the case was declared submitted for decision.[47]

The parties submitted the following issue for the Court's decision:

> Whether FTC is liable to pay the total amount of ₱2,602,478,844.21 for IAET for taxable year 2009 as

---

[45] Dockets, Vol. II.
[46] Dockets, Vol. II.
[47] Dockets, Vol. II.

ℓ

well as 25% Surcharge, 20% Deficiency and Delinquency interest pursuant to Sections 248 and 249 of the National Internal Revenue Code of 1997.

Pertinent to the resolution of this issue is Section 29 of the National Internal Revenue Code (NIRC) of 1997, as amended, quoted hereunder for ready reference:

"SEC. 29. *Imposition of Improperly Accumulated Earnings Tax –*

(A) In General. - In addition to other taxes imposed by this Title, there is hereby imposed for each taxable year on the improperly accumulated taxable income of each corporation described in Subsection B hereof, an improperly accumulated earnings tax equal to ten percent (10%) of the improperly accumulated taxable income.

(B) *Tax on Corporations Subject to Improperly Accumulated Earnings Tax. –*

(1) *In General.* - The improperly accumulated earnings tax imposed in the preceding Section shall apply to every corporation formed or availed for the purpose of avoiding the income tax with respect to its shareholders or the shareholders of any other corporation, by permitting earnings and profits to accumulate instead of being divided or distributed.

(2) *Exceptions.* - The improperly accumulated earnings tax as provided for under this Section shall not apply to:

L

(a) Publicly-held corporations;
(b) Banks and other nonbank financial intermediaries; and
(c) Insurance companies.

(C) *Evidence of Purpose to Avoid Income Tax* –

(1) *Prima Facie Evidence.* - The fact that any corporation is a mere holding company or investment company shall be *prima facie* evidence of a purpose to avoid the tax upon its shareholders or members.

(2) *Evidence Determinative of Purpose.* -The fact that the earnings or profits of a corporation are permitted to accumulate beyond the reasonable needs of the business shall be determinative of the purpose to avoid the tax upon its shareholders or members unless the corporation, by the clear preponderance of evidence, shall prove to the contrary.

(D) *Improperly Accumulated Taxable Income.*- For purposes of this Section, the term 'improperly accumulated taxable income' means taxable income adjusted by:

(1) Income exempt from tax;
(2) Income excluded from gross income;
(3) Income subject to final tax; and

L

(4) The amount of net operating loss carryover deducted;

And reduced by the sum of:

(1) Dividends actually or constructively paid; and
(2) Income tax paid for the taxable year.

Provided, however, That for corporations using the calendar year basis, the accumulated earnings tax shall not apply on improperly accumulated income as of December 31, 1997. In the case of corporations adopting the fiscal year accounting period, the improperly accumulated income not subject to this tax, shall be reckoned, as of the end of the month comprising the twelve (12)-month period of fiscal year 1997-1998.

(E) *Reasonable Needs of the Business.* - For purposes of this Section, the term 'reasonable needs of the business' includes the reasonably anticipated needs of the business."

The foregoing provision is implemented by Sections 5, 6 and 7 of Revenue Regulations (RR) No. 02-01,[48] which provide:

"SECTION 5. *Tax Base of Improperly Accumulated Earnings Tax.* - For corporations found subject to the tax, the *'Improperly Accumulated Taxable Income'* for a particular year is first determined by adding to that year's taxable income the following:

(a) income exempt from tax;

---

[48] Prescribes the rules and regulations in the implementation of the provision on Improperly Accumulated Earnings Tax.

L

(b) income excluded from gross income;

(c) income subject to final tax; and

(d) the amount of net operating loss carry-over (NOLCO) deducted.

The taxable income as thus determined shall be reduced by the sum of:

(a) income tax paid/payable for the taxable year;

(b) dividends actually or constructively paid/issued from the applicable year's taxable income;

(c) amount reserved for the reasonable needs of the business as defined in these Regulations emanating from the covered year's taxable income.

The resulting *'Improperly Accumulated Taxable Income'* is thereby multiplied by 10% to get the Improperly Accumulated Earnings Tax (IAET).

XXX XXX XXX

SECTION. 6. *Period for Payment of Dividend/Payment of IAET.* - The dividends must be declared and paid or issued not later than one year following the close of the taxable year, otherwise, the IAET, if any, should be paid within fifteen (15) days thereafter.

