REPUBLIC OF THE PHILIPPINES
COURT OF TAX APPEALS
QUEZON CITY

SPECIAL SECOND DIVISION

SUBIC WATER & SEWERAGE CO., INC., *Petitioner,*	**CTA Case No. 9074**
	Members:
-*versus*-	**CASTAÑEDA, JR.**, *Chairperson* *and* **MANAHAN**, *JJ.*
COMMISSIONER OF INTERNAL REVENUE, *Respondent.*	Promulgated: AUG 14 2019 9:30 a.m.

x- x

DECISION

MANAHAN, *J.*:

Before this Court is a Petition for Review[1] filed by Subic Water and Sewerage Co., Inc. (SWSCI) praying that the Final Decision on Disputed Assessment dated May 20, 2015, assessing it in the amount of ₱238,407,520.17 for the period April 1, 2011 to December 31, 2011, be annulled, reversed and set aside.

THE PARTIES

Petitioner SWSCI is a corporation duly organized and existing under Philippine laws with principal office at Subic Water Complex, Rizal Highway, SUBCOM Area, Subic Freeport Zone, 2200, Philippines.[2] Its primary purpose is to carry on the business of providing water and sewerage services in the Subic Special Economic and Free Port Zone.[3]

---

[1] Docket, CTA Case No. 9074, Vol. I, pp. 10-48.
[2] Par. 1, Stipulation of Facts, Joint Stipulation of Facts and Issues (JSFI), docket (vol. III), p. 1295.
[3] Exhibit "P-1".

Petitioner is registered as a Subic Bay Freeport Enterprise, as shown in the Certificate of Registration and Tax Exemption[4] (Certificate No. 96-0064) dated May 5, 2011 issued by the Subic Bay Metropolitan Authority (SBMA) and effective until May 4, 2012.

On the other hand, respondent is the Commissioner of the Bureau of Internal Revenue (BIR), the government agency charged with, among other powers and duties, the responsibility of collecting all national internal revenue taxes. He holds office at the BIR National Office Building, BIR Road, Diliman, Quezon City.

THE FACTS

A Letter of Authority (LOA) No. LOA-116-2012-00000029 (SN: eLA201100006952)[5] dated August 10, 2012 was issued authorizing Revenue Officers Maria Gracielle Cecilia San Pedro and Riza Budano and Group Supervisor Marivic Bautista to examine petitioner's books of accounts and other accounting records for all internal revenue taxes for the period from April 1, 2011 to December 31, 2011.

On August 20, 2014, petitioner received the Preliminary Assessment Notice[6] (PAN) dated August 18, 2014 issued by respondent.[7]

In response thereof, petitioner submitted a Reply[8] on September 3, 2014.[9]

On October 7, 2014, petitioner received a Formal Letter of Demand[10] (FLD) with attached Final Assessment Notices[11] (FAN) of even date issued by respondent.[12]

Thereafter, on November 5, 2014, or within thirty (30) days from receipt of the FLD, petitioner filed its Protest with Request for Reinvestigation[13] of even date.[14]

---

[4] Exhibit "P-4".
[5] Exhibit "R-1".
[6] Exhibit "P-5"; Exhibit "R-9".
[7] Par. 3, Stipulation of Facts, JSFI, docket (vol. III), p. 1296.
[8] Exhibit "P-6".
[9] Par. 4, Stipulation of Facts, JSFI, docket (vol. III), p. 1296.
[10] Exhibit "P-7"; Exhibit "R-11".
[11] Exhibits "R-12" to "R-12-f".
[12] Par. 5, Stipulation of Facts, JSFI, docket (vol. III), p. 1296.

Petitioner submitted supporting documents in support of its protest on December 5, 2014[15], on December 5, 2014[16], and on December 23, 2014[17].

On May 20, 2015, petitioner received the Final Decision on Disputed Assessment[18] (FDDA) issued by respondent on even date for deficiency income tax for taxable year ending December 31, 2011.[19]

Based on the FDDA, petitioner is being assessed for deficiency income tax (IT), final withholding value-added tax (FWVAT), value-added tax (VAT), withholding tax on compensation (WTC), expanded withholding tax (EWT) and final withholding tax (FWT) in the total amount of ₱238,407,520.17, for the period covering April 1, 2011 to December 31, 2011, broken down as follows:

Tax Type	**Basic Tax**	**Surcharge**	**Interest**	**Compromise Penalty**	**Total**
IT	₱ 79,154,105.10	-	₱49,400,836.01	₱50,000.00	₱ 128,604,941.11
FWVAT	9,577,926.59	₱ 4,788,963.29	6,355,544.71	-	20,722,434.59
VAT	37,788,047.23	18,894,023.61	25,261,050.75	-	81,943,121.59
WTC	722,542.80	361,271.40	486,974.05	-	1,570,788.25
EWT	135,164.03	67,582.02	91,467.17	-	294,213.22
FWT	2,723,302.97	680,825.74	1,842,892.70	25,000.00	5,272,021.41
Total	₱130,101,088.72	₱24,792,666.06	₱83,438,765.39	₱75,000.00	**₱238,407,520.17**

On May 29, 2015, without prejudice to its position that the assessment is erroneous, petitioner paid a total of ₱5,182,566.92 to pay off assessment items: (1) Income Tax[20] – ₱2,107,918.42; (2) Income Tax[21] – ₱1,175,276.48; (3) Withholding Tax on Compensation[22] – ₱1,570,788.25; (4) Expanded Withholding Tax[23] – ₱294,213.22; and (5) Final Withholding Tax[24] – ₱34,370.55.[25]

Hence, on June 19, 2015, petitioner filed the instant Petition for Review pursuant to Section 3(a) of Rule 8, in

---

13 Exhibit "P-8".
14 Par. 6, Stipulation of Facts, JSFI, docket (vol. III), p. 1296.
15 Exhibit "P-8.1".
16 Exhibit "P-8.2".
17 Exhibit "P-8.3".
18 Exhibit "P-9"; Exhibits "R-14".
19 Par. 7, Stipulation of Facts, JSFI, docket (vol. III), p. 1296.
20 Exhibit "P-10.1.4".
21 Exhibit "P-10.1.5".
22 Exhibit "P-10.1.6".
23 Exhibit "P-10.1.7"
24 Exhibit "P-10.1.8".
25 Par. 8, Stipulation of Facts, JSFI, docket (vol. III), p. 1296.

relation to Section 3(a)(1) of Rule 4, of the Revised Rules of the Court of Tax Appeals.[26]

In his Answer (to the Petition for Review dated 17 June 2015)[27], filed on September 29, 2015, respondent interposed Special and Affirmative Defenses, alleging, among others, that (1) petitioner's income is subject to the 30% corporate income tax and the corresponding 12% value-added tax; (2) petitioner is indirectly assailing the validity of a revenue regulation which the Court is bereft of any jurisdiction to pass upon; (3) the assessment has bases both in fact and in law; (4) petitioner is liable for deficiency income tax due to (a) Undeclared Income in the amount of ₱7,662,613.62; (b) Unaccounted Expenses in the amount of ₱7,326,148.13; (c) Unaccounted Expenses/Purchases based on vouching of Check Vouchers in the amount of ₱332,659.38; (d) Construction Revenue not subjected to Income Tax in the amount of ₱41,474,427.00; (e) disallowed expenses in excess of the amounts allowable pursuant to Revenue Regulations (RR) No. 13-2005 in the amount of ₱12,021,426.86; (f) Overclaimed Expenses based on matching of Audited Financial Statements, Trial Balance (TB) and Check Voucher Register in the amount of ₱2,273,999.62; (g) Unsupported Expenses/ Purchases in the amount of ₱300,332.81; (h) Disallowed Purchases/Expenses in the amount of ₱3,991,363.02 for failure to withhold the corresponding taxes; (i) Disallowed Salaries Expenses in the amount of ₱5,815,653.33 for failure to withhold the corresponding taxes; and (j) Unsupported Creditable Withholding Tax Claimed in the amount of ₱25,626.72; (5) petitioner is liable for deficiency final withholding VAT due from income payments to non-resident foreign corporation and non-resident alien for services rendered within the Philippines; (6) petitioner is liable for deficiency VAT for Undeclared Income, Unaccounted Expenses/Purchases and Construction Revenue not subjected to Income Tax; (7) petitioner is liable for deficiency withholding tax on compensation; (8) petitioner is liable for deficiency expanded withholding tax; (9) petitioner is liable for deficiency final tax arising from payments to non-resident foreign corporation and non-resident alien; (10) the imposition of the 50% surcharge against petitioner has bases both in fact and in law; and (11) the LOA, the PAN, the FLD, the Final Assessment Notice, and the FDDA were issued in accordance with law, rules and jurisprudence.

---

[26] Par. 9, *ibid.*
[27] Docket (vol. II), pp. 583-604.

Petitioner then filed a Reply[28], through registered mail, on October 26, 2015.

Thereafter, a Notice of Pre-Trial Conference[29] was issued by the Court, setting the case for pre-trial conference on November 26, 2015. However, upon respondent's Motion[30], the pre-trial conference was reset to January 21, 2016.[31]

On November 23, 2015, Petitioner's Pre-Trial Brief[32] was filed through registered mail, while Respondent's Pre-Trial Brief[33] was filed on January 14, 2016.

Meanwhile, on January 14, 2016, petitioner filed a Motion for Commissioning of Independent Certified Public Accountant[34] praying that in the interest of speedy administration of justice, Mr. George V. Villaruz of Villaruz, Villaruz & Co., CPAs be commissioned as an Independent Certified Public Accountant (ICPA) pursuant to Rule 12, Section 5 of the Revised Rules of the Court of Tax Appeals.

During the pre-trial conference on January 21, 2016, this Court granted petitioner's motion, thereby commissioning Mr. George V. Villaruz, as ICPA for the present case.[35] Thereafter, the parties submitted their Joint Stipulation of Facts and Issues[36] on February 10, 2016. Thus, the Court issued a Pre-Trial Order[37] on February 22, 2016 and the pre-trial was deemed terminated.

Then, trial ensued. Petitioner presented as witnesses (1) Ms. Edna G. Canlas[38], petitioner's Chief Operating Officer; (2) Mr. Graham J. Fairclough[39], a member of petitioner's Board of

---

[28] *Ibid*, pp. 616-641.
[29] Docket, vol. II, pp. 613-614.
[30] Motion to Defer Pre-Trial Conference (Set on November 26, 2015) filed on November 10, 2015, docket (vol. II), pp. 643-646.
[31] Order dated November 12, 2015, docket (vol. III), p. 1218.
[32] Docket, vol. III, pp. 1198-1214.
[33] *Ibid*, pp. 1219-1226.
[34] *Id.*, pp. 1251-1255.
[35] Minutes of the Hearing dated January 21, 2016, docket (vol. III), p. 1289.
[36] Docket (vol. III), pp. 1295-1305.
[37] *Ibid*, pp. 1307-1314.
[38] Minutes of the Hearing dated February 29, 2016, docket (vol. III), p. 1319; Amended Judicial Affidavit of Ms. Edna G. Canlas, filed on November 21, 2016, docket (vol. V), pp. 2368-2411.
[39] Minutes of the Hearing dated March 28, 2016, docket (vol. III), p. 1600; Judicial Affidavit of Mr. Graham J. Fairclough, filed on March 23, 2016, docket (vol. III), pp. 1347-1357.

Directors; (3) Mr. Rolly DC. Mulato[40], Chief of the Technical Services Division of the Department of Environment and Natural Resources (DENR) – Provincial Environment and Natural Resources Office of Pilar, Bataan; and, (4) Mr. George V. Villaruz[41], the ICPA, who all testified on direct examination by way of judicial affidavits.

Petitioner's Formal Offer of Documentary Evidence[42] was filed May 3, 2016 and Amended Formal Offer of Documentary Evidence[43] on April 10, 2017. After evaluation, all of petitioner's documentary exhibits were admitted by this Court except for Exhibits "AAA-4.345" and "AAA-5.147", pursuant to the Resolutions dated July 5, 2016[44] and October 10, 2017[45]. Thereafter, petitioner was deemed to have rested its case.

When respondent was called to present his case, he presented his lone witness, Revenue Officer (RO) Maria Gracielle Cecilia F. San Pedro[46], who likewise testified on direct examination by way of judicial affidavit.

On February 5, 2018, respondent filed his Formal Offer of Evidence[47]. Accordingly, all of respondent's documentary exhibits were admitted by this Court in the Resolution[48] dated May 30, 2018. Thereafter, respondent was deemed to have rested its case. Furthermore, this Court ordered the parties to submit their respective memoranda within thirty (30) days.

In view of the filing of respondent's Memorandum[49] on July 31, 2018 and petitioner's Memorandum[50] on July 31, 2018, the present case was deemed submitted for decision in the Resolution[51] dated August 15, 2018.

---

[40] Minutes of the Hearing dated March 28, 2016, docket (vol. III), p. 1600; Judicial Affidavit of Mr. Rolly DC. Mulato, filed on March 23, 2016, docket (vol. III), pp. 1329-1337.
[41] Minutes of the Hearing dated April 18, 2016, docket (vol. IV), p. 1619; Amended Judicial Affidavit of Mr. George V. Villaruz, filed on April 10, 2017, docket (vol. V), pp. 2428-2437.
[42] Docket (vol. IV), pp. 1620-1650.
[43] Docket (vol. V), pp. 2447-2478.
[44] *Ibid*, pp. 2283-2285.
[45] *Id.*, pp. 2481-2483.
[46] Minutes of the Hearing dated January 22, 2018, docket (vol. V), p. 2499; Exhibit "R-17", docket (vol. III), pp. 1235-1250.
[47] Docket (vol. V), pp. 2507-2517.
[48] *Ibid*, pp. 2532-2533.
[49] *Id.*, pp. 2552-2571.
[50] *Id.*, pp. 2623-2666.
[51] *Id.*, p. 2669.

ISSUE

The lone issue[52] submitted by the parties for the Court's resolution is, whether respondent is correct in assessing petitioner deficiency taxes for CY 2011 in the aggregate amount of ₱238,407,520.17, inclusive of interests and surcharge.

Petitioner's Arguments

Petitioner argues that respondent grossly violated the law when it considered the former's operations in Olongapo City as not entitled to the 5% preferential tax treatment (PTR) since under the law, rules and regulations, Olongapo City is part of the Subic Bay Special Economic Zone (SSEZ) and outside of the customs territory. Hence, the latter erred in assessing the subject deficiency taxes.

Petitioner also argues that respondent grossly violated its constitutional right against impairment of contracts and the latter cannot supersede or repeal a law or contract entered into by a government instrumentality by mere regulation.

Respondent's Counter-Arguments

Respondent argues that petitioner's income is subject to 30% regular corporate IT and VAT and that revenue regulations enjoy presumption of regularity, hence, the assessments have bases both in fact and in law.

Respondent also avers that petitioner is liable for deficiency IT for undeclared income, unaccounted expenses and purchases, disallowed expenses, overclaimed expenses unsupported expenses and purchases, disallowed salaries expenses, and unsupported creditable withholding tax claim.

Respondent argues that petitioner is liable for deficiency VAT due from payments for services rendered by non-resident foreign corporation and alien, for undeclared income, unaccounted expenses and purchases, and construction revenue not subjected to IT.

---

[52] Statement of Issue, JSFI, docket, vol. III, p. 1296

Respondent further avers that petitioner is liable for deficiency WTC, EWT, and final tax arising from payments to non-resident foreign corporation and alien for services rendered in the Philippines. He also avers that the issueance of LOA, PAN, FAN, FLD, and FDDA were issued in accordance with law, rules and jurisprudence.

RULING OF THE COURT

Before discussing each item of assessment, this Court shall first resolve whether the income derived by petitioner from outside the Freeport Zone, although within the Ecozone, such as those derived from Olongapo City, is income from Customs Territory.

According to the Details of Discrepancies, attached to the FLD, Revenue Regulations (RR) No. 2-2005 states that Subic Ecozone-registered enterprise shall enjoy the special tax regime of 5%, with a condition that the income that may be generated from sources in the Customs Territory is restricted up to 30% of its total income from all sources, and in the event that it generates income from sources within Customs Territory in excess of 30% of its total income from all sources, all of its income shall be subject to the regular internal revenue tax rate imposed for enterprise in the Customs Territory. In this connection, extraction of the income transaction from the transactional General Leger allegedly revealed that 68% of petitioner's total income came from Customs Territory, to wit:

	Total Income per Location	
Customs Territory	256,851,849.40	68%
Freeport Zone	120,111,571.83	32%
Total	**376,963,421.23**	**100%**

Thus, petitioner's total income was considered to be subject to the 30% regular income tax rate. In his Memorandum, respondent stresses that his audit revealed that petitioner is catering to residents in the Subic Special Economic Zone or outside of the Freeport Zone.

In addition, the Details of Discrepancies, attached to the FDDA, states that Section 6(b) of RR No. 2-2005 provides that all income derived by service establishments within the Subic Ecozone shall be subject to the 5% preferential rate, provided that such services are paid in foreign currency inwardly remitted through the *Bangko Sentral ng Pilipinas* (BSP).

On the other hand, petitioner argues that it is a Subic Special Economic Zone (SSEZ)-registered enterprise, authorized to operate within the entire SSEZ; and Olongapo City is expressly included in the SSEZ under Section 12 of Republic Act (RA) No. 7227 and echoed in Section 3(c) of the Implementing Rules and Regulations (IRR) of RA No. 7227.

Section 12 of RA No. 7227 or the Bases Conversion and Development Act of 1992, approved on March 13, 1992, created the Subic Special Economic Zone, to wit:

> SECTION 12. *Subic Special Economic Zone.* – Subject to the concurrence by resolution of the Sangguniang Panlungsod of the City of Olongapo and the Sangguniang Bayan of the Municipalities of Subic, Morong and Hermosa, there is hereby created a Special Economic and Free-port Zone consisting of the City of Olongapo and the Municipality of Subic, Province of Zambales, the lands occupied by the Subic Naval Base and its contiguous extensions as embraced, covered, and defined by the 1947 Military Bases Agreement between the Philippines and the United States of America as amended, and within the territorial jurisdiction of the municipalities of Morong and Hermosa, Province of Bataan, hereinafter referred to as the Subic Special Economic Zone whose metes and bounds shall be delineated in a proclamation to be issued by the President of the Philippines. Within thirty (30) days after the approval of this Act, each local government unit shall submit its resolution of concurrence to join the Subic Special Economic Zone to the Office of the President. Thereafter, the President of the Philippines shall issue a proclamation defining the metes and bounds of the Zone as provided herein.

On February 1, 1995, Proclamation No. 532 was signed by then President Fidel V. Ramos, delineating the exact metes and bounds of the Subic Special Economic and Free Port Zone (SSEFZ) established pursuant to RA No. 7227.

Proclamation No. 532 was later amended by Proclamation No. 1475, issued on March 17, 2008, where a portion of land situated at Barangay Cawag, Municipality of Subic, Province of Zambales, was excluded from the coverage of the Subic Special Economic and Freeport Zone.

In connection with this, petitioner presented a Map Showing Proclamation No. 532 (Subic Special Economic and Freeport Zone)[53], prepared by the DENR, showing that Olongapo City is within the SSEFZ.

RA No. 7227 was later amended by RA No. 9400, which was approved on March 20, 2007. Section 12(c) of RA No. 9400 provides for the 5% special tax rate on gross income accorded to enterprises within the Subic Special Economic Zone, to wit:

> SEC. 12. *Subic Special Economic Zone.* – xxx
>
> x x x
>
> (c) The provision of existing laws, rules and regulations to the contrary notwithstanding, no national and local taxes shall be imposed within the Subic Special Economic Zone. In lieu of said taxes, a five percent (5%) tax on gross income earned shall be paid by all business enterprises within the Subic Special Economic Zone and shall be remitted as follows: three percent (3%) to the National Government, and two percent (2%) to the Subic Bay Metropolitan Authority (SBMA) for distribution to the local government units affected by the declaration of and contiguous to the zone, namely: the City of Olongapo and the municipalities of Subic, San Antonio, San Marcelino and Castillejos of the Province of Zambales; and the municipalities of Morong, Hermosa and Dinalupihan of the Province of Bataan, on the basis of population (50%), land area (25%), and equal sharing (25%).

Section 4(a) and (b) of Department of Finance (DOF) Department Order No. 3-08, issued on February 13, 2008 to implement RA No. 9400, clarified the above provision as follows:

> SECTION 4. *Tax Incentives in Ecozones and Freeport Zones.* – Ecozone and Freeport Enterprises shall be entitled to the following tax incentives:
>
> a. Subic Special Economic Zone – Ecozone Enterprises in the SSEZ shall be entitled to the 5% special tax on Gross Income Earned, in lieu of national and local taxes.
>
> b. Subic Freeport Zone – Freeport Enterprises in the SFZ shall be entitled to: (i) the freeport status of the zone; and (ii) the 5% special tax on Gross Income Earned, in lieu of national and local taxes.

