REPUBLIC OF THE PHILIPPINES
COURT OF TAX APPEALS
QUEZON CITY

SPECIAL FIRST DIVISION

KEPCO PHILIPPINES CORPORATION,
Petitioner,

- versus -

THE COMMISSIONER OF INTERNAL REVENUE,
Respondent.

C.T.A. CASE NO. 8112

Members:

UY, *Chairperson and*
FABON-VICTORINO, *JJ.*

Promulgated:

DEC 0 6 2013 ; 2:55 p.m.

x- x

DECISION

***Fabon-Victorino, J.*:**

This *Petition for Review*[1] assails the inaction of respondent Commissioner of Internal Revenue (CIR) on the protest letter[2] filed by petitioner KEPCO Philippines Corporation against the Formal Letter of Demand (FLD)[3]issued against it for alleged deficiency value-added tax (VAT) and final withholding tax (FWT) in the total amount of ₱283,927,571.90, inclusive of interest and compromise penalties, covering the taxable year 2006.

Petitioner is a duly organized domestic corporation, with address at the 18th Floor Citibank Tower, 8741 Paseo de Roxas, Salcedo Village, Makati City.[4] Its primary purpose is to "rehabilitate, operate, maintain and manage the Malaya Power Complex in Pililia, Rizal, Philippines and other power generating plants and related facilities for the conversion of

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[1] Docket, pp. 1-14.
[2] Exhibit "B".
[3] Exhibit "A".
[4] Par. 1, Facts Admitted, Joint Stipulation of Facts and Issues (JSFI), docket, p. 412.

fuel into electricity: provided, that, in no event shall the corporation itself engage in the general supply or distribution of electricity in retail trade or in the business of a public utility, or furnish electricity to end-users or consumers, or provide a public service, or engage in industries or activities reserved by the Constitution or by law to corporations wholly or partially-owned by Filipino citizen".[5]

Respondent, on the other hand, is the head of the Bureau of Internal Revenue (BIR), with the authority to assess and collect all national internal revenue taxes, fees and charges under the National Internal Revenue Code (NIRC), as amended. She holds office at the 5th Floor, BIR National Office Building, Agham Road, Diliman, Quezon City.

On May 17, 1995, petitioner and National Power Corporation (NPC) executed the Rehabilitation, Operation, Maintenance and Management Agreement for 650 MW Malaya Thermal Power Plant Complex (ROMM Agreement)[6]. Under the Agreement, petitioner as the Contractor shall rehabilitate, operate, maintain and manage the Malaya Power Plant owned by NPC. NPC shall supply the fuel which petitioner will convert into electricity and NPC shall take and pay all electricity delivered on the high voltage side of each transformer requested by NPC. Petitioner shall dedicate to NPC the entire Power Complex output, net of power complex usage.[7] NPC's payment for the electricity delivered by petitioner consists of: (i) energy fees[8], to be calculated using the applicable parameters provided in Schedule 7; and (ii) operation and maintenance (O & M) fees[9], to be calculated using the applicable parameters provided in Schedule 7 and subject to price escalation based on the formula provided in paragraph 7.5, Article 7 of the ROMM Agreement.[10]

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[5] Exhibit "L-1".
[6]Exhibits "C", "N", and "O".
[7] Exhibits "C-1", "N", "O", and "S".
[8]The fees payable by NPC to petitioner in respect of energy supplied to NPC as provided in Schedule 7 (Delivery of Power and Energy) and denominated in dollars. (Page 4 of ROMM Agreement, docket, p. 1323).
[9]The fees payable by NPC to petitioner in respect of the services supplied to NPC as provided in Schedule 7 (Delivery of Power and Energy) and denominated in pesos. (Page 5 of ROMM Agreement, docket, p. 1324).
[10] Docket, p. 1348.

On November 10, 2000, petitioner together with Korea Electric Power Corporation (KEPCO), KEPCO International Philippines, Inc. (KIPI) and KEPCO Ilijan Corporation (KEILCO) executed the Kepco Replacement Loan Agreement,[11] wherein petitioner, KEPCO and KIPI agreed to extend a credit to KEILCO to finance the cost of the construction of the power plant located at Ilijan, Batangas City.

On August 29, 2005, petitioner contracted OCE Catering Services for the food requirements of petitioner's employees and guests at Malaya Thermal Power Plant, Bo. Malaya, Pililla, Rizal. Under the Contract Agreement,[12] the concessionaire shall use petitioner's canteen free of charge, but shall pay a monthly maintenance fee of ₱2,000.00 for water, electricity and other repairs of the facility and make an advance payment for a period of one (1) year through twelve (12) postdated checks payable every first (1st) day of the month.

On February 10, 2006, petitioner and KEPCO Philippines Holdings, Inc. (KPHI) executed a contract[13] wherein the former agreed to extend a loan facility to the latter to fund its equity investment in Salcon Power Corporation (SPC).

On July 8, 2008, petitioner filed a letter dated July 4, 2008 with the BIR International Tax Affairs Division (BIR ITAD) requesting for a ruling pursuant to the Philippines-Korea tax treaty relative to its payments to KEPCO under the Technical Services Agreement (TSA) executed between petitioner and KEPCO.[14] In the BIR Ruling No. ITAD-134-11[15] dated April 25, 2011, respondent held that "the profits derived by KEPCO from the rendition of services under the Agreement shall not be subject to Philippine income tax pursuant to Article 7(1) in relation to Article 5(3)(b) of the Philippines-Korea tax treaty."

[11] Exhibit "E".
[12] Exhibit "G".
[13] Exhibits "F" and "F-1".
[14] Exhibit "J".
[15] Exhibit "M".

On September 8, 2009,[16] petitioner received a Preliminary Assessment Notice (PAN) dated September 4, 2009 with the attached Details of Discrepancy and Audit Result/Assessment Notice issued by respondent for alleged deficiency income tax (IT), value-added tax (VAT), expanded withholding tax (EWT), and final withholding tax (FWT) for 2006.[17]

On October 30, 2009, petitioner received a Final Letter of Demand (FLD) with attached Details of Discrepancy and Audit Results/ Assessment Notices dated October 28, 2009 issued by respondent covering taxable year 2006 for alleged deficiency VAT and FWT inclusive of interest and penalties, in the aggregate amount of ₱283,927,571.90, broken down as follows:[18]

Particulars	Basic Tax	Interest	Compromise Penalty	Total
VAT	102,409,676.58	57,181,074.21	50,000.00	159,640,750.79
FWT	79,459,643.84	44,802,177.27	25,000.00	124,286,821.11
Total	**₱181,869,320.42**	**101,983,251.48**	**₱75,000.00**	**₱283,927,571.90**

The said FLD shows deficiency VAT pertaining to petitioner's escalation fees for the year 2005 collected in year 2006, interest income on loans to affiliate and miscellaneous income, and deficiency FWT, detailed as follows:

A. VALUE-ADDED TAX		
Gross Taxable Sales per VAT Returns		P3,537,864,440.98
Add: Adjustments		
Escalation fees for the year 2005 collected in year 2006	**P374,714,642.25**	
Interest Income on loans to affiliate	**477,094,128.55**	
Miscellaneous Income	**1,605,200.67**	853,413,971.47
Adjusted Taxable Base		4,391,278,412.45
Multiply by VAT Rate (See Computation)		12%
Output Tax per Audit		521,343,370.60
Less: Input Tax		
Deferred Input Tax, Beg.	9,550,969.64	
Current Input Tax	12,297,175.18	
Total	21,848,144.82	
Add: Standard Input Tax	222,568,333.67	
Total Available Input Tax	244,416,478.49	
Less: Deferred Input Tax End	(312,622.60)	

[16] Exhibit "17".
[17] Exhibit "11", BIR Records, pp. 1085-1096.
[18] Par. 3, Facts Admitted, JSFI, docket, p. 413; Exhibit "A".