SECTION. 7. *Determination of Purpose to Avoid Income Tax.* - The fact that a corporation is a mere holding company or investment company shall be *prima facie* evidence of a purpose to avoid the tax upon its shareholders or members. Likewise, the fact that the earnings or profits of a corporation are permitted to accumulate beyond the reasonable needs of the business shall be determinative of the purpose to avoid the tax upon its shareholders or members. In both instances, the corporation may, by clear preponderance of evidence in its favor, prove the contrary.

C

XXX XXX XXX

The following are *prima facie* instances of accumulation of profits beyond the reasonable needs of a business and indicative of purpose to avoid income tax upon shareholders:

(a) Investment of substantial earnings and profits of the corporation in unrelated business or in stock or securities of unrelated business;
(b) Investment in bonds and other long-term securities;
(c) Accumulation of earnings in excess of 100% of paid-up capital, not otherwise intended for the reasonable needs of the business as defined in these Regulations.

In order to determine whether profits are accumulated for the reasonable needs of the business as to avoid the imposition of the improperly accumulated earnings tax, the controlling intention of the taxpayer is that which is manifested at the time of accumulation, not subsequently declared intentions which are merely the product of afterthought. A speculative and indefinite purpose will not suffice. The mere recognition of a future problem or the discussion of possible and alternative solutions is not sufficient. Definiteness of plan/s coupled with action/s taken towards its consummation are essential."

In the Supreme Court case of *Cyanamid Philippines, Inc., vs. The Court of Appeals, The Court of Tax Appeals and Commissioner of Internal Revenue,*[49] the reason for the imposition of IAET was elaborated therein, thus:

"The provision discouraged tax avoidance through corporate surplus accumulation. When corporations do not declare dividends, income taxes are not paid on the undeclared dividends received by the shareholders. The tax on improper accumulation

[49] G.R. No. 108067, January 20, 2000.

l

> of surplus is essentially a penalty tax designed to compel corporations to distribute earnings so that the said earnings by shareholders could, in turn, be taxed."

FTC claims that the CIR's IAET assessment has no legal basis for the following reasons: (a) FTC accumulated its earnings and profits for reasonable business requirements to meet working capital needs and retirement of indebtedness; (b) FTC is 99% owned by another domestic corporation. This being the case, no individual shareholder of FTC could have evaded or prevented the imposition of individual income taxes by FTC's accumulation of earnings and profits, instead of distribution of the same; (c) FTC had an outstanding loan to a consortium of banks through the Syndicated Loan Agreement, that FTC needs to reserve funds for the payment of such obligation. FTC was granted a loan of ₱20,000,000,000.00 "for the purpose of refinancing the Borrower's (FTC) existing maturing debts and of financing some of its capital expenditures." The loan was payable within a period of five (5) years in five (5) installment payments of 500 million pesos for the first four (4) years and 18 billion pesos for the last year, commencing February 8, 2009 and every eight day of February in 2010, 2011, 2012 and 2013 thereafter.[50] (d) As a company engaged in the manufacture and marketing of cigarettes, FTC needed to assure that factors which threatened the cigarette market were provided for, such as the increasing pressure from anti-tobacco lobby groups and the Government to increase taxes on "sin products" to reduce consumption, especially among the poor and to comply with commitments to the World Health Organization, the strong pressure to revise the multi-tiered excise tax system, which was favorable to FTC, into a single-tier system in order to lessen the gap between the low and high-priced segments, the trade liberalization agreements were lifting trade barriers that served as protection for local brands, and FTC's low-priced segment market was not invulnerable; and (e) FTC is among the defendants in an ill-gotten wealth case before the Sandiganbayan entitled *Republic of the Philippines vs. Lucio*

---

[50] Syndicated Loan Agreement, Exhibit "P-5," Schedule of Principal Repayment Dates, Dockets, Vol. I, p. 364.

C. Tan, et al.,[51] docketed as Civil Case No. 0005. In the said case, the Republic sought to recover assets of FTC among others, and to pay compensatory and other forms of damages, jointly and severally, amounting to billions of pesos. Transferring any asset at the time while the case was still pending may be viewed by the court as an improper, if not, illegal disposition of assets which may expose FTC to the issuance of a writ of attachment against its assets and properties.

Moreover, even if FTC is liable to pay IAET, the 10 billion pesos, which is part of the 14.3 billion pesos assessed by the CIR for IAET should be excluded from the computation as such was accumulated in 2008. Since Section 29(A) of the NIRC imposes accumulated earnings tax "for each taxable year," and the CIR had already assessed FTC deficiency tax for taxable year 2008, the tax for improperly accumulated earnings payable for the year 2008 had already prescribed.