---

[53] Exhibit "P-14".

However, in order to avail of the 5% special rate on gross income, Section 44 of the Implementing Rules and Regulations (IRR) of RA No. 7227 provides that the income generated by the Ecozone/Freeport Enterprise from sources within the Customs Territory should not exceed 30% of its total income from all sources, to wit:

> SECTION 44. *Percentage of Income Allowable from Sources Within the Customs Territory.* – SBF Enterprises may generate income from sources within the Customs Territory of up to Thirty Percent (30%) of its total income from all sources; *provided*, that should an SBF Enterprise's income from sources within the Customs Territory exceed Thirty Percent (30%) of its total income from all sources, then it shall be subject to the income tax laws of the Customs Territory; *provided*, further, that in any case, customs duties and taxes must be paid with respect to income from sales of articles to the Customs Territory.

Section 8(A) of DOF Department Order No. 3-08 reiterated the 30% threshold provided in Section 44 of the IRR of RA No. 7227, in this wise:

> SECTION 8. *Other Tax and Fiscal Obligations.* –
>
> A. If the Ecozone or Freeport Enterprise wants to avail of the incentives under the 5% special tax regime, it may generate income from sources outside the Ecozone or Freeport Zone or within the Customs territory of up to thirty percent (30%) of its total income from all sources, Provided, however, that if the income of an Ecozone or Freeport Enterprise exceeds said thirty percent (30%) threshold, then all of its income whether from the Zone or the Customs Territory shall be subject to the relevant internal revenue taxes under the National Internal Revenue Code of 1997, as amended.

From the foregoing, to avail of the incentives under the 5% special tax regime, the income generated from sources outside the Ecozone or Freeport Zone or within the Customs Territory should be up to 30% of the Ecozone or Freeport Enterprise's total income from all sources, otherwise, all of its income, whether from the Zone or the Customs Territory, shall be subject to the relevant internal revenue taxes under the National Internal Revenue Code (NIRC) of 1997, as amended.

More so, Customs Territory is defined under Section 3(n) of the IRR of RA No. 7227 as follows:

> n. *Customs Territory* – refers to the portion of the Philippines outside the SBF where the Tariff and Customs Code of the Philippines and other national tariff and customs laws are in force and effect.

In relation thereto, Section 3(c) of the IRR of RA No. 7227 provides that the SBF is a separate customs territory consisting of the City of Olongapo and the municipality of Subic, Province of Zambales, and the lands formerly occupied by the Subic Naval Base, to wit:

> c. *SBF* – is the Subic Bay Freeport referred to as the Special Economic and Freeport Zone in Section 12 of the Act, a separate customs territory consisting of the City of Olongapo and the municipality of Subic, Province of Zambales, the lands occupied by the Subic Naval Base and its contiguous extensions as embraced, covered and defined by the 1947 Philippine-U.S. Military Base Agreement as amended and within the territorial jurisdiction of Morong and Hermosa, Province of Bataan, the metes and bounds of which shall be delineated in a proclamation to be issued by the President of the Philippines; *provided*, that pending the establishment of secure perimeters around the entire SBF, the SBF shall refer to the area demarcated by the SBMA pursuant to Section 13 hereof.

Under Section 2(o) of DOF Department Order No. 3-08, Customs Territory is defined as:

> o. Customs territory – shall refer to the national territory of the Philippines outside of the boundaries of the Ecozones or Freeport Zones, duly defined or proclaimed in accordance with RA 7227, where the customs and tax laws of the Philippines are in full force or effect, and outside of those areas specifically declared by other laws and/or presidential proclamations to have the status of special economic zones and/or freeports.

Meanwhile, Ecozones and Freeport Zones are defined under Section 2(l) and (m) of DOF Department Order No. 3-08, as follows:

> l. Ecozones – shall refer to Special Economic Zones which are selected areas, already created and identified under RA 7227 with highly developed or which have the potential to be developed into agro-industrial, industrial, tourist, recreational, commercial, banking, investment, and financial centers. Provided that the areas declared or constituted as Special Economic Zones (SEZ) shall be fenced-in;

x x x

> n. Freeport Zones – shall refer to the presently fenced-in area within Subic Special Economic Zone, and the areas identified in R.A. 7227 as constituting the Clark Freeport Zone and the Poro Point Freeport Zone within which there shall be a free and unimpeded flow of goods and merchandise from one Freeport Enterprise to another or to other establishments and residents within the boundaries thereof in accordance with law;

In this case, petitioner is registered as a Subic Bay Freeport Enterprise as shown in the Certificate of Registration and Tax Exemption[54] dated May 5, 2011 issued by the SBMA and effective until May 4, 2012. Articles I to III of the said certification states that:

> **ARTICLE I** The Company shall be classified as a Subic Bay Freeport Enterprise, as such term is defined under Section 3, Paragraph G of the Implementing Rules, for the following purpose: Engaged in the business of privatization of water and sewerage services of Subic Bay Freeport and Olongapo City from Subic Water Complex, Subcom Area, CBD, Subic Bay Freeport Zone.
>
> **ARTICLE II** The Company is hereby granted a **PERMIT TO OPERATE** the aforementioned business at the address specified in Article I.
>
> **ARTICLE III** The Company shall enjoy all the rights, privileges, and benefits established under the Act and the Implementing Rules with regard to the business and the location described above.[55]

Section 3(g) of the IRR of RA No. 7227 provides the definition of a Subic Bay Freeport Enterprise as follows:

> g. *SBF Enterprise* – refers to any business entity or concern within the SBF duly registered with and/or licensed by the SBMA to operate any lawful economic activity within the SBF.

It should be noted that under Section 2(y) and (aa) of DOF Department Order No. 3-08 or the IRR of RA No. 9400, the rules made a distinction between an Ecozone Enterprise and a Freeport Enterprise, to wit:

> y. Ecozone Enterprise – shall refer to a business entity located within the SSEZ, CSEZ, MSEZ and JHSEZ which is entitled to incentives as provided by law and duly registered with the Incentives Administration Authority, other than PEZA, of the Ecozone where the business entity is located;

---

[54] Exhibit "P-4".
[55] Exhibit "P-4.1".

x x x

> aa. Freeport Enterprise – shall refer to a business entity located within CFZ, PPFZ, and within the Subic Freeport Zone, which is entitled to incentives, including tax and duty free importation, as may be provided by law, and duly registered with the Incentives Administration Authority of the Freeport Zone where the business entity is located.

However, considering that Section 3(g) of the IRR of RA No. 7227 was referred to in petitioner's Certificate of Registration and Tax Exemption in classifying petitioner instead of the above classification, then, petitioner is a Subic Bay Freeport Enterprise, which is a "business entity or concern within the SBF duly registered with and/or licensed by the SBMA to operate any lawful economic activity within the SBF" and was granted a permit to operate at the "Subic Bay Freeport and Olongapo City from Subic Water Complex, Subcom Area, CBD, Subic Bay Freeport Zone".

On the other hand, "SBF", as defined in Section 3(c) of IRR of RA No. 7227, is the "Subic Bay Freeport referred to as the Special Economic and Freeport Zone in Section 12 of the Act, a separate customs territory consisting of the City of Olongapo and the municipality of Subic, Province of Zambales, the lands occupied by the Subic Naval Base xxx".

Based on the following documents, Olongapo City is one of the areas serviced by petitioner:

Document	**Pertinent provision**
Terms of Reference dated August 1994 for the Privatization of Water and Sewerage Services[56]	4.5 Basis for Inclusion of OCWD and SWD SBMA intend to privatise water and sewerage services throughout the Freeport Zone. The principal areas of activity for the present and early years will be the Secured Area, Olongapo City and Subic Municipality. xxx[57] 5.4 Area of Appointment The Area of Appointment shall be the territory of the ex-Naval Base, referred to as the Secured Area, together with those areas in which responsibility for water services rests at

[56] Exhibit "P-3.4".
[57] Exhibit "P-3.4.5".

	present with Olongapo City Water District and Subic Water District.[58] Administrative boundaries are shown in Figure 1.[59]
Joint Venture Agreement entered into by and among SBMA, Olongapo City Water District, Biwater International Limited and D.M. Consunji, Inc. dated November 24, 1996[60]	1(a) Joint Venture In entering into this Agreement, the parties hereby declare and affirm that their primary contractual intent is to establish and operate a company engaged in the provision of water and sewerage services and in the establishment, operation and maintenance of water and sewerage facilities and systems in the Subic Special Economic and Free Port Zone ("Zone") consisting of the City of Olongapo and the Municipality of Subic, Province of Zambales and the lands occupied by the Subic Naval Base and its contiguous extensions as embraced, covered and defined by the 1947 Military Bases Agreement between the Philippines and the United States of America, as amended.[61]
Franchise Agreement dated November 24, 1996[62]	1.(a) The SBMA, pursuant to its power under Section 13 of Republic Act No. 7227, hereby grants to SUBIC WATER and SUBIC WATER hereby accepts, for the consideration and on the terms and conditions of this Agreement, the right, privilege, and authority ("Franchise") to carry on the business of providing water and sewerage services in the Subic Special Economic and Free Port Zone ("Zone"), and for this purpose, to establish, operate, manage, lease, maintain and purchase water and sewerage facilities and systems and to exercise any and all rights and privileges convenient or essential to efficiently carry out the purposes of the Franchise.[63]
Certificate of Registration and Tax Exemption dated May 5, 2011[64]	**<u>ARTICLE I</u>** The Company shall be classified as a Subic Bay Freeport Enterprise, as such term is defined under Section 3, Paragraph G of the Implementing Rules, for the following purpose: <u>Engaged in the business of privatization of water and sewerage services of Subic Bay Freeport and Olongapo City from Subic Water Complex, Subcom Area, CBD, Subic Bay Freeport Zone.</u>

[58] Exhibit "P-3.4.4".
[59] Docket (vol. III), p. 1437.
[60] Exhibit "P-2".
[61] Exhibit "P-2.2".
[62] Exhibit "P-3".
[63] Exhibit "P-3.1".
[64] Exhibit "P-4".

Considering that petitioner is registered as a Subic Bay Freeport Enterprise providing water and sewerage services in the Subic Special Economic and Freeport Zone, which includes Olongapo City pursuant to Section 12 of RA No. 7227, as implemented in Section 3(c) of the IRR of RA No. 7227, hence, its income generated from Olongapo City should not be treated as income within the Customs Territory, which refers to the "portion of the Philippines outside the SBF" under Section 3(n) of the IRR of RA No. 7227 or refers to the "national territory of the Philippines outside of the boundaries of the Ecozones or Freeport Zones" under Section 2(o) of DOF Department Order No. 3-08.

From all the foregoing, petitioner's income generated from Olongapo City is considered income generated within the Subic Special Economic Zone, for purposes of determining whether petitioner's income generated from sources outside the Subic Special Economic Zone or within the Customs Territory exceeded the 30% threshold.

As to respondent's contention in his FDDA that petitioner's income should be subject to the regular income tax rate since it is a service enterprise and payments were not made in the manner provided in Section 6(b) of RR No. 2-2005 which provides that "all income derived by service establishments within SUBIC-ECOZONE, xxx shall be subject to the five percent (5%) preferential tax rate, provided that such services are paid in foreign currency inwardly remitted through the Bangko Sentral ng Pilipinas", as pointed out by petitioner, Section 6 of RR No. 2-2005 was suspended by RR No. 13-2005, which states:

> SECTION 2. *Suspension of Certain Provisions of Revenue Regulations No. 2-2005.* – The effectivity of Sections 3, 4, and 6 of Revenue Regulations No. 2-2005 is hereby suspended in so far as it applies to enterprises registered under paragraph (c) of Section 12 of R.A. 7227, pending the issuance of a new regulations pertaining on the matter related thereto. Pending the issuance of said new regulations, the provisions of Revenue Regulations No. 1-95, in so far as the same is not in conflict with these Regulations, shall apply.

Evidently, there is nothing in DOF Department Order No. 3-08, implementing RA No. 9400, requiring that services should be paid in foreign currency inwardly remitted through the BSP in order that the Subic Ecozone or Freeport Enterprise shall be subject to the 5% preferential tax rate.

Moreover, there is nothing in RA No. 7227 nor in RA No. 9400 requiring that payments should be made in foreign currency before a Subic Ecozone or Freeport Enterprise can avail of the 5% preferential tax rate. It is well-settled that the administrative agency issuing the regulations may not enlarge, alter or restrict the provisions of the law it administers; it cannot engraft additional requirements not contemplated by the legislature. In case of conflict, the law must prevail. A regulation adopted pursuant to law is law. Conversely, a regulation or any portion thereof not adopted pursuant to law is no law and has neither the force nor the effect of law.[65]

That having been settled, this Court shall now discuss each item of assessment.

In the FDDA[66], respondent assessed petitioner of deficiency income tax (IT), final withholding VAT (FWVAT), value-added tax (VAT), withholding tax on compensation (WTC), expanded withholding tax (EWT), and final tax (FT) in the total amount of ₱238,407,520.17, inclusive of interest and penalties, for the period covering April 1, 2011 to December 31, 2011, broken down as follows:

Tax Type	Basic	Surcharge	Interest	Compromise	Total
Income Tax	₱ 79,154,105.10	₱ -	₱ 49,400,836.01	₱ 50,000.00	₱ 128,604,941.11
FWVAT	9,577,926.59	4,788,963.29	6,355,544.71		20,722,434.59
VAT	37,788,047.23	18,894,023.61	25,261,050.75		81,943,121.59
WTC	722,542.80	361,271.40	486,974.05		1,570,788.25
EWT	135,164.03	67,582.02	91,467.17		294,213.22
FT	2,723,302.97	680,825.74	1,842,892.70	25,000.00	5,272,021.41
TOTAL	**₱130,101,088.72**	**₱24,792,666.06**	**₱83,438,765.39**	**₱ 75,000.00**	**₱238,407,520.17**

In relation thereto, on May 29, 2015, without prejudice to its position that the assessment is erroneous, petitioner paid a total of ₱5,182,566.92 to pay off assessment items: (1) Income Tax – ₱2,107,918.42; (2) Income Tax – ₱1,175,276.48; (3) Withholding Tax on Compensation – ₱1,570,788.25; (4) Expanded Withholding Tax – ₱294,213.22; and (5) Final

---

[65] *Commissioner of Internal Revenue vs. Central Luzon Drug Corporation*, G.R. No. 159647, April 15, 2005.

[66] Exhibit "P-9".

Withholding Tax – ₱34,370.55,[67] details of which are as follows:[68]

Tax Type	Basic	Surcharge	Interest	Compromise	Total
Income Tax	₱1,267,105.64	₱ -	₱ 790,812.78	₱ 50,000.00	₱ 2,107,918.42
Income Tax	723,643.58		451,632.90		1,175,276.48
WC	722,542.80	361,271.40	486,974.05		1,570,788.25
WE	135,164.03	67,582.02	91,467.17		294,213.22
WF	5,000.00	1,250.00	3,120.55	25,000.00	34,370.55
Total	**₱2,853,456.05**	**₱430,103.42**	**₱1,824,007.45**	**₱75,000.00**	**₱5,182,566.92**

I. Income Tax (IT) – ₱128,604,941.11

The details of respondent's assessment on petitioner's deficiency income tax are as follows:[69]

Taxable Income per Return		**₱202,581,077.00**
Add: Adjustments per Audit		
Under-declared receipts/income:		
IT-1 Undeclared Income due to discrepancy on Other Income - Credits per General Ledger (GL) vs. Audited Financial Statements (AFS)/ Income Tax Return (ITR)		7,662,613.62
IT-3 Undeclared Income due to unaccounted expenses/purchases based on tracing of CV Register to Trial Balance (TB) to AFS		7,326,148.13
IT-4 Undeclared Income due to unaccounted expenses/purchases based on vouching of Check Vouchers		332,659.38
IT-5 Construction Revenue not subjected to Income Tax		41,714,427.00
Disallowance:		
IT-6 Disallowed expenses in excess of the amounts allowable pursuant to Revenue Regulation (RR) 13-2005		12,021,426.86
IT-7 Overclaimed Expenses based on matching of AFS vs. TB vs. CV Register		2,273,999.62
IT-8 Disallowed expenses/purchases for being unsupported		300,332.81
IT-9 Disallowed Purchases/Expenses due to failure to withhold		3,991,363.02
IT-10 Disallowed Salaries Expense due to failure to withhold		5,815,653.33
Total Taxable Income per Audit		**₱284,019,700.77**
Income Tax Rate		30%
Total Income Tax Due		**₱ 85,205,910.23**
Less: Allowable Credit/Payments		
Payments	₱ 6,034,202.73	
Creditable Withholding Tax Claimed Per ITR	43,229.12	
IT-11 Less: Unsupported Creditable Withholding Tax	(25,626.72)	6,051,805.13

---

[67] Par. 8, Stipulation of Facts, JSFI, docket (vol. III), p. 1296.
[68] Exhibits "P-10-1.4" to "P-10-1.8".
[69] Exhibit "P-9".

BASIC DEFICIENCY INCOME TAX		**₱ 79,154,105.10**
Add: Penalties		
Interest on Basic Deficiency Tax until 05/29/2015	₱49,400,836.01	
Compromise Penalty	50,000.00	49,450,836.01
DEFICIENCY INCOME TAX PAYABLE		**₱128,604,941.11**

Based on the foregoing, the income tax assessment is composed of the following items:

IT-1	Undeclared Income due to discrepancy on Other Income - Credits per GL vs. AFS/ITR	₱ 7,662,613.62
IT-3	Undeclared Income due to unaccounted expenses/purchases based on tracing of CV Register to TB to AFS	7,326,148.13
IT-4	Undeclared Income due to unaccounted expenses/purchases based on vouching of Check Vouchers	332,659.38
IT-5	Construction Revenue not subjected to Income Tax	41,714,427.00
IT-6	Disallowed expenses in excess of the amounts allowable pursuant to RR 13-2005	12,021,426.86
IT-7	Overclaimed Expenses based on matching of AFS vs. TB vs. CV Register	2,273,999.62
IT-8	Disallowed expenses/purchases for being unsupported	300,332.81
IT-9	Disallowed Purchases/Expenses due to failure to withhold	3,991,363.02
IT-10	Disallowed Salaries Expense due to failure to withhold	5,815,653.33
IT-11	Unsupported Creditable Withholding Tax	₱ 25,626.72

IT-1. Undeclared Income due to discrepancy on Other Income-Credits per General Ledger (GL) vs. Audited Financial Statements/Income Tax Return (AFS/ITR) – ₱7,662,613.62

Respondent's audit of petitioner's books of accounts revealed that the following credit entries in the Other Income account[70] does not fall within the definition of petitioner's registered activity as indicated in its Certificate of Registration and Tax Exemption[71]:

Classification	Amounts
A. Sale of Scrap Materials	₱ 2,240,000.00
B. Sale to Non-Resident Foreign Corporation (NRFC)	654,574.32
C. Proceeds from Retirement Insurance	3,215,500.00
D. To amortize deferred credits based on a straight line-	1,552,539.30

[70] Details of Discrepancies, Exhibit "P-9".

[71] "The Company (Subic Water) shall be classified as a Subic Bay Export Zone Enterprise, as such term is defined under Section 3, Paragraph G of the Implementing Rules, for the following purposes: Engaged in the business of privatization of water and sewerage services of Subic Bay Freeport x x x", Article I of Exhibit "P-4".

IFRIC 12 adjustment	
Total Credits per GL	**₱7,662,613.62**

Respondent asserts that the income derived from sources other than the registered activity shall be subject to the regular corporate income tax pursuant to Sections 27 and 32 of the NIRC of 1997. In addition, Revenue Regulations No. 20-2002 specifically laid down the tax treatment of income earned from unregistered activities by Freeport Zone-registered enterprises, to wit:

> SECTION 1. *Tax Treatment.* – Income derived by an enterprise with the Subic Bay Metropolitan Authority (SBMA)... from its registered activity/ies shall be subject to such tax treatment as may be specified in its terms of registration (*i.e.*, the 5% preferential tax rate xxx) Nonetheless, whatever the tax treatment of said enterprise with respect to its registered activity/ies, **income realized by such registered enterprise that is not related to its registered activity/ies shall be subject to the regular internal revenue taxes** xxx *(Emphasis supplied)*

A. Sale of Scrap Materials – ₱2,240,000.00

B. Sale to Non-Resident Foreign Corporation – ₱654,574.32

In his report[72], Court-commissioned ICPA George V. Villaruz stated that the original copy of Official Receipt (OR) No. 462317 supporting the sale of scrap materials was not available and was not presented for examination. However, based on the file generated from the Point-of-Sales (POS) system[73], the collection was received by petitioner from Ma. Elenita G. Bergira/Meng Junkshop.