Excess of standard input & actual input tax	(9,550,969.64)	
Total Available Input Tax		234,552,886.25
VAT Payable Per Audit		286,790,484.35
Less: Creditable Taxes Withheld		184,380,807.77
Basic Tax Due		102,409,676.58
Add: 20% Interest (1-26-07 to 11-15-09)	57,181,074.21	
Compromise Penalty	50,000.00	57,231,074.21
Total Deficiency VAT		**159,640,750.79**

B. FINAL WITHHOLDING TAX		
Final Withholding Tax Due Per Audit		79,633,050.81
Final Withholding Tax Paid		173,406.97
Deficiency Final Withholding Tax		79,459,643.84
Add: Interest (1-16-2007 to 11-15-2009)	44,802,177.27	
Compromise Penalty	25,000.00	44,827,177.27
Total Deficiency Final Tax		**124,286,821.11**

On November 26, 2009, petitioner filed with the BIR Large Taxpayer Service-HREA, BIR National Office a protest letter dated November 25, 2009[19] with supporting documents.

On June 25, 2010, petitioner filed the instant Petition for Review with this Court, pursuant to Section 228 of the NIRC of 1997, as amended, alleging inaction on the part of the respondent.

On September 29, 2010, respondent, after several requests for extension, filed a *Motion to Admit Attached Answer*, which the Court granted on October 6, 2010.

In her *Special and Affirmative Defenses*,[20] respondent counters that the deficiency VAT was assessed on receipts which were not subjected to VAT such as escalation fees for the year 2005 collected in the year 2006 amounting to ₱374,714,642.25, interest income earned on loans extended to affiliates amounting to ₱477,094,128.55, and miscellaneous income amounting to ₱1,605,200.67, which were subject to VAT pursuant to Section 108 of the NIRC of 1997, as amended. On the other hand, the income payments in the total amount of ₱248,311,387.00 which were not subjected to FWT were assessed pursuant to Section 57(A) of the NIRC of 1997, as amended.

[19] Exhibit "B".
[20] Docket, pp. 336-350.

According to respondent, the deficiency VAT assessment on the ₱374,714,642.25 escalation fees was due to petitioner's failure to submit the required inventory or information return to the Revenue District Office (RDO) concerned within thirty (30) days after the effectivity of R.A. No. 9337, in violation of the transitory provision of Republic Act (R.A.) No. 9337. Hence, petitioner's alleged adjustments on the billed and paid sale of electricity to NPC reflected in its annual Income Tax Return (ITR) for taxable year 2006 should now be subject to VAT.

Further, the imposition of VAT on petitioner's miscellaneous income from the lease of its canteen and dormitory amounting to ₱10,298.39, inclusive of penalties, sales of used/empty computer toners, interest income earned from advances to NPC amounting to ₱289,428.23, inclusive of interest and penalty, for petitioner's loans extended to its affiliates and Final Taxes with respect to the payments made to petitioner pertaining to the TSA between petitioner and KEPCO, a non-resident foreign corporation domiciled in Korea, is correct and made in good faith.

Finally, the subject assessment enjoys the presumption of correctness and regularity. Citing *Sy Po vs. Court of Tax Appeals, 164 SCRA 524,* respondent posits that in the absence of proof of any irregularities in the performance of duties, an assessment made by the BIR will not be disturbed.

After the pre-trial conference, or on April 5, 2011, the parties submitted their *Joint Stipulation of Facts and Issues*[21] which the Court approved on April 11, 2011.

During the trial, petitioner presented Godofredo Saises, Division Manager of NPC, Marvin Chan, the Finance and Shared Service Manager of Nido Petroleum Philippines Pty. Ltd., and Jennylin Layson, petitioner's Tax Specialist.

Witness **Godofredo Saises**, testified by way of a Judicial Affidavit[22] that he is a Mechanical Engineer and a

[21] Docket, pp. 412-417.
[22] Docket, pp. 467-475.

Division Manager in NPC. He is responsible for the contract implementation of Independent Power Producers (IPP's) in South Luzon such as Pagbilao Coal Fired Thermal Power Plant, Ilijan Combined Cycle Power Plant, Malaya Thermal Power Plant and Caliraya-Botocan-Kalayaan Hydro Power Complex.

He explained that under the May 17, 1995 ROMM Agreement, petitioner, as the Contractor, shall rehabilitate, operate, manage and maintain the Malaya Thermal Power Plant in Pililia, Rizal owned by NPC, as well as generate and sale electricity to NPC. In consideration thereof, NPC shall pay petitioner Energy Fees and Operation and Maintenance Fees or O&M Fees following the formula or parameters in Schedule 7 of the ROMM. Upon determination of the amount, petitioner shall deliver to NPC an invoice on a monthly basis, payable within 30 days from receipt thereof.

The Energy Fees are for the energy supplied to NPC, denominated in dollars, while the O&M Fees are for operation and maintenance of the power plant, denominated in pesos and subject to two (2) adjustments, to wit: price escalation and price escalation adjustment. O&M Fees are computed in accordance with Section 5, paragraph 5.2.2 of Schedule 7 of the ROMM Agreement. The same fees are then subject to price escalation based on the formula provided in Article 7, paragraph 7.5 of the ROMM Agreement where several factors are considered, such as the peso-dollar exchange rate, inflation rate and price indices. Price escalation adjustment, on the other hand, is the adjustment made on the price escalation when the other necessary data become available after the price escalation fees were billed and paid, since the fees are first calculated depending on the data available at the time of the billing period. Separate invoices are issued on both the price escalation and price escalation adjustments.

Petitioner's former Assistant Manager of the Planning Department **Julie B. Macorol** executed a Deposition[23] before Vice Consul Jed Martin A. Llona on September 22,

[23] Docket, pp. 856-866.

2011, at the Philippine Embassy in Singapore, which petitioner also presented.

The deponent stated that she assisted the management in the preparation and implementation of its corporate plans. Her responsibility included billing and collection of fees pursuant to the ROMM Agreement.

She was the one who computed the fees payable by petitioner pursuant to the provisions of the ROMM Agreement. The payments for O&M Fees were not deemed final as per the ROMM Agreement, the fees may be subject to two (2) adjustments, namely: price escalation and price escalation adjustments. The formula for the price escalation consists of the following: (a) US Consumer price Index; (b) Retail Price Index as published by the National Economic Development Authority (NEDA); and (c) peso-dollar exchange rate as published by the Bankers Association of the Philippines (BAP). Often, these data were available few months after the billing period and only upon their availability that previously billed amount, although already paid and settled by NPC, would be adjusted in accordance with the ROMM Agreement.

The factors for the price escalation adjustments or the third invoice sent to NPC after the second invoice covering the price escalation was issued, were the same. The amount of price escalation initially billed and paid by NPC was not yet final since both parties had to wait and agree on how to effect the rebased or the newly issued US and Philippine Price Indices, as the case maybe. The agreement of the parties regarding the application of the rebased factors was done only on September 15, 2005. Thus, the price escalation based on the agreed rebased amounts of the US Prices Indices and the Philippine Wholesale Price Indices were all billed on December 29, 2005 and paid by petitioner to NPC in the early months of 2006.

Witness **Marvin A. Chan**, also executed a Judicial Affidavit[24] in lieu of his direct testimony in which he declared

[24]Docket, pp. 1221-1231.

that he was petitioner's Finance Tax Specialist and became its Senior Accountant in 2001 until 2007.

Petitioner's position that VAT on the price escalation and price escalation adjustments should not be imposed was based on the Energy Regulatory Commission's (ERC) Resolution No. 20, Series of 2005, particularly Part 1, paragraph (i), and Revenue Memorandum Circular (RMC) No. 61-05, specifically Question and Answer No. 30. In 2006, NPC paid to petitioner only the adjustments related to the sale of electricity which NPC had already paid for the period covering December 2003 until October 2005, thus, within the coverage of the said issuances.

Further, petitioner was not a lending investor nor one engaged in lending money precisely it did not impose VAT on the loans extended to its affiliates - KIELCO and KPHI. No VAT was also imposed on the lease of petitioner's premises such as canteen and dormitory as the same was exempt from VAT pursuant to Section 109 of the Tax Code. The same was true with the sale of used and empty computer toner and cartridges as petitioner was not engaged in the business of selling said office equipment.

On the assessed FWT on petitioner's payments to KEPCO, he explained that KEPCO is a foreign corporation domiciled in Korea, a country with whom the Philippines has a tax treaty for purposes of avoiding double taxation. Petitioner applied for tax exemption under the tax treaty and which was approved per BIR Ruling No. DA-ITAD-37-07 dated March 8, 2007.

