REPUBLIC OF THE PHILIPPINES
DEPARTMENT OF FINANCE
BUREAU OF INTERNAL REVENUE
National Office Building
Quezon City

Section 311 the Tax Code; Section 5, Rule 18 of IRR of RA No. 11534	VAT-4	37 - 2022

Person to Contact: Chief, Law & Legislative Division
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Date: DEC 01 2022

PHILIPPINE ECONOMIC ZONE AUTHORITY
10th Floor, Double Dragon Center
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Macapagal Avenue
Pasay City, 1302

Attention: **BGen CHARITO B. PLAZA MNSA, PhD**
Director General

Gentlemen:

This refers to your request for a clear determination from the Bureau of Internal Revenue ("**BIR**") whether health maintenance organization ("**HMO**") related expenses incurred by business enterprises ("**RBEs**") registered with the Philippine Economic Zone Authority ("**PEZA**") are subject to zero-rated Value Added Tax ("**VAT**"), as one of the incentives granted to RBEs under the sunset provisions of the Corporate Recovery and Tax Incentives for Enterprises ("**CREATE**") Act.[1]

Background:

1. PEZA has various registered IT-BPM (Business Process Management) Enterprises (the "**IT-BPM Enterprises**") within its ecozone.

2. Prior to the effectivity of the CREATE Law, these IT-BPM Enterprises were granted incentives, among others, VAT zero rating on their local purchases in accordance with the Cross-Border Doctrine as provided in Republic Act No. 7916[2] ("**PEZA Law**") and jurisprudence, including its HMO expenses for its employees.

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[1] Republic Act No. 11534, An Act Reforming the Corporate Income Tax and Incentives System, Amending for the Purpose Sections 20, 22, 25, 27, 28, 29, 34, 40, 57, 109, 116, 204 and 290 of the National Internal Revenue Code of 1997, as Amended, and Creating Therein New Title XIII, and for Other Purposes, March 26, 2021.
[2] An Act Providing for the Legal Framework and Mechanisms for the Creation, Operation, Administration, and Coordination of Special Economic Zones in the Philippines, Creating for This Purpose, the Philippine Economic Zone Authority (PEZA), and for Other Purposes, February 21, 1955.

3. In support of the request, it was claimed that pursuant to Section 5, Rule 18 of the Implementing Rules and Regulations ("**IRR**") of the CREATE Law,[3] all RBEs may continue to avail of their respective existing tax incentives until the expiration of the transitory period under Section 311 of the National Internal Revenue Code of 1997, as amended ("**Tax Code**").

In reply, please be informed that Rule 18 of the amended IRR of CREATE Law[4] states:

> ***"RULE 18. Investments prior to the effectivity of the Act***
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> ***SECTION 1. Projects or Activities Granted Only an ITH.*** *— Registered business enterprises whose projects or activities were granted only an ITH prior to the effectivity of this Act shall be allowed to continue with the availment thereof for the remaining period of the ITH as specified in the terms and conditions of their registration: Provided, That for those that have been granted the ITH but have not yet availed of the incentive upon the effectivity of this Act, they may use the ITH for the period specified in the terms and conditions of their registration.*
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> ***SECTION 2. Projects or Activities Granted an ITH and are Entitled to the Five Percent (5%) Tax on Gross Income Earned.*** *— Registered business enterprises whose projects or activities were granted an ITH prior to the effectivity of this Act and that are entitled to the five percent (5%) tax on gross income earned incentive after the ITH be allowed to use the ITH for the period specified in the terms and conditions of their registration and thereafter, avail of the five percent (5%) tax on gross income earned incentive, subject to the 10-year limit for both incentives under this Act.*
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> ***SECTION 3. Registered Business Enterprises Currently Availing of the Five Percent (5%) Tax on Gross Income Earned.*** *— Registered business enterprises currently availing of the five percent (5%) tax on gross income earned granted prior to the effectivity of this Act shall be allowed to continue availing the said tax incentive at the rate of five percent (5%) for ten (10) years.*
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> ***SECTION 4. Allocation of Gross Income Earned.*** *— If applicable, the allocation of shares for LGUs and IPAs as specified in the latter's governing laws shall be observed and shall not result in the diminution of their respective shares.*
>
> ***SECTION 5. Non-income related tax incentives.*** *– <u>All registered export and domestic market enterprises that will continue to avail of their existing tax incentives subject to sections 1, 2 and 3 of this Rule, may continue to enjoy the duty exemption, VAT exemption on importation, and VAT zero-rating on local purchases as provided in their respective IPA registrations; provided, that the</u>*

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[3] Revenue Memorandum Circular No. 83-2021, Circularizing the Implementing Rules and Regulations of Title XIII of Republic Act No. 8424 Otherwise Known as the "National Internal Revenue Code of 1997", As Amended by Republic Act No. 11534 or the "Corporate Recovery and Tax Incentives for Enterprises (CREATE) Act, July 12, 2021.