The said sale of scrap materials was subjected to 5% preferential tax rate in the computation of petitioner's income tax per ITR for the period ended December 31, 2011.

On the other hand, the alleged sale to Non-Resident Foreign Corporation (NRFC) pertains to disposal and sale of petitioner's software for Billing and Meter reading system to PT. ADHYA TIRTA BATAM, an NRFC located in Jakarta, Indonesia as per Sales Invoice (SI) No. SWSCI-0001 and

---

[72] Exhibit "P-20" (ICPA Report), pp. 6-7.
[73] Exhibit "AAA-1.1".

Journal Voucher (JV) No. 719 with accompanying Bank of the Philippine Islands (BPI) Debit Memo/Credit Memo Statement as proof of collection.[74]

Petitioner submits that the sale of scrap materials from its water treatment facilities is clearly related to its registered activity. While, the sale to NFRC pertains to the sale of billing software used in managing petitioner's registered activities.

Unfortunately, this Court disagrees.

"Scrap" is a term used to describe manufactured articles or parts rejected or discarded and useful only as material for reprocessing, especially waste and discarded metal.[75]

At the outset, petitioner is organized for the business of providing water and sewerage services in the Subic Special Economic Zone and Freeport Zone. Thus, considering the nature of the two transactions, the sale of scrap materials and the disposal and sale of software for billing and meter reading system do not fall under the registered activities of petitioner. In fact, the Court had the occasion to rule in the case of *Commissioner of Internal Revenue vs. Nidec Copal Philippines Corporation*[76] that even when the sale of scrap materials is incidental to the taxpayer's registered activities, such sale shall be subject to regular income tax. Consequently, respondent's assessment shall be sustained.

C. Proceeds from Retirement Insurance – ₱3,215,500.00

Petitioner maintains that the proceeds from retirement insurance do not represent actual income but mere reimbursements made by Prudentialife Plans, Inc. for the amounts advanced by petitioner to its employees as pay out for their retirement insurance policy. In other words, the cash received as reimbursement is not income, but mere return of capital, thus, not subject to income tax.

In his report[77], the ICPA ascertained that the proceeds from Prudentialife Plans, Inc. amounting to ₱3,215,500.00 are

[74] Exhibit "AAA-1.2".
[75] Webster's New Collegiate Dictionary, 1977 edition, p. 1037.
[76] CTA EB Nos. 250 and 255 (CTA Case No. 6577), October 1, 2007.
[77] Exhibit "P-20" (ICPA Report), p. 7.

supported by OR No. 0000324221[78] dated May 27, 2011. According to the ICPA, these proceeds were initially recorded under the account Other Income but subsequent reversing entries per JV No. 731[79] and proposed adjusting journal entry (PAJE)[80] during audit were made and reflected in the books as follows:

- JV No. 731 and jv#2011-0591 with accompanying computation of Maturity Benefits-Group Sale was made to reverse the Other Income account against Accounts Receivable-Others account in the amount of ₱2,067,000.00. This entry was made to close the initial recognition of Accounts Receivable-Others when petitioner made an initial payment to their employees amounting to ₱2,067,000.00 and subsequently applied for reimbursement before Prudentialife Plans, Inc. Thus, the cash received from reimbursement should not be treated and taxed as Other Income since this was properly corrected and adjusted in the Audited Financial Statement (AFS).

- A PAJE[81] during the year-end audit, the remaining amount of ₱1,148,500.00 under the Other Income account was closed/reversed and recorded to set-up Pension Liability in the same amount. The recognition of the Pension Liability was made to establish petitioner's liability to those employees who have not been paid of their benefits as of December 31, 2011 but reimbursements were already received from Prudential Life Plans, Inc.

However, this Court is not convinced.

Upon examination of the documents submitted before the Court, petitioner's actual payment of the retirement insurance to its employees was not established.

JV No. 731 and the accompanying Computation of Maturity Benefits-Group Sale presented by petitioner deserve scant consideration as these merely create paper trails showing the purported allocation of the amount it received from Prudentialife Plans, Inc. The same do not prove the fact of petitioner's actual payment to the employees.

In the case of *Towne & City Development Corporation vs. Court of Appeals, et al.*[82], the Supreme Court held that a

---

[78] Exhibit "AAA-1.3".
[79] Exhibit "AAA-1.3".
[80] Exhibit "AAA-1.4".
[81] Exhibit "AAA-1.4".
[82] G.R. No. 135043, July 14, 2004.

voucher remains a piece of paper having no evidentiary weight, to wit:

> x x x as correctly pointed out by the trial court which the appellate court upheld, vouchers are **not** receipts.
>
> > It should be noted that a voucher is **not necessarily** an evidence of payment. It is merely a way or method of recording or keeping track of payments made. A procedure adopted by companies for the orderly and proper accounting of funds disbursed. Unless it is supported by xxx an actual payment of cash duly receipted for as is customary among businessmen, a voucher remains a piece of paper having no evidentiary weight. (Emphasis supplied)
>
> A receipt is a written and signed acknowledgment that money has been or goods have been delivered, while a voucher is documentary record of a business transaction.
>
> The references to alleged check payments in the vouchers presented by the petitioner do not vest them with the character of receipts. x x x

Thus, respondent's deficiency IT assessment on the proceeds from retirement insurance of ₱3,215,500.00 shall remain.

D. To amortize deferred credits based on a straight line-IFRIC[83] 12 adjustment – ₱1,552,539.30

Petitioner claims that the deferred credits pertain to the computed difference between the actual deposit received from customers and the fair value of the deposits at initial recognition, which are amortized over the remaining life of the franchise. Petitioner asserts that since the customer's deposit is an initial requirement before petitioner may provide water and sewerage services to its customers, these are necessary and directly related to petitioner's registered services. Thus, it should not be subjected to 30% corporate income tax.

Upon examination of petitioner's AFS for the period ending December 31, 2011, the amortized deferred credit amounting to ₱1,552,539.30 was reflected as Other Income in the Statement of Comprehensive Income.[84] Moreover, under

---

[83] International Financial Reporting Interpretations Committee.
[84] BIR Records, Folder No. 1, p. 283.

Note 19[85] of the same AFS, it was disclosed that this account pertains to deposits collected from customers and are carried at amortized cost.

For purposes of implementing the tax incentive provision under Section 12(c) of RA No. 7227, otherwise known as the Bases Conversion and Development Act of 1992, Section 3(o) of RR No. 1-95[86], as amended by RR Nos. 16-99[87] and 13-2005[88], provides that the term "gross income earned" refers to gross sales or gross revenues derived from business activity within the Zone, net of sales discounts, sales returns and allowances and minus costs of sales or direct costs but before any deduction is made for administrative, marketing, selling and/or operating expenses or incidental losses during a given taxable period.

Considering that the customer's deposit is an initial requirement before petitioner can provide water and sewerage services to its customers, hence, an integral part of the administration of the registered activities of petitioner, then, these amortized deferred credits should not be subjected to 30% corporate income tax. Consequently, respondent's assessment pertaining thereto shall be cancelled.

IT-3. Undeclared Income due to unaccounted expenses/ purchases based on tracing of Check Voucher (CV) Register to TB to AFS – ₱7,326,148.13

Respondent's validation of petitioner's CV register to Auditor's Trial Balance/AFS revealed that there were expenses reflected in the books of accounts that were not reported in the AFS. The funds used on the said expenses were not

---

[85] BIR Records, Folder No. 1, p. 256.

[86] Rules and Regulations to Implement the Tax Incentives Provisions under Paragraphs (b) and (c) of Section 12, Republic Act No. 7227 Otherwise Known as the Bases Conversion and Development Act of 1992.

[87] Amending Revenue Regulations No. 1-95, as Amended, and Other Related Rules and Regulations to Implement the Provisions of Paragraphs (b) & (c) of Section 12 of Republic Act No. 7227, Otherwise Known as the "Bases Conversion and Development Act of 1992" Relative to the Tax Incentives Granted to Enterprises Registered in the Subic Special Economic and Freeport Zone.

[88] Regulations Defining "Gross Income Earned" to Implement the Tax Incentive Provision under Paragraph (c) of Section 12 of Republic Act No. 7227, otherwise known as "The Bases Conversion Development Act of 1992" Revoking Section 7 of Revenue Regulations No. 2-2005, and Suspending the Effectivity of Certain Provisions of Revenue Regulations No. 2-2005.

accounted for and were declared as unaccounted sources of cash, which respondent translated to undeclared income, citing the case of *Perez vs. Court of Tax Appeals, et al.*, G.R. No. L-10507 dated May 30, 1958, where it has been held that unreflected sources of funds not accounted for in the taxpayer's tax returns led to the inference that part of his income had not been reported, hence, the noted discrepancies were added to the gross income pursuant to Section 32 of the NIRC of 1997 and subjected to income tax pursuant to Section 24 of the same Code.

The schedule below summarizes the various accounts where the discrepancies were noted:[89]

Account Name	Amount per AFS/Auditor's Trial Balance	Adjusted Amount per Books	Unaccounted Expenses/ Purchases
Supplies	₱1,223,489.00	₱1,226,873.15	₱ 3,384.15
Travel and Transportation	4,567,647.00	4,569,375.56	1,728.56
Entertainment, Amusement and Recreation	134,243.00	133,863.26	379.74[90]
Repairs and Maintenance	934,758.00	1,023,389.83	88,631.83[91]
License and Regulatory Fees	₱ 25,251.00	₱7,257,274.87	7,232,023.87
Total			**₱ 7,326,148.15**[92]

Petitioner counters respondent's assessment for unaccounted expenses/purchases for being unsupported by the records and merely based on presumption. Petitioner cites the ruling of this Court in the case of *Agrinurture, Inc. vs. Commissioner of Internal Revenue*[93] which involves an assessment based on undeclared purchases, to wit:

> "[W]hile there is a presumption of correctness of assessment issued by [the BIR], being a mere presumption, the same cannot be made to rest on another assumption, which is [the] presumption that the under-declared purchases translated and would automatically result in under-declared income or additional taxable sales, which would in turn increase petitioner's income tax."

Moreover, petitioner contends that three (3) elements in the imposition of income tax are lacking, to wit: (a) there must

---

[89] Details of Discrepancies, Exhibit "P-9".
[90] Rounding off difference, per BIR's schedule - ₱380.00.
[91] Rounding off difference, per BIR's schedule - ₱88,631.55.
[92] With ₱0.02 difference due to rounding off, per BIR's schedule - ₱7,326,148.13.
[93] CTA Case No. 8345, May 29, 2013, as affirmed in CTA EB No. 1054, January 13, 2015.

be a gain or profit, (b) that the gain or profit is realized or received, actually or constructively, and (c) it is not exempted by law or treaty from income tax.[94] Income tax is assessed on income received from any property, activity or service. Thus, it must be clear that there was income received by the taxpayer. Income cannot be presumed when there is supposed under-declaration of purchases or expenses, as in this case.

This Court agrees with petitioner.

It is worthy to note that the imputation of alleged undeclared income is based on a mere presumption that since there were alleged unaccounted expenses and purchases in its FS, there was likewise undeclared income which corresponds to it. Even if these alleged undeclared expenses and purchases are to be considered as income, the same will be offset by recording the equivalent payment as expense. Hence, no taxable income will result from the said transaction.[95]

Furthermore, it must be emphasized that, for income tax purposes, a taxpayer is free to deduct from its gross income a lesser amount or not claim any deduction at all. What is prohibited by the income tax law is to claim a deduction beyond the amount authorized therein.[96] Hence, even granting that there is an undeclared expense, the same is not prohibited by law.

Bearing in mind that an undeclared expense is not prohibited by law, it goes without saying that petitioner can exercise its discretion on whether it will declare a lesser amount of deduction or none at all.[97]

While axiomatic is the fact that all presumptions are in favor of the correctness of tax assessments, the assessment itself should not be based on presumptions no matter how logical the presumption might be. In order to stand the test of

---

[94] *Philippine Daily Inquirer, Inc. v. CIR,* CTA Case No. 7853, February 16, 2012.

[95] *IDS Logistics (Phils.), Inc. vs. Commissioner of Internal Revenue,* CTA Case No. 7540, May 20, 2010; *Philippine Aerospace Development Corporation vs. Commissioner of Internal Revenue,* CTA Case No. 7830, December 11, 2012; *FSM Cinemas, Inc. vs. Commissioner of Internal Revenue,* CTA Case No. 8551, October 2, 2015; *PNOC Development and Management Corporation vs. Commissioner of Internal Revenue,* CTA Case No. 8649, January 22, 2016; *Ithiel Corporation vs. Commissioner of Internal Revenue,* CTA Case No. 8872, February 23, 2017.

[96] *The Commissioner of Internal Revenue vs. Phoenix Assurance Co., Ltd.*, G.R. No. L-19727, May 20, 1965.

[97] *Modern Imaging Solutions, Inc. vs. Commissioner of Internal Revenue,* CTA Case No. 8987, March 21, 2017.

judicial scrutiny, the assessment must be based on actual facts. The presumption of correctness of assessment being a mere presumption cannot be made to rest on another presumption.[98]

For lack of factual basis, the deficiency income tax assessment corresponding to the alleged undeclared income from unaccounted expenses and purchases amounting to ₱7,326,148.13 should be cancelled.

IT-4. Undeclared Income due to unaccounted expenses/purchases based on vouching of Check Vouchers – ₱332,659.38

The BIR's audit of the source documents such as vouchers, invoices, and official receipts *vis-à-vis* the CV register revealed that there were amounts per source documents that were not recorded in the CV register, thus, funds used on the said expenses were not accounted for and were declared as unaccounted source of cash, leading to the inference that part of petitioner's income had not been reported. Hence, the noted discrepancies of ₱332,659.38, as listed below, were added to the gross income pursuant to Section 32 of the NIRC of 1997 and subjected to income tax pursuant to Section 24 of the same Code:[99]

CV No	Supplier's Name	Amount
26063	Glocke Security System Inc.	₱ 73,545.78
26468	U-Bix Subic Bay Corp	10,350.00
26299	U-Bix Subic Bay Corp	10,350.00
26157	IP Business Holdings, Inc.	61,810.00
26729	Olongapo City Treasurer's Office	103,390.00
26679	U-Bix Subic Bay Corp	12,033.60
26507	IP Business Holdings, Inc.	61,180.00
Total		**₱ 332,659.38**

This Court finds respondent's conclusion untenable.

Based on the documents submitted by petitioner, the alleged unaccounted purchases/expenses pertain to disbursements that are outside the scope of the period of

[98] *Collector of Internal Revenue vs. Benipayo*, G.R. No. L-13656, January 31, 1962.
[99] Details of Discrepancies, Exhibit "P-9".

assessment.[100] Even if such disbursements were within the scope of the period of assessment, it must be emphasized that the assessment, like under item IT 3, is bereft of merit as it was based on a mere presumption that since there were alleged unaccounted expenses and purchases in the FS, there were likewise unaccounted source of cash and undeclared income which correspond to said expenses.

Thus, for lack of factual basis, the deficiency income tax assessment pertaining to the alleged undeclared income from unaccounted expenses of ₱332,659.38 shall be cancelled.

IT-5. Construction Revenue not subjected to Income Tax - ₱41,714,427.00

Respondent's comparison of revenue declared per AFS versus Sales and Other Income per ITR revealed that Construction Revenue amounting to ₱41,714,427.00 was not declared as part of income in the ITR, thus, this amount is considered as undeclared income, computed as follows:[101]

Revenue per AFS		
Services	₱355,085,514.00	
Construction	41,714,427.00	
Penalties, connection fees and others	12,853,324.00	₱ 409,653,265.00
Per ITR		
Sales	355,085,514.00	
Other Taxable Income	₱ 12,853,324.00	367,938,838.00
Total		**₱41,714,427.00**

Petitioner argues that the account "Construction Revenue" does not constitute actual income but was merely a booking/reclassification entry in compliance with International Financial Reporting Interpretations Committee (IFRIC) 12, as proposed by its external auditor.

Petitioner explains that the assets it put up were originally booked under Plant, Property, and Equipment. At the end of the accounting year, to comply with the reportorial requirement of IFRIC 12, these were reclassified to Construction Costs. Thereafter, Concession Asset was debited

[100] Exhibit "AAA-3.2" to "AAA-3.6".
[101] Details of Discrepancies, Exhibit "P-9".

and Construction Revenue was credited. Concession Asset is an intangible asset account representing a right to use these assets until the end of the concession. The principle here is that service concessions such as petitioner are only vested with the right to use the assets; these assets are to be turned over to the Government at the end of the concession period or franchise term. Petitioner avers that even though it spent money to acquire these assets, it is not the owner of these assets, but is merely allowed the right to use the same. It is as if these were sold to the grantor, or Government, and the consideration received is the right to use.

This Court finds the assessment partly meritorious.

As can be gleaned in the Statement of Comprehensive Income in the AFS, petitioner reflected the amount of ₱41,714,427.00 as Construction Revenue and at the same time, as Construction Costs.[102]

The IFRIC 12 requires the operators under the concession agreement to account the revenues and cost relating to the construction or upgrade services phase of the contract. As ascertained by the ICPA, based on its Franchise Agreement with the SBMA, petitioner shall refurbish the existing facility and construct new water and/or sewerage facilities. In connection thereto, petitioner incurred costs of materials and labor. In turn, in accordance with IFRIC 12, petitioner recognized Construction Revenue based on the actual costs of construction of its sewerage facilities.

The ICPA's examination of documents supporting the construction cost reveals the following:[103]

Particulars	**Amount**
Duly supported by AP Invoice for Approval, Sales Invoices and Official Receipts[104]	₱ 13,369,182.08
Supported by JV and Order of Payment	23,854,554.51
Supported by IC Transaction Form	2,307,468.66
Supported by JVs for reclassification/accruals	280,902.58
No supporting documents presented for examination	1,902,319.31
Total	**₱41,714,427.14**

[102] BIR Records, Folder No. 1, p. 283.
[103] Exhibit "P-20" (ICPA Report), p. 11.
[104] Exhibits "AAA-4.1" to "AAA-4.803"; Exhibits "AAA-4.832" to "AAA-4.838".

Based on records, the construction cost amounting to ₱23,854,554.51 refers to accrual of cost which is supported by Journal Vouchers and Order of Payment Form. Tracing from the Check Voucher Journal Listing shows that subsequent payments related to said accruals of cost amounting to ₱17,175,781.82 were made. However, only the amount of ₱8,221,781.82 was duly supported by Sales Invoices and/or Official Receipts. [105]

Meanwhile, of the construction cost supported by IC Transaction Form amounting to ₱2,307,468.66, the ICPA alleged that these material issuances were from the accumulated sum of the beginning inventory balance of ₱15,300,398.00 and the purchases for the period of April 1, 2011 to December 31, 2011 amounting to ₱5,127,699.85, which sufficiently covered the material issuances for the period amounting to ₱2,307,468.66. Based on the records, the material purchases of ₱5,127,699.85 are duly supported by AP invoices for approval, sales invoices, delivery receipts and official receipts,[106] thus, the material issuances amounting to ₱2,307,468.66 may be validly claimed as part of the construction cost.

Anent the construction cost amounting to ₱280,902.58, petitioner alleges that the same pertains to reclassification entries and accrual entries. An examination of petitioner's AFS[107] reveals that it adopts the accrual method in reporting its income and expenses for income tax purposes. Verily, revenue is recognized as it accrues, while expenses are recognized and charged to operation as incurred. The employment of such accounting method, or any method for that matter, as long as it clearly reflects income, is recognized in Section 43 of the NIRC of 1997, as amended.

In the case of *Commissioner of Internal Revenue vs. Isabela Cultural Corporation*[108], the Supreme Court held that the accrual of income and expense is permitted when the all-events test has been met, to wit:

> The accrual method relies upon the taxpayer's right to receive amounts or its obligation to pay them, in opposition to actual receipt or payment, which characterizes the cash method

---

[105] Exhibits "AAA-4.841" to "AAA-4.855".
[106] Exhibits "AAA-4.804" to "AAA-4.831"; Exhibits "AAA-4.839" to "AAA-4.840".
[107] BIR Records, Folder No. 1, pp. 250-288.
[108] G.R. No. 172231, February 12, 2007.