Petitioner's tax specialist **Jennylin Layson** also testified on direct examination through her Judicial Affidavit.[25] She stated that she is a Certified Public accountant. She is familiar with the case as it is part of her duties and responsibilities to monitor tax issues affecting the company. Petitioner filed this appeal to assail respondent's inaction to its protest to the FLD issued against it for the calendar year 2006.

[25] Docket, pp. 1782-1784.

After petitioner rested its case, respondent presented her lone witness **Ma. Theresa V. Carillo.**[26]

By way of a Judicial affidavit,[27] Ms. Carillo testified that she is a Revenue Officer IV and currently assigned at Excise Taxpayers Audit Division I of the BIR. She conducts investigation/examination of the internal revenue tax cases and performs other duties and functions assigned to her.

She was one of the revenue examiners assigned to conduct the investigation/examination of petitioner's internal revenue tax liabilities for taxable year 2006 pursuant to Letter of Authority (LOA) No. 2007-00011759 dated August 31, 2007. The LOA together with the Letter dated September 3, 2007 requesting submission of books of accounts and related records for all internal revenue taxes for taxable year 2006 was personally served to petitioner on September 9, 2007.

After the investigation, the group prepared a Memorandum on the result of the investigation and recommended for the issuance of a Notice of Informal Conference for petitioner to present its side of the case. After the Notice of Informal Conference dated March 30, 2009 with attachments was issued, petitioner executed two (2) Waivers of the Defense of Prescription under the NIRC's Statute of Limitations. The first waiver extends the period to assess until June 30, 2009 while second, until September 30, 2009. On September 8, 2009, a Preliminary Assessment Notice (PAN) with Details of Discrepancy dated September 4, 2009 was issued to petitioner. Thereafter, petitioner executed another waiver extending the period to assess until October 31, 2009.

On October 30, 2009, a FLD with Details of Discrepancy and Audit Result/Assessment Notices all dated October 28, 2009, was served to petitioner.

She clarified that prior to the effectivity of R.A. No. 9337 or the E-VAT Law on November 1, 2005, the NPC was

[26] Minutes of Hearing dated June 14, 2012 and July 10, 2012, docket, pp. 1848 and 1851.
[27] Docket, pp. 1841-1847.

exempt from VAT. Also before the said law took effect, the sale of generated power by generation companies were subject to VAT at zero-rate under R.A No. 9136 or the EPIRA Law.

She confirmed that the escalation fees stated in respondent's Exhibit 14, were for 2005 but collected in 2006.

Respondent rested her case after the Court admitted all her exhibits in the Resolution dated September 19, 2012.[28]

On January 4, 2013, the case was submitted for decision, after taking into consideration petitioner's Memorandum[29] filed on November 26, 2012 and respondent's Memorandum[30] filed on January 2, 2013.[31]

THE ISSUES

The parties submitted the following issues[32] for the resolution of the Court, *viz.*:

> 1. Whether petitioner is liable to pay the assessed deficiency VAT on the sales adjustments relative to the sale of generated electricity to the National Power Corporation (NPC), covering the period December 25, 2003 to October 21, 2005, as reflected in petitioner's Fourth Quarter Return for the taxable year 2006.
>
> 2. Whether petitioner is liable to pay VAT for the (a) loans extended to its affiliates KEPCO Ilijan Corporation (KEILCO) and KEPCO Philippines Holdings, Inc. (KPHI); (b) lease of its premises as

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[28] Docket, pp. 1876-1877
[29] Docket, pp. 1888-1908.
[30] Docket, pp. 1921-1944.
[31] Resolution dated January 4, 2013, docket, p. 1947.
[32] Docket, pp. 413-414.

> canteen and dormitory; (c) sale of used and empty computer toner and cartridges; and (d) interest income earned from the payment it received from NPC.
>
> 3. Whether petitioner, pending the approval of its application for tax treaty relief, is liable to pay the assessed Final Withholding Tax deficiency on payments made to Korea Electric Power Corporation (KEPCO) for: (a) the expenses the latter incurred in securing the performance security bond; and (b) the services rendered under the Technical Services Agreement (TSA).

The afore-quoted issues may be summed up into one, to wit:

> WHETHER THE ASSESSMENTS ISSUED AGAINST PETITIONER FOR ALLEGED DEFICIENCY VAT AND FINAL WITHHOLDING TAX FOR TAXABLE YEAR 2006 SHOULD BE CANCELLED AND WITHDRAWN.

THE COURT'S RULING

Petitioner impugns the FLD issued against it by respondent for alleged deficiency VAT and FWT in the aggregate amount of P283,927,571.90. The Court shall discuss each tax covered by the subject assessment as follows:

A. On Deficiency VAT of ₱159,640,750.79

Respondent computed the deficiency VAT assessment in the amount of ₱159,640,750.79, by adding adjustments to petitioner's gross taxable sales per VAT returns for the year 2006, consisting of (1) Escalation Fees for 2005 but collected 2006 amounting to ₱374,714,642.25, (2) Interest Income on loans to affiliates amounting to ₱477,094,128.55, and (3) Miscellaneous Income amounting to ₱1,605,200.67, as shown below:

Gross Taxable Sales per VAT Returns		₱3,537,864,440.98
Add: Adjustments		
Escalation fees for the year 2005 collected in the year 2006	₱374,714,642.25	
Interest Income on loans to affiliate	477,094,128.55	
Miscellaneous Income	1,605,200.67	853,413,971.47
Adjusted Taxable Base		₱4,391,278,412.45
Multiply by VAT Rate		12%
Output Tax Due		₱ 521,343,370.60
Less: Input VAT		
Deferred Input Tax, Beg.	₱ 9,550,969.64	
Current Input Tax	12,297,175.18	
Total	21,848,144.82	
Standard Input Tax	222,568,333.67	
Total Available Input Tax	244,416,478.49	
Less: Deferred Input Tax, End	312,622.60	
Excess of Standard Input & Actual Input Tax	9,550,969.64	
Total Available Input Tax		234,552,886.25
VAT Payable per Audit		₱ 286,790,484.35
Less: Creditable Taxes Withheld		184,380,807.77
Basic Tax Due		₱ 102,409,676.58
Add: 20% Interest (01.26.07 to 11.15.09)	₱ 57,181,074.21	
Compromise Penalty	50,000.00	57,231,074.21
Total Deficiency VAT		**₱159,640,750.79**

1. *Escalation Fees for the year 2005 collected in the year 2006- ₱374,714,642.25*

Per respondent examination, petitioner had billed escalation fees covering the period December 25, 2003 to October 31, 2005 but the payments thereof were received only in 2006 in the amount of ₱374,714,642.25,[33] broken down as follows:

[33]BIR Records, p. 1168.

Escalation fees Dec. 2003-Mar. 2005	₱ 21,603,518.33
Escalation fees June 25-Aug. 25, 2005	122,345,062.67
Escalation fees Dec. 25, 2003-April 25, 2004	60,946,754.28
Adjustment in billing not taken up in PAN	(6,336,548.04)
Adjustment for escalation fees June - Aug. 25, 2005	24,067,383.99
Escalation fees Aug. 25, 2005 - Sept.25, 2005	71,269,611.11
Escalation fees Sept. 25, 2005 - Oct. 25, 2005	68,970,591.40
Escalation fees Oct. 25, 2005 to Oct. 31, 2005	11,848,268.51
Total	**₱374,714,642.25**

Based on the amount of ₱374,714,642.25, respondent assessed petitioner of deficiency VAT for taxable year 2006 due to non-compliance with Revenue Regulations (R.R.) No. 16-2005, implementing Republic Act (R.A.) No. 9337, which states:

TRANSITORY AND OTHER PROVISIONS

xxx xxx xxx

(c) *Billed but uncollected sale of services.* - Amounts due on sale of services becoming liable to VAT under RA No. 9337 rendered before the *effectivity of RA No. 9337*, payments of which are received on or after *the effectivity of RA No. 9337*, shall be considered as accrued as of *the day immediately preceding the effectivity of RA No. 9337* for the purpose of VAT exemption and payment of any applicable percentage tax, if any, or VAT exemption as the case may be, subject to the following conditions:

(i) Information return to be filed on or before *sixty (60) days from the effectivity of RA No. 9337* showing the name(s) of the contractor(s), client(s), customer(s) and the amount(s) of the contract price outstanding as of *the day immediately preceding the effectivity of RA No. 9337*, and containing a declaration of the obligation to pay the applicable percentage tax due if any;

