REPUBLIC OF THE PHILIPPINES
COURT OF TAX APPEALS
QUEZON CITY

SECOND DIVISION

AGM PACKAGING SYSTEM LTD. CORP.,
Petitioner,

-versus-

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

CTA CASE NO. 8947

Members:
CASTAÑEDA, JR., *Chairperson;*
CASANOVA, *and*
MANAHAN, *JJ.*

Promulgated:
JUN 09 2017
4:10 p.m.

x - x

DECISION

CASANOVA, *J.*:

This is a Petition for Review[1], filed on December 17, 2014 by petitioner, AGM Packaging System Ltd. Corp against respondent Commissioner of Internal Revenue (CIR) praying for the cancellation of the latter's assessment for deficiency Income Tax, Value-Added Tax (VAT), Expanded Withholding Tax (EWT), Improperly Accumulated Earnings Tax (IAET) and Documentary Stamp Tax (DST) in the aggregate amount of ₱5,066,781.11, inclusive of interests, surcharges and penalties for taxable year 2009.

Petitioner is a corporation organized and existing under the laws of the Republic of the Philippines with principal office address at Block 18, Lots 1 and 3, Philippine Economic Zone Authority (PEZA), Rosario, Cavite. It is registered with Philippine Economic Zone Authority (PEZA) as an Ecozone Export Enterprise inside Cavite Economic Zone under PEZA Registration Certificate No. 06-59 dated July 28, 2006, to engage in the manufacture of specialized wooden pallets.[2] It is registered with the Bureau of Internal Revenue (BIR) with Tax Identification Number

[1] Docket (Vol. I), pp. 17-47.
[2] Par. 1, Joint Stipulation of Facts & Issues (JSFI), Docket (Vol. II), p. 575.

(TIN) 247-296-350-000 and Certificate of Registration No. OCN 1RC0000385690 issued on August 31, 2006.[3]

Respondent is the duly appointed Commissioner of the BIR who has the power to decide disputed assessments, refunds of internal revenue taxes, fees or other charges, penalties imposed in relation thereto or other matters arising under the National Internal Revenue Code (NIRC) or other laws or portions thereof administered by the BIR. He holds office at 5th Floor, BIR Building, Diliman, Quezon City.

Petitioner started its commercial operations on October 2006 per PEZA Notice of Approval Start of Commercial Operations (SCO No. 10-041).[4]

On July 7, 2010, petitioner, through its duly authorized representative, Rodolfo C. Latayan[5], received a Letter of Authority (LOA) No. 200800025918[6] dated June 22, 2010, together with a Checklist of Requirements[7] from the BIR, authorizing the conduct of examination of petitioner's books of accounts and other accounting records for period of January 1, 2009 to December 31, 2009. The BIR issued a Notice of Informal Conference[8] on April 11, 2011 and Amended Notice of Informal Conference[9] on January 12, 2012.

The BIR, through Regional Director Jose N. Tan of Revenue Region No. 9, San Pablo City, issued a Preliminary Assessment Notice (PAN) with Details of Discrepancies[10] on June 21, 2012. Petitioner filed its protest[11] dated July 25, 2012 to the PAN on July 26, 2012.

The BIR, through Regional Director Jose N. Tan issued a Formal Letter of Demand (FLD) with attached Details of Discrepancies[12] and Audit/Results Assessment Notices[13] all dated August 7, 2012, assessing petitioner for the deficiency Income Tax, VAT, EWT, IAET and DST in the total amount of ₱4,071,654.56 for taxable year 2009. Petitioner

[3] Docket (Vol. II), p. 629.
[4] Par. 4, JSFI, Docket (Vol. II), p. 576.
[5] Par. 6, JSFI, Docket (Vol. II), p. 577.
[6] Exhibit "P-1".
[7] Docket (Vol. II), p. 614.
[8] Exhibit "P-4".
[9] Exhibit "R-7".
[10] Exhibit "P-8".
[11] Exhibit "P-10".
[12] Docket (Vol. II), pp. 668-671.
[13] Exhibit "P-11".

filed its reply[14] dated August 25, 2012 to the FLD on August 29, 2012. Petitioner wrote another letter[15] dated January 28, 2013, which was received by the respondent on January 30, 2013, addressing the issue on IAET.

On October 27, 2014, BIR, through Regional Director Jose N. Tan issued its Final Decision on Disputed Assessment[16] (FDDA), which was received by petitioner on November 17, 2014,[17] assessing petitioner for the deficiency Income Tax, VAT, EWT, IAET and DST in the adjusted total amount of ₱5,066,781.11 for taxable year 2009.

Petitioner filed the present Petition for Review on December 17, 2014, while respondent filed his Answer[18], through registered mail on March 16, 2015, interposing the following Special and Affirmative Defenses:

"SPECIAL AND AFFIRMATIVE DEFENSES

4. Respondent reiterates and re-pleads the preceding paragraphs of this Answer as part of her Special and Affirmative Defense.

The Bureau of Internal Revenue is empowered to make assessments to determine if the correct amount of tax has been paid by a taxpayer.

5. Petitioner posits that it is not within the power of the Bureau of Internal Revenue, in the exercise of its power to assess, to determine whether it is qualified to avail of the preferential income tax rate granted to PEZA registered entities.

6. Petitioner is clearly mistaken.

7. It must be stressed that the Commissioner of Internal Revenue has the power to examine any taxpayer and make assessment of the correct amount of tax.

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[14] Exhibit "P-12".
[15] Exhibit "P-14".
[16] Exhibit "P-15".
[17] Par. 7, JSFI, Docket (Vol. II), p. 577.
[18] Docket (Vol. I), pp. 149-158.

Sections 5 and 6 of the National Internal Revenue Code (NIRC) of 1997, as amended provides:

> **SEC. 5. Power of the Commissioner to Obtain Information, and to Summon, Examine, and Take Testimony of Persons. - In ascertaining the correctness of any return, or in making a return when none has been made, or in determining the liability of any person for any internal revenue tax, or in collecting any such liability, or in evaluating tax compliance, the Commissioner is authorized**
>
> (A) To examine any book, paper, record, or other data which may be relevant or material to such inquiry;
>
> (B) To obtain on a regular basis from any person other than the person whose internal revenue tax liability is subject to audit or investigation, or from any office or officer of the national and local governments, government agencies and instrumentalities, including the Bangko Sentral ng Pilipinas and government-owned or – controlled corporations, any information such as, but not limited to, costs and volume of production, receipts or sales and gross incomes of taxpayers, and the names, addresses, and financial statements of corporations, mutual fund companies, insurance companies, regional operating headquarters of multinational companies, joint accounts, associations, joint ventures or consortia and registered partnerships, and their members;
>
> (C) To summon the person liable for tax or required to file a return, or any officer or employee of such person, or any person having possession,

custody, or care of the books of accounts and other accounting records containing entries relating to the business of the person liable for tax, or any other person, to appear before the Commissioner or his duly authorized representative at a time and place specified in the summons and to produce such books, papers, records, or other data, and to give testimony;

(D) To take such testimony of the person concerned, under oath, as may be relevant or material to such inquiry; and

(E) To cause revenue officers and employees to make a canvass from time to time of any revenue district or region and inquire after and concerning all persons therein who may be liable to pay any internal revenue tax, and all persons owning or having the care, management or possession of any object with respect to which a tax is imposed.