[4] Circularizing Amendments to the IRR of Title XIII of R.A. No. 8424 (NIRC of 1997), as Amended by R.A. No. 11543 (CREATE Act), Revenue Memorandum Circular No. 120-2021, December 13, 2021.

duty exemption, VAT-exemption on importation, and VAT zero-rating on local purchases shall only apply to goods and services directly attributable to and exclusively used in the registered project or activity of said registered export enterprises located inside the ecozones and freeports until the expiration of the transitory period; provided, further, that importation of capital equipment, spare parts, and accessories by existing export enterprises and domestic market enterprises registered with the BOI prior to the effectivity of the act shall continue to be subject to duty exemption for a period of five (5) years from date of registration." (Underscoring supplied)

As mentioned in the foregoing provision, Section 311 of the Tax Code[5] reads as follows:

> "***SEC. 311. Investments Prior to the Effectivity of This Act.*** *– Registered business enterprises with incentives granted prior to the effectivity of this Act*[6] *shall be subject to the following rules:*
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> *(A) Registered business enterprises whose projects or activities were granted only an income tax holiday prior to the effectivity of this Act shall be allowed to continue with the availment of the income tax holiday for the remaining period of the income tax holiday as specified in the terms and conditions of their registration: Provided, That for those that have granted the income tax holiday but have not yet availed of the incentive upon the effectivity of this Act, they may use the income tax holiday for the period specified in the terms and conditions of their registration.*
>
> *(B) Registered business enterprises, whose projects or activities were granted an income tax holiday prior to the effectivity of this Act and that are entitled to the five percent (5%) tax on gross income earned incentive after the income tax holiday, shall be allowed to avail of the five percent (5%) tax on gross income earned incentive based on Subsection (C); and*
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> *(C) Registered business enterprises currently availing of the five percent (5%) tax on gross income earned granted prior to the effectivity of this Act shall be allowed to continue availing the said incentive at the rate of five percent (5%) for ten (10) years."* (Underscoring supplied)

Prescinding from the above-cited provisions, it is clear that RBEs may continue to avail of the income tax incentives granted to them before the effectivity of the CREATE Law (i.e., income tax holiday ("**ITH**"), five percent (5%) tax on gross income earned incentive after the ITH). However, these incentives:

1. may only be availed within the transitory period (For ITH, the remaining period of the ITH as specified in the terms and conditions of their registration; For 5% gross income tax, for ten (10) years from the effectivity of the CREATE Law or until April 11, 2031[7]); and

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[5] As amended by Section 16 of CREATE Law.
[6] The term "Act" refers to the CREATE Law.
[7] The CREATE was signed into law on March 26, 2021. It was published on March 27, 2021 and took effect on April 11, 2021; Revenue Memorandum Circular No. 38-2022, April 6, 2022.

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2. excludes the VAT zero-rating incentive on local purchases of non-export enterprises.[8]

When it comes to the VAT zero-rating incentive, it bears stressing that Section 5, Rule 18 of the amended IRR of CREATE Law expressly states that the VAT zero-rating on local purchases incentive shall only apply to goods and services directly attributable to and exclusively used in the registered project or activity of the export enterprises until the expiration of the transitory period. Hence, while it is true that a registered export enterprise ("**REE**") may still avail of the VAT zero rating, the same is limited only to goods and services directly attributable to and exclusively used in the registered project or activity of said export enterprises.

Section 5, Rule 2 of the amended IRR provides what constitutes "directly and exclusively used in its registered project or activity," to *wit*:

> *"Rule 2*
> *Tax and Duty Incentives*
>
> *SECTION 5. Value-Added Tax (VAT) Zero-Rating and Exemption. – xxx*
>
> *The direct and exclusive use for the registered project or activity refers to <u>raw materials, inventories, supplies, equipment, goods, packaging materials, services, including provision of basic infrastructure, utilities, and maintenance, repair and overhaul of equipment,</u> <u>and other expenditures directly attributable to the registered project or activity without which the registered project or activity cannot be carried out</u>; provided, that the VAT zero-rating on local purchases shall be granted upon the endorsement of the concerned IPA, in addition to the documentary requirements of the BIR."* (Underscoring supplied)

For this purpose, under Questions No. 13 and 14 of Revenue Memorandum Circular ("**RMC**") No. 24-2022,[9] the Bureau clarified that the phrase "direct and exclusive use" referred to as:

> *"Q13: What is meant by direct and exclusive use in the registered project or activity?*
>
> *A13: Direct and exclusive use in the registered project or activity refers to raw materials, supplies, equipment, goods, packaging materials, services, including provision of basic infrastructure, utilities, and maintenance, repair and overhaul of equipment, and <u>other expenditures directly attributable to the registered project or activity</u>* ***<u>without which the registered project or activity cannot be carried out</u>****."*
>
> *xxx xxx xxx*