> (ii) The seller billed the amount before *the effectivity of RA No. 9337*, and a copy of such billing is attached to the information return required in (i) hereof;
>
> (iii) The seller has recorded in his books of accounts as of *the day immediately preceding the effectivity of RA No. 9337* the amount receivable; and
>
> (iv) The seller files on or before the 20th day after each month, the regular percentage tax return for the payment of the percentage tax on payments received *after the effectivity of RA No. 9337*.
>
> In the case of sale of electricity, if a billing period covers power consumption for the period before *and* after *the effectivity of RA No. 9337*, 10% VAT shall be applied only to electricity consumption for the period on or after *the effectivity of RA No. 9337*. The electricity consumption before the effectivity of RA No. 9337 shall not be subject to 10% VAT but to the applicable franchise/percentage tax.
>
> **Failure to comply with the above-stated conditions shall automatically subject the gross receipts to the VAT.** *(Emphasis supplied)*

Given that petitioner failed to submit the required inventory or information return to the Revenue District Office (RDO) concerned within thirty (30) days after the effectivity of R.A. No. 9337 in violation of the foregoing provision, its gross receipts automatically became subject to VAT. For respondent, the assessment for deficiency VAT on the escalation fees for 2005 collected by petitioner in 2006 in the amount of ₱374,714,642.25 is correct.

Petitioner argues that the amount of ₱374,714,642.25 merely reflects the total adjustments already paid by the

NPC under the ROMM Agreement[34] for the period covering December 25, 2003 until October 31, 2005 and cannot and should not be categorized as billed but uncollected sale of electricity within the coverage of the transitory provision of Revenue Regulations (R.R.) No. 16-2005, implementing R.A. No. 9337. The said transitory provision of R.R. No. 16-2005 is not applicable as the concept of generation rate or foreign currency adjustment was never mentioned or contemplated in R.A. No. 9337; the sale of electricity by petitioner to NPC prior to November 2005 was considered as VAT zero-rated, under the "Electric Power Industry Reform Act of 2001" (EPIRA), and not VAT exempt; and that being merely adjustments of fully paid sale of electricity to NPC, the governing provision should be RMC No. 61-05 and ERC Resolution No. 20, Series of 2005.

The Court is one with petitioner.

Under Section 6 of Republic Act No. 9136 or the EPIRA of 2001, sales of generated power by generation companies are VAT zero-rated beginning June 26, 2001. The pertinent portion of the provision reads as follows:

> SECTION 6.*Generation Sector.*- Generation of electric power, a business affected with public interest, shall be competitive and open.
>
> xxx xxx xxx
>
> **Pursuant to the objective of lowering electricity rates to end-users, sales of generated power by generation companies shall be value added tax zero-rated.**"*(Emphasis supplied)*
>
> Further, Section 6 of Rule 5 of the Implementing Rules and Regulations of R.A. No. 9136 provides:

[34]Exhibit "C".

RULE 5
Generation Sector

xxx xxx xxx

SECTION 6.*Generation Charges and VAT.* -

xxx xxx xxx

(b) Pursuant to the policy of reducing electricity rates to End-users, sales of generated power by a Generation Company shall, from the effectivity of the Act, be zero-rated for the purpose of imposition of value-added tax. Towards this end, the imposition of zero percent (0%) VAT shall apply to the sale of generated power by a Generation Company through all stages of sale until it reaches the End-user. **The DOF, through the BIR, shall issue the necessary revenue regulation within sixty (60) calendar days from effectivity of these Rules.***(Emphasis supplied)*

However, when R.A. No. 9337 took effect on November 1, 2005, the sale of electricity by generation, transmission and distribution companies became subject to ten percent (10%)[35] VAT. This is evident when Section 108(A) of the NIRC of 1997 was amended by Section 6 of R.A. No. 9337 to subject to VAT at 10% the sale or exchange of services, including the sale of electricity by generation, transmission, and distribution companies. Corollary thereto, Section 24 of R.A. No. 9337 repealed the fifth paragraph of Section 6 of R.A. No. 9136 on the zero VAT rate imposed on the sales of generated power by generation companies. It is only the sale of power or fuel generated through renewable sources of energy that is now subject to zero percent (0%) rate pursuant to Section6(B) of R.A. No. 9337, amending Section 108(B)(7) of the NIRC of 1997.

[35] Now 12% VAT.

To clarify certain provisions of R.R. No. 16-05, implementing R.A. No. 9337, affecting generation, transmission and distribution companies as well as electric cooperatives as defined in R.A. No. 9136 (EPIRA) subject to VAT as well as their suppliers and customers effective November 1, 2005, the BIR, on October 27, 2005 issued RMC No. 61-05,[36] which in part states:

> Q30 – What will be the treatment of generation rate and foreign exchange rate adjustments to electricity sold on or before October 31, 2005?
>
> A30 – Generation rate and foreign exchange rate adjustments to electricity sold on or before October 31, 2005, although billed and collected thereafter, shall be considered as VAT zero-rated.

In relation thereto, the Energy Regulatory Commission issued ERC Resolution No. 20-05,[37] which provides that:

> **I. GENERAL PRINCIPLES**
>
> xxx xxx xxx
>
> (i) Generation rate and foreign exchange rate adjustments to electricity sold on or before October 31, 2005, although billed and collected thereafter, shall be considered as VAT zero-rated.

[36]Clarifying the VAT Provisions of R.A. 9337 Applicable to the Power Industry.
[37]Implementing the Recovery of Value Added Tax (VAT) and other Provisions of Republic Act No. 9337 Affecting the Electric Power Industry.

Clear from the foregoing provisions of RMC No. 61-05 and ERC Resolution No. 20-05 that the generation rate and foreign exchange rate adjustments to electricity sold on or before October 31, 2005, although billed and collected thereafter, shall be considered as VAT zero-rated.

To prove that the amount of ₱374,714,642.25 subject of the deficiency VAT assessment pertains to generation and foreign exchange rate adjustments to electricity sold on or before October 31, 2005, although billed and collected thereafter, petitioner presented the ROMM Agreement,[38] Schedule of the Invoices and Official Receipts[39] issued by petitioner to NPC for the period December 25, 2003 to October 31, 2005 and the related Invoices and Official Receipts,[40] Certification dated September 5, 2005[41] issued by the National Statistics Office (NSO), Certification dated January 17, 2006[42] issued by the NPC, Letter dated September 15, 2005[43] from the NPC, and the testimonies of its witnesses.[44]

The ROMM Agreement between petitioner and NPC reveals that petitioner will generate and sell electricity solely to NPC and the latter shall be billed for the following fees:[45]

> 1. Energy Fees to be calculated based on the applicable parameters in Schedule 7; and
>
> 2. O&M Fees to be calculated based on the applicable parameters in Schedule 7 subject to price escalation.

The O&M Fees are subject to two adjustments, namely, price escalation and price escalation adjustments depending on several factors such as peso-dollar exchange rate,

[38]Exhibit "C".
[39]Exhibit "D".
[40] Exhibits "D-1" to "D-39".
[41]Exhibit "P".
[42] Exhibit "Q".
[43]Exhibit "R".
[44] Exhibits "N", "O", and "S".
[45] Exhibit "C-2".

inflation rate and pertinent price indices as elaborated by petitioner's witness Godofredo Saises in this wise:[46]:

> **Q: Mr. witness, you mentioned that the O&M Fees is subject to two (2) adjustments, namely price escalation and price escalation adjustments. Can you describe and differentiate these types of adjustments?**
>
> A: Yes. The O&M Fees are first computed in accordance with Section 5, paragraph 5.2.2 of Schedule 7 of the ROMM Agreement. The same fees are then subject to <u>price escalation</u> based on the formula provided in Article 7, paragraph 7.5 of the ROMM Agreement where several factors are considered, such as the peso-dollar exchange rate, inflation rate and price indices. <u>Price escalation adjustment</u>, on the other hand, is the adjustment made on the same price escalation when the other necessary data become available after the price escalation fees were billed and paid, considering the fees are first calculated depending on the data available at the time of the billing period.
>
> xxx xxx xxx
>
> **Q: The first adjustment that you were referring to, what would be the factors that will be considered when such is implemented?**
>
> A: The O&M Fees as mentioned are subject to price escalation, which is the first adjustment. Article 7, paragraph 7.5 of the ROMM Agreement provides the formula for

[46]Exhibit "N", pp. 7-8.