The provisions of the foregoing paragraphs notwithstanding, nothing in this Section shall be construed as granting the Commissioner the authority to inquire into bank deposits other than as provided for in Section 6(F) of this Code.

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SEC. 6. Power of the Commissioner to Make assessments and Prescribe additional Requirements for Tax Administration and Enforcement. –

(F) Examination of Returns and Determination of Tax Due - **After a return has been filed** as required under the provisions of this Code, **the Commissioner or his duly authorized representative may**

> **authorize the examination of any taxpayer and the assessment of the correct amount of tax:** Provided, however; That failure to file a return shall not prevent the Commissioner from authorizing the examination of any taxpayer.
>
> -xxx-

(**Emphasis supplied**).

8. It cannot be denied that petitioner has been submitting tax returns with the Bureau of Internal Revenue.

9. Thus, in the course of the examination of such returns, the Bureau of Internal Revenue is empowered, among others, to examine any book, paper, record, or other data which may be relevant or material to such inquiry to determine if the correct amount of tax has been paid by petitioner.

10. In the instant case, after careful examination and investigation made by respondent, it was revealed that contrary to petitioner's registration as a PEZA zone export enterprise engaged in the manufacture of wooden wooden pallets, it was actually engaged in trading of wooden pallets, proved as follows:

    a. The machines *(sic)* acquired machines inappropriate, if not obsolete, to manufacture wooden pallets; and
    b. The wooden pallets were manufactured by an affiliate, AGP Venture Enterprises, Inc.

11. Thus, having failed to qualify for the preferential tax rate, petitioner was correctly subjected to the tax imposed by the Tax Code, as amended.

Petitioner failed to qualify for the preferential tax rate. As such, it is liable for all internal revenue taxes imposed by the Tax Code.

12. Petitioner contended that the assessment is void for being contrary to law since the assessment has deprived it of its entitlement of tax exemptions under the PEZA Law.

13. Petitioner's contention are bereft of merit.

14. The well settled rule is that legal provisions providing for tax exemption are to be construed strictly against the grantee and liberally in favor of the taxing power.

15. As here, petitioner is qualified to avail of the special tax rate, if and only if, it is to engage in the manufacture of wooden pallets. The PEZA certification is clear:

CERTIFICATION

> This is to certify that AGM PACKAGING SYSTEMS LTD. CORP. (APSLC) at the Cavite Economic Zone, is a PEZA registered Ecozone Export Enterprise with Registration Certificate No. 06-59 dated 28 July 2006, **to engage in the manufacture of specialized wooden pallets.**
>
> -xxx-
>
> (**Emphasis supplied**).

16. As explained above, after careful examination and investigation made by the Bureau pursuant to the mandate of the Tax Code, it was found that petitioner was actually engaged in trading, rather than manufacture, of wooden pallets; in violation of its PEZA certification.

17. It must be stressed that trading and manufacturing are worlds apart.

18. Manufacturing presupposes an act of producing something out of raw materials. Trading, on the other hand, is the business of buying and selling for money.

19. In this case, it was AGM Ventures Enterprises, Inc. that manufactured the wooden pallets being sold by

petitioner after it bought the same from the former; in short trading of wooden pallets.

20. Clearly, this is beyond the registered activity of petitioner, which is limited to the manufacture of wooden pallets.

21. Having engaged in a different activity than its registered activity, petitioner is clearly disqualified from availing the preferential tax rate provided by the PEZA Law.

22. Consequently, it follows that:

   a. All its taxable income is subject to the normal income tax rate provided under Section 28 of the Tax Code, as amended;
   b. In addition, for petitioner's failure to substantiate petitioner's interest income and foreign exchange loss in the amount of P141,618.58 and to withhold taxes on certain income payments in the aggregate amount of P1,308,733.88, the total amount of P1,450,352.46 should be disallowed as deductions pursuant to Sections 34(A)(1)(b) and 24(K) of the Tax Code, as amended;
   c. For petitioner's retention of income rather than payment of dividends, it is liable for Improperly Accumulated Earnings Tax under Section 29 of the Tax Code, as amended;
   d. Petitioner's income payments are subject to Expanded Withholding Tax pursuant to Section 57 of the Tax Code, as amended as implemented by Section 2.57.2(A), (C), (E) and (M) of Revenue Regulations No. 2-1998;
   e. Petitioners' rental is subject to Documentary Stamp Tax pursuant to Section 194 of the Tax Code, as amended as implemented by Revenue Regulations No. 13-2004.

23. Based on all the foregoing, the finding of deficiency tax liabilities against petitioner is proper in all respects. It is a well-settled principle that:

> 'Tax assessments by tax examiners are presumed correct and made in good faith.

> The taxpayer has the duty to prove otherwise. In the absence of proof of any irregularities in the performance of duties, an assessment duly made by a Bureau of Internal Revenue examiner, and approved by his superior officers will not be disturbed. All presumptions are in favor of the correctness of tax assessments.

24. Dereliction on the part of petitioner to satisfactorily overcome the presumption of regularity and correctness of the assessment will justify the judicial upholding of said assessment notices.

25. Notably, petitioner, in the instant Petition for Review, failed to refute respondent's assessment of Income Tax, Value Added Tax, Expanded Withholding Tax, Improperly Accumulated Earnings Tax and Documentary Stamp for taxable year 2009.

26. All told, it is very clear that petitioner is indeed liable for deficiency taxes in the aggregate amount of P5,066,781.11."

The case was scheduled for Pre-Trial Conference on May 28, 2015[19] and June 25, 2015[20] but was reset on July 23, 2015.[21] Respondent's Pre-Trial Brief[22] was filed on May 21, 2015, while petitioner filed its Pre-Trial Brief[23] on May 25, 2015.

The parties filed their Joint Stipulation of Facts & Issues[24] on August 12, 2015 which was approved by the Court in the Pre-Trial Order[25] dated August 25, 2015.

During trial, petitioner presented documentary and testimonial evidence to support its claims. Petitioner presented the following witnesses: (1) Espiridion L. Gabayan III and (2) Rommel R. Galarse.[26]

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[19] Notice of Pre-Trial Conference, Docket (Vol. I), pp. 173-174.
[20] Notice of Resetting, Docket (Vol. I), p. 230.
[21] Order dated June 9, 2015, Docket (Vol. II), p. 558.
[22] Docket (Vol. I), pp. 184-189.
[23] Docket (Vol. I), pp. 356-382.
[24] Docket (Vol. II), pp. 575-583.
[25] Docket (Vol. II), pp. 586-593.
[26] Minutes of the hearing dated October 28, 2015, Docket (Vol. II), p. 599.