> of accounting. Amounts of income accrue where the right to receive them become fixed, where there is created an enforceable liability. Similarly, liabilities are accrued when fixed and determinable in amount, without regard to indeterminacy merely of time payment.
>
> For a taxpayer using the accrual method, the determinative question is, when do the facts present themselves in such a manner that the taxpayer must recognize income or expense? The accrual of income and expense is permitted when the all-events test has been met. This test requires: (1) fixing of a right to income or liability to pay; and (2) the availability of the reasonable accurate determination of such income or liability.

In the above-quoted case, the Supreme Court explained that the all-events test requires that the right to income or liability should be fixed, and the amount thereof should be determinable with reasonable accuracy.

In the present case, a perusal of the records shows that petitioner failed to present sufficient evidence to satisfy the first condition of the all-events test, *i.e.*, the right to income or liability should be fixed. Petitioner should be able to substantiate the accruals made for the year 2011 with relevant pieces of evidence, such as, but not limited to, purchase agreements, billing statements, statement of accounts or invoices, as well as the official receipts proving the subsequent payments of the accruals made.

In sum, only the unsupported construction cost of ₱17,815,994.58 shall be subject to deficiency income tax, as computed below:

Construction Cost		₱ 41,714,427.14
Less: Allowable Construction Cost		
Duly supported by AP Invoice for Approval, Sales Invoices and Official Receipts	₱13,369,182.08	
Supported by JV and Order of Payment	8,221,781.82	
Supported by IC Transaction Form	₱ 2,307,468.66	23,898,432.56
Unsupported Construction Cost		**₱17,815,994.58**

IT-6. Disallowed expenses in excess of the amounts allowable pursuant to RR No. 13-2005 – ₱12,021,426.86

Respondent contends that pursuant to RR No. 13-2005 dated April 25, 2005, there are allowable deductions for specific type of Subic Ecozone Enterprise that may be considered in computing the gross income subject to the special tax rate of 5%, to wit:

3. Service Enterprises:

- Direct salaries, wages or labor expense
- Service supervision salaries
- Direct materials, supplies used
- Depreciation of machineries and equipment used in the rendition of registered services, and of that portion of the building owned or constructed that is used exclusively in the rendition of the registered service
- Rent and utility charges for buildings and capital equipment used in the rendition of registered services
- Financing charges associated with fixed assets used in the registered service business the amount of which were not previously capitalized.

Considering the allowable deductions, respondent noted a discrepancy in the amount claimed in the ITR compared with the expenses booked in the general ledger (GL). The following discrepancy was disallowed in respondent's assessment pursuant to the above-quoted provision:[109]

Allowable Expenses (RR 13-2005)	**Per GL**
1. Direct Salaries, wages or labor expense 2. Service Supervision Salaries	₱ 39,004,613.78
3. Direct Materials, supplies used	13,952,288.96
4. Depreciation of machineries, equipment used in the rendition of registered services	20,259,009.99
5. Financing Charges associated with fixed assets used in the service business the amount of which were not previously capitalized	501,600.63
6. Rent and utility charges for buildings and capital equipment used in the rendition of registered services	79,618,820.78
Total	**₱153,336,334.14**
Per ITR	165,357,761.00
Discrepancy	**₱ 12,021,426.86**

Petitioner maintains that the enumeration in RR No. 13-2005 must not be read exclusively and should take into account the nature of the business of every taxpayer. Otherwise, this may lead to a myopic view of the allowable

---

[109] Details of Discrepancies, Exhibit "P-9".

direct costs, which is not the intention of Congress when it granted various fiscal and tax incentives via RA No. 7227.

This Court finds the assessment partly meritorious.

A perusal of pertinent exhibits showed that petitioner is a duly registered enterprise with the SBMA as a Subic Bay Freeport Enterprise[110] which provides water and sewerage services in the Subic Special Economic and Freeport Zone entitled to the 5% preferential tax rate on gross income under Section 12(c) of RA No. 7227, as amended, by RA No. 9400, which provides:

> SEC. 12. *Subic Special Economic Zone.* – xxx
>
> x x x
>
> (c) The provision of existing laws, rules and regulations to the contrary notwithstanding, no national and local taxes shall be imposed within the Subic Special Economic Zone. In lieu of said taxes, **a five percent (5%) tax on gross income earned shall be paid by all business enterprises within the Subic Special Economic Zone** and shall be remitted as follows: three percent (3%) to the National Government, and two percent (2%) to the Subic Bay Metropolitan Authority (SBMA) for distribution to the local government units affected by the declaration of and contiguous to the zone, namely: the City of Olongapo and the municipalities of Subic, San Antonio, San Marcelino and Castillejos of the Province of Zambales; and the municipalities of Morong, Hermosa and Dinalupihan of the Province of Bataan, on the basis of population (50%), land area (25%), and equal sharing (25%). *(Emphasis supplied)*

"Gross income" earned is defined in Section 57(b) of the IRR of the Subic Special Economic and Freeport Zone and the Subic Bay Metropolitan Authority under RA No. 7227 as follows:

> b. "Gross Income Earned" for purposes of these Rules refers to gross sales or gross revenues derived from any business activity, net of returns, discounts and allowances, less costs of sales, cost of production or direct costs of services (depending on the nature of business) but before any deduction for administrative expenses and incidental losses during a given taxable period.

Relative thereto, for purposes of computing the gross income subject to the 5% preferential tax rate, specific

---

[110] Exhibit "P-4".

allowable deductions are enumerated under RR No. 13-2005 and DOF Department Order No. 3-08.

RR No. 13-2005 dated April 25, 2005 provides for the list of costs which are allowed as deductions from gross income subject to 5% tax rate, pursuant to RA No. 7227, as enumerated above.

Likewise, Section 5(a)(2)(iii) of DOF Department Order No. 3-08, expressly provides that **only the following costs of sales/direct costs** shall be allowed as deductions for purposes of calculating the Gross Income Earned (GIE) by the following Ecozone or Freeport enterprises/industries, to wit:

> 2. Only the following cost of sales/direct cost shall be allowed as deductions for purposes of calculating the GIE earned for the following Ecozone or Freeport enterprises/industries, to wit:
>
> x x x
>
> iii. Service Enterprises –
>
> - Direct salaries, wages, or labor expenses, inclusive of training directly related to the registered activity;
> - Service supervision salaries;
> - Direct materials, supplies used;
> - Depreciation of machinery, equipment used in the rendition of registered services, and of that portion of the building owned or constructed by the registered enterprise that is used exclusively in the rendition of the registered service;
> - Rent and utility charges for buildings and capital equipment used in the rendition of registered services;
> - Financing charges associated with fixed assets used in the registered service business the amount of which were not previously capitalized.

Needless to say, only the above costs are allowed to be deducted from petitioner's gross income, applying the principle *inclusio unius est exclusio alterius* (what is not included is deemed excluded).

The ICPA's reconciliation[111] of allowable expenses as declared by petitioner per ITR for the year 2011 versus the allowable expenses per BIR computation is shown as follows:

---

[111] Exhibit "P-20" (ICPA Report), p. 12.

Particulars	Amount per BIR's FDDA and Details of Discrepancies	Amount per ITR	Variance
Direct salaries, wages or labor expense and Service Supervision Salaries	₱ 39,004,613.78	₱ 27,204,966.13	₱ 11,799,647.65
Direct Materials, supplies used, rent and utility charges for buildings and capital equipment used in the rendition of registered services	93,571,109.74	87,998,872.80	5,572,236.94
Depreciation of machineries, equipment used in the rendition of registered services	20,259,009.99	21,856,112.08	(1,597,102.09)
Financing charges associated with fixed asset used in the service business which were not previously capitalized	501,600.63	-	501,600.63
Other Direct Cost	-	28,297,809.03	(28,297,809.03)
Total	**₱153,336,334.14**	**₱165,357,760.04**	**(₱12,021,425.90)**

The discrepancy amounting to ₱12,021,425.90 is further detailed as follows:

Particulars	Amount	
Expenses disallowed by BIR		
A. Other direct cost	₱ 28,297,809.22	
B. Lease rental	4,500,000.00	
C. Depreciation of vehicle	1,597,102.12	₱ 34,394,911.34
Presented as General and Admin Expenses in the AFS but was considered by BIR as part of allowable expenses		(12,640,799.40)
Credit entries per General Ledger not considered by the BIR		(9,732,686.88)
Total		**₱12,021,425.06**

A. Other direct cost – ₱28,297,809.22

Per ICPA report, Other Direct Costs pertain to the following:

Particulars	Amount
a. Franchise Fee	₱ 7,232,024.25
b. Travel Expense	215,939.92
c. Safety	151,364.00
d. Other Direct Cost	979,525.95
e. Repairs and Maintenance	17,109,135.11
f. Direct Consultancy Fee	2,609,819.99
Total	**₱ 28,297,809.22**

a. Franchise Fee - ₱7,232,024.25

The Franchise fee amounting to ₱7,232,024.25 pertains to payments made to SBMA for the right, privilege, and authority to carry on the business of providing water and sewerage services in the Subic Special Economic and Freeport Zone, which were supported by AP Invoice for Approval and official receipts.[112] However, considering that franchise fee is not among the costs allowed as deduction from gross income earned, the deficiency assessment thereon shall be sustained.

b. Travel expense - ₱215,939.92

The travel expense amounting to ₱215,939.92 pertains to costs incurred during technical seminars attended by petitioner's personnel and chemist under Water Distribution Department. This also includes per diem during concrete testing, seminar of personnel under Engineering Department as well as the per diem of Water Laboratory Supervisor during seminar.[113] However, considering that travel expense is also not among the costs allowed as deduction from gross income earned, the deficiency assessment thereon shall be sustained.

c. Safety - ₱151,364.00

The safety expense refers to purchase of safety supplies for the welfare of employees directly engaged in the performance of their registered activity. Upon examination of the supporting documents submitted by petitioner, the Court finds that only the amount of ₱103,317.00, as detailed below, is supported by official receipts and/or sales invoices.[114] Consequently, the remaining amount of ₱48,047.00 shall be disallowed as deduction in computing its gross income.

Invoice Date	Invoice No	OR Date	OR No	Other Supporting Documents	Amount	Exhibit No.
3/16/2011	SI#46240	5/23/2011	OR#31739	CV 26788	₱ 9,790.00	5.33
5/4/2011	SI#47282	5/23/2011	OR#31740	CV 26910	1,360.00	5.34
5/4/2011	SI#47308	5/23/2011	OR#31740	CV 26910	2,300.00	5.34
5/4/2011	SI#47309	5/23/2011	OR#31740	CV 26910	2,510.00	5.34
5/4/2011	SI#47281	5/23/2011	OR#31740	CV 26910	5,960.00	5.34

[112] Exhibits "AAA-5.1" to "AAA-5.9".
[113] Exhibits "AAA-5.10" to "AAA-5.32"; Exhibit "AAA-5.809".
[114] Exhibits "AAA-5.33" to "AAA-5.49".

6/14/2011	SI#2691	online		CV 27143	9,000.00	5.37
6/29/2011	SI#48447	7/7/2011	OR#32141	CV 27216	1,160.00	5.38
6/29/2011	SI#48459	7/7/2011	OR#32141	CV 27216	3,870.00	5.38
8/10/2011	SI#49619	9/22/2011	OR#33952	CV 27485	1,150.00	5.41
8/10/2011	SI#49619	9/22/2011	OR#33952	CV 27485	1,150.00	5.41
8/10/2011	SI 4927, 49430.			CV 27468 dated 8/15/2011;PO 100001954; System generated printouts; PO 100001940; DR 29740 dated 9/9/2011	1,360.00	5.41
5/25/2011	None	6/23/2011	OR#0443	CV 27060	1,750.00	5.35
9/7/2011	SI#12687			CV 27371	2,800.00	5.39
	SI#50053	11/15/2011	OR#34588	CV 27709	1,150.00	5.42
	SI#50406	11/15/2011	OR#34588	CV 27709	11,500.00	5.43
	Various invoices	7/7/2011	OR#0491	CV 27076	7,825.00	5.36
8/10/2011	SI 4927, 49430			CV 27468 dated 8/15/2011; PO 100001954; System generated printouts; PO 100001940; DR 29740 dated 9/9/2011	3,660.00	5.41
8/17/2011	SI#49304	9/22/2011	OR#33952	CV 27485	2,300.00	5.42
9/14/2011	SI#50231	11/14/2011	OR#34587	CV 27721	4,591.00	5.44
9/14/2011	SI#50231	11/14/2011	OR#34587	CV 27721	13,680.00	5.44
8/25/2011	CI#2451	None	None	CV 27986	350.00	5.46
8/27/2011	CI#2474	None	None	CV 27986	5,950.00	5.46
11/23/2011	SI#51737	1/26/2012	OR#35937	CV 28014	1,150.00	5.47
11/23/2011	SI#51738	1/26/2012	OR#35937	CV 28014	7,001.00	5.47
TOTAL					**₱103,317.00**	

d. Other Direct Cost - ₱979,525.95

The other direct cost refers to purchases of chemicals, supplies and materials used for water treatment and water testing as part of petitioner's quality control procedures. It also includes cost for environment monitoring, calibration charges and road restoration.

Based on the examination of the supporting documents, out of the total amount of ₱979,525.95, only the amount of ₱722,841.81 pertaining to purchases of chemicals, supplies and materials directly used in its quality control procedures and duly supported by official receipts and/or sales invoices,[115] as detailed below, shall be recognized as allowable other direct cost, while the remaining amount of ₱256,684.14 shall be disallowed, *viz.*:

Invoice Date	Invoice No	OR Date	OR No	Other Supporting Documents	Amount	Exhibit No
None	None	5/4/2011	OR#22971	CV 26746	₱ 8,850.00	5.50
4/26/2011	BI#4918	online		CV 26925	16,000.00	5.53
5/21/2011	CI#247493	7/21/2011	OR#145677	CV 27000	228.00	5.54
5/21/2011	CI#247494	7/21/2011	OR#145677	CV 27000	3,648.00	5.54
5/21/2011	CI#247495	7/21/2011	OR#145677	CV 27000	2,856.00	5.54
5/21/2011	CI#247492	7/21/2011	OR#145677	CV 27000	37,032.00	5.54
None	None	7/21/2011	OR#145679	CV 27017	29,500.00	5.55
3/22/2011	CI#244493	7/21/2011	OR#145679	CV 27017	25,896.00	5.55
5/21/2011	CI#247523	7/21/2011	OR#145678	CV 27027	16,644.00	5.56
4/25/2011	SI#21995	None	OR#22294	CV 27103	71,762.50	5.57
6/16/2011	SI#1898	8/16/2011	OR#1502	CV 27172	15,054.56	5.58
None	None	7/8/2011	OR#23904	CV 27215	71,762.50	5.59
6/9/2011	CI#0619	online		CV 27285	4,610.00	5.60
6/30/2011	CI#249085	9/16/2011	OR#146880	CV 27336	10,422.00	5.61
7/20/2011	CI#249815	9/16/2011	OR#146880	CV 27336	40,031.00	5.61
None	None	8/12/2011	OR#2336	CV 27380	171,800.00	5.62
7/21/2011	Invoice PHP170986			CV 27448 dated 8/11/2011;Price quotation; Test reports; Quotation request; 2307; SAP printouts dated 8/19/2011	6,892.50	5.63
7/21/2011	Intertek SI PH170985			CV 27455 dated 8/15/2011;PO 100001866; Photocopy of the test report; Quotation of the service; Subic Water''s canvass sheet dated 8/19/2011	10,053.75	5.64
7/29/2011	SI PH171433			CV 27483 dated 8/22/2011;Annual water testing reports dated 8/26/2011	57,900.00	5.65
7/15/2011	SI#2909	9/9/2011	OR#4341	CV 27520	4,600.00	5.66
11/9/2011	CI#255129	12/28/2011	OR#149270	CV 27955	37,724.00	5.67
11/22/2011	SI#0838	None	OR#3456	CV 28048	12,000.00	5.68
9/21/2011	BI#5904	on-line		CV 28053	25,990.00	5.69
11/22/2011	SI#193549	on-line		CV 28066	41,585.00	5.70
TOTAL					**₱ 22,841.81**	

[115] Exhibits "AAA-5.50" to "AAA-5.207".

e. Repairs and Maintenance - ₱17,109,135.11

Repairs and Maintenance pertains to preventive maintenance and regular cleaning of sewerage facility, repairs of leak and relocation of meters, tools and supplies relative to the repair and maintenance of the sewerage facilities. Upon examination of the supporting documents[116] submitted by petitioner, the Court finds that only the amount of ₱1,427,774.07 is supported by official receipts and/or sales invoices. Consequently, the remaining amount of ₱15,681,361.04 shall be disallowed as deduction in computing its gross income.

Invoice Date	Invoice No	OR Date	OR No	Other Supporting Documents	Amount
3/25/2011	Sales Invoice No. 0937	4/26/2011	OR 2378	CV 26765 dated 4/13/2011; PO 100001649; Billing Statement; 2307 dated 4/20/2011	₱ 320.00
2/15/2011	SI#21206	4/25/2011	OR#36342	CV 26766	3,556.00
3/16-17/2011	Invoice 219602, 219603, 219604			CV 26771 dated 4/13/2011;Fuel and oil lubricant request; Schedule of shell invoices; SOA dated 3/16/2011 dated 4/20/2011	5,646.00
2/23/2011	SI#13811	9/20/2011	OR#8157	CV 26787	8,745.00
4/28/2011	SI 80965	7/13/2011	OR 30729	CV 26841 dated 4/29/2011;DR 61942; 2307;Letter of acknowledgment; PO 100001643; Quotation reply; Quotation query dated 6/28/2011	27,450.00
4/28-29/2011	Charge invoice 44828, 45228.	5/25/2011	OR 38020	CV 26849 dated 4/29/2011	1,250.00
4/28-29/2011	Charge invoice 44828, 45228.	5/25/2011	OR 38020	CV 26849 dated 4/29/2011	560.00
5/12/2011	Invoice 224740			CV 26864 dated 4/29/2011;Fuel and oil lubricant request; Schedule of shell invoices; Invoice 224838; SOA dated 5/1/2011; PO 100001731 dated 5/12/2011	18,660.00
2/25/2011	Sales Invoice 138079			CV 26891 dated 5/5/2011;PO 100001398; Bid Request; Bid reply; 2307; Printout of	9,204.00

[116] Exhibits "AAA-5.78" to "AAA-5.801"; Exhibits "AAA-5.810" to "AAA-5.817".

				entry on SAP dated 5/12/2011	
6/3/2011	SI 1635	6/10/2011	OR 1241	CV 26937 dated 5/12/2011;PO 100001382; DR 1579; Price quote; Quotation Request; SAP Printout of the entry; 2307 dated 6/3/2011	23,614.58
6/3/2011	SI 1635	6/10/2011	OR 1241	CV 26937 dated 5/12/2011;PO 100001382; DR 1579; Price quote; Quotation Request; SAP Printout of the entry; 2307 dated 6/3/2011	23,614.58
5/19/2011	SI#10230	6/30/2011	OR#6544	CV 26990	72,550.00
5/18/2011	SI#4092			CV 27018	13,500.00
5/23/2011	SI#0430	6/17/2011	OR#00645	CV 27022	9,100.00
5/30/2011	SI#81115	online	online	CV 27029	226,800.00
5/13/2011	SI#14277	online	online	CV 27030	19,380.00
5/18/2011	SI#19750	6/8/2011	OR#13162	CV 27035	40,178.57
5/30/2011	SI 2119	7/12/2011	OR 1410	CV 27059 dated 6/3/2011;PO 100001885; Price quote; Quotation Request; SAP Printout of the entry; 2307 dated 6/30/2011	7,961.00
5/26/2011	SI 0433	6/17/2011	OR 00644	CV 27067 dated 6/6/2011;PO 100001913, 100001916, 100001931; SAP printout of entry; 2307 dated 6/13/2011	10,750.00
5/31/2011	SI 0435	6/17/2011	OR 00644	CV 27067 dated 6/6/2011;PO 100001913, 100001916, 100001931; SAP printout of entry; 2307 dated 6/13/2011	15,250.00
5/31/2011	SI 0436	6/17/2011	OR 00644	CV 27067 dated 6/6/2011;PO 100001913, 100001916, 100001931; SAP printout of entry; 2307 dated 6/13/2011	42,800.00
5/30-31/2011	Charge invoice 45490, 45431	6/23/2011	OR 39708	CV 27075 dated 6/6/2011;PO 100001909 dated 6/23/2011	3,750.00