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the price escalation where the factors to be considered, among others, are the US Consumer Price Index, Retail Price Index as published by NEDA, and the peso-dollar exchange rate as published by the Bankers Association of the Philippines. These data are not usually readily available at the time of the billing period; hence, the amount billed for a period is not final considering that the necessary data would be available months thereafter. Thus, when the data become available, the billed amount, while already previously paid and settled, would have to be adjusted in accordance with the ROMM.

xxx xxx xxx

Q: Mr. Witness, you also mentioned that there is a second adjustment. What would be the factors that will be considered when such is implemented?

A: The second adjustment is on the price escalation, which in simple terms, another adjustment of the first price escalation revision. The price escalation adjustments are also based on the formula provided for price escalation. Adjustments are made when the necessary data become available. The amount billed for price escalation would necessarily be adjusted as the data to calculate the exact amount become available.

As found by respondent and as evidenced by the various invoices and official receipts[47] submitted by petitioner, the amount of ₱374,714,642.25 subject of the deficiency VAT assessment pertains to price escalation and price escalation adjustments covering petitioner's sale of

[47] Exhibits "D-1" to "D-39".

electricity to PNC for the period December 25, 2003 to October 31, 2005. Pursuant to RMC No. 61-05 and ERC Resolution No. 20, Series of 2005, the amount of ₱374,714,642.25 is VAT zero-rated as it pertains to generation and foreign exchange rate adjustments to petitioner's sale of electricity on or before October 31, 2005, although billed and collected thereafter.

Contrary to respondent's claim, the transitory provision under R.R. No. 16-05, which requires the submission of inventory or information return for "billed and uncollected sale of services," is not applicable to the instant case. The amount of ₱374,714,642.25 had not been billed as of October 31, 2005 as the calculation or determination of the said amount was dependent on the release of government data such as inflation rate and Consumer Price Index. Moreover, as correctly pointed out by petitioner, if generation rate adjustments billed and collected after October 31, 2005 were envisioned to be subject to the inventory requirement, respondent would not have issued RMC No. 61-05 on October 27, 2005 regarding the VAT treatment of the power generation sector wherein it was categorically stated that the generation rate adjustments on electricity sold on or before October 31, 2005 shall still be VAT zero-rated regardless of when these were billed and collected.

In fine, respondent's deficiency VAT assessment on the ₱374,714,642.25 price escalation and price escalation adjustments to petitioner's sale of electricity for the period covering December 23, 2004 to October 31, 2005 is erroneous and should be cancelled and withdrawn.

2. *Interest Income on loans to affiliates - ₱477,094,128.55*

Respondent claims that petitioner's interest income in the amount of ₱477,094,128.55, derived from the loans extended to its affiliates KEILCO under the KEPCO Replacement Loan (KRL) Agreement[48] and KPHI under the

[48]Exhibit "E".

Loan Agreement,[49]is subject to VAT under Section 105 in relation to Section 108(A) of the NIRC of 1997, as amended.

Respondent contends that the interest income on loan assistance extended by petitioner to its affiliates, being incidental to its business, is deemed a transaction "in the course of trade or business" contemplated under Section 105 of the NIRC of 1997, as amended. Thus, if the income from the main business activity is subject to VAT, the incidental income, such as petitioner's interest income on loans extended to its affiliates, shall also be subject to VAT. Moreover, Section 108(A) of the NIRC of 1997, as amended, defines the phrase "sale of service" as the performance of all kinds of services for others for a fee, remuneration or consideration. Hence, when petitioner extended interest bearing loans to its affiliates, it provided financial assistance for a fee or remuneration or consideration, regardless of whether petitioner has realized profit or not, such financial assistance is considered as sale of service subject to VAT.

Petitioner explains that the KRL was extended to KEILCO on November 10, 2000 during the construction period of the latter's Ilijan Power Plant and that since KEILCO did not have the necessary access to financial institutions which could extend the necessary loans during that period, it had to provide the short term solution to KEILCO's financial situation as the better established and more stable company. On the other hand, the loan to KPHI was for the purpose of funding KPHI's equity investment to acquire a controlling interest in Salcon Power Corporation (SPC), a company engaged in the generation of electricity in the Province of Cebu.

Further, based on Section 105 of the NIRC of 1997, as amended, a transaction, for VAT purposes, is characterized as having been entered into by a person in the course of trade of business if it is: (1) regularly conducted; and (2) undertaken in the pursuit of a commercial or economic activity. The best parameter on this aspect, for purposes of imposing the VAT, will be its primary purpose enumerated in the Articles of Incorporation, namely – to rehabilitate,

[49]Exhibit "F".

operate, maintain and manage the Malaya Thermal Power Plant owned by NPC. The loans were extended merely in response to the situations which KEILCO and KPHI had to address immediately. Thus, the grant of these loans to its affiliates is not pursuant to its main line of business, as clearly stated in its Articles of Incorporation.

Petitioner suspects that the Court's Decision in the Lapanday case might have been the basis of the BIR's position. However, the ruling in the Lapanday case, which relied mainly on the COMASERCO[50] case is not applicable to the case at bar since petitioner was organized as a power generation company and not for the purpose of extending loans or any other type of assistance (financial, technical or managerial) to its affiliates or other corporations.

The Court again agrees with respondent.

The issue is certainly not new. In the case of *Kepco Philippines Corporation vs. The Commissioner of Internal Revenue,*[51] the First Division of this Court had the occasion to rule on the same issue involving the same parties, to wit:

> Section 105 of the NIRC of 1997 states that:
>
> 'SEC. 105.*Persons Liable*. – Any person who, **in the course of trade or business, sells, barters, exchanges, leases goods or properties, renders services**, and any person who imports goods shall be subject to the value-added tax (VAT) imposed in Sections 106 to 108 of this Code.
>
> The value-added tax is an indirect tax and the amount of tax may be shifted or passed on to the buyer, transferee or lessee of the goods, properties or services.

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[50]*Commissioner of Internal Revenue v. Court of Appeals and Commonwealth Management and Services Corporation* (COMASERCO), G.R. No. 125355, March 30, 2000, 329 SCRA 237.
[51]CTA Case No. 8319, November 7, 2013.

This rule shall likewise apply to existing contracts of sale or lease of goods, properties or services at the time of the effectivity of Republic Act No. 7716.

The phrase '*in the course of trade or business*' means the regular conduct or pursuit of a commercial or an economic activity, including transactions incidental thereto, by any person regardless of whether or not the person engaged therein is a nonstock, nonprofit private organization (irrespective of the disposition of its net income and whether or not it sells exclusively to members or their guests), or government entity.

The rule of regularity, to the contrary notwithstanding, services as defined in this Code rendered in the Philippines by nonresident foreign persons shall be considered as being rendered in the course of trade or business.' *(Emphasis supplied)*

Pertinent thereto, Section 108 of the NIRC of 1997, as amended, provides:

SEC. 108.*Valued-added Tax on Sale of Services and Use or Lease of Properties.* -

(A) *Rate and Base of Tax.* – There shall be levied, assessed and collected, a value-added tax equivalent to ten percent (10%) of the gross receipts, derived from the sale or exchange of services, including the use or lease of properties; *Provided*, That the President, upon the recommendation of the Secretary of Finance, shall, effective January 1, 2006, raise the rate of value-added tax to twelve percent (12%), after any of the following conditions has been satisfied:

xxx xxx xxx

The **phrase 'sale or exchange of services' means the performance of all**

> **kinds of services in the Philippines for others for a fee, remuneration or consideration, including those performed or rendered by** construction and service contractors; stock, real estate, commercial, customs and immigration brokers, lessors of property, whether personal or real; warehousing services; lessors or distributors of cinematographic films; persons engaged in milling, processing, manufacturing or repacking goods for others; proprietors, operators or keepers of hotels, motels, resthouses, pension houses, inns, resorts; proprietors or operators of restaurants, refreshment parlors, cafes and other eating places, including clubs and caterers; dealers in securities; **lending investors**; transportation contractors on their transport of goods or cargoes, including persons who transports goods or cargoes for hire and other domestic common carriers by land relative to their transport of goods or cargoes; common carriers by air and sea relative to their transport of passengers, goods or cargoes from one place in the Philippines to another place in the Philippines; sales of electricity by generation companies, transmission, and distribution companies; services of franchise grantees of electric utilities, telephone and telegraph, radio and television broadcasting and all other franchise grantees except those under Section 119 of this Code; and non-life insurance companies (except their crop insurances), including surety, fidelity, indemnity and bonding companies; **and similar services regardless of whether or not the performance thereof calls for the exercise or use of the physical or mental faculties**. xxx'*(Emphasis supplied)*