Thereafter, petitioner filed its Formal Offer of Evidence[27] on November 9, 2015, offering Exhibits "P-1" to "P-27-a" as its documentary evidence, which were all admitted in the Resolution[28] dated January 4, 2016.

On the other hand, respondent presented the following witnesses: (a) Edwin E. Aritumba; (b) Ramon G. Deniega; (c) Teresita D. Tibayan;[29] (d) Revenue Officer Danon A. De Jesus; and (e) James Geoffrey H. Rivarez.[30]

Respondent's Formal Offer of Evidence[31] was filed on March 7, 2016, offering Exhibits "R-1" to "R-22-a", which were all admitted in the a Resolution[32] dated April 13, 2016.

Taking into consideration the Memorandum for the Petitioner[33] filed on May 19, 2016 and respondent's Memorandum[34] filed on June 21, 2016, the case was submitted for decision.[35]

The parties submitted the following issues[36] for the Court's resolution:

> Whether petitioner is liable for deficiency Income Tax, VAT, EWT, IAET and DST, inclusive of interest and surcharge in the aggregate amount of ₱5,066,781.11 for taxable year 2009.
>
> a. Whether respondent, through its power to assess taxes under Section 6 of the NIRC of 1997 encompasses the authority to determine PEZA-registered enterprises, including petitioner, qualification for tax and fiscal incentives provided under Republic Act (RA) No. 7916, otherwise known as the Special Economic Zone Act of 1995, as amended by RA 8748.

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[27] Docket (Vol. II), pp. 600-612.
[28] Docket (Vol. II), pp. 725-726.
[29] Minutes of the hearing dated February 3, 2016, Docket (Vol. II), p. 730.
[30] Minutes of the hearing dated March 2, 2016, Docket (Vol. II), p. 729.
[31] Docket (Vol. II), pp. 731-746.
[32] Docket (Vol. II), pp. 751-752.
[33] Docket (Vol. II), pp. 753-790.
[34] Docket (Vol. II), pp. 796-808.
[35] Resolution dated June 23, 2016, Docket (Vol. II), p. 809.
[36] Joint Stipulation of Facts & Issues, Docket (Vol. II), pp. 577-578.

b. Whether the sub-contracting of manufacturing of wooden pallets between petitioner and AGM Ventures Enterprises Inc., can be legally declared by respondent as "trading" contrary to petitioner's PEZA Registration.

c. Whether the deficiency assessment on income tax and improperly accumulated earnings tax, denying petitioner its income tax holiday or its 5% preferential tax on gross income is valid against the petitioner.

At the outset, it must be recalled that respondent issued the FLD with attached Details of Discrepancies and Audit/Results Assessment Notices, on August 7, 2012, which assessed petitioner for deficiency Income Tax, VAT, EWT, IAET and DST in the total amount of ₱4,071,654.60 for taxable year 2009. Petitioner filed its reply dated August 25, 2012 to FLD, which was received by the respondent on August 29, 2012. Petitioner wrote another letter[37] dated January 28, 2013, which was received by the respondent on January 30, 2013, addressing the issue on IAET.

Respondent did not give merit and denied the protest lodged by petitioner against the assessment. Accordingly, respondent issued the Final Decision on Disputed Assessment (FDDA)[38] dated October 27, 2014, which was received by petitioner on November 17, 2014. The Respondent adjusted the computation of the alleged deficiency taxes from ₱4,071,654.60 to ₱5,066,781.11, as broken down below:

I. Income tax		
Taxable income per ITR		₱ (620,420.63)
Add: NOLCO	₱ 620,420.63	
Adjustments – Annex A	1,450,352.46	2,070,773.09
Total taxable income per audit		₱ 1,450,352.46
Tax due thereon		₱ 435,105.74
Less: Payments	₱ 11,079.33	
Creditable withholding tax per LN		11,079.33
Deficiency tax		₱ 424,026.41
Add: 20% Interest from 4/16/10 to 8/11/14		376,217.46
Total amount payable		**₱ 800,243.87**

[37] Exhibit "P-14".
[38] Exhibits "P-15" and "P-16".

II. Value-added tax		
Sales per VAT returns		₱ -
Add: Adjustments – Annex A		1,073,656.00
Total vatable sales per audit		₱ 1,073,656.00
Multiply by 12% VAT rate		12%
Output tax per audit		₱ 128,838.72
Less: Input tax per VAT returns	₱ -	
Payments per VAT returns	-	
Excess to be applied the next period	-	-
Deficiency tax		₱ 128,838.72
Add: 20% Interest from 1/26/10 to 8/11/14		117,049.09
Total amount payable		**₱ 245,887.82**
III. Expanded withholding tax		
Total expenses subject to EWT		₱ 39,482,219.61
Tax due thereon		₱ 463,226.89
Less: Payments		445,424.82
Deficiency tax		₱ 17,802.07
Add: 20% Interest from 4/16/10 to 8/11/14		15,392.69
Total amount payable		**₱ 33,194.76**
IV. Improperly accumulated earnings tax		
Improperly accumulated earnings		₱ 18,224,702.76
Multiply by rate		10%
Output tax per audit		₱ 1,822,470.28
Less: Payments		-
Deficiency tax		₱ 1,822,470.28
Add: 25% Surcharge	₱ 455,617.57	
20% Interest from 1/10/10 to 8/11/14	1,671,679.59	2,127,297.16
Total amount payable		**₱ 3,949,767.44**
V. Documentary stamp tax		
Rental expense per FS		₱ 777,500.00
Tax due thereon		₱ 778.50
Less: Payments		-
Deficiency tax		₱ 778.50

Add: 25% Surcharge	₱ 194.63	
20% Interest from 1/10/10 to 8/11/14	714.09	908.72
Total amount payable		**₱ 1,687.22**
VI. Compromise penalty		
Late payment of income tax		₱ 16,000.00
Late payment of value-added tax		16,000.00
Late payment of expanded withholding tax		4,000.00
Total amount payable		**₱ 36,000.00**
GRAND TOTAL		**₱ 5,066,781.11**

Seeking judicial relief, petitioner filed the instant Petition for Review with this Court on December 17, 2014, or within the thirty (30)-day period prescribed under Section 228 of the NIRC of 1997, as amended. Clearly, this Court has acquired the jurisdiction over the case.

Proceeding on the merits of the case, the Court will discuss the deficiency taxes one by one.

I. Income Tax – ₱800,243.87

Respondent's investigation revealed that petitioner, is actually engaged in the trading of wooden pallets manufactured and supplied by AGP Ventures Enterprises, Inc., an affiliate company in Sta. Rosa, Laguna, contrary to its registration as an ECOZONE export enterprise engaged in the manufacturing of wooden pallets. Therefore, petitioner is allegedly not qualified to the ITH or to the 5% preferential tax on gross income therefrom, thus, assessed under the normal income tax rate of 30% pursuant to Section 28 of the NIRC of 1997, as amended.