6/8/2011	SI 05941			CV 27123 dated 6/13/2011;PO 10001876; DR 35638; 2307; Manufacturing request dated 7/8/2011	6,750.00
6/8/2011	SI 05941			CV 27123 dated 6/13/2011;PO 10001876; DR 35638; 2307; Manufacturing request dated 7/8/2011	6,750.00
5/30/2011	Invoice 33362	7/3/2011	OR 24392	CV 27140 dated 6/15/2011;Validated deposit slip - BPI; SOA dated May 9, 2011; 2307 dated 6/22/2011	59,437.50
6/15/2011	SI 5340	7/22/2011	OR 3272	CV 27155 dated 6/22/2011;PO 100001953; Purchase Request; Price Quote; Quotation request; 2307 dated 6/29/2011	8,600.00
6/7/2011	SI#0438	None	OR#00647	CV 27163	8,700.00
6/8/2011	Charge invoice 45753.	7/8/2011	OR 39718	CV 27165 dated 6/21/2011	900.00
6/29/2011	SI 10303	8/19/2011	OR 6327	CV 27214 dated 6/30/2011;DR 13314; PO 100001064; Purchase requisition; Quotation request; Quotation reply; 2307 dated 7/22/2011	30,000.00
7/27/2011	SI 0067 and yellow duplicate	8/1/2011	OR 0848	CV 27218 dated 6/30/2011;PO 1000019606, DR 04-4326; Open bid analysis report; Quotation request; Quotation reply; 2307 dated 7/27/2011	10,548.72
3/28/2011	SI#44510	7/8/2011	OR#39719	CV 27227	2,280.00
6/30/2011	Multiple unreadable magnetic tape Charge invoices	6/30/2011	OR#29729	CV 27257 dated 7/6/2011;Schedule of Subic Gas Philippines invoices; SOA dated 6/30/2011	2,443.57
6/22/2011	SI 32679	8/3/2011	OR 26464	CV 27344 dated 7/26/2011;PO 100001724; DR 31982; Price quote; Quotation Request; SAP Printout of the entry; 2307 dated 8/3/2011	53,900.00

6/13/2011	SI#440	8/3/2011	OR#00642	CV 27351	35,750.00
7/15/2011	CI#46139	8/15/2011	OR#40410	CV 27369	1,260.00
7/23/2011	Invoice 231677.			CV 27435 dated 8/11/2011;Fuel and oil lubricant request; Schedule of shell invoices; Invoice 231677 dated 8/29/2011	131.00
6/24/2011	Sales Invoice 136421, 139007, 143080, 143081			CV 27440 dated 8/11/2011;Sales Invoice 136421, 139007, 143080, 143081; PO 100001258, 100001959; Credit memo 11-187 and 11-262; Bid Request; Bid reply; 2307; Printout of entry on SAP dated 8/19/2011	29,318.50
1/17/2011	Sales Invoice 136421, 139007, 143080, 143081			CV 27440 dated 8/11/2011;PO 100001258, 100001959; Credit memo 11-187 and 11-262; Bid Request; Bid reply; 2307; Printout of entry on SAP dated 8/19/2011	10,780.00
6/24/2011	Sales Invoice 136421, 139007, 143080, 143081			CV 27440 dated 8/11/2011;PO 100001258, 100001959; Credit memo 11-187 and 11-262; Bid Request; Bid reply; 2307; Printout of entry on SAP dated 8/19/2011	29,318.50
		9/23/2011	OR#44563	CV 27499	4,200.00
		9/23/2011	OR#44563	CV 27499	468.00
		9/23/2011	OR#44563	CV 27499	5,373.00
7/4/2011	SI#2882	9/9/2011	OR#4345	CV 27501	37,200.00
8/16/2011	SI#4666	10/27/2011	OR#4020	CV 27605	51,598.35
8/9/2011	SI#53515421025797	None	None	CV 27627	11,955.00
8/23/2011	CI#47434	9/23/2011	OR#44564	CV 27657	5,488.00
8/25/2011	CI#47246	9/23/2011	OR#44564	CV 27657	1,400.00
9/19/2011	SI#0080	9/26/2011	OR#0055	CV 27670	20,000.00
9/23/2011	SI#0210	10/24/2011	OR#0966	CV 27691	9,080.00
9/18/2011	Sales Invoice 146736			CV 27705 dated 9/30/2011;PO 100002434; Bid Request; Bid reply; 2307; Printout of entry on SAP dated 10/20/2011	12,230.00
		9/2/2011	OR 5410	CV 27707 dated 9/30/2011;PO 100002433; SAP Printout of the entry;	8,300.00

				2307 dated 10/5/2011	
9/22/2011	SI 11903	10/26/2011	OR 5097	CV 27708 dated 9/30/2011;PO 100002392; DR 17101; Price quote; Quotation Request; SAP Printout of the entry; 2307 dated 10/26/2011	12,227.67
9/6,8,15/2011	Charge invoice 47792, 48023, 48098	10/14/2011	OR 44591	CV 27718 dated 9/30/2011;PO 100002437, 100002420, 100002449 dated 10/14/2011	220.00
9/6,8,15/2011	Charge invoice 47792, 48023, 48098	10/14/2011	OR 44591	CV 27718 dated 9/30/2011;PO 100002437, 100002420, 100002449 dated 10/14/2011	900.00
9/6,8,15/2011	Charge invoice 47792, 48023, 48098	10/14/2011	OR 44591	CV 27718 dated 9/30/2011;PO 100002437, 100002420, 100002449 dated 10/14/2011	5,195.00
9/2/2011	Invoice 236553, 235267, 234084			CV 27746 dated 10/6/2011;Fuel and oil lubricant request; Schedule of shell invoices; SOA dated 9/9/2011 dated 10/28/2011	262.00
9/19/2011	Invoice 236553, 235267, 234084			CV 27746 dated 10/6/2011;Fuel and oil lubricant request; Schedule of shell invoices; SOA dated 9/9/2011 dated 10/28/2011	1,120.00
8/19/2011	Invoice 236553, 235267, 234084			CV 27746 dated 10/6/2011;Fuel and oil lubricant request; Schedule of shell invoices; SOA dated 9/9/2011 dated 10/28/2011	524.00
		9/7-8/2011	OR 4667, 4669	CV 27801 dated 10/18/2011;PO 100002480, 100002506; SAP printout of entry; 2307 dated 10/21/2011	14,500.00
		9/7/2011	OR 4668	CV 27801 dated 10/18/2011;PO 100002480, 100002506; SAP printout of entry;	3,000.00

a

				2307 dated 10/21/2011	
10/18/2011	Sales Invoice 147982			CV 27886 dated 10/28/2011;PO 100002511, 100002497; Bid Request; Bid reply; 2307; Printout of entry on SAP dated 11/18/2011	7,750.00
10/18/2011	Sales Invoice 147982			CV 27886 dated 10/28/2011;PO 100002511, 100002497; Bid Request; Bid reply; 2307; Printout of entry on SAP dated 11/18/2011	39,581.00
11/2/2011	SI#1240	1/10/2012	OR#0841	CV 27925	59,800.00
None	None	11/28/2011	OR#0507	CV 27932	35,699.20
11/10/2011	IR#1095	11/28/2011	OR#0507	CV 27932	10,975.00
10/4/2011	CI#52656/58	11/22/2011	R#49334	CV 27935	1,255.00
10/4/2011	CI#52656/58	11/22/2011	OR#49334	CV 27935	8,495.00
10/20/2011	SI#0142	11/22/2011	OR#1108	CV 27936	20,932.00
11/14/2011	SI#1579	1/2/2011	OR#1420	CV 27951	26,000.00
11/23/2011	IR#1102	12/1/2011	OR# was cut	CV 28007	60,000.00
10/11/2011	CI#53081	12/16/2011	R#51268	CV 28015	281.00
11/18/2011	SI#0234	None	OR#3456	CV 28049	7,150.00
		11/19/2011	OR#0011	CV 28050	9,600.00
None	None	12/21/2011	OR#2886	CV 28051	5,710.00
None	None	12/21/2011	OR#2886	CV 28051	11,700.00
Various invoices	Various invoices	online	online	CV 28103	393.00
		10/19/2011	OR 834777 stamped as paid.	CV 27916 dated 11/10/2011;Work order 102120 with cost estimate; Letter Re: Stolen Secondary Line Replacament Cost dated 11/8/2011	35,704.33
TOTAL					**₱1,427,774.07**

f. Direct Consultancy Fee - ₱2,609,819.99

The consultancy fees pertain to payments made to SEMBCORP Utilities Services Ltd. for the offshore consultancy services. Considering that consultancy fee is not among the costs allowed as deduction from gross income earned, the deficiency assessment thereon shall be sustained.

B. Disallowed Lease – ₱4,500,000.00

This disallowed lease expense refers to accrual of rental of real and personal property leased out by Olongapo City Water District. As ascertained by the ICPA, out of the total amount of ₱4,500,000.00 lease expense, the amount of ₱978,260.87 shall be disallowed for being in excess of the amount agreed upon per Amended Franchise Agreement vis-à-vis the Original Franchise Agreement.[117] Accordingly, only the amount of ₱3,521,739.13 shall be allowed as direct cost deductible in the computation of gross income subject to preferential tax rate.

C. Disallowed Depreciation on Vehicle – ₱1,597,102.12

The ICPA examined the list of vehicle assets against the vehicle registrations with Land Transportation Office (LTO) and identified the officers accountable for each vehicle. Based on verification and re-computation of depreciation expense, the ICPA confirmed that charges supported by Official Receipts and Certificate of Registration issued by the LTO amounting to ₱553,173.64 pertain to depreciation of vehicles used by the Water Production Division, Water Laboratory Division, Water Distribution Division, and Sanitary and Engineering Department.[118] While charges in the amount of ₱105,123.11 pertain to depreciation of vehicle used by the Finance, Commercial Service Division and the Integrated Management Services Department, the remaining amount of ₱938,805.37 is unsupported and unaccounted.

Notwithstanding the above ICPA findings, as enumerated under RR No. 13-2005 and DOF Order No. 3-08 above, only the depreciation pertaining to machinery, equipment and a portion of the building owned or constructed by the registered enterprise shall be allowed as deduction from gross income earned. Consequently, the depreciation on vehicles amounting to ₱1,597,102.12 shall be disallowed.

In view of the foregoing, the Court finds the disallowances made by respondent proper but only to the extent of ₱6,245,754.85, as computed below:

---

[117] Exhibits "AAA-5.806" to "AAA-5.808".
[118] Exhibits "AAA-5.804".

Disallowed expenses per FDDA		₱ 12,021,426.86
Less: Adjustment/Allowable		
Other Direct Cost		
Safety	₱ 103,317.00	
Other Direct Cost	722,841.81	
Repairs and Maintenance	1,427,774.07	
Lease Rental	₱3,521,739.13	5,775,672.01
Disallowed expenses in excess of the amounts allowable pursuant to RR 13-2005		**₱6,245,754.85**

IT-7. Over-claimed Expenses based on matching of AFS vs. TB vs. CV Register – ₱2,273,999.62

BIR's validation of expenses claimed per AFS when traced back to the TB and then to the CV register revealed that there were over-claimed expenses in the AFS. These discrepancies were disallowed for failure to correctly reflect the amount of expense recorded in the books, pursuant to Section 34 of the NIRC of 1997. The details of the discrepancies are enumerated as follows:[119]

Account Name	**Amount per AFS / Auditor's TB 31 December 2011**	**Adjusted Amount per Books**	**Over-claimed Expenses/Purchases**
Utilities and Chemical	₱77,729,428.00	₱75,559,921.14	₱ 2,169,506.86
Rent and Utilities	2,106,527.00	2,002,034.24	104,492.76
Total			**₱2,273,999.62**

It may be observed that respondent arrived at the alleged over-claimed expenses based on the comparison of the amounts per petitioner's AFS and Trial Balance as against the amounts per CV register, instead of the amount per ITR. As stated in the matrix from FLD to FDDA[120], the expenses amounting to ₱2,273,999.62 pertain to expenses not claimed in the computation of GIT subject to 5%.

Considering that the same was not even claimed by petitioner as deduction in the ITR for tax purposes, respondent has no basis in disallowing the same as expense. Thus, the deficiency income tax thereon shall be cancelled.

[119] Details of Discrepancies, Exhibit "P-9".
[120] BIR Records, Folder 1, p. 609.

IT-8. Disallowed expenses/ purchases for being unsupported – ₱300,332.81

Respondent's verification of the invoices and official receipts issued by petitioner's suppliers disclosed that petitioner failed to substantiate with valid source documents some of the purchases as reflected in the CV register. Hence, the said purchases, as listed below, were disallowed pursuant to Section 34(A)(1)(b) of the NIRC of 1997:[121]

CV No	SAP No	Supplier's Name	Amount per CV
27793	3423	Cleared, Inc.	₱ 5,880.00
27557	3169	DML Subic Freeport Corp.	5,411.00
27648	3275	Glocke Security Systems Inc.	93,749.34
28068	3846	Infocom	4,900.00
28086	3865	Juanito P. Rellora	10,000.00
27772	3401	Landbank Insurance Brokerage Inc.	96,592.67
27280	2875	LBC Express Inc.	60,750.20
27255	2846	Subic Amusement Enterprises Inc.	11,524.80
26942	2502	Subic Amusement Enterprises Inc.	11,524.80
Total			**₱ 300,332.81**

Section 34(A)(1)(b) of the NIRC of 1997, as amended, requires the taxpayer to substantiate deductions by sufficient evidence, to wit:

> SEC. 34. *Deductions from Gross Income.* – xxx
>
> (A) *Expenses.* –
>
> (1) *Ordinary and Necessary Trade, Business or Professional Expenses.*
>
> (a) *In General.* – xxx
>
> (b) *Substantiation Requirements.* – No deduction from gross income shall be allowed under Subsection (A) hereof unless the taxpayer shall substantiate with sufficient evidence, such as official receipts or other adequate records: (i) the amount of the expense being deducted, and (ii) the direct connection or relation of the expense being deducted to the development, management, operation and/or conduct of the trade, business or profession of the taxpayer.

Based on the examination of the supporting documents[122] submitted by petitioner, the Court finds that only the amount of ₱255,992.21 is duly substantiated with

---

[121] Details of Discrepancies, Exhibit "P-9".
[122] Exhibits "AAA-7.1" to "AAA-7.9".

sufficient evidence, such as the Statement of Accounts, Billing Invoices, and Bank Validated payment slips, while the remaining amount of ₱44,340.60 is not properly supported by sufficient evidence, to wit:

Vendor	Reference No.	Other attachments	Amount
Cleared, Inc.	Check No. 392245	Request for payment dated 10/13/11 amounting to ₱6,000. Signed: requested by, recommended by & approved by; subjected to EWT	₱ 5,880.00
Dml Subic Freeport Corp	392129	Delivery receipts no. 345 dated 7/21/2011, no. 388 dated 8/5/2011, no.387 dated 8/5/2011, no. 462 dated 8/16/2011 & no. 463 dated 8/16/11,	5,411.00
Juanito P. Rellora	Check No. 392594	Acceptance certification dated 11/24/2011	10,000.00
Subic Amusement Enterprises Inc.	Check No. 358541	Memo & Request for payment dated 07/06/11 amounting to ₱11,760. Signed: requested by, recommended by & approved by; BIR 2307	11,524.80
Subic Amusement Enterprises Inc.	Check No. 358312	Memo; BIR 2307	11,524.80
Total			**₱44,340.60**

As such, the disallowance by respondent to the extent of ₱44,340.60 shall be sustained.

IT-9. Disallowed Purchases/ Expenses due to failure to withhold – ₱3,991,363.02

Respondent's line by line analysis of the income payments per AFS accounts in comparison with the Alphalist of Annual Information Return of Creditable Income Taxes Withheld (BIR Form No. 1604E) disclosed that there were income payments that were not subjected or failed to be subject in full to EWT, which is in violation of RR No. 2-98, as amended. Hence, the following discrepancies were disallowed due to failure to withhold and remit the corresponding withholding tax pursuant to Section 34(K) of the NIRC of 1997:[123]

[123] Details of Discrepancies, Exhibit "P-9".

Supplier's Name	Income Payment	EWT Rate	EWT Due
Samasa Maintenance Services	₱ 19,500.00	2%	₱ 390.00
Aurora M. Ramos	18,242.81	15%	2,736.42
Avelinda G. Esma	126,369.19	15%	18,955.38
Mariquit C. Sunga	8,399.66	10%	839.97
Subic Bay Freeport Chamber of Commerce	5,000.00	2%	100.00
Fairclough, Graham J	20,000.00	25%	5,000.00
Crizaldy Duka	41,000.00	15%	6,150.00
Efren Amoguis	12,000.00	10%	1,200.00
Jardine Lloyd Thompson Insurance Brokers Inc	88,183.79	2%	1,763.68
Jimmy Mamolo	5,000.00	10%	500.00
Juanito P. Rellora	10,000.00	10%	1,000.00
Landbank Insurance Brokerage Inc	265,850.35	2%	5,317.01
Oilver Josafat	23,463.38	15%	3,519.51
Pahayagang Pang Masa	5,000.00	2%	100.00
Petron Corporation	2,400.18	1%	24.00
Philippine Institute of Certified Public Accountants	6,000.00	2%	120.00
Philippine Water Works Association, Inc.	6,000.00	2%	120.00
Ricky T. Romano	159,300.00	15%	23,895.00
Ridon S St Jude Medical Center	500.00	10%	50.00
Small Enterprises Research and Development Foundation, Inc	9,500.00	2%	190.00
Trade Union Congress of the Philippines Subic District Office	5,000.00	2%	100.00
Zambales II Electric Cooperative, Inc.	3,154,653.66	2%	63,093.07
Total	**₱3,991,363.02**		**₱135,164.03**

Based on the examination of the documents presented by petitioner, the ICPA summarized his findings as follows:[124]

Particulars	Amount
Income Payments made to ZAMECO II duly registered with NEA	₱ 2,750,234.01
Duly Supported expenses subject to EWT	427,151.88
Duly Supported employee's reimbursement of expenses, not subject to EWT	111,226.03
Duly Supported expenses subject to Final Tax	20,000.00
Duly Supported expenses paid to Subic Bay Freeport Zone (SBFZ) enterprise, thus not subject to EWT	24,500.00
No Supporting documents presented for examination	658,251.10
Total	**₱ 3,991,363.02**

As ascertained by the ICPA, out of the alleged payment in the amount of ₱3,154,653.66 to Zambales II Electric Cooperative, Inc. (ZAMECO), a duly registered electric cooperative with the National Electrification Administration

[124] Exhibit "P-20" (ICPA Report), p. 21.

(NEA)[125], only the amount of ₱2,750,234.01 was duly supported.

Relative thereto, Section A(3) of Revenue Memorandum Circular (RMC) No. 72-2003[126] provides that electric cooperatives registered with the National Electrification Administration are exempt from income tax. Cooperatives registered with NEA are governed by the provisions of Presidential Decree No. 269, which expressly grants exemption to cooperatives from income tax under Section 39(a)(1) thereof, as held in the CTA *En Banc* case of *Commissioner of Internal Revenue vs. Samar-I Electric Cooperative, Inc.*[127], which affirmed the following findings of the Court in Division:

> x x x since petitioner remained registered with NEA; thus, governed by the provisions of PD 269. This being the case, Section 39 of PD 269 clearly grants tax exemption to electric cooperatives, such as petitioner, from income tax. x x x

Thus, petitioner's income payment to ZAMECO, being entitled to income tax exemption, is consequently not subject to 2% EWT. However, considering that the remaining amount of ₱404,419.65 is unsupported, the Court cannot ascertain whether the same indeed pertains to payment made to ZAMECO, thus, shall be disallowed.

Meanwhile, in his Report, the ICPA alleged that the amount of ₱111,226.03 pertains to employee reimbursements from income payments to non-regular suppliers and/or single purchases, hence, not subject to withholding tax pursuant to Section 3 of RR No. 17-2003.

Pursuant to RR No. 2-98, as amended by RR No. 14-2008, the casual purchases amounting to less than ₱10,000.00 are not subject to EWT, to wit:

> Sec. 2.57.2. *Income payment subject to creditable withholding tax and rates prescribed thereon.* – Except as herein otherwise provided, there shall be withheld a creditable income tax at the rates herein specified for each class of payee from the following items of income payments to persons residing in the Philippines.