Based on the foregoing provisions, any person who performs any kind of services for a fee, remuneration or consideration including those specifically mentioned above and similar services in the course of trade or business is subject to value-added tax.

xxx xxx xxx

In the present case, petitioner extended financial assistance through loans with interest to its affiliates. It falls under similar services as that of a lending investor. This act is clearly a performance of service for a fee, remuneration or consideration within the context of Sec. 108, *supra.*

Furthermore, the provision of Section 105 of the NIRC of 1997 is clear and categorical in stating that a person shall be liable to VAT when the sale of services is done in the ordinary course of trade or business. The phrase 'in the course of trade or business' connotes regular conduct or pursuit of a commercial or an economic activity, including transactions incidental thereto.

A transaction will be characterized as having been entered into by a person in the course of trade or business, if it is regularly conducted and undertaken in pursuit of a commercial or economic activity. Transactions that are undertaken incidental to the pursuit of a commercial or economic activity are considered as entered into in the course of trade or business. 'Incidental' means something else as primary; something necessary, appertaining to, or depending upon another, which is termed principal.

There is no denying that petitioner is a power generating company. Its primary purpose is to rehabilitate, operate, maintain and manage the Malaya Power Complex in Pililia, Rizal, Philippines and other power generating plants and related facilities for the conversion into electricity of fuel.

Petitioner's purpose of extending loan to its affiliate KEILCO in 2000 was to give financial assistance in order for the latter to design, construct, furnish, install, test, commission, own, operate and maintain a 1251 MW natural gas fired combined cycle generating plant with diesel fuel firing capability to be located at Ilijan, Batangas City. On the other hand, the purpose of the loan given to petitioner's affiliate KPHI on February 10, 2006 was for KPHI to purchase shares of stocks in Salcon Power Corporation (SPC), a publicly listed power generation company operating in the Province of Cebu.

Petitioner assisted its affiliate KEILCO in operating and maintaining other power generating plant located at Ilijan, Batangas. Petitioner also extended financial assistance to KPHI in order for the latter to acquire shares of stock in other generating plant (Salcon Power Corporation). In a sense, petitioner acts through its affiliates in pursuing its primary purpose of rehabilitating, operating, maintaining and managing other power generating plants and related facilities for the conversion into electricity of fuel.

Further, upon careful examination of the records, this Court finds that one of the secondary purposes of petitioner is to 'aid in any manner any corporation, association, or trust, estate, domestic or foreign, or any firm or individual xxx. In extending loans with interest to its affiliates, petitioner performed services which are incidental to its business. The financial assistance given by petitioner, being incidental to its business, is deemed a transaction in the course of its trade or business.*(Citations omitted)*

Thus, considering that the present assessment pertains to the same loans extended by petitioner to its affiliates referred to in the afore-quoted case, the interest income received therefrom by petitioner for the year 2006 in the amount of ₱477,094,128.55 shall be subject to VAT pursuant to Section 105, in relation to Section 108(A) of the NIRC of 1997, as amended.

3. *Miscellaneous Income - ₱1,605,200.67*

Respondent imposed VAT on petitioner's Miscellaneous Income amounting to ₱1,605,200.67 consisting of the following:

Interest income earned from advances to NPC	₱ 1,547,237.10
Lease of canteen and dormitory	55,053.57
Sale of used and empty computer toner/cartridges	2,910.00
Total	**₱1,605,200.67**

a. *Interest Income earned from advances to NPC - ₱1,547,237.10*

Petitioner posits that the interest income of ₱1,547,237.10 arose from its advances to NPC in accord with the ROMM Agreement. These advances were made to NPC for payment of the retirement benefits of employees and security guards of the Malaya Power Plant previously employed on the condition that the same shall be repaid within 15 years. Thus, for the taxable year 2006, NPC paid a total amount of ₱1,547,237.10 interest. Petitioner asserts that since it is not engaged in the lending business, such advances to NPC should not be subject to VAT.

On this regard, the Court finds for respondent

As admitted by petitioner, the loan it extended to NPC was part of its contractual obligations under the ROMM Agreement, the pertinent portion of which reads:[52]

[52]Exhibit "C", docket, pp. 1331-1333.

ARTICLE 3
REHABILITATION OF THE POWER COMPLEX

3.1 REHABILITATION RESPONSIBILITY.

(a) CONTRACTOR shall be responsible for the rehabilitation of the Power Complex in accordance with Schedule 1 (Scope of Works) and shall commence work on the Turnover Date.

xxx xxx xxx

(e) Contractor shall advance to NPC the amount of the actual retirement benefits due from NPC to the Power Complex personnel who are transferring to CONTRACTOR and NPC shall amortize such amount advanced by CONTRACTOR within fifteen (15) years from the Turnover Date at the prevailing Interest Rate, payable in thirty (30) equal semi-annual installments.

Plain from the foregoing that the advances made by petitioner to NPC shall be for the retirement benefits of NPC employees who would be transferring to petitioner and help in the rehabilitation of the Malaya Power Plant located in Barrio Malaya, Pililia, Rizal.[53] Undoubtedly, the said advances were made in the pursuit of petitioner's business of power generation services. Hence, the related interest income of ₱1,547,237.10 shall be deemed to have been earned by petitioner "in the course of its trade or business" and shall be subject to VAT pursuant to Section 105 in relation to Section 108(A) of the NIRC of 1997, as amended.

b. *Lease of canteen and dormitory - ₱55,053.57*

Petitioner alleges that its dormitory and canteen facilities were leased to suppliers who needed to stay at the plant site for a certain period of time and to the

[53]Exhibit "C", docket, p. 1325

concessionaire who operated the canteen. The total amount paid by these entities amounted to ₱55,053.57 (₱33,053.57 for dormitory accommodations and ₱22,000.00 for the lease of the canteen[54]) for taxable year 2006. It was assessed of the corresponding deficiency VAT on the ground that the lease from these facilities, being incidental to petitioner's business, is deemed a transaction "in the course of trade and business".

This assessment is partly correct.

While petitioner's lease of its canteen and dormitory facilities was necessary or incidental to its power generation services, however, Section 4.109-1(B)(1)(q) of R.R. No. 16-05 implementing Section 109(Q) of the NIRC of 1997, as amended, specifically exempts lease of a residential unit where the monthly rental per unit does not exceed ₱10,000.00 or the monthly rental per unit exceeds ₱10,000.00 but the aggregate of such rentals during the year does not exceed ₱1,500,000.00, to wit:

> SEC. 109.*Exempt Transactions.* – xxx the following transactions shall be exempt from the value-added tax:
>
> xxx xxx xxx
>
> (Q) Lease of a residential unit with a monthly rental not exceeding Ten thousand pesos (P10,000): *Provided*, That not later than January 31, 2009 and every three (3) years thereafter, the amount herein stated shall be adjusted to its present value using the Consumer Price Index, as published by the National Statistics Office (NSO);
>
> SECTION 4.109-1.*VAT-Exempt Transactions.*-
>
> xxx xxx xxx
>
> (B) Exempt transactions. -

[54]BIR Records, p. 1113

> (1) Subject to the provisions of Subsection (2) hereof, the following transactions shall be exempt from VAT:
>
> xxx xxx xxx
>
> (q) Lease of residential units with a monthly rental per unit not exceeding Ten Thousand Pesos (P10,000.00), regardless of the amount of aggregate rentals received by the lessor during the year; Provided, that not later than January 31, 2009 and every three (3) years thereafter, the amount of P10,000.00 shall be adjusted to its present value using the Consumer Price Index, as published by the NSO;
>
> The foregoing notwithstanding, **lease of residential units where the monthly rental per unit exceeds Ten Thousand Pesos (P10,000.00) but the aggregate of such rentals of the lessor during the year do not exceed One Million Five Hundred Pesos (P1,500,000.00) shall likewise be exempt from VAT**, however, the same shall be subjected to three percent (3%) percentage tax. *(Emphasis supplied)*

Thus, petitioner's rental income from its dormitory facilities for the year 2006 in the amount of ₱33,053.57 is not subject to VAT and the deficiency VAT assessment thereon must be cancelled.