Lastly, on the assumption that FTC is liable to pay the IAET, surcharge and interest should not be imposed as it acted in good faith.

FTC claims that 99% of its shareholder is a domestic corporation, thus, distribution of earnings to its shareholder is a mere intercorporate dividend, which is not subject to income tax in accordance with Section 27(D)(4)[52] of 1997 NIRC. It must be noted, however, that the amendatory provision of Section 25 of the 1997 NIRC enumerated the corporations exempt from the imposition of improperly

---

[51] *Supra* note 27.
[52] SEC. 27. Rates of Income tax on Domestic Corporations. –

xxx xxx xxx

(D) Rates of Tax on Certain Passive Incomes. –

xxx xxx xxx

(4) Intercorporate Dividends. - Dividends received by a domestic corporation from another domestic corporation shall not be subject to tax.

xxx xxx xxx

accumulated tax, *i.e.,* (a) Publicly-held corporations; (b) Banks and other nonbank financial intermediaries; and (c) Insurance companies. Furthermore, Section 4 of RR No. 02-01 enumerates those corporations exempt from imposition of IAET, to wit:

> "SECTION 4. Coverage. xxx Improperly Accumulated Earnings Tax shall not apply to the following corporations:
>
> a. Banks and other non-bank financial intermediaries;
> b. Insurance companies;
> c. Publicly-held corporations;
> d. Taxable partnerships;
> e. General professional partnerships;
> f. Non-taxable joint ventures; and
> g. Enterprises duly registered with the Philippine Economic Zone Authority (PEZA) under R.A. 7916, and enterprises registered pursuant to the Bases Conversion and Development Act of 1992 under R.A. 7227, as well as other enterprises duly registered under special economic zones declared by law which enjoy payment of special tax rate on their registered operations or activities in lieu of other taxes, national or local.
>
> xxx xxx xxx"

FTC does not fall among those exempt classes. Besides, the rule on enumeration is that the express mention of one person, thing, act, or consequence is construed to exclude all others.[53] Laws granting exemption from tax are construed *strictissimi juris* against the taxpayer and liberally in favor of the taxing power.[54] Taxation is the rule and exemption is the exception.[55] The burden of proof rests upon the party

---

[53] *Supra,* note (Cyanamid), citing *Commissioner of Customs vs. Court of Tax Appeals*, 224 SCRA 665, 669-670 (1993); *Centeno vs. Villalon-Pornillos*, 236 SCRA 197 (1994).
[54] *Ibid.,* citing *Commissioner of Internal Revenue vs. Mitsubishi Metal Corporation,* 181 SCRA 214, 223-224 (1990).
[55] *Ibid.*

h

claiming exemption to prove that it is, in fact, covered by the exemption so claimed,[56] a burden which FTC here has failed to discharge.

FTC also presented a certified true copy of a Second Amended Complaint dated September 5, 1991 in Civil Case No. 0005, entitled *Republic of the Philippines vs. Lucio Tan et. al.,*[57] to prove that it was not legally feasible for FTC to declare dividends on the accumulated earnings of the corporation for the year 2009 and that one reason that was considered by its Board of Directors in not declaring dividends for the year 2009 is that as of taxable year 2009, the said ill-gotten wealth case is still pending before the Sandiganbayan.

While FTC presented the above-mentioned Second Amended Complaint, there was no temporary restraining order, or *status quo ante* order presented that required FTC to refrain from declaring dividends while the case was still pending.

A Memorandum to the FTC Board of Directors dated January 15, 2010[58] was presented in Court, showing that per recommendation of Mr. Nestor C. Mendones,[59] there was an immediate need for FTC to invest in programs and investments, which he enumerated therein, that would ease competitive pressure and expand its business portfolio, squaring the risks and opportunities emerging from developments in the local tobacco industry, and recommended that the appropriation of surplus profits was urgently warranted by the then operating environment of FTC.

Section 3 of RR No. 02-01 prescribes the "Immediacy Test" in determining what constitutes the reasonable needs of business to justify earmarking of earnings. Under this test, the taxpayer must be able to prove an *immediate need* for the accumulation of its earnings or profits, or the direct

---

[56] *Ibid.*
[57] *Supra,* note 27.
[58] Dockets, Vol. I, pp. 322-324.
[59] Dockets, Vol. I, pp. 311-321.