[125] Certificate of Registration issued by NEA, Exhibit "AAA-8.20".
[126] Tax Implications of Electric Cooperatives Registered with the National Electrification Administration and Cooperative Development Authority.
[127] CTA EB Nos. 460 and 462, March 11, 2010.

x x x

> (M) *Income payments made by the top twenty thousand (20,000) private corporations to their local/resident supplier of goods and local/resident supplier of services other than those covered by other rates of withholding tax.* – xxx
>
> x x x
>
> The term *"local/resident suppliers of goods"* pertains to a supplier from whom any of the *top twenty thousand (20,000) private corporations*, as determined by the Commissioner, regularly makes its purchases of goods. **As a general rule, this term does not include a casual purchase of goods, that is, purchase made from a non-regular supplier and oftentimes involving a single purchase.** However, a single purchase which involves Ten thousand pesos (₱10,000.00) or more shall be subject to a withholding tax. The term *"regular suppliers"* refers to suppliers who are engaged in business or exercise of profession/calling with whom the taxpayer-buyer has transacted at least six (6) transactions, regardless of amount per transaction, either in the previous year or current year. The same rules apply to local/resident supplier of services other than those covered by separate rates of withholding tax *(Emphasis supplied)*

Furthermore, in the case of *First Lepanto Taisho Insurance Corporation vs. Commissioner of Internal Revenue*[128], the Supreme Court ruled that the expenses would not be subject to withholding tax if the same were reimbursements for actual expenses of the company. In a number of rulings, even the BIR held the same.[129] In order for the expenses to be not subject to withholding tax, it must first be established that they are reimbursements of actual expenses.

Be that as it may, petitioner fell short of establishing that the income payments are actually casual purchases from non-regular suppliers, as petitioner failed to present as evidence a list of its regular suppliers, required to be submitted every semester to the Large Taxpayers Assistance Division/Large Taxpayers District Office or Revenue District Office (RDO) having jurisdiction over petitioner's principal place of business, pursuant to RR No. 14-2008.

Anent the income payments to Fairclough, Graham J. in the amount of ₱20,000.00, records reveal that petitioner indeed failed to subject the same to withholding tax. Petitioner's subsequent payment of the corresponding

---

[128] G.R. No. 197117, April 10, 2013.

[129] BIR Ruling Nos. 28-80, undated, 156-84 dated September 12, 1984, and 129-92, dated April 20, 1992.

deficiency final withholding tax on May 29, 2015 is of no moment, as the same was made only after the issuance of the FDDA – that is, beyond "the time of the audit/investigation or reinvestigation/reconsideration", pursuant to Section 2.58.5 of RR No. 2-98, as amended by RR No. 14-2002.[130] Thus, the same shall be disallowed.

As to the expenses amounting to ₱24,500.00, verification disclosed that the same were paid to Samasa Maintenance Services and Subic Bay Freeport Chamber of Commerce in the amounts of ₱19,500.00 and ₱5,000.00, respectively. Petitioner, however, failed to present documents to prove that payments to the said entities are exempt from withholding tax, thus, this Court finds no reason to cancel the disallowance of the corresponding expenses.

Accordingly, for failure of petitioner to prove that the income payments paid to the following entities/individuals are not subject and/or exempted to EWT, the Court finds the disallowance valid:

Supplier's Name	**Income Payment**
Samasa Maintenance Services	₱ 19,500.00
Aurora M. Ramos	18,242.81
Avelinda G. Esma	126,369.19
Mariquit C. Sunga	8,399.66
Subic Bay Freeport Chamber of Commerce	5,000.00
Fairclough, Graham J.	20,000.00
Crizaldy Duka	41,000.00
Efren Amoguis	12,000.00
Jardine Lloyd Thompson Insurance Brokers Inc	88,183.79
Jimmy Mamolo	5,000.00
Juanito P. Rellora	10,000.00
Landbank Insurance Brokerage Inc	265,850.35
Oilver Josafat	23,463.38
Pahayagang Pang Masa	5,000.00
Petron Corporation	2,400.18
Philippine Institute of Certified Public Accountants	6,000.00

---

[130] Sec. 2.58.5. *Requirements for Deductibility.* – Any income payment which is otherwise deductible under the Code shall be allowed as a deduction from the payor's gross income only if it is shown that the income tax required to be withheld has been paid to the Bureau in accordance with Secs. 57 and 58 of the Code.

A deduction will also be allowed in the following cases where no withholding of tax was made:

x x x

(C) The withholding agent erroneously underwithheld the tax but pays the difference between the correct amount and the amount of tax withheld, including the interest, incident to such error, and surcharges, if applicable, **at the time of the audit/investigation <u>or</u> reinvestigation/reconsideration**. *(Emphasis supplied)*

Philippine Water Works Association, Inc.	6,000.00
Ricky T. Romano	159,300.00
Ridon S St Jude Medical Center	500.00
Small Enterprises Research and Development Foundation, Inc.	9,500.00
Trade Union Congress of the Philippines Subic District Office	5,000.00
Zambales II Electric Cooperative, Inc.	404,419.65
Total	**₱1,241,129.01**

IT-10. Disallowed Salaries Expense due to failure to withhold – ₱5,815,653.33

The BIR's verification disclosed that, after comparing the income payment subject to withholding tax on compensation per Alphalist of Employees against the salaries claimed in the AFS, there were payments which were not subjected to withholding tax, hence, disallowed as mandated under Section 34(K)[131] of the NIRC of 1997, as amended, *viz.*:

Particulars	Non-Taxable	Taxable	Total Salaries
PER ALPHALIST			
Schedule 7.1			
13th Month	₱ 135,939.23	₱ 18,840.40	
De Minimis Benefits	302,307.82	-	
SSS, PHIC, etc.	66,670.20	-	
Salaries and Other Form of Comp	3,598,230.51	302,538.41	
Basic Salaries	-	1,227,103.66	
	₱4,103,147.76	**₱1,548,482.47**	**₱ 5,651,630.23**
Schedule 7.3			
13th Month	₱ 1,366,865.96	-	
De Minimis Benefits	3,202,306.52	-	
SSS, PHIC, etc.	803,386.19	-	
Salaries and Other Form of Comp	1,238,304.46	2,590,353.36	
Basic Salaries	-	14,707,851.93	
	₱6,610,863.13	**₱17,298,205.29**	**₱ 23,909,068.42**
Schedule 7.4			
13th Month	₱ 4,726.99	-	
De Minimis Benefits	10,295.25	-	
SSS, PHIC, etc.	5,308.40	-	
Salaries and Other Form of Comp	-	43,894.83	
Basic Salaries	-	102,952.41	
	20,330.64	**146,847.24**	**167,177.88**
Total	**₱10,734,341.53**	**₱18,993,535.00**	**₱ 29,727,876.53**
PER FS/ITR			

---

[131] SEC. 34. *Deductions from Gross Income.* – xxx

x x x

(K) Additional Requirements for Deductibility of Certain Payments. – Any amount paid or payable which is otherwise deductible from, or taken into account in computing gross income or for which depreciation or amortization may be allowed under this Section, shall be allowed as a deduction only if it is shown that the tax required to be deducted and withheld therefrom has been paid to the Bureau of Internal Revenue in accordance with this Section, Sections 58 and 81 of this Code.

Cost-Compensation & Employee Benefits		₱ 27,204,966.00	
Salaries, wages and benefits		12,956,396.00	₱ 40,161,362.00
Discrepancy			10,433,485.47
Alphalist for Confidential Payroll			4,617,832.14
Disallowed Salaries Expense due to failure to withhold			**₱ 5,815,653.33**

As ascertained by the ICPA, the composition of salaries and wages per AFS in the amount of ₱40,161,362.00[132] are as follows:[133]

Account	Amount
Compensation and Employee Benefits per Note 13 of AFS	
Salaries & Wages	₱ 14,692,018.90
Overtime	1,042,499.33
Night Differential	337,565.53
Holiday Pay	244,503.71
13th month pay	1,170,957.14
Benefits	4,809,846.14
Performance & Incentive Bonus	2,259,874.68
Pension Costs	1,511,382.31
SSS, Medicare and HDMF contributions	1,136,318.39
Sub - total	***₱27,204,966.13***
Salaries, Wages, and Benefits per Note 14 of AFS	
Salaries & Wages	₱ 5,322,022.45
Overtime	60,468.91
Night Differential	2,157.86
Holiday Pay	1,178.03
13th month pay	537,859.34
Benefits	2,253,637.48
Temporary Staff	262,103.57
Security Services	628,800.77
Uniform	185,293.23
Performance & Incentive Bonus	1,472,661.53
Medical Private	937,392.69
Pension Costs	698,268.89
SSS, Medicare and HDMF contributions	353,124.80
Training	241,426.52
Sub - total	***₱12,956,396.07***
Total per AFS / ITR	**₱40,161,362.20**

From the foregoing, the amount of ₱4,569,321.68 pertains to expenses classified under salaries and wages and employee benefits account which are allegedly not subject to withholding tax on compensation, listed as follows:

---

132 With ₱0.20 difference due to rounding off.
133 Annex B_9 of Exhibit "P-20" (ICPA Report).

Particulars	Amount
Compensation and Employee Benefits per Note 13 of AFS	
Employer Contribution on SSS, Medicare and HDMF	₱ 1,136,318.39
Pension Costs	1,511,382.31
Salaries, Wages, and Benefits per Note 14 of AFS	
Employer Contribution on SSS, Medicare and HDMF	353,124.80
Pension Costs	698,268.89
Security services	628,800.77
Training	241,426.52
Total	**₱ 4,569,321.68**

i. Employer Contribution on SSS, Medicare and HDMF contributions – ₱1,136,318.39 and ₱353,124.80 (₱1,489,443.19)

The Employer Contributions on SSS, Medicare and HDMF are not considered income payments to employees, thus, shall not form part of the taxable salaries and wages of the employees in computing the withholding tax on compensation. However, of the total amount of ₱1,489,443.19, only the amount of ₱1,219,850.50 is duly supported by documents,[134] to wit:

Period Covered (2011)	SSS	PHILHEALTH	HDMF	TOTAL
April	₱ 132,743.70	₱ 25,400.00	₱ 13,000.00	₱ 171,143.70
May	130,660.20	25,100.00	12,700.00	168,460.20
June	128,671.40	24,712.50	12,500.00	165,883.90
July	127,717.30	24,675.00	12,400.00	164,792.30
August	127,857.20	24,850.00	12,361.49	165,068.69
September	125,945.20	24,412.50	12,300.00	162,657.70
October	123,714.30	23,937.50	12,100.00	159,751.80
November	126,615.90	25,512.50	12,000.00	164,128.40
December	129,144.00	25,337.50	12,100.00	166,581.50
Adjustment	500.00	375.00	100.00	975.00
Total	**₱1,153,569.20**	**₱224,312.50**	**₱111,561.49**	**₱1,489,443.19**
Less: Unsupported Payments				
April	₱ 132,743.70			₱ 132,743.70
September		24,412.50		24,412.50
Adjustment	500.00	375.00		875.00
April to December-HDMF			111,561.49	111,561.49
Total	**133,243.70**	**24,787.50**	**₱111,561.49**	**₱ 269,592.69**
Net Total	**₱1,020,325.50**	**₱199,525.00**	**₱ -**	**₱ 1,219,850.50**

---

[134] Exhibits "AAA-8.24" to "AAA-8.39".

Hence, the unsupported income payments in the amount of ₱269,592.69 shall be disallowed.

ii. Pension Costs – ₱1,511,382.31 and ₱698,268.89 (₱2,209,651.20)

Section 79(A) of the NIRC of 1997, as amended by RA No. 9504, as implemented by Section 2.79(A) of RR No. 2-98, as amended by RR No. 10-2008, mandates the withholding of tax on compensation, as follows:

> SEC. 79. *Income Tax Collected at Source.* –
>
> (A) *Requirement of Withholding.* – Except in the case of a minimum wage earner as defined in Section 22(HH) of this Code, **every employer making payment of wages shall deduct and withhold upon such wages a tax** determined in accordance with the rules and regulations to be prescribed by the Secretary of Finance, upon recommendation of the Commissioner. *(Emphasis supplied)*
>
> xxx xxx xxx
>
> Sec. 2.79. *Income Tax Collected at Source on Compensation Income.* –
>
> (A) *Requirement of Withholding.* – **Every employer must withhold from compensation paid** an amount computed in accordance with these Regulations. *Provided,* that no withholding of tax shall be required on the SMW, including holiday pay, overtime pay, night shift differential and hazard pay of MWEs in the private/public sectors as defined in these Regulations. *Provided, further,* that an employee who receives additional compensation such as commissions, honoraria, fringe benefits, benefits in excess of the allowable statutory amount of P30,000.00, taxable allowances and other taxable income other than the SMW, holiday pay, overtime pay, hazard pay and night shift differential pay shall not enjoy the privilege of being a MWE and, therefore, his/her entire earnings are not exempt from income tax and, consequently, shall be subject to withholding tax. *(Emphasis supplied)*

Clearly, from the foregoing law and regulations, the liability of the employer to withhold tax on its employees' compensation arises upon payment of the compensation and not upon mere accrual thereof.

The ₱2,209,651.20 being assessed by respondent pertains to the accrued pension cost or expense of petitioner for the year 2011. As disclosed under Note 18 of the AFS[135],

[135] BIR Records, Folder 1, pp. 257-258.

petitioner has a funded and defined benefit pension plan covering all of its regular employees. The accrual of pension cost amounting to ₱2,209,651.20 for the period ended December 31, 2011 was computed based on Actuarial Valuation Report as of March 31, 2011.[136]

However, as disclosed also in the same Note 18 of the AFS, the benefits paid out by petitioner during the year amounted to ₱2,819,752.00. Since the said amount has already been paid, the same should have been subjected to withholding tax.

In relation to the foregoing, Section 32(B)(6)(a) of the NIRC of 1997 provides:

> SEC. 32. *Gross Income.* –
>
> x x x
>
> (B) *Exclusions from Gross Income.* – xxx
>
> x x x
>
> (6) *Retirement Benefits, Pensions, Gratuities, etc.* –
>
> (a) Retirement benefits received under Republic Act No. 7641 and those received by officials and employees of private firms, whether individual or corporate, in accordance with a reasonable private benefit plan maintained by the employer: *Provided*, That the retiring official or employee has been in the service of the same employer for at least ten (10) years and is not less than fifty (50) years of age at the time of his retirement: *Provided, further*, That the benefits granted under this subparagraph shall be availed of by an official or employee only once. For purposes of this Subsection, the term *'reasonable private benefit plan'* means a pension, gratuity, stock bonus or profit-sharing plan maintained by an employer for the benefit of some or all of his officials or employees, wherein contributions are made by such employer for the officials or employees, or both, for the purpose of distributing to such officials and employees the earnings and principal of the fund thus accumulated, and wherein it is provided in said plan that at no time shall any part of the corpus or income of the fund be used for, or be diverted to, any purpose other than for the exclusive benefit of the said officials and employees.

It is noted that retirement benefits under a qualified private benefit plan within the contemplation of the afore-quoted provision of law shall not be included in gross income and shall be exempt from income tax and consequently from

---

[136] Exhibit "AAA-8.71".

the withholding tax prescribed in Section 79(A) of the NIRC of 1997, as amended.

However, under Section 2.78.1(B)(1)(a) of RR No. 2-98, in relation to Section 32(B)(6)(a) of the NIRC of 1997, in order to avail of the exemption with respect to retirement benefits, the following requirements must be met:

a) the plan must be reasonable;
b) the benefit plan must be approved by the Bureau;
c) the retiring official or employee must have been in the service of the same employer for at least ten (10) years and is not less than fifty (50) years of age at the time of retirement; and
d) the retiring official or employee should not have previously availed of the privilege under the retirement benefit plan of the same or another employer.

In the present case, there is no showing that petitioner secured the BIR approval of its retirement benefit plan. Consequently, all contributions or accruals pertaining to its retirement benefit plan shall not be excluded from taxable income but rather be subject to tax.

Accordingly, the Court finds that the assessment must be sustained, but only as much as the amount of ₱1,511,382.31[137] which petitioner declared as deductible expense per ITR.

iii. Security services – ₱628,800.77

As indicated in the ICPA Report[138], the security services pertain to payments to Glocke Security Systems Inc. for the reimbursement of salaries of security guards and agency fees. These security guards are not employees of petitioner, thus, their salaries are not subject to withholding tax on compensation.

Sections IV and V of RMC No. 39-07 dated January 22, 2007 clarify the tax treatment of the salaries of security

---

[137] ₱1,511,382.31 is included in the Salaries, Wages and Benefits of ₱27,204,966 declared as part of Cost of Services, see Schedule of Taxable Income and Deductible Expenses for the year ended December 31, 2011, attached to Exhibit "P-11", docket, vol. II, p. 1103.

[138] Par. 9.iv of Exhibit "P-20" (ICPA Report), p. 23.

guards which form part of the contract price of the security services rendered by a security agency, to wit:

> SUBJECT: Clarifying the Income Tax and VAT Treatment of Agency Fees/Gross Receipts of Security Agencies Including the Withholding of Taxes Due thereon.
>
> x x x
>
> IV. MANNER OF ISSUING RECEIPT FOR THE ENTIRE CONTRACT PRICE. –
>
> x x x
>
> With respect to the security guards' salaries which are mandated by law to be paid by the Client through the Security Agency, the amount so paid representing salaries must be covered by a Non-VAT Acknowledgement Receipt. This document, coupled with the notarized certification of the expanded withholding taxes prescribed in Paragraph V hereunder, shall be a sufficient substantiation for the expense that will be claimed as a deduction from gross income by the Client.
>
> V. WITHHOLDING TAX COMPLIANCE. –
>
> x x x
>
> Insofar as the Agency Fee is concerned, the Client is constituted as the withholding agent of the EWT following the rule above-mentioned. However, **with respect to the portion of the Contract Price representing the amount segregated and earmarked as salaries of the security guards, the Security Agency shall be the one responsible for the withholding of the tax on compensation income.** This is so because while it is the Client who claims the payment as an expense, it is the Security Agency who physically controls the payment to the salaries of the Security Guards. However, **in order to comply with the requirement for deductibility under Section 34 (K), in relation to Section 58 and 81, all of the National Internal Revenue Code, as amended, the Security Agency must furnish its Client, on or before January 31 of the year following the year of withholding, a Notarized Certification *(see Annex "A")* indicating the names of the guards employed by the Client, their respective TINs, the amount of their salaries and the amount of tax withheld from each. This certification together with the covering Non-VAT-acknowledgment Receipt must be kept on file by the Client as substantiation for the claim of the expense.** *(Emphasis supplied)*

Pursuant to the foregoing provisions of RMC No. 39-07, petitioner is mandated to withhold and remit EWT only on the agency fee, not on the salaries paid to the security guards, as it is the security agency which shall be responsible for the withholding of the tax on compensation income of the said security guards.

However, in order that the salaries may be claimed as deductible expense by petitioner, the same must be supported by a non-VAT acknowledgement receipt and a notarized certification issued by the security agency indicating the names of the guards employed by petitioner, their respective TINs, the amount of their salaries and the amount of tax withheld from each one.

Based on the examination of the supporting documents, the ICPA noted the following findings:

Particulars	Amount
Supported by Accounts Payable (AP) Invoice for Approval, Sales Invoices, Official Receipts and Acknowledgement Receipt	₱ 558,287.47
No Supporting Documents presented for examination	65,513.30
Supported by Journal Voucher (JV) only	5,000.00
Total	**₱628,800.77**

While petitioner submitted the AP Invoice for Approval, Sales and Billing Invoices, Acknowledgement and Official Receipts, as well as the Billing Summary,[139] purportedly supporting the amount of ₱558,287.47, the Court finds the same insufficient to warrant the cancellation of the assessment, as petitioner failed to provide the Court with the breakdown of such payment; and petitioner failed to present before the Court the notarized certification issued by the security agency, indicating the names of the guards employed by petitioner, their respective TINs, the amount of their salaries and the amount of tax withheld from each one, as required by RMC No. 39-07.

Verily, the security services amounting to ₱628,800.77 remain unsupported. Nevertheless, for income tax purposes, the Court finds that respondent has no basis in disallowing the same considering that it was not even claimed as deductible expense by petitioner in its ITR. Thus, the deficiency income tax thereon shall be cancelled.

---

[139] Exhibits "AAA-8.40" to "AAA-8.56".

iv. Training – ₱241,426.52

Based on the ICPA report, the training expenses pertain to payments for training and seminars attended by petitioner's employees. Hence, these are not salaries subject to withholding taxes.