In addition, petitioner allegedly failed to substantiate its claimed interest income and foreign exchange loss in the aggregate amount of ₱141,618.58, thus, disallowed pursuant to Section 34(A)(1)(b) of the NIRC of 1997, as amended. Petitioner also allegedly failed to fully withhold taxes on certain income payments in the total amount of ₱1,308,733.88, thus, disallowed pursuant to Section 34(K) of the same

Code, in relation to Revenue Regulations (RR) No. 14-2008. Said disallowances consist of the following items:[39]

Other income		₱ 69.45
Foreign exchange loss		141,549.13
Purchase of goods		
Total amount subject to EWT	₱ 37,858,250.25	
Less: Tax withheld and paid	37,020,985.73	837,264.52
Purchase of services		
Delivery expenses	198,023.10	
Membership dues & fees	19,258.94	
Repairs & maintenance	85,982.04	
Seminars & training	13,900.00	
Shipping & freight	27,339.37	
Telephone expense	66,259.62	
Utilities	60,706.29	471,469.36
Total disallowed expenses		**₱1,450,352.46**

Firstly, petitioner avers that the respondent has exceeded his power to make assessments under Section 4 of the NIRC of 1997, when the latter concluded that petitioner was allegedly engaged in trading of wooden pallets; therefore, it is not qualified to either the ITH or the 5% preferential tax rate incentives.

Secondly, petitioner argues that the respondent cannot legally declare that the sub-contracting of manufacturing of wooden pallets between petitioner and AGM Ventures Enterprises, Inc. constitutes "trading" which contravenes petitioner's PEZA registration.

It further adds that said sub-contracting agreement had been fully explained in the protest letter[40] dated July 25, 2012, which reads in part:

> "Without offense, I believe the interpretation and supposition of the BIR Examiner is absolutely unfounded and untrue. In the first paragraph of your Annex A under 'Income Tax', [t]he BIR Examiner deduced that AGM Packaging is engaged in trading of wooden pallets manufactured and supplied by AGM Ventures Enterprises

[39] Exhibit "P-15".
[40] Exhibit "P-10".

Inc, an affiliate. This is not correct. The truth is AGM Packaging engaged the services of AGM Ventures as a 'SUBCONTRACTOR' which is covered by a Memorandum [o]f Agreement approved by Philippine Export Processing Zone Administration (see annex 1).

The imported raw materials like plywood, metal strap and medium density fiber board imported by AGM Packaging are being 'FARM OUT' to AGM Ventures for assembly and converted to wooden pallets using the form Application For Permit To Bring Goods From the Zone To Customs Territory (please see annex 2). Once raw materials are converted to pallets, they will be brought back to our warehouse (FARM IN) using the form Application For Permit To bring Goods From The Customs Territory To Zone (please see annex 3). Thus, the business relationship of the two companies is not simply trading, but a subcontracting one."

Moreover, petitioner's then Operations Manager, Rommel R. Galarse, testified on the sub-contracting agreement and the PEZA approval thereof, to wit:

"8. Q: What is the registered activity of Petitioner APSLC inside Cavite Economic Zone (CEZ)?
A: Manufacturing of specialized wooden pallets.

9. Q: In its manufacturing of specialized wooden pallets, would you know the actual processes of the same?
A: Yes. APSLC imports raw materials. The raw materials are delivered from APSLC to AGM Ventures ('Farm Out') for assembly into finished goods or the specialized wooden pallets. The finished goods are then transferred from AGM Ventures to APSLC ('Farm In').

10. Q: What do you mean by 'Farm In' and 'Farm Out'?
A: The PEZA by virtue of several letters of authority (LOA) has allowed the subcontracting between APSLC and AGM Ventures (**EXHIBIT '<u>P-24</u>' and '<u>P-24 series</u>'**).

The raw materials transferred from APSLC to AGM Ventures is considered as 'Farm Out' and the transfer of finished goods from AGM Ventures to

APSLC is considered a 'Farm-In' with corresponding PEZA forms.

11. Q: You mentioned that as the then Operations Manager of APSLC, you were responsible in securing PEZA certifications. What are these PEZA certifications?

A: When I am still employed by APSLC, I have secured PEZA certifications for the years 2008, 2009 and 2010 (**EXHIBITS '<u>P-18</u>', '<u>P-19</u>' and '<u>P-20</u>'**).

12. Q: What requirements, if any, did you submit before APSLC can be issued these PEZA certification?

A: Before PEZA issues the certification, APSLC must comply with all submission of reportorial requirements of PEZA which includes:

- Quarterly Income Tax Return (BIR Form 1702Q)
- Annual PEZA Report on sales, purchases, importations, financial statement, list of equipment/machineries, stockholder's information
- Audited financial statement
- Income tax return

13. Q: What is the significance of these PEZA certifications that you have secured?

A: The PEZA certification provides that APSLC at the Cavite Economic Zone, is a PEZA-registered Ecozone Export Enterprise with Registration Certificate No. 06-59 dated July 28, 2006, authorized to engage in the manufacture of specialized wood pallets. It also provides the fiscal and tax incentives of APSLC."[41]

Thus, petitioner maintains that there is documentary evidence to support that its sub-contracting agreement, in relation to its manufacturing of wooden pallets, was duly authorized and approved by PEZA and not merely conducted at the behest of the petitioner.

Lastly, petitioner argues that the deficiency assessment, particularly on income tax and IAET, as a result of the respondent's denial of petitioner's entitlement to either the ITH or 5% preferential tax rate on gross income, is void for being contrary to law.

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[41] Exhibit "P-27".

According to petitioner, under Section 23 of RA No. 7916, in relation to Book VI of EO No. 226, and Section 6 of Rule XV of the IRR of RA No. 7916, petitioner shall enjoy its ITH within a period of four (4) years from the actual start of its commercial operations, or from October 19, 2006, until October 19, 2010.

The entitlement to fiscal incentives was provided in petitioner's Registration Agreement and PEZA Certification Nos. 2008-776, 2009-855 and 2010-0935. Respondent's failure to appreciate and give due course to these Certifications, which stated therein that it is a *bona fide* Export ECOZONE Enterprise entitled to ITH or 5% preferential tax rate, can be considered as capricious and an arbitrary act which must render the assessment void.

Petitioner's arguments must fail.