[8] Section 5, Rule 18 of the amended CREATE IRR.
[9] Clarifying Issues Relative to Revenue Regulations (RR) No. 21-2021 Implementing the Amendments to the Value-Added Tax (VAT) Zero Rating Provisions Under Sections 106 and 108 of the National Internal Revenue Code of 1997 (Tax Code), in Relation to Sections 294(e) and 295(D), Title XIII of the Tax Code, Introduced by Republic Act 9R/A.) No. 11534 (CREATE Act), and Section 5, Rule 2 and Section 5, Rule 18 of the CREATE Act Implementing Rules and Regulations (CREATE IRR), February 23, 2022.

> *Q14: What cost items fall under the "other expenditures" in the preceding question?*
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> *A14: These are costs that are* *indispensable to the project or activity, i.e., without which, the project or activity cannot proceed,* *and these include expenses that are* *necessary or required to be incurred* *depending on the nature of the registered project or activity of the export enterprise."* (Emphasis and underscoring supplied)

Based on the afore-quoted provisions, purchases of goods and services includes the expenditures that are/will be directly and exclusively used in or attributable to the registered project or activity, without which the registered project or activity cannot be carried out. These are expenses that are indispensable to the project or activity, without which, the same cannot be carried out.

In the case of HMO related expenses, this Office has clarified in RMC No. 137-2022[10] that HMO plans acquired by REEs for employees directly involved in the operations of their registered projects or activities and forming part of their compensation package can be considered necessary expenses since providing health benefits is not only an indispensable tool for building a competitive workforce but also ensures continuous and smooth operation of the registered project or activity by having a healthy workforce. Considering the foregoing, HMO related expenses are considered expenses directly and exclusively used in the registered business or activity of REEs, hence, subject to zero percent (0%) VAT. It must be emphasized, however, that the VAT zero-rating shall not extend to HMO plans procured for employees' dependents, as well as HMO plans for employees NOT directly involved in the operations of the registered projects or activities of the REEs. For this purpose, REEs are mandated to submit the documentary requirements as prescribed in RMC No. 137-2022 and other existing rules and regulations relating to this matter to ensure that only HMO expenses for qualified employees are given VAT zero rating.

Further, in relation to the letter of IT and Business Process Association of the Philippines (**"IBPAP"**), it should be clarified that the Bureau agrees that CREATE Law did not repeal Republic Act No. 7916 in its entirety, but only those provisions that were inconsistent with the provisions of the CREATE Law.[11] As such, the Bureau still recognizes PEZA zones as separate customs territory. However, it bears stressing that the concept of "Cross-Border Doctrine" was rendered ineffectual and inoperative for VAT purposes.

The legal basis for saying this is that:

(i) First, the CREATE Law now expressly requires that only the purchase of goods and services that are directly and exclusively used in the registered project or activity shall qualify for VAT zero-rating. In other words, not all goods coming into, or services rendered within the Freeport Zones or Ecozones are automatically accorded VAT zero-rating. Only the goods and services that are directly and exclusively used in the registered project or activity of a registered export enterprise are entitled to VAT zero-rating.

(ii) Second, the IRR of the CREATE Law provides for the requirements for the availment of VAT zero-rating on local purchases of registered export

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[10] October 14, 2022.

[11] Section 18, CREATE Law.

enterprises, that is, only the goods and services that are directly and exclusively used in the registered project or activity of a registered export enterprise are entitled to VAT zero-rating.

Hence, the unqualified or sweeping application of the cross-border doctrine can no longer be made because it will now violate the conditions imposed under the CREATE and its IRR that only the goods and services that are directly and exclusively used in the registered project or activity of a registered export enterprise are entitled to VAT zero-rating.

In the case of *Commissioner of Internal Revenue v. Toshiba*,[12] the Supreme Court explained that the cross-border doctrine was clearly established only on October 15, 1999 when the BIR issued RMC No. 74-99. Prior to the issuance of RMC No. 74-99, the rule depends on the tax regime of the entity. If the entity is enjoying the 5% preferential tax, then it is VAT-exempt. If it is enjoying the ITH, then it is subject to VAT. This distinction was abolished by RMC No. 74-99 which clarified, among others, that the sales of goods and services to entities located within the Ecozones are considered constructive exports pursuant to the "cross border doctrine" and, therefore, subject to 0% VAT. However, with the recent issuance of RMC No. 24-2022, the cross-border doctrine is now abandoned in order to align the VAT rules with the provision of the CREATE and its IRR.

Please be guided accordingly.

Very truly yours,

ROMEO D. LUMAGUI, JR.
Commissioner of Internal Revenue

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[12] G.R. No. 150154, August 9. 2005.