Particulars	Amount
Supported by AP Invoice for Approval and Official Receipts	₱ 108,804.85
No Supporting Documents presented for examination	134,696.67
Supported by JV for the reversal of entry re: return of CA due to cancellation of training	(2,075.00)
Total	**₱241,426.52**

Upon further verification, this Court finds that only the amount of ₱101,541.22, as shown below, is duly supported by sufficient pieces of evidence proving that the same is not subject to withholding tax on compensation:

Name of the Payee/s	Nature	Exhibit No.	OR Date	OR No.	Other Attachments	Amount
Up Natural Sciences Research Institute	Training Fee	AAA-8.57	4/28/2011	2303584	Check# 358175 dated 4/18/2011; AP Invoice for approval dated 4/28/2011	₱ 10,000.00
Philippine Red Cross Olongapo Chapter	Training Fee	AAA-8.58	5/13/2011	938134	Check# 358216 dated 4/28/2011	10,200.00
Cleared, Inc.	Seminar	AAA-8.59	5/26/2011	38301	Check# 358337 dated 5/25/2011; AP Invoice for approval dated 5/26/2011	5,000.00
Neville Clarke Phils Inc	Training Fee	AAA-8.61	12/13/2011	20597	AP Invoice for approval dated 12/13/2011	9,000.00
Environmental Counselors Inc	Training Fee	AAA-8.62	6/28/2011	1917	Check# 358448 dated 6/20/2011; AP Invoice for approval dated 6/28/2011	6,900.00
Training Edge Inc	Seminar	AAA-8.63	6/30/2011	765	Check# 358494 dated 6/28/2011; AP Invoice for approval dated 6/30/2011	28,061.22
Cleared, Inc.	Seminar-Workshop	AAA-8.64	9/14/2011	38609	Check# 392085 dated 9/8/2011; AP Invoice for approval dated 9/14/2011	6,000.00
Punongbayan And Araullo	Seminar	AAA-8.65	9/7/2011	125233	Check# 392063 dated 9/2/2011	7,500.00

Trust International Paper Corporation	Training Fee	AAA-8.66	11/17/2011	65480	Check# 392239 dated 10/14/2011; AP Invoice for approval dated 11/15/2011	4,000.00
Kairos Management Technologies	Seminar/ Training	AAA-8.67	10/20/2011	3271	Check# 392256 dated 11/20/2011	7,500.00
European Innovation, Technology And Science Center Foundation	Training Fee	AAA-8.68	11/21/2011	115	Check# 392475 dated 11/15/2011; AP Invoice for approval dated 11/21/2011; Request for Payment	7,380.00
Total						**₱101,541.22**

Therefore, only the amount of ₱101,541.22 shall be allowed as deduction from gross income, while the remaining amount of ₱139,885.30 shall be disallowed.

Nevertheless, for income tax purposes, this Court finds that respondent has no basis in disallowing the same considering that it was not even claimed as deductible expense by petitioner in its ITR. Thus, the deficiency income tax thereon shall be cancelled.

In sum, the total salaries and wages that should be disallowed due to failure to withhold amount to ₱3,027,306.65, computed as follows:

SSS, Medicare and HDMF Contributions	₱ 269,592.69
Pension Cost	1,511,382.31
Unaccounted Difference	1,246,331.65
Total Disallowed Salaries and Wages	**₱3,027,306.65**

IT-11. Unsupported Creditable Withholding Tax – ₱25,626.72

Petitioner claimed in its Annual ITR, creditable withholding taxes (CWT) in the amount of ₱43,229.12. However, upon vouching of the Certificates of Taxes Withheld (BIR Form No. 2307), the BIR found that the CWT claimed amounting to ₱25,626.72 was unsupported with actual CWT returns, thus, disallowed as tax credit pursuant to Section 2.58.3(B) of RR No. 2-98, as amended.[140]

[140] Details of Discrepancies, Exhibit "P-9".

Recon on CWT Certificates	
Claimed per ITR	₱ 43,229.12
Per Actual Certificates	17,602.40
Unsupported CWT	**₱ 25,626.72**

Records show that petitioner did not present before the Court the certificates supporting the discrepancy noted by the BIR, hence, this part of assessment shall remain.

In summary, petitioner is liable to pay the deficiency income tax subject to special rate of 5% and regular rate of 30% in the amounts of ₱248,049.62 and ₱7,177,820.67, respectively, re-computed as follows:

Income subject to income tax per return		**Special Rate (5%)**	**Regular Rate (30%)**
		₱ 202,581,077.00	
Add: Adjustments per audit			
IT-1 Undeclared Income due to discrepancy on Other Income – Credits per GL vs. AFS/ITR			
A. Sale of Scrap Materials		(2,240,000.00)	₱ 2,240,000.00
B. Sale to NRFC		(654,574.32)	654,574.32
C. Proceeds from Retirement Insurance		(3,215,500.00)	3,215,500.00
IT-5 Construction Revenue not subjected to Income Tax			17,815,994.58
IT-6 Disallowed expenses in excess of the amounts allowable pursuant to RR 13-2005		6,245,754.85	
IT-8 Disallowed expenses/purchases for being unsupported		44,340.60	
IT-9 Disallowed Purchases/Expenses due to failure to withhold		1,241,129.01	
IT-10 Disallowed Salaries Expense due to failure to withhold		3,027,306.65	
Total Taxable Income per Audit		**₱207,029,533.79**	**₱23,926,068.90**
Income Tax Rate		5%	30%
Total Income Tax Due		**₱ 10,351,476.69**	**₱ 7,177,820.67**
Less: Allowable Credits/Payments			
Payments (3% to National)	₱ 6,034,202.73		
Payments (2% to SBMA)[141]	4,051,621.94		
Creditable Withholding tax claimed per ITR	43,229.12		
Less: IT 11 Unsupported Creditable Withholding Tax	(25,626.72)	10,103,427.07	
Basic Deficiency Income Tax		**₱ 248,049.62**	**₱ 7,177,820.67**

[141] Exhibits "P-10.1-.1" to "P-10.1.3".

However, in light of the payment made by petitioner on May 29, 2015, the said payment shall accordingly be deducted from petitioner's total deficiency income tax. Consequently, the basic deficiency income tax subject to special rate of 5% shall be cancelled, based on the following computation:

	Deficiency Income Tax	**Less: Payment on May 29, 2015**[142]	**Remaining Balance**
Basic Deficiency Income Tax at Special Rate (5%)	₱ 248,049.62	₱ 1,267,105.64	₱ (1,019,056.02)
Surcharge (25%)	62,012.41		62,012.41
Deficiency Interest (20%) from April 16, 2012 to May 20, 2015 (₱248,049.62 x 20% x 1,130 days/ 365 days)	153,586.89	790,812.78	(637,225.89)
Total Amount Due, May 20, 2015	**₱463,648.92**		
Deficiency Interest (20%) from May 21, 2015 until payment on May 29, 2015 (₱248,049.62 x 20% x 9 days/ 365 days)	1,223.26		1,223.26
Compromise Penalty		50,000.00	(50,000.00)
Total Amount Due, May 29, 2015	**₱464,872.18**	**₱2,107,918.42**	**₱(1,643,046.24)**

On the other hand, petitioner shall still be liable to pay the deficiency income tax subject to 30%, the details of which shall be reflected in the dispositive portion.

II. Value-added Tax (VAT) – ₱81,943,121.59

Respondent assessed petitioner of deficiency VAT amounting to ₱81,943,121.59, computed as follows:

Total Collection per Books/Sales per ITR		**₱ 355,085,514.00**
Less: Collection from Services Rendered within Subic Bay Freeport (Excl. Domestic)		97,220,968.56
Vatable Collection/Sales (Services Rendered outside Subic Bay Freeport)		257,864,545.44
Add: Adjustments per Audit		
Discrepancies		
VT-1 Undeclared Income due to discrepancy on Other Income - Credits per GL vs. FS/ITR	₱ 7,662,613.62	
VT-3 Undeclared Income due to unaccounted expenses/purchases based on tracing of CV Register to TB to AFS	7,326,148.13	
VT-4 Undeclared Income due to unaccounted expenses/purchases based on vouching of Check Vouchers	332,659.38	

---

[142] Exhibit "P-10.1.4".

VT-5 Construction Revenue not subjected to Income Tax	41,714,427.00	
VT-5.1 No supporting documents presented for examination		
Total Adjustments per Audit		57,035,848.13
Total Vatable Sales per Audit		314,900,393.57
Multiplied by VAT Rate		12%
BASIC DEFICIENCY VALUE-ADDED TAX		**₱ 37,788,047.23**
Add: Penalties		
50% Surcharge	18,894,023.61	
Interest on Basic Deficiency Tax until 05/29/2015	₱25,261,050.75	
Compromise Penalty	-	44,155,074.36
DEFICIENCY VALUED-ADDED TAX PAYABLE		**₱ 81,943,121.59**

Perforce, the deficiency VAT assessment arose from the following:

Vatable Collection/Sales (Services Rendered outside Subic Bay Freeport)	₱ 257,864,545.44
VT-1 Undeclared Income due to discrepancy on Other Income - Credits per GL vs. FS/ITR	7,662,613.62
VT-3 Undeclared Income due to unaccounted expenses/purchases based on tracing of CV Register to TB to AFS	7,326,148.13
VT-4 Undeclared Income due to unaccounted expenses/purchases based on vouching of Check Vouchers	332,659.38
VT-5 Construction Revenue not subjected to Income Tax	₱41,714,427.00

The above-listed VAT issues (VT-1, VT-3, VT-4, and VT-5) are related to the under-declaration of income as discussed under item "I. Income Tax (IT)". The alleged under-declared income was subjected by respondent to VAT pursuant to Section 108 of the NIRC of 1997.

VATable Collection/Sales (Services Rendered outside Subic Bay Freeport) – ₱257,864,545.44

Per FDDA, the amount of ₱257,864,545.44 represents petitioner's income derived from Olongapo City which respondent treated as outside the Subic Bay Freeport Zone. Consequently, respondent treated the same as income from within the Customs Territory, thus, subject to VAT.

Based on records[143], the amount of ₱257,864,545.44 pertains to the following sales of petitioner:

A. City	
Domestic	₱ 189,641,808.46
Industrial/Commercial	39,306,226.31
Institutional	11,114,798.82
Shipping	213,428.38
Total	**₱ 240,276,261.97**
B. Freeport	
Domestic	17,588,782.97
Sub-total	**₱ 17,588,782.97**
Total	**₱257,865,044.94**[144]

As discussed earlier, petitioner's income generated from Olongapo City is considered income generated within the Subic Special Economic Zone, for purposes of determining whether petitioner's income generated from sources outside the Subic Special Economic Zone or within the Customs Territory exceeded the 30% threshold.

Consequently, the VAT assessment pertaining thereto shall be cancelled.

VT-1 Undeclared income due to discrepancy on Other Income-Credits per GL vs. per AFS/ITR – ₱7,662,613.62

This assessment was based on the same finding under the deficiency income tax assessment *(IT-1)* pertaining to the following items:

Classification	Amounts
A. Sale of Scrap Materials	₱ 2,240,000.00
B. Sale to Non-Resident Foreign Corporation (NRFC)	654,574.32
C. Proceeds from Retirement Insurance	3,215,500.00
D. To amortize deferred credits based on a straight line-IFRIC 12 adjustment	1,552,539.30
Total Credits per GL	**₱ 7,662,613.62**

As previously discussed, petitioner had undeclared income pertaining to items A, B and C with a total amount of ₱6,110,074.32, to wit:

---

[143] Exhibit "R-8".
[144] With unexplained discrepancy of ₱499.50.

Particulars	Amount
A. Sale of Scrap Materials	₱ 2,240,000.00
B. Sale to Non-Resident Foreign Corporation (NRFC)	654,574.32
C. Proceeds from Retirement Insurance	3,215,500.00
Total Undeclared Income	**₱ 6,110,074.32**

Consequently, the same shall be subject to VAT.

VT-3 Undeclared income due to unaccounted expenses/purchases based on tracing of CV register to TB to AFS – ₱7,326,148.13

VT-4 Undeclared income due to unaccounted expenses/purchases based on vouching of Check Vouchers – ₱332,659.38

As discussed under IT-3 and IT-4, the assessment lacks factual basis because it was based on a mere presumption that since there were alleged unaccounted expenses, there must be a corresponding undeclared income. Even if these alleged unaccounted expenses are to be considered as income subject to output VAT, the same will be offset by treating the equivalent payments as purchases for which input tax credits may be claimed. Hence, no VATable income will result from the said transactions. Accordingly, the deficiency VAT assessment on these items shall be cancelled.

VT-5 Construction Revenue – ₱41,714,427.00

As discussed under IT-5 (Construction Revenue not subjected to Income Tax - ₱41,714,427.00), petitioner shall be liable for deficiency VAT on the unsupported construction cost resulting in undeclared construction revenue in the amount of ₱17,815,994.58.

In sum, the Court finds that the basic deficiency VAT must be reduced to ₱2,871,128.27:

VT-1 Undeclared Income due to discrepancy on Other Income - Credits per GL vs. AFS/ITR	₱ 6,110,074.32
VT-5 Construction Revenue not subjected to Income Tax	17,815,994.58

Total Undeclared Income subject to VAT	23,926,068.90
Multiplied by VAT Rate	12%
BASIC DEFICIENCY VALUE-ADDED TAX	**₱2,871,128.27**

III. Withholding Tax on Compensation (WTC) – ₱1,570,788.25

As stated in the FDDA, respondent's verification disclosed that petitioner failed to pay the corresponding withholding tax on compensation/salaries expense claimed in the audited FS, pursuant to Section 80(A) of the NIRC of 1997, in the amount of ₱1,570,788.25, computed as follows:

Salaries/Compensation Expense		
Per FS		₱ 40,161,362.00
Per Alphalist		34,345,708.67
Salaries/Compensation Expense subject to W/Tax		₱ 5,815,653.33
Tax Rate		12.4241%
Basic Deficiency Tax		**₱ 722,542.80**
Add: Increments		
50% Surcharge	₱ 361,271.40	
Interest - Until 05/29/2015	486,974.05	
Compromise Penalty		848,245.45
Deficiency Withholding Tax on Compensation		**₱ 1,570,788.24**

As earlier discussed under "I. Income Tax (IT)" *(item IT-10)*, the Court finds that the total salaries and wages not subjected to withholding amount to ₱4,494,261.61, computed below:

SSS, Medicare and HDMF Contributions	₱ 269,592.69
Pension Cost	2,209,651.20
Security Services	628,800.77
Training	139,885.30
Unaccounted Difference	1,246,331.65
Total Salaries and Wages not subjected to WT	**₱4,494,261.61**

Accordingly, the corresponding basic deficiency withholding tax on compensation shall be upheld but in the reduced amount of ₱558,371.56, computed as follows:

Salaries and Wages not subjected to withholding tax	₱4,494,261.61
Tax Rate	12.4241%
Basic Deficiency Withholding Tax on Compensation	**₱558,371.56**

However, in light of the full payment by petitioner of the deficiency withholding taxes on compensation in the total amount of ₱1,570,788.25, including interest and surcharges [145] on May 29, 2015, the same shall be cancelled.

IV. Expanded Withholding Tax (EWT) – ₱294,213.22

Respondent assessed petitioner of deficiency expanded withholding tax in the amount of ₱294,213.22, pursuant to RR No. 2-98, as amended, detailed as follows:

Supplier's Name	Income Payment	EWT Rate	EWT Due
Samasa Maintenance Services	₱ 19,500.00	2%	₱ 390.00
Aurora M. Ramos	18,242.81	15%	2,736.42
Avelinda G. Esma	126,369.19	15%	18,955.38
Mariquit C. Sunga	8,399.66	10%	839.97
Subic Bay Freeport Chamber of Commerce	5,000.00	2%	100.00
Fairclough, Graham J	20,000.00	25%	5,000.00
Crizaldy Duka	41,000.00	15%	6,150.00
Efren Amoguis	12,000.00	10%	1,200.00
Jardine Lloyd Thompson Insurance Brokers Inc	88,183.79	2%	1,763.68
Jimmy Mamolo	5,000.00	10%	500.00
Juanito P. Rellora	10,000.00	10%	1,000.00
Landbank Insurance Brokerage Inc	265,850.35	2%	5,317.01
Oilver Josafat	23,463.38	15%	3,519.51
Pahayagang Pang Masa	5,000.00	2%	100.00
Petron Corporation	2,400.18	1%	24.00
Philippine Institute of Certified Public Accountants	6,000.00	2%	120.00
Philippine Water Works Association, Inc.	6,000.00	2%	120.00
Ricky T. Romano	159,300.00	15%	23,895.00
Ridon S St Jude Medical Center	500.00	10%	50.00
Small Enterprises Research and Development Foundation, Inc	9,500.00	2%	190.00
Trade Union Congress of the Philippines Subic District Office	5,000.00	2%	100.00
Zambales II Electric Cooperative, Inc.	3,154,653.66	2%	63,093.07
Total	**₱ 3,991,363.02**		**₱ 135,164.03**
Add: Surcharge			67,582.02
Interest			91,467.17
Total Deficiency Expanded Withholding Tax			**₱ 294,213.22**

As earlier discussed under "I. Income Tax (IT)" *(item IT-9)*, petitioner failed to prove that the income payments amounting ₱1,241,129.01 are not subject and/or exempted to EWT. Accordingly, petitioner shall be held liable for the

[145] Exhibit "P-10.1.6". *ar*

corresponding basic deficiency EWT, in the amount of ₱75,159.35 (for income payments amounting to ₱1,221,129.01[146]), as detailed below:

Supplier's Name	Income Payment	EWT Rate	EWT Due
Samasa Maintenance Services	₱ 19,500.00	2%	₱ 390.00
Aurora M. Ramos	18,242.81	15%	2,736.42
Avelinda G. Esma	126,369.19	15%	18,955.38
Mariquit C. Sunga	8,399.66	10%	839.97
Subic Bay Freeport Chamber of Commerce	5,000.00	2%	100.00
Crizaldy Duka	41,000.00	15%	6,150.00
Efren Amoguis	12,000.00	10%	1,200.00
Jardine Lloyd Thompson Insurance Brokers Inc	88,183.79	2%	1,763.68
Jimmy Mamolo	5,000.00	10%	500.00
Juanito P. Rellora	10,000.00	10%	1,000.00
Landbank Insurance Brokerage Inc	265,850.35	2%	5,317.01
Oilver Josafat	23,463.38	15%	3,519.51
Pahayagang Pang Masa	5,000.00	2%	100.00
Petron Corporation	2,400.18	1%	24.00
Philippine Institute of Certified Public Accountants	6,000.00	2%	120.00
Philippine Water Works Association, Inc.	6,000.00	2%	120.00
Ricky T. Romano	159,300.00	15%	23,895.00
Ridon S St Jude Medical Center	500.00	10%	50.00
Small Enterprises Research and Development Foundation, Inc	9,500.00	2%	190.00
Trade Union Congress of the Philippines Subic District Office	5,000.00	2%	100.00
Zambales II Electric Cooperative, Inc.	404,419.65	2%	8,088.39
Total Deficiency Expanded Withholding Tax	**₱ 1,221,129.01**		**₱75,159.35**

However, in light of the full payment by petitioner of the deficiency expanded withholding taxes in the total amount of ₱294,213.22, including interest and surcharges[147] on May 29, 2015, the same shall be cancelled.

V. Final Withholding VAT (FWVAT) – ₱20,722,434.59

Respondent's verification disclosed that petitioner failed to withhold on the following income payments to NRFC and Non-Resident Alien for services rendered within the

[146] The payment to Fairclogh, Graham J. in the amount of 20,000.00 was excluded as the same is subject to FWT, not EWT.
[147] Exhibit "P-10.1.7".

Philippines, in violation of Section 4.114-2(b)(3) of RR No. 16-2005 and Section 7 of RR No. 14-2002:[148]

Payments Made To	CV Register
A. Sembcorp Utilities Services Ltd	₱ 9,061,009.91
B. Cascal Services Ltd	55,793,327.40
C. Sembcorp Utilities (Netherlands) NV	14,781,717.60
D. Fairclough, Graham J	180,000.00
Total	**₱79,816,054.91**

Thus, respondent assessed petitioner of the corresponding deficiency FWVAT in the amount of ₱20,722,434.59, computed as follows:[149]

Income Payments to NRFC	₱ 79,816,054.91
FWVAT	9,577,926.59
Add: Increments	
50% Surcharge	4,788,963.29
Interest until 05/15/2015	6,355,544.71
Total Deficiency Final Withholding VAT	**₱ 20,722,434.59**

A. Payments made to Sembcorp Utilities Services Ltd. – ₱9,061,009.91

According to petitioner, the payments made to SEMBCORP Utilities Services Ltd. (SEMBCORP) in the amount of ₱9,061,009.91 refer to specialized financial and engineering services and offshore support in relation to petitioner's operational and management responsibilities under its Franchise Agreement with SBMA.