It is worthy to note that the power and duty to assess national internal revenue taxes are lodged with the respondent. Sections 2 and 6 of the NIRC of 1997, as amended, provide:

> SEC. 2. **Powers and Duties of the Bureau of Internal Revenue.** – The Bureau of Internal Revenue shall be under the supervision and control of the Department of Finance and its powers and duties shall comprehend the assessment and collection of all national internal revenue taxes, fees, and charges, and the enforcement of all forfeitures, penalties, and fines connected therewith, including the execution of judgments in all cases decided in its favor by the Court of Tax Appeals and the ordinary courts. The Bureau shall give effect to and administer the supervisory and police powers conferred to it by this Code or other laws.
>
> SEC. 6. **Power of the Commissioner to Make Assessments and Prescribe additional Requirements for Tax Administration and Enforcement.** –
>
> (A) *Examination of Returns and Determination of Tax Due.* - After a return has been filed as required under the provisions of this Code, the Commissioner or his duly authorized representative may

> authorize the examination of any taxpayer and the assessment of the correct amount of tax: Provided, however, That failure to file a return shall not prevent the Commissioner from authorizing the examination of any taxpayer.
>
> xxx xxx xxx

The term "assessment" refers to the determination of amounts due from a person obligated to make payments. In the context of national internal revenue collection, it refers to the determination of the taxes due from a taxpayer under the National Internal Revenue Code of 1997.[42]

Furthermore, Revenue Regulations (RR) No. 27-2002 confirms the authority of respondent to assess the five percent (5%) special income tax under RA No. 7916, as amended by RA No. 8748, as follows:

> "**SEC 2. AMENDMENT.**- Section 6 of RR No. 1-2000 is hereby amended to read as follows:
>
> ***'SECTION 6. Authority to Issue, Collect, Compromise or Abate Any Deficiency 5% Special Income Tax Assessment.-***
>
> *'(a)* ***Jurisdiction****.- Pursuant to Section 6 of the National Internal Revenue Code of 1997, in relation to Section 24 of R.A. 7916, as amended by R.A. 8748, the power to audit and assess the herein five percent (5%) special income tax,* ***as well as the power to abate, cancel, or compromise the payment of the said tax, including the power to implement special voluntary payment program/s for last priority in audit****, shall be under the exclusive jurisdiction of the Commissioner of Internal Revenue or his duly authorized representative,* ***subject to the approval of the Secretary of Finance in cases where such approval is necessary.***

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[42] *SMI-ED Philippines Technology, Inc. vs. Commissioner of Internal Revenue*, G.R. No. 175410, November 12, 2014.

xxx xxx xxx"

Thus, it is clearly within respondent's authority, in the exercise of his power to assess, to determine whether petitioner is qualified to avail of the preferential income tax rate granted to PEZA registered entities.

Section 23 of Republic Act (RA) No. 7916, otherwise known as The Special Economic Zone Act of 1995, provides that business establishments operating within the ECOZONES[43] shall be entitled to fiscal incentives as provided for under the same RA, or those under Book VI of Executive Order (EO) No. 226, otherwise known as the Omnibus Investment Code of 1987, to wit:

> "SEC. 24. Exemption from National and Local Taxes.— Except for real property taxes on land owned by developers, **no taxes, local and national, shall be imposed on business establishments operating within the ECOZONE. In lieu thereof, five percent (5%) of the gross income** earned by all business enterprises within the ECOZONE shall be paid and remitted as follows:
>
> a. Three percent (3%) to the National Government;
>
> b. Two percent (2%) which shall be directly remitted by the business establishments to the treasurer's office of the municipality or city where the enterprise is located." *(Emphasis supplied)*
>
> "Art. 39. Incentives to Registered Enterprises.— All registered enterprises shall be granted the following incentives to the extent engaged in a preferred area of investment:
>
> (a) **Income Tax Holiday.**

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[43] "SEC. 4. Definition of Terms. – For purposes of this Act, the following definitions shall apply to the following terms:
(a) 'Special Economic Zones (SEZ)' – hereinafter referred to as the ECOZONES, are selected areas with highly developed or which have the potential to be developed into agro-industrial, Industrial tourist/recreational, commercial, banking, investment and financial centers. An ECOZONE may contain any or all of the following: Industrial Estates (IEs), Export Processing Zones (EPZs), Free Trade Zones, and Tourist/Recreational Centers."

> (1) For six (6) years from commercial operation for pioneer firms and four **(4) years for non-pioneer firms**, new registered firms shall be fully exempt from income taxes levied by the National Government." *(Emphasis supplied)*

Simply put, registered enterprise has the option to choose between two fiscal incentives: *a)* a 5% preferential tax rate on its gross income; or *b)* an income tax holiday (ITH). If the entity avails itself of the first scheme, it is exempt from all taxes; under the second, it is exempt from income taxes for a number of years, but not from other national internal revenue taxes.[44]

In relation thereto, the implementing rules and regulations (IRR) of RA No. 7916 provides that enterprises registered with Philippine Economic Zone Authority (PEZA) whose ITH entitlement has expired shall be subject to the 5% special tax rate, to wit:

> "SECTION 4. Existing PEZA-Registered Enterprises — Export enterprises registered with the Export Processing Zone Authority (EPZA) under the Decree or the Code shall continue to be entitled to the incentives under the terms and conditions provided therein. However, **EPZA export enterprises whose Income Tax Holiday entitlement under the Code has expired shall be subject to the 5% special tax rate under Rule XX of these Rules.** EPZA Enterprises registered under the Decree which are still availing of the Net Operating Loss Carry-Over incentive shall be subject to such regulations as may be determined by the Board and Department of Finance / Bureau of Internal Revenue." *(Emphasis supplied)*

Based on the Certificate of Registration No. 06-59[45] issued on July 28, 2006 by the PEZA, the petitioner was registered with the former as an ECOZONE EXPORT ENTERPRISE at the CAVITE ECONOMIC ZONE. Moreover, the Registration Agreement[46] attached thereto stipulates that the petitioner's registered activity is limited to the manufacture of wooden pallets, to wit:

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[44] *Commissioner of Internal Revenue vs. Sekisui Jushi Philippines, Inc.*, G.R. No. 149671, July 21, 2006.
[45] Exhibit "P-17".
[46] Exhibit "P-17".

"ARTICLE II
SCOPE OF REGISTRANT'S REGISTERED ACTIVITY

2. The scope of the REGISTRANT'S registered activity shall be limited to the **manufacture of wooden pallets** and the importation of raw materials, machinery, equipment, tools, goods, wares, articles, or merchandise directly used in its registered operations at CEZ. In the event the REGISTRANT decides to engage in a new or additional activity, directly or indirectly related to its registered activity, it shall apply anew with PEZA for the latter's approval." *(Emphasis supplied)*

In addition, the PEZA Certifications[47], particularly No. 2009-855[48], confirm the incentives available to petitioner, to wit:

"1. Incentives under Book VI of EO 226 which include the following:

a. Corporate income tax holiday (ITH) for four (4) years for non-pioneer project effective on the committed date of start of commercial operations, or the actual date of start of commercial operations, whichever is earlier; ITH entitlement for the original project can also be extended for another three (3) years provided specific criteria are met and prior PEZA approval is obtained; duly approved and registered 'Expansion' and 'New' projects are entitled to a three-year, and four-year ITH, respectively;

x x x x x x x x x

2. After the lapse of ITH, the following incentives shall apply:

a. Exemption from national and local taxes, in lieu thereof payment of 5% final tax on gross income as provided in Section 24 of R.A. 7916 and Rule XX of the Rules and Regulations to Implement R.A. 7916, and

x x x x x x x x x

---

[47] Exhibits "P-18" to "P-19".
[48] Exhibit "P-19".