However, petitioner's lease income from its canteen facilities for the year 2006 in the amount of ₱22,000.00, being incidental to its primary business of power generation services, is subject to VAT pursuant to Section 105 in relation to Section 108(A) of the NIRC of 1997, as amended.

c. *Sale of used and empty computer toner/cartridges - ₱2,910.00*

The proceeds from petitioner's sale of used and empty computer toner/cartridges shall likewise be subject to VAT pursuant to Section 105 in relation to Section 106(A) of the NIRC of 1997, as amended, considering that prior to the sale, the computer toner/cartridges were used by petitioner in carrying out its primary business of power generation services.

In sum, petitioner is liable to pay basic deficiency VAT for the year 2006 in the amount of ₱57,439,953.08, computed as follows:

Interest Income on loans to affiliate		₱ 477,094,128.55
Miscellaneous Income		
Interest income earned from advances to NPC	₱1,547,237.10	
Lease of canteen	22,000.00	
Sale of used and empty computer toner/cartridges	2,910.00	1,572,147.10
Total Income Subject to VAT		₱ 478,666,275.65
Multiply by VAT Rate		12%
Basic Deficiency VAT		**₱ 57,439,953.08**

B. On Deficiency Final Withholding Tax

Respondent found income payments made by petitioner in 2006 to KEPCO, a non-resident foreign corporation domiciled in Korea, relative to the TSA between petitioner and KEPCO in the amount of ₱248,311,387.00 which were not subjected to FWT. Thus, the assessment for deficiency FWT for taxable year 2006 in the amount of ₱124,286,821.11, computed as follows:

Final Withholding Tax Due per Audit		₱ 79,633,050.81
Final Withholding Tax Paid		173,406.97
Deficiency Final Withholding Tax		79,459,643.84
Add: 20% Interest (01.17.07 -11.15.09)	₱ 44,802,177.27	
Compromise Penalty	25,000.00	44,827,177.27
Total Deficiency Final Tax		**₱124,286,821.11**

Respondent maintains that the income payments by petitioner to KEPCO should be subjected to FWT since its application for tax treaty relief was still pending approval. Respondent argues that when petitioner made the payments to KEPCO, there was yet no exemption issued by the BIR. In order to claim exemption from taxes pursuant to the Philippines-Korea tax treaty, petitioner should have filed an Application for Relief from Double Taxation fifteen (15) days prior to the transaction or payment of services rendered under the TSA pursuant to Revenue Memorandum Order (RMO) No. 01-00 dated November 25, 1999, which states:

> II. Coverage:
>
> This Order covers exclusively applications for tax treaty relief, including claims or requests for tax exemption, preferential tax treaty rate, refund or credit of taxes on the following income derived or to be derived by the taxpayer under existing tax treaties, to wit:
>
> a. dividends
> b. interests
> c. royalties
> d. business profits
> e. gains from sale of shares of stocks
> f. salaries, compensation, etc.
> g. income from services (entertainment, profession, etc.)
> h. profits from the operation of ships and air carriers
> i. all other income covered by tax treaties
>
> xxx xxx xxx
>
> III. Policies:
>
> In order to achieve the above-mentioned objectives, the following policies shall be observed:
>
> xxx xxx xxx

> 2. Any availment of the tax treaty relief shall be preceded by an application by filing BIR Form No. 0901 (Application for Relief from Double Taxation) with ITAD at least 15 days before the transaction i.e. payment of dividends, royalties, etc., accompanied by supporting documents justifying the relief. Consequently, BIR Form Nos. TC 001 and TC 002 prescribed under RMO 10-92 are hereby declared obsolete.

The assessment for FWT should be cancelled.

The Supreme Court, in the very resent case of *Deutsche Bank AG Manila Branch vs. Commissioner of Internal Revenue,*[55] explained that taxpayers cannot be deprived of their entitlement to the benefit of a treaty for failure to comply with an administrative issuance requiring the prior application for tax treaty relief. The obligation to comply with a tax treaty must take precedence over RMO No. 01-00. Below is the pertinent part of the Decision:

> ***Tax Treaty vs. RMO No. 1-2000***
>
> Our Constitution provides for adherence to the general principles of international law as part of the law of the land. The time-honored international principle of *pacta sunt servanda* demands the performance in good faith of treaty obligations on the part of the states that enter into the agreement. Every treaty in force is binding upon the parties, and obligations under the treaty must be performed by them in good faith. More importantly, treaties have the force and effect of law in this jurisdiction.
>
> xxx xxx xxx

[55] G.R. No. 188550, August 19, 2013.

'A state that has contracted valid international obligations is bound to make in its legislations those modifications that may be necessary to ensure the fulfillment of the obligations undertaken.' Thus, laws and issuances must ensure that the reliefs granted under tax treaties are accorded to the parties entitled thereto. The BIR must not impose additional requirements that would negate the availment of the reliefs provided for under international agreements. xxx

Likewise, it must be stressed that there is nothing in RMO No. 1-2000 which would indicate a deprivation of entitlement to a tax treaty relief for failure to comply with the 15-day period. We recognize the clear intention of the BIR in implementing RMO No. 1-2000, but the CTA's outright denial of a tax treaty relief for failure to strictly comply with the prescribed period is not in harmony with the objectives of the contracting state to ensure that the benefits granted under tax treaties are enjoyed by duly entitled persons or corporations.

Bearing in mind the rationale of tax treaties, the period of application for the availment of tax treaty relief as required by RMO No. 1-2000 should not operate to divest entitlement to the relief as it would constitute a violation of the duty required by good faith in complying with a tax treaty. The denial of the availment of tax relief for the failure of a taxpayer to apply within the prescribed period under the administrative issuance would impair the value of the tax treaty. At most, the application for a tax treaty relief from the BIR should merely operate to confirm the entitlement of the taxpayer to the relief.

The obligation to comply with a tax treaty must take precedence over the objective of RMO No. 1-2000. Logically, noncompliance with tax treaties has

> negative implications on international relations, and unduly discourages foreign investors. While the consequences sought to be prevented by RMO No. 1-2000 involve an administrative procedure, these may be remedied through other system management processes, e.g., the imposition of a fine or penalty. But we cannot totally deprive those who are entitled to the benefit of a treaty for failure to strictly comply with an administrative issuance requiring prior application for tax treaty relief.

In the instant case, the BIR issued BIR Ruling No. ITAD 134-11 dated April 25, 2011, confirming that petitioner's income payments to KEPCO for the year 2006 under the TSA are not subject to Philippine income tax pursuant to Article 7(1) in relation to Article 5(3)(b) of the Philippines-Korea tax treaty, as quoted below:

> In reply, please be informed that Section 28 (B) (1) of the National Internal Revenue Code (Tax Code) of 1997, as amended applies, in general, to income received by a nonresident foreign corporation which provides:
>
> 'Section 28. *Rates of Income Tax on Foreign Corporations.-*
>
> (B) *Tax on Nonresident Foreign Corporation. –*
>
> (1) In General. - Except as otherwise provided in this Code, a foreign corporation not engaged in trade or business in the Philippines shall pay a tax equal to thirty-five percent (35%) of the gross income received during each taxable year from all sources within the Philippines, such as interests, dividends, rents, royalties, salaries, premiums (except reinsurance premiums), annuities,

emoluments or other fixed or determinable annual, periodic or casual gains subject to tax under subparagraphs 5(c): Provided, That effective January 1, 2009, the rate of income tax shall be thirty percent (30%).'

However, Section 32 (B) (5) of the Tax Code of 1997, as amended provides:

'Section 32. *Gross Income.-*

(B) Exclusions from Gross Income. - The following items shall not be included in gross income and shall be exempt from taxation under this Title:

(5) Income Exempt under Treaty. - Income of any kind, to the extent required by any treaty obligation binding upon the Government of the Philippines.'