ℓ

correlation of anticipated needs to such accumulation of profits.[60]

In this case, the non-utilization of FTC's appropriated earnings to the recommended programs and investments, and the absence of evidence or the existence of the said programs and investments, only proves that there was no immediate need for such appropriation or accumulation. As such, this Court finds that FTC failed to pass the "Immediacy Test". To reiterate, Section 7 of RR No. 02-01 states:

> "xxx A speculative and indefinite purpose will not suffice. The mere recognition of a future problem or the discussion of possible and alternative solutions is not sufficient. Definiteness of plan/s coupled with action/s taken towards its consummation are essential." (Underlining Supplied.)

On the other hand, upon review of the Syndicated Loan Agreement,[61] the Company is required to comply with certain covenants, as follows:

> "Section 7. COVENANTS OF THE BORROWER
>
> **7.01** Affirmative Covenants
>
> xxx xxx xxx
>
> (p) *Financial Ratios.* The Borrower shall maintain the following financial ratios:
>
> (i) The borrower's net debt to stockholder's equity ratio, computed as total liabilities less cash, cash equivalents and marketable securities divided by its total stockholder's equity, computed in accordance with

---

[60] *Wellington Investment and Manufacturing Corp., vs. Commissioner of Internal Revenue*, CTA Case No. 8726, September 14, 2017.
[61] Dockets, Vol. I, pp. 325-383.

> PFRS and based on the most recent audited financial statements of the Borrower, shall have a maximum ratio of 2.0x; and
>
> (ii) The Borrower's current assets to current liabilities ratio, computed in accordance with PFRS and based on the most recent audited financial statements of the Borrower, shall have a minimum ratio of 1.25x."[62]

Moreover, the said Syndicated Loan Agreement is explicit as to the consequence in case of non-observance of covenants by the borrower, to wit:

> "SECTION 8. EVENTS OF DEFAULT
>
> **8.01** Events of Default
>
> Each of the following events and circumstances shall be an Event of Default:
>
> xxx xxx xxx
>
> (b) *Non- Observance of Representations, Warranties, Covenants or Other Material Provisions.* Any representation or warranty made by the Borrower in this Agreement or in any certificate delivered or made pursuant hereto shall prove to be incorrect, untrue or misleading in any material respect as and when made or <u>any violation of any other material provision, term, condition, representation, warranty, covenant or obligation contained in this Agreement</u> or the Notes and such failure, if remediable, shall remain unremedied

---

[62] Dockets, Vol. I, pp. 347-348.

> during the applicable grace period or, in the absence of such grace period, for a period of thirty (30) days in respect of the maintenance of the financial ratios provided for in this Agreement, and for a period of fifteen (15) days with respect to any other material provision, term, representation, warranty, condition, covenant or obligation under this Agreement, after written notice thereof shall have been received by the Borrower from the Facility Agent. For avoidance of doubt, it is understood that no curing period shall be allowed for a default by the Borrower in any of its payment obligations under this Agreement and the Notes."[63] (Underlining Supplied.)

Not to mention the existence of the syndicated loan agreement itself, the Memorandum to the FTC Board of Directors dated January 15, 2010[64] that was presented in Court, stated therein the advice to the Board of Directors of FTC on the propriety of non-declaration of dividends for the year 2009 and the findings and recommendations, as attested to by Mr. Nestor C. Mendones[65] and Mr. Salvador M. Mison.[66] In the said Memorandum, it was found among others that in view of the five-year syndicated loan which FTC obtained in February 2008 from seven local banks amounting to ₱20 billion, which was payable in annual installments of ₱500 million per year starting February 2009 and a lump sum payment of ₱18 billion in February 2013, there was an immediate need for FTC to set aside funds for the full repayment of the debt in 2013.

More importantly, the Memorandum made reference to certain financial ratios which had to be maintained by FTC while the ₱20 Billion loan remained outstanding. It was also stated that non-compliance with any of the financial ratios is considered an event of default if not cured or remedied within thirty (30) days from the breach thereof. Thus, FTC must maintain the financial ratios while the ₱20 Billion loan

---

[63] Dockets, Vol. I, p. 350.
[64] *Supra,* note 58.
[65] Dockets, Vol. I, pp. 311-321.
[66] Dockets, Vol. I, pp. 384-389.

ℒ

remained outstanding by not allowing its total equity to fall below ₱101 billion and its current assets to go below ₱65 billion.