3. Pursuant to BIR's Revenue Regulations No. 14-2002 [Amending Further Pertinent Provisions of Revenue Regulations No. 2-98, as amended], income payments to PEZA registered enterprises under the ITH and 5% GIT incentives are exempt from expanded withholding tax."

Applying the aforementioned provisions, petitioner has four (4) years from start of commercial operations, On October 2006[49], or until October 2010 to enjoy ITH, with respect to its registered activity-that is, the manufacture of wooden pallets.

The primary purpose of the company is to engage in manufacturing of wooden pallets, crates or other packaging materials like plastic sheets, bubble sheets, foams and cartons which are used in packaging products produced, assembled and manufactured inside CEPZAs, while its secondary purpose is to engage in the trading activity.[50]

Petitioner, as approved by PEZA, sub-contracted the services of AGM Ventures Enterprises, Inc. for the manufacture of wooden pallets. However, examination of the Letters of Authority[51], particularly No. CEZ-SC-10-155, discloses that the sub-contracting was approved only on July 13, 2010, which was valid for a period of six (6) months and subject to renewal for another six (6) months. Apparently, the sub-contracting in 2009 is not in accord with its registration agreement with PEZA. Hence, the assessments founded on this ground shall be upheld.

As regards the interest income and foreign exchange loss, the disallowance of the same is not proper.

Section 34 of the NIRC of 1997, as amended, reads as follows:

"SEC. 34. *Deductions from Gross Income.* – x x x

(A) *Expenses.* – e

[49] Par. 4, Stipulation of Facts, JSFI, Docket (Vol. II), p. 576.
[50] BIR Records, pp. 12 and 50.
[51] Exhibits "P-22", "P-24", "P-24-a" to "P-24-i".

(1) *Ordinary and Necessary Trade, Business or Professional Expenses.* –

xxx xxx 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."

A perusal of petitioner's Statement of Income[52] for the year 2009 reveals that the assessed amount of ₱141,618.58 pertains to petitioner's Other Income. Also, the Notes to FS, particularly Note 15[53], disclose that the said account consists of the interest income of ₱69.45 and gain, not loss, on foreign exchange of ₱141,549.13. Clearly, the assessed items are not deductions from gross income or, more specifically, expenses. Hence, respondent's assessment shall be cancelled.

On the other hand, the disallowance of petitioner's purchases of goods and services due to non-withholding of tax is tenable.

Section 34(K) of the NIRC of 1997, as amended, provides as follows:

"SEC. 34. *Deductions from Gross Income.* – x x x

x x x x x x 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

[52] BIR Records, p. 15.
[53] BIR Records, p. 2.

paid to the Bureau of Internal Revenue in accordance with this Section, Sections 58 and 81 of this Code."

In relation thereto, RR No. 02-98, as amended by RR No. 14-2008, mandates the withholding of 1% and 2% on purchases of goods and services, respectively, by top 20,000 corporations as follows:

"Sec. 2.57. *Withholding of Tax at Source.* –

x x x x x x x x x

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.

x x x x x x 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. – Income payments made by any of the top twenty thousand (20,000) private corporations, as determined by the Commissioner, to their local/resident supplier of goods and local/resident supplier of services, including non-resident alien engaged in trade or business in the Philippines

Supplier of goods – One percent (1%)
Supplier of services – Two percent (2%)"

A comparison of the purchases of goods and services which were subjected to EWT as reported in petitioner's Alphalist of Payees Subject to Expanded Withholding Tax[54] attached to its Annual Information Return of Creditable Income Taxes Withheld (Expanded)/Income Payments Exempt from Withholding Tax (BIR Form No. 1604-E)[55] for taxable year 2009 with those reflected in its FS/ITR as found by respondent[56] discloses the following discrepancies:

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[54] BIR Records, p. 156.
[55] BIR Records, p. 157.
[56] Exhibit "P-15".

Payee	Per Alphalist		Per Assessment		Discrepancy	
	Income Payment	EWT	Income Payment	EWT	Income Payment	EWT
Purchases of goods:						
AGM Ventures Enterprises, Inc.	₱ 37,020,986.37	₱370,209.86	₱ 37,858,250.25	₱378,582.50	₱ 837,263.88	₱ 8,372.64
Purchases of services:						
Delivery expenses			198,023.10			
Membership dues & fees			19,258.94			
Repairs & maintenance			85,982.04			
Seminars & training			13,900.00			
Shipping & freight			27,339.37			
Telephone expense			66,259.62			
Utilities			60,706.29			
	-	-	471,469.36	9,429.39	471,469.36	9,429.39
Total	**₱37,020,986.37**	**₱370,209.86**	**₱38,329,719.61**	**₱388,011.89**	**₱1,308,733.24**	**₱17,802.03**

Clearly, petitioner failed to withhold EWT of ₱17,802.03 on its purchases of goods and services (delivery expenses, membership dues & fees, repairs and maintenance, seminars & training, shipping & freight, telephone expense and utilities) amounting to ₱1,308,733.24. Hence, respondent's deficiency income tax assessment on this item shall be upheld.

However, respondent's imposition of deficiency income tax on the Net Operating Loss Carry-Over (NOLCO) in the amount of ₱620,420.63 is incorrect. Respondent cited as legal basis Section 34(D)(3) of the NIRC of 1997,[57] which states:

"SEC. 34. *Deductions from Gross Income.* — xxx

xxx xxx xxx

(D) *Losses.* —

xxx xxx xxx

(3) *Net Operating Loss Carry-over.* — The net operating loss of the business or enterprise for any taxable year immediately preceding the current taxable year, which had not been previously offset as deduction from

[57] Exhibit "P-11", Details of Discrepancies.

gross income shall be carried over as a deduction from gross income for the next three (3) consecutive taxable years immediately following the year of such loss: xxx."

However, respondent failed to present evidence to prove that petitioner used its 2009 net loss as NOLCO in the succeeding years. Furthermore, said NOLCO is beyond the scope of the present assessment as it can only be the subject of assessment in the taxable year when it is claimed as a deduction. Thus, respondent was wrong to add back the net loss in the amount of ₱620,420.63 to petitioner's taxable income.

To reiterate, the Court held earlier that the sub-contracting for the manufacture of wooden pallets is outside the registered activity of the petitioner. Thus, the latter is not entitled to the ITH.