In relation thereto, the provision of the Philippines-Korea Tax Treaty may apply to the compensation to be paid by KEPHILCO to KEPCO under the Agreement.

A. *Compensation for Services*

Generally, business profits (or industrial and commercial profits) include payments for the supply of goods and services, and for the lease of personal properties. In this case, the compensation for project management and administrative advisory services, technical services, and training services, compensation for the supply of tools, equipment and materials, and compensation for the rental of tools and materials (but not equipment), being in the nature of *business profits*, are taxed under Article 7 in relation to Article 5 of the Philippines-Korea tax treaty, thus:

'Article 7
BUSINESS PROFITS

1. The profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other State but only so much of them as is attributable to that permanent establishment.'

'Article 5
PERMANENT ESTABLISHMENT

1. For the purposes of this Convention, the term 'permanent establishment' means a fixed place of business through which the business of an enterprise is wholly or partly carried on.

2. The term 'permanent establishment' includes especially:

a) a place of management;
b) a branch;
c) an office;
d) a factory;
e) a workshop;
f) a mine, an oil or gas well, a quarry or any other place of extraction of natural resources;
g) premises used as a sales outlet; and
h) a warehouse, in relation to a person providing storage facilities for others.

3. a) a building site or construction, installation or assembly project or supervisory activities in connection therewith, constitute a permanent establishment only if such site, project or activity continues for a period of more than six months;

b) the furnishing of services including consultancy services by an enterprise through an employee or other personnel constitutes a permanent establishment only if activities of that nature continues within a Contracting State for a period or periods exceeding in the aggregate 183 days within any twelve-month period; and

c) a place of exploration of natural resources constitutes a permanent establishment only if it exists for more than six months.'

Under Article 7, the compensation for project management and administrative advisory services, etc., is subject to Philippine income tax if it is attributable to a permanent establishment of KEPCO in the Philippines; otherwise, the compensation is exempt from Philippine income tax. Under Article 5, KEPCO is considered to have a permanent establishment if it has in the Philippines a fixed place of business through which it carries on its business (like a branch or an office) or if it furnishes services in the Philippines for more than 183 days within any twelve-month period.

Accordingly, inasmuch as KEPCO does not have a branch, neither an office nor any other fixed place of business in the Philippines, and the services rendered in the Philippines pursuant to the Agreement did not exceed 183 days within any twelve-month period, KEPCO is considered as not having a permanent establishment in the Philippines. This is supported by the Certification of Non-Registration of Corporation/Partnership dated July 1, 2008, issued by the Securities and Exchange Commission confirming that KEPCO is not registered as a corporation or a partnership in the Philippines, which shows that it is unlikely for KEPCO to have a branch nor an office nor any other fixed place of business in the Philippines.

> Furthermore, in its Sworn Certification dated June 18, 2008 KEPCO signified and attested to the fact that the application for the treaty relief covers the services rendered outside the Philippines or those performed in the Philippines, but did not exceed an aggregate of 183 days within any twelve-month period, for the years 2006 and 2007. Moreover, the services under the Agreement purely involve the rendition of management, administrative and technical services, as well as other services related to the ROMM Agreement between it and the National Power Corporation (NPC), and that for the same period, no supply or rental of tools, equipment and material nor importation of the foregoing were made pursuant to the Agreement.
>
> The documents submitted to this Office support the foregoing representation and show that the personnel of KEPCO rendered services under the Technical Services Agreement, for an aggregate period not exceeding 183 days within a twelve-month period. Thus, KEPCO is not deemed to have a permanent establishment by virtue of the rendition of said services in the Philippines to which its profits could be attributable. In view thereof, this Office is of the opinion and so holds that the profits derived by KEPCO from the rendition of services under the Agreement shall not be subject to Philippine income tax pursuant to Article 7 (1) in relation to Article 5 (3) (b) of the Philippines-Korea tax treaty.

This Court finds no reason to ignore the interpretation made by respondent that the management, administrative and technical services rendered by KEPCO to petitioner for the year 2006 under the TSA were not subject to Philippine income tax pursuant to Article 7(1) in relation to Article 5(3)(b) of the Philippines-Korea tax treaty. Simply put, petitioner is not liable to pay any deficiency FWT relative thereto for the year 2006.

C. *Compromise Penalties - ₱75,000.00*

Respondent imposed compromise penalties on the subject deficiency taxes in the total amount of ₱75,000.00, broken down as follows:

Tax Type	Compromise Penalty
Deficiency VAT	₱ 50,000.00
Deficiency FWT	25,000.00
Total	**₱75,000.00**

The imposition is bereft of merit.

RMO No. 1-90[56]provides that compromise penalties are only amounts suggested in settlement of criminal liability, thus:

> III. *Guidelines and Instructions:*
>
> xxx xxx xxx
>
> 5. Since **compromise penalties are only amounts suggested in settlement of criminal liability**, and may not therefore be imposed or exacted on the taxpayer in the event that a taxpayer refuses to pay the suggested compromise penalty, the violation shall be referred for criminal action as heretofore mentioned. *(Emphasis supplied)*

In cases more than one, the Court had ruled that compromise penalties imply mutual agreement between the taxpayer, on one hand, and respondent, on the other.

[56] Amendments to the provisions of a "Revised Schedule of Compromise Penalties" for Internal Revenue Violations as Prescribed in RMO 26-86.

Absent any showing that the taxpayer consented to the compromise penalty, its imposition should not be allowed.[57]

In the instant case, there is no showing that both parties have mustered a compromise agreement or that the taxpayer has consented to the compromise penalty. There is also no showing that the amount of ₱75,000.00 was "in settlement of criminal liability", there being no criminal case filed against petitioner. Hence, the compromise penalty of ₱75,000.00 charged by respondent against petitioner cannot be sustained and must be cancelled.

WHEREFORE, the instant *Petition for Review* is hereby **PARTIALLY GRANTED**. The assessment representing deficiency FWT in the aggregate amount of ₱124,286,821.11 for taxable year 2006 and the compromise penalties are **CANCELLED** and **SET ASIDE**. However, the assessment for deficiency VAT for taxable year 2006 is **AFFIRMED** with **MODIFICATIONS**. Accordingly, petitioner is **ORDERED TO PAY** respondent the amount of ₱71,799,941.35 representing basic deficiency VAT for taxable year 2006 in the amount of ₱57,439,953.08 and the twenty-five percent (25%) surcharge imposed under Section 248(A)(3) of the NIRC of 1997, in the amount of ₱14,359,988.27, as shown below:

Basic Deficiency VAT	₱ 57,439,953.08
Add: 25% Surcharge	14,359,988.27
Total Amount Due	**₱71,799,941.35**

In addition, petitioner is **ORDERED TO PAY**:

a) Deficiency interest at the rate of twenty percent (20%) per annum on the basic deficiency VAT of ₱57,439,953.08 computed from January 25, 2007 until full payment thereof pursuant to Section 249(B) of the NIRC of 1997, as amended;

[57]*Commissioner of Internal Revenue vs. Philippine Airlines, Inc.*, CTA EB No. 648, December 15, 2010; *Perpetual Succour Hospital, Inc., et al. vs. Commissioner of Internal Revenue*, CTA Case No. 7304, December 1, 2010; *Covanta Energy Philippine Holdings, Inc. vs. Commissioner of Internal Revenue*, CTA Case No. 7103, September 15, 2010.

b) Delinquency interest at the rate of 20% per annum on the amount of ₱71,799,941.35 representing the basic deficiency VAT of ₱57,439,953.08 and 25% surcharge of ₱14,359,988.27 computed from November 15, 2009 until full payment thereof pursuant to Section 249(C)(3) of the NIRC of 1997, as amended; and

c) Delinquency interest at the rate of 20% per annum on the deficiency interest which have accrued as afore-stated in (a) computed from November 15, 2009 until full payment thereof pursuant to Section 249(C)(3) of the NIRC of 1997, as amended.

SO ORDERED.

ESPERANZA R. FABON-VICTORINO
Associate Justice

I Concur:

ERLINDA P. UY
Associate Justice

ATTESTATION

I attest 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.

ERLINDA P. UY
Chairperson

CERTIFICATION

Pursuant to Article VIII, Section 13 of the Constitution, and the Division Chairperson's Attestation, 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.

ROMAN G. DEL ROSARIO
Presiding Justice