Petitioner founded its claim on the provision under RMC 50-2007 which states that the Philippine VAT Law adheres to the "cross border doctrine" of the VAT system, which basically means that no VAT shall be imposed to form part of the cost of goods destined for consumption outside the territorial border of the Philippine taxing authority. As such, the income payments to SEMBCORP for services rendered outside the Philippine tax jurisdiction should not be subjected to final withholding VAT.

---
[148] Details of Discrepancies, Exhibit "P-9".
[149] Exhibit "P-9". *cm*

This Court finds merit in petitioner's claim.

It bears stressing that the VAT imposed under Section 108 of the NIRC of 1997, as amended, applies only to services performed in the Philippines and not to services rendered outside the Philippines.

According to the Destination Principle, goods and services are taxed only in the country where these are consumed.[150] In connection with the said principle, the "Cross Border Doctrine" mandates that no VAT shall be imposed to form part of the cost of the goods destined for consumption outside the territorial border of the taxing authority.[151]

Relative thereto, pursuant to Sections 12 and 15 of RA No. 7227, as amended by RA No. 9400, Subic Bay Freeport (SBF), operating within the Subic Special Economic and Freeport Zone (SSEFZ), is operated and managed as separate custom territory and as such, by legal fiction, is regarded as foreign territory. As held by the Supreme Court, this legal fiction is necessary to give meaningful effect to the policies of the special law creating the said freeport zone.[152]

Further, in the case of *Coconut Oil Refiners Association, Inc., et al. vs. Hon. Ruben Torres, et al.*[153], the Supreme Court quoted the Senate discussion of the concept of *"special economic zone"*, to wit:

> The records of the Senate containing the discussion of the concept of "special economic zone" in Section 12 (a) of Republic Act No. 7227 show the legislative intent that consumer goods entering the SSEZ **which satisfy the needs of the zone and are consumed there** are not subject to duties and taxes in accordance with Philippine laws, thus:
>
> x x x
>
> Senator Enrile. *For as long as the goods remain within the zone, whether we call it an economic zone or a free port, for as long as we say in this law that all goods entering this particular territory will be duty-free and tax-free, for as long as they remain*

---

[150] *Commissioner of Internal Revenue vs. Seagate Technology (Philippines),* G.R. No. 153866, February 11, 2005.

[151] *Atlas Consolidated Mining and Development Corporation vs. Commissioner of Internal Revenue,* G.R. Nos. 141104 and 148763, June 8, 2007.

[152] *Commissioner of Internal Revenue vs. Seagate Technology (Philippines),* G.R. No. 153866, February 11, 2005 and *Commissioner of Internal Revenue vs. Toshiba Information Equipment (Phils.), Inc.,* G.R. No. 150154, August 9, 2005.

[153] G.R. No. 132527, July 29, 2005.

> *there, consumed there or reexported or destroyed in that place, then they are not subject to the duties and taxes in accordance with the laws of the Philippines?*
>
> Senator Guingona. *Yes.*

Simply put, the services rendered by SEMBCORP within the SSEFZ shall be regarded as services outside the custom territory. As such, the same is beyond the taxing jurisdiction of the Philippine taxing authority or the BIR.

In support of the said payment amounting to ₱9,061,009.91, petitioner submitted in evidence the invoices issued by SEMBCORP as well as its Application to Purchase Foreign Exchange and the Telegraphic Transfer[154] of its payment. Upon verification, the Court finds that, indeed, petitioner's payment for services rendered by SEMBCORP were performed outside the custom territory, thus, not subject to FWVAT.

B. Payments made to Cascal Services Ltd. – ₱55,793,327.40

C. Payments made to Sembcorp Utilities (Netherlands) NV – ₱14,781,717.60

According to petitioner, the payments made to CASCAL Services Ltd. in the amount of ₱55,793,327.40 and SEMBCORP Utilities (Netherland) NV in the amount of ₱14,781,717.60 pertain to payment of cash dividends. Petitioner asserts that these payments of cash dividends are not subject to 12% Final Withholding VAT.

This Court agrees with petitioner.

As indicated in its Secretary's Certificates dated June 17, 2011[155] and December 8, 2011[156], petitioner resolved to declare and distribute cash dividends to its stockholders. Such cash dividends are not subject to 12% Final Withholding VAT. Foremost, VAT is a form of sales tax. It is a tax on consumption levied on the sale, barter, exchange or lease of

---

[154] Exhibits "AAA-9.1" to "AAA-9.3".
[155] Exhibit "P-15.1".
[156] Exhibit "P-15.2".

goods or properties and services in the Philippines and on importation of goods into the Philippines.

Accordingly, attention should be drawn to the statutory definition of what constitutes "dividends". Pursuant to Section 73(A) of the NIRC of 1997, as amended, "[t]he term 'dividends' xxx means any distribution made by a corporation to its shareholders out of its earnings or profits and payable to its shareholders, whether in money or in other property."

Based on the foregoing, the amounts distributed by petitioner among its stockholders are outside the scope of VAT as they do not represent consideration for any sale, barter, exchange or lease of goods or properties and services, but rather, as payment out of its earnings or profit.

Consequently, the FWVAT assessment pertaining thereto shall be cancelled.

D. Payments made to Fairclough, Graham J – ₱180,000.00

According to petitioner, the payments to Fairclough, Graham J, pertain to payment of per diem for attending board meeting with SWSCI.[157] These payments are not subject to 12% Final Withholding VAT consistent with the "cross border doctrine".

Again, this Court agrees.

As earlier discussed, petitioner is registered with the Subic Bay Freeport operating within the Subic Special Economic and Freeport Zone, which is operated and managed as separate custom territory and as such, by legal fiction, is regarded as foreign territory. Considering that it is beyond the taxing jurisdiction of the Philippine taxing authority or the BIR, the management fees for services rendered by Fairclough, Graham J outside the custom territory cannot be imposed with FWVAT.

---

[157] Exhibits "AAA-9.7" to "AAA-9.13".

VI. Final Withholding Tax (FWT) – ₱5,272,021.41

Respondent's verification disclosed that petitioner had income payments to NRFC and Non-Resident Alien, which petitioner failed to subject to final withholding tax pursuant to Section 28(B) and Section 25(B) of the NIRC of 1997 and RR No. 2-1998, as amended, to wit:

Payments Made To	CV Register	Final Tax Base	Discrepancy	Rate	FWT Due
Sembcorp Utilities Services Ltd	₱9,061,009.91	-	₱9,061,009.91	0.30	₱ 2,718,302.97
Cascal Services Ltd	55,793,327.40	₱55,793,327.40	-		-
Sembcorp Utilities (Netherlands) NV	14,781,717.60	14,781,717.60	-		-
Fairclough, Graham J	180,000.00	160,000.00	20,000.00	0.25	5,000.00
Total					**₱2,723,302.97**
Add: Increments					
25% Surcharge					680,825.74
Interest until 5/29/2015					1,842,892.70
Compromise Penalty					25,000.00
Deficiency Final tax					**₱5,272,021.41**

A. Payments made to Sembcorp Utilities Services Ltd. – ₱9,061,009.91

As mentioned earlier, petitioner avers that the payments made to SEMBCORP Utilities Services Ltd. in the amount of ₱9,061,009.91 refer to specialized financial and engineering services and offshore support services in relation to petitioner's operational and management responsibilities under its Franchise Agreement with SBMA.

Petitioner is of the view that payments made to this entity are not subject to Philippine tax pursuant to the Republic of the Philippines – United Kingdom (RP-UK) Tax Treaty. According to petitioner, SEMBCORP is a UK tax resident and has no permanent establishment in the Philippines. Consequently, its income is not subject to final tax.

This Court rules otherwise.

Article 7(1) of the Convention Between the Government of the Republic of the Philippines and the Government of the

United Kingdom of Great Britain and Northern Ireland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital Gains (RP-UK Tax Treaty) provides that profits derived by an enterprise of the United Kingdom (UK) may be taxed in the Philippines if the profits are attributable to a permanent establishment of the enterprise situated in the Philippines, to wit:

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 directly or indirectly attributable to that permanent establishment. (*Emphasis supplied*)

Relative thereto, Article 5 of the RP-UK Tax Treaty defines a permanent establishment as follows:

ARTICLE 5

Permanent Establishment

1. For the purposes of this Convention, the term "permanent establishment" means a fixed place of business in which the business of the enterprise is wholly and partly carried on.

2. The term "permanent establishment" shall include especially;

(a) a place of management;

(b) a branch;

(c) an office;

(d) a factory;

(e) a workshop;

(f) a mine, oil well, quarry or other place of extraction of natural resources;

(g) an installation or structure used for the exploration of natural resources;

(h) a building site or construction or assembly project which exists for more than 183 days.

3. An enterprise of a Contracting State shall likewise be deemed to have a permanent establishment in the other Contracting State if:

(a) it carries on supervisory activities within that other Contracting States for more than 183 days in connection with a building site, or a construction or assembly project which is being undertaken, in that other Contracting State; or

(b) **it furnishes services, including consultancy services, in that other Contracting State through its employees or other personnel** (other than agents of an independent status within the meaning of paragraph (7) of this Article) **for a period exceeding in the aggregate 183 days within any twelve-month period**. (*Emphasis supplied*)

In the Management Services Agreement[158] dated March 27, 2006 executed between petitioner and Cascal Services Limited (CSL), CSL agreed to provide Specialized Financial and Engineering Services and Offshore Support Services in connection with petitioner's operational and management responsibilities under the Franchise Agreement.

Based on the Certificate of Incorporation on Change of Name[159] dated November 8, 2010, Cascal Services Limited changed its name to SEMBCORP Utilities Services Limited.

However, the Court noted that petitioner did not present in evidence any certification issued by the taxing authority of the UK stating that SEMBCORP Utilities Services Ltd. is a resident of such country for purposes of the tax treaty being invoked as proof of its residency. Likewise, the Articles of Incorporation (or its equivalent) of SEMBCORP Utilities Services Ltd. was not presented in evidence.

To prove that CSL/SEMBCORP Utilities Services Ltd. has no branch or is not registered to engage in business in the Philippines, petitioner presented the Securities and Exchange Commission (SEC) Certificate of Withdrawal of License of a Foreign Corporation of Cascal Services Limited[160] dated May

---

158 Exhibit "P-17"; Exhibit "AAA-9.14".
159 Exhibit "AAA-9.15".
160 Exhibit "AAA-9.15".

31, 2011 and SEC Certification of Non-Registration of Company[161] of SEMBCORP Utilities Services Ltd.

Nonetheless, under Article 5 of the RP-UK Tax Treaty quoted earlier, a permanent establishment is not limited to having a branch or office in the Philippines. It also includes the furnishing of services, including consultancy services, in the Philippines by an enterprise of the UK (through employees or other personnel thereof) for a period exceeding an aggregate of 183 days within any twelve-month period.

In this case, petitioner's witness, Ms. Edna Canlas, testified as follows:

> 159. Q: You also mentioned Respondent erroneously found SWSCI liable for Final Income Tax. What is your basis?
>
> A: The amount assessed pertained to payments of consultancy services to Sembcorp Utilities Services, Ltd. (formerly Cascal Services Limited), a tax resident of United Kingdom. **The consultancy services were rendered by Sembcorp Utilities Services, Ltd. abroad and its representative only came to the Philippines for the purpose of attending board meetings of SWSCI, which did not exceed forty (40) days within any twelve (12) month period.**
>
> Hence, the foregoing payment is exempt from Philippine income tax pursuant to Article (VII)(1) of the Republic of the Philippines – United Kingdom Tax Treaty. It has no permanent establishment in the Philippines. On 8 February 2010, SWSCI, through its counsel, filed a tax treaty relief application ("TTRA") with the International Tax Affairs Division ("ITAD") of the BIR requesting for confirmation that fees paid to Cascal Services Limited (now Sembcorp Utilities Services, Ltd), is exempt from Philippine taxes.[162] (*Emphasis supplied*)

However, aside from the above testimony, petitioner did not present any evidence to substantiate such claim, such as the passport of the employees concerned showing the dates of arrival in and departure from the Philippines.

---

[161] Exhibit "P-16".

[162] Q/A159, Amended Judicial Affidavit of Ms. Edna G. Canlas, docket (vol. V), pp. 2407-2408.

From the foregoing, there is no sufficient evidence to prove that SEMBCORP Utilities Services Ltd. is a non-resident foreign corporation which is a tax resident of the UK and that it has no permanent establishment in the Philippines.

Consequently, the assessment pertaining thereto shall be upheld.

B. Payments made to Fairclough, Graham J – ₱20,000.00

Records show that as member of the Board, Fairclough, Graham J received per diem from petitioner in the amount of ₱180,000.00.[163] However, only the amount of ₱160,000.00 was subjected to FWT. As a consequence, the discrepancy of ₱20,000.00 shall be subject to deficiency FWT.

To recapitulate, the deficiency FWT assessment issued by respondent is upheld. Accordingly, petitioner shall be liable to pay the amount of ₱2,723,302.97, as computed below:

Payments Made To	**Tax Base**	**Tax Rate**	**Final Withholding Tax Due**
Sembcorp Utilities Services Ltd	₱9,061,009.91	30%	₱ 2,718,302.97
Fairclough, Graham J	₱ 20,000.00	25%	5,000.00
Total Deficiency Final Withholding Tax			**₱ 2,723,302.97**

This Court also notes that petitioner filed and paid on May 29, 2015 via eFPS the Final Tax amounting to ₱34,370.55 including interest, surcharge and compromise penalties per BIR Tax Payment Details Acknowledgement No. ELY05292015000951042 on income payment made to Fairclough, Graham J. amounting to ₱20,000.00.[164] Accordingly, the same shall be deducted from petitioner's total deficiency FWT due (to be reflected in the dispositive portion).

VII. Compromise Penalties – ₱75,000.00

Respondent imposed compromise penalty in the total amount of ₱75,000.00 against petitioner for its failure to file and/or pay an internal revenue tax at the time or times

---

[163] Exhibits "AAA-9.7" to "AAA-9.13".
[164] Exhibit "P-10.1.8". cm

required by law or regulation pursuant to Section 255 of the Tax Code, as amended, as determined using the schedule of suggested compromise penalties prescribed under Revenue Memorandum Order (RMO) No. 19-2007, broken down as follows:[165]

Income Tax	₱ 50,000.00
Final Withholding Tax	25,000.00
Total Compromise Penalties	**₱ 75,000.00**

It must be stressed that a compromise penalty is imposed to avoid prosecution for violation of the provisions of the Tax Code.[166] Under RMO No. 01-90, as amended by RMO No. 19-2007, compromise penalties are only amounts suggested in settlement of criminal liability, and may not be imposed or exacted on the taxpayer in the event that a taxpayer refuses to pay the same. Absent a showing that petitioner consented to the compromise penalty, its imposition should be deleted. The imposition of the same without the conformity of the taxpayer is illegal and unauthorized.[167]

Since there is nothing in the records which would show that petitioner consented to the compromise penalty, the amount of suggested compromise penalties of ₱75,000.00 cannot be sustained.

WHEREFORE, premises considered, the instant Petition for Review is **PARTIALLY GRANTED**. Consequently, the assessments issued by respondent against petitioner for the period April 1, 2011 to December 31, 2011 covering deficiency income tax subject to special rate of 5%, FWVAT, WTC, and EWT, including the imposition of compromise penalties are **CANCELLED** and **SET ASIDE**.

On the other hand, the deficiency income tax subject to regular rate of 30%, VAT and FWT assessments are **AFFIRMED but with MODIFICATION**. Accordingly, petitioner is **ORDERED TO PAY** respondent the amount of **₱22,062,463.26**, **₱9,876,075.45** and **₱9,347,043.20**, representing basic deficiency IT, VAT and FWT, respectively, inclusive of the 25% surcharge, 20% deficiency interest and

[165] Exhibit "P-9".
[166] *The Philippines International Fair, Inc. vs. The Collector of Internal Revenue, et al.*, G.R. Nos. L-12928 and L-12932, March 31, 1962.
[167] *Commissioner of Internal Revenue vs. Lianga Bay Logging Co., Inc., et al.*, G.R. No. L-35266, January 21, 1991.

20% delinquency interest imposed thereon under Sections 248(A)(3), 249(B) and (C) of the NIRC of 1997, as amended, respectively, computed until December 31, 2017, as determined below:

	Deficiency Income Tax	**Less: Payment on May 29, 2015**[168]	**Remaining Balance**
Basic Deficiency Income Tax at Regular Rate (30%)	₱ 7,177,820.67	₱ 723,643.58	₱ 6,454,177.09
Surcharge (25%)	1,794,455.17		1,794,455.17
Deficiency Interest (20%) from April 16, 2012 to May 20, 2015 (₱7,177,820.67 x 20% x 1,130 days/365 days)	4,444,349.24	451,632.90	3,992,716.34
Total Amount Due, May 20, 2015	**₱13,416,625.08**		
Deficiency Interest (20%) from May 21, 2015 until payment on May 29, 2015 (₱7,177,820.67 x 20% x 9 days/365 days)	35,397.47		35,397.47
Total Amount Due, May 29, 2015	**₱13,452,022.55**	**₱1,175,276.48**	**₱12,276,746.07**
Deficiency Interest (20%) from May 30, 2015 to December 31, 2017 (₱6,454,177.09 x 20% x 947 days/365 days)			3,349,099.02
Delinquency Interest (20%)			
from May 21, 2015 until payment on May 29, 2015 (₱13,416,625.08 x 20% x 9 days/365 days)			66,164.18
from May 30, 2015 until December 31, 2017 (₱12,276,746.07 x 20% x 947 days/365 days)			6,370,453.99
Total Deficiency Income Tax Due as of December 31, 2017			**₱22,062,463.26**

	Deficiency VAT
Basic Deficiency VAT	₱ 2,871,128.27
Surcharge (25%)	717,782.07
Deficiency Interest (20%) from January 26, 2012 to May 20, 2015 (₱2,871,128.27 x 20% x 1,211 days/365 days)	1,905,170.59
Total Amount Due, May 20, 2015	**₱5,494,080.93**
Deficiency Interest (20%) from May 21, 2015 to December 31, 2017 (₱2,871,128.27 x 20% x 956 days/365 days)	1,503,999.25
Delinquency Interest (20%)	
from May 21, 2015 until December 31, 2017 (₱5,494,080.94 x 20% x 956 days/365 days)	2,877,995.27
Total Deficiency VAT Due as of December 31, 2017	**₱9,876,075.45**

[168] Exhibit "P-10.1.5".

	Deficiency FWT	Less: Payment on May 29, 2015[169]	Remaining Balance
Basic Deficiency FWT	₱ 2,723,302.97	₱ 5,000.00	₱ 2,718,302.97
Surcharge (25%)	680,825.74	1,250.00	679,575.74
Deficiency Interest (20%) from January 14, 2012 to May 20, 2015 (₱2,723,302.97 x 20% x 1,223 days/365 days)	1,824,986.05	3,120.55	1,821,865.50
Total Amount Due, May 20, 2015	**₱5,229,114.76**		
Deficiency Interest (20%) from May 21, 2015 until payment on May 29, 2015 (₱2,723,302.97 x 20% x 9 days/365 days)	13,429.99		13,429.99
Compromise Penalty		25,000.00	(25,000.00)
Total Amount Due, May 29, 2015	**₱5,242,544.75**	**₱34,370.55**	**₱5,208,174.20**
Deficiency Interest (20%) from May 30, 2015 to December 31, 2017 (₱2,718,302.97 x 20% x 947 days/365 days)			1,410,538.58
Delinquency Interest (20%)			
from May 21, 2015 until payment on May 29, 2015 (₱5,229,114.76 x 20% x 9 days/365 days)			25,787.42
from May 30, 2015 until December 31, 2017 (₱5,208,174.20 x 20% x 947days/365 days)			2,702,543.00
Total Deficiency FWT Due as of December 31, 2017			**₱ 9,347,043.20**

In addition, petitioner is **ORDERED TO PAY** delinquency interest at the rate of 12% computed from January 1, 2018 until full payment thereof, pursuant to Section 249(C) of the NIRC of 1997, as amended by Republic Act No. 10963, also known as the Tax Reform for Acceleration and Inclusion (TRAIN) and as implemented by RR No. 21-2018, on the following amounts:

Income Tax	₱12,276,746.07
VAT	₱5,494,080.93
FWT	₱5,208,174.20

SO ORDERED.

Catherine T. Manahan

CATHERINE T. MANAHAN
Associate Justice

[169] Exhibit "P-10.1.8".

I CONCUR:

Juanito C. Castañeda, Jr.
JUANITO C. CASTAÑEDA, JR.
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.

Juanito C. Castañeda, Jr.
JUANITO C. CASTAÑEDA, JR.
Associate Justice
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