Accordingly, the previously exempt income shall be subject to income tax. Combining the same with the taxable income and effecting thereto the disallowance of income payments, petitioner is liable for basic deficiency Income Tax of ₱602,619.65, as computed below:

	Per FS/ITR			**Per this Court's verification**
	Exempt	**Taxable**	**Total**	**Total**
Revenues				
Sales from operations	₱ 30,522,077.32	₱ 11,034,067.00	₱ 41,556,144.32	₱ 41,556,144.32
Less: Cost of goods Manufactured & sold	25,794,046.74	10,480,100.68	36,274,147.42	36,274,147.42
Gross income from operations	₱ 4,728,030.58	₱ 553,966.32	₱ 5,281,996.90	₱ 5,281,996.90
Less: Operating expenses	3,503,299.14	1,123,247.73	4,626,546.87	3,317,813.63[58]
Net ordinary income	₱ 1,224,731.44	₱ (569,281.41)	₱ 655,450.03	₱ 1,964,183.27
Add: Other income	141,618.58	(60,139.22)	81,479.36	81,479.36
Net income (loss) before tax	₱ 1,366,350.02	₱ (629,420.63)	₱ 736,929.39	₱ 2,045,662.63
Tax due	₱ -	₱ 11,079.33[59]	₱ 11,079.33	₱ 613,698.79[60]
Less: Tax paid	-	11,079.33	11,079.33	11,079.33
Income Tax Still Due				**₱ 602,619.46**

58

Operating expenses per FS/ITR	₱4,626,546.87
Less: Disallowed expenses due to non-withholding	1,308,733.24
Allowed Deductions for Operating expenses	₱3,317,813.63

59 2% Minimum Corporate Income Tax on Gross Income of ₱553,966.32.

60 Computed using regular income tax rate of 30%.

The income tax still due from petitioner of ₱602,619.65 as computed above is much higher than the amount of ₱424,026.41 assessed by respondent. In the consolidated cases of *Commissioner of Internal Revenue vs. Transnational Plans, Inc.* and *Transnational Plans, Inc. vs. Commissioner of Internal Revenue*[61], the CTA *En Banc* held that **the Court cannot go beyond the contested assessment per FDDA**, to wit:

> "In as much as this Court's jurisdiction is appellate in nature, it is essential that matters taken up in the appeal should be included in the contested assessment. It must be realized that with respect to the deficiency VAT of TPI, the appealed amount before this Court's jurisdiction is only with respect to the ₱67,446,873.00, as what is indicated in the FDDA. As stated in the case of *Commissioner of Internal Revenue vs. Guerrero, et al.*:[62]
>
>> 'Although these charges and taxes are not included in the original and revised assessments made in this case, petitioner herein maintains that Guerrero may nevertheless be held liable therefor xxx
>>
>> Petitioner's contention is untenable. xxx In short, it refers to a point in issue. In the case at bar, the additional [amount] under consideration were not included in the contested assessments. Since the jurisdiction of the Court of Tax Appeals is purely appellate, said Court correctly declined to make an award thereon, for lack of jurisdiction over the same.'
>
> Section 228 of the Tax Code clearly states that 'the taxpayer shall be informed in writing of the facts and the law on which the assessment is made; otherwise, the assessment shall be void.' As thus worded, the respondent has the bounden duty to inform the taxpayer not only of the law but more importantly, the surrounding circumstances supporting the assessment, for it is only through a detailed appraisal of its basis that the taxpayer

[61] CTA EB Nos. 1337 and 1339 (CTA Case No. 8291), March 27, 2017.
[62] G.R. No. L-19074, January 31, 1967.

may be able to dispute the imposition or agree with it.[63] The underlying reason of the law is the basic constitutional requirement that 'no person shall be deprived of his property without due process of law.'[64]

Thus, the amount to be collected from TPI should not go beyond what is stated in the assessment. In excess of such stated therein, TPI was not informed in writing of the facts and law on which the amount is made, thus, the taxpayer has no opportunity to dispute the said amount, in violation of due process.

Furthermore, as the said excess amount was not indicated in the FAN, it should be considered as not assessed by the CIR, hence, already beyond the prescriptive period for it to be included only at this time of judicial trial.

Consequently, the findings of the BIR as that stated in the assessment should be the basis for the deficiency VAT, i.e., only the amount of P67,446,873.00."

Considering that the power to assess is lodged in the respondent and is not within the province of this Court, the Court is constrained to limit its findings based on respondent's assessment, albeit the erroneous computation per FLD. Hence, petitioner is liable only to the extent of that assessed by respondent in the amount of ₱424,026.41.

II. Value-added Tax – ₱245,887.82

Respondent's verification disclosed that petitioner sold a motor vehicle in the amount of ₱1,073,656.00, without subjecting the same to VAT. Hence, pursuant to Section 106 of the NIRC of 1997, as amended in relation to Section 4.106-3 of RR No. 16-2005, respondent assessed petitioner of deficiency VAT in the amount of ₱128,838.72, computed as follows:

Sale of motor vehicle	₱ 1,073,656.00
Multiply by tax rate	12%

[63] *Ima Land Holdings, Inc. vs. Commissioner Internal Revenue*, CTA Case No. 6389, October 7, 2004, citing *Abbott Laboratories, Inc. vs. Commissioner of Internal Revenue*, CTA Case No. 5718, February 16, 2001.

[64] *Ibid.*, citing *Subic Power Corporation vs. Commissioner of Internal Revenue*, CTA Case No. 6059, May 8, 2003.

VAT Due	**₱**	**128,838.72**

The Court sustains the assessment.

Section 105 of the NIRC of 1997, as amended, provides:

"**SEC. 105.** *Persons Liable.* - Any person who, in the course of trade or business, sells, barters, exchanges, leases goods or properties, renders services, and any person who imports goods shall be subject to the value-added tax (VAT) imposed in Sections 106 to 108 of this Code.

The value added tax is an indirect tax and the amount of tax may be shifted or passed on to the buyer, transferee or lessee of the goods, properties or services. This rule shall likewise apply to existing contracts of sale or lease of goods, properties or services at the time of the effectivity of Republic Act 7716.

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

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

From the foregoing provision, it is clear that the "*regular course of trade or business*", for all intents and purposes, is not confined to the primary business that a taxpayer is engaged in but is an all-encompassing phrase pertaining to the pursuit of business opportunities that produce profits for petitioner (economic activity), including those which are merely incidental to petitioner's trade and industry.