On that basis, FTC could not possibly distribute all its earnings as it will need all funds as required by the loan agreement's covenants. To stress, the touchstone of the liability is the purpose behind the accumulation of the income and not the consequences of the accumulation.[67] Thus, if the failure to pay dividends is due to some other causes, such as the use of undistributed earnings and profits for the reasonable needs of the business, particularly compliance with the covenants of the syndicated loan agreement in this case, such purpose would not generally make the accumulated or undistributed earnings subject to the tax.[68]

As ruled by this Court in the case of *Wellington Investment and Manufacturing Corporation vs. Commissioner of Internal Revenue:*[69]

> "Section 3 of RR No. 02-01 clarified that an accumulation of earnings or profits (including undistributed earnings or profits of prior years) is unreasonable if it is not necessary for the purpose of the business, considering all the circumstances of the case. To determine the "reasonable needs" of the business in order to justify an accumulation of earnings, these regulations adhere to the so-called "Immediacy Test" under American jurisprudence as adopted in this jurisdiction. Accordingly, the term "reasonable needs of the business" are hereby construed to mean the immediate needs of the business, including reasonably anticipated needs. In either case, the corporation should be able to prove an immediate need for the accumulation of the earnings and profits, or the direct correlation of anticipated needs to such accumulation of profits." (Underlining Supplied.)

---

[67] Section 2, R.R. No. 02-01.
[68] *The Manila Wine Merchants, Inc., vs. the Commissioner of Internal Revenue*, G.R. No. L-26145, February 20, 1984, citing Mertens, Law of Federal Income Taxation, Vol. 7, Chapter 39, p. 47.
[69] CTA Case No. 8726, September 14, 2017.

L

More importantly, no other than RR 02-01 is explicit that compliance with covenants of loan agreements is considered as reasonable needs to accumulate earnings. Thus, Section 3 thereof provides that "(e)arnings reserved for compliance with any loan covenant or preexisting obligation established under a legitimate business agreement,"[70] may constitute accumulation of earnings for the reasonable needs of the business.

As to the inclusion of retained earnings from prior years, such should no longer be taken into consideration in order to determine unreasonable accumulation of profits. Although there are Supreme Court decisions which held that the undistributed earnings or profits of prior years are taken into consideration in determining unreasonable accumulation for purposes of IAET,[71] such decisions are based on the 1939 Tax Code and not on the 1997 NIRC. The main difference between the two versions of IAET is the explicitly provided formula under the 1997 Tax Code, and this does not include retained earnings for the prior years. Even on the argument that R.R. No. 35-2011[72] already includes retained earnings for prior years for computation of IAET, this specific regulation would not apply to taxable year 2009, as in this instant case, since Revenue Regulations must be applied prospectively.

It is well settled in jurisprudence that tax administrators are not allowed to expand or contract the legislative mandate and that the "plain meaning rule" or *verba legis* principle in statutory construction should be applied[73] such that where the words of a statute are clear,

[70] Section 3(d), RR No. 02-01.
[71] *Basilan Estates, Inc., vs. the Commissioner of Internal Revenue, et. al.*, G.R. No. L-22492, September 5, 1967; The Manila Wine Merchants, *Supra,* note 68.
[72] Clarifies issues concerning the imposition of Improperly Accumulated Earnings Tax pursuant to Section 29 of the Tax Code of 1997, in relation to RR No. 02-01, issued on August 17, 2011.
[73] *The Commissioner of Internal Revenue vs. Central Luzon Drug Corporation*, G.R. No. 159647, April 15, 2005.

plain and free from ambiguity, it must be given its literal meaning and applied without attempted interpretation.[74]

WHEREFORE, premises considered, the Petition for Review is **GRANTED**. The assessment issued by respondent Commissioner of Internal Revenue against petitioner Fortune Tobacco Corporation for the calendar year 2009 as to Improperly Accumulated Earning Tax is hereby **CANCELLED and SET ASIDE.**

SO ORDERED.

Cielito N. Mindaro-Grulla
CIELITO N. MINDARO-GRULLA
Associate Justice

WE CONCUR:

ROMAN G. DEL ROSARIO
Presiding Justice

ERLINDA P. UY
Associate Justice

CERTIFICATION

Pursuant to Section 13 Article VIII of the Constitution, it is hereby certified that the conclusions in the above Decision were reached in consultation before the case was assigned to the writer of the opinion of the Court's Division.

ROMAN G. DEL ROSARIO
Presiding Justice
Chairperson, 1st Division

---

[74] *Ibid.*, citing *National Federation of Labor vs. NLRC*, 383 Phil. 910, 918, March 2, 2000, per De Leon Jr., J. (quoting *Fianza vs. People's Law Enforcement Board*, 243 SCRA 165, 178, March 31, 1995, per Romero, J.).