In the case of *CS Garments, Inc. vs. CIR*[65], the CTA *En Banc* defined the phrase "in the course of trade or business", as follows:

> "xxx A transaction will be characterized as having been entered into by a person in the course of trade or business if it is: (1) regularly conducted; and (2) undertaken in pursuit of a commercial or economic activity. Likewise, transactions that are made incidental to the pursuit of a commercial or economic activity are considered as entered into in the course of trade or business. 'Incidental' means something else as primary; something necessary, appertaining to, or depending upon another, which is termed the principal. Hence, an isolated transaction is not necessarily disqualified from being made incidentally in the course of trade or business.
>
> xxx xxx xxx
>
> Once an activity has been identified as a business, any supply[sale] made while carrying it on is likely to be made in the course or furtherance of business. No distinction is made between capital and revenue items. Thus, a supply[sale]in the course or furtherance of business includes:
>
> > (1) *the disposition of the assets and liabilities of a business*;
> >
> > (2) the disposition of a business as going concern; and
> >
> > (3) anything done in connection with the termination or intended termination of a business."

Moreover, the Supreme Court, in the case of *Mindanao II Geothermal Partnership vs. Commissioner of Internal Revenue and Mindanao I Geothermal Partnership vs. Commissioner of Internal Revenue*,[66] finally settled the issue on whether an isolated transaction, such as the sale of a motor vehicle by a person not regularly engaged

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[65] CTA EB Case No. 287, January 14, 2008.
[66] G.R. No. 193301 & 194637, March 11, 2013.

in this business, partakes the nature of an incidental transaction and as such, shall be subject to VAT, to wit:

> "Mindanao II's sale of the Nissan Patrol is said to be an isolated transaction. However, it does not follow that an isolated transaction cannot be an incidental transaction for purposes of VAT liability. Indeed, a reading of Section 105 of the 1997 Tax Code would show that a transaction 'in the course of trade or business' includes 'transactions incidental thereto.' Mindanao II's business is to convert the steam supplied to it by PNOC-EDC into electricity and to deliver the electricity to NPC. In the course of its business, Mindanao II bought and eventually sold a Nissan Patrol. Prior to the sale, the Nissan Patrol was part of Mindanao II's property, plant, and equipment. Therefore, the sale of the Nissan Patrol is an incidental transaction made in the course of Mindanao II's business which should be liable for VAT."

A perusal of petitioner's Notes to Financial Statements and Statement of Cash Flows (for the years ended December 31, 2009 and 2008) disclosed that petitioner, indeed, disposed of a motor vehicle at ₱1,073,656.00.[67]

Clearly, from the foregoing, petitioner's sale of motor vehicle is an incidental transaction which should be subject to 12% VAT. Moreover, petitioner did not contest this deficiency finding of the respondent. Thus, petitioner is liable for basic deficiency VAT in the amount of ₱128,838.72.

III. Expanded Withholding Tax – ₱33,194.76

As discussed earlier under the deficiency income tax assessment, petitioner failed to withhold tax on certain income payments. Hence, respondent's assessment on this item shall be upheld. Accordingly, petitioner is liable for basic deficiency EWT in the amount of ₱17,802.03, as computed earlier.

IV. Improperly Accumulated Earnings Tax – ₱3,949,767.44

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[67] BIR Records, pp. 200-201 and 209.

Considering petitioner is not qualified to enjoy ITH or 5% preferential tax rate, respondent assessed petitioner IAET in excess of 100% of the paid up capital pursuant to Section 29 of the NIRC of 1997, as implemented by RR No. 2-2001.

Citing Section 4 of RR No. 2-2001, petitioner contends that it falls under the exception (f). As such, there is no legal basis for respondent's imposition of the 10% IAET against the petitioner.

Further, petitioner points out that Section 2 of the same RR states the rationale for the imposition of 10% IAET – that is, if the earnings and profits were distributed, the shareholders would then be liable to income tax thereon, whereas if the distribution were not made to them, they would incur no tax in respect to the undistributed earnings and profits of the corporation. Thus, the tax being imposed is in the nature of a penalty to the corporation for the improper accumulation of its earnings, and a form of deterrent to the avoidance of tax upon shareholders who are supposed to pay dividends tax on the earnings distributed to them by the corporation.

Allegedly, the non-imposition of the 10% IAET to PEZA registered-enterprises, including petitioner, is to align the very purpose of encouraging investments inside the ECOZONES, where every investor would aim for business expansion. Therefore, petitioner maintains that it should not be restricted to accumulate its income for business purposes.

According to petitioner, even assuming *arguendo* that there is a basis to impose the 10% IAET, the ₱18,224,702.76 tax base used by respondent can be considered as mathematically impossible. Petitioner with a paid-up capital of ₱125,000.00 and a net loss in the year 2009 in the amount of ₱620,420.63, could not have accumulated ₱18,224,702.76 in barely three (3) years' time from the start of its commercial operations sometime in October 2006 until December 2009. Thus, petitioner states that there might be an error in this tax assessment by the respondent.

Petitioner's contentions are untenable.

Section 4 of RR No. 2-2001, implementing the provision on IAET under Section 29 of the NIRC of 1997, as amended, reads:

"SEC. 4. *Coverage.* The 10% Improperly Accumulated Earnings Tax (IAET) is imposed on improperly accumulated taxable income earned starting January 1, 1998 by domestic corporations as defined under the Tax Code and which are classified as closely-held corporations. Provided, however, that Improperly Accumulated Earnings Tax shall not apply to the following corporations:

x x x x x x x x x

g. Enterprises duly registered with the Philippine Economic Zone Authority (PEZA) under R.A. 7916, and enterprises registered pursuant to the Bases Conversion and Development Act of 1992 under R.A. 7227, as well as other enterprises duly registered under special economic zones declared by law which enjoy payment of special tax rate on their registered operations or activities in lieu of other taxes, national or local."

As held earlier, petitioner's activity is outside the registered activity with the PEZA. Accordingly, petitioner is not entitled to the fiscal incentives provided for under RA No. 7916. More so, it is not exempt from any national internal revenue taxes.

Section 7 of the same RR further provides the following:

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

x x x x x x x x x

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

x x x x x x x x x

c. **Accumulation of earnings in excess of 100% of paid-up capital, not otherwise intended for the reasonable needs of the business as defined in these Regulations.**"

Absent any evidence proving the contrary, petitioner's accumulation of earnings in excess of 100% of paid-up capital shall be determinative of the purpose to avoid the tax upon its shareholders.

It should be noted that petitioner's taxable income for 2009 is ₱2,045,662.62 and the corresponding income tax paid/payable is ₱613,698.79, as computed earlier. Considering these facts, petitioner is liable for IAET in the total amount of ₱1,830,139.59, as computed below:

Taxable income for 2009	₱ 2,045,662.63
Less: Income tax paid/payable	613,698.79
Total	₱ 1,431,963.84
Add: Retained earnings from prior years	16,994,432.07
Less: Amount that may be retained	125,000.00
Net Retained Earnings	₱ 18,301,395.91
Improperly Accumulated Earnings Tax (10%)	**₱ 1,830,139.59**

However, as discussed earlier, this Court has no jurisdiction beyond the contested assessment per FDDA. Hence, petitioner is liable only to the extent of that assessed by respondent in the amount of ₱1,822,470.28.

V. Documentary Stamp Tax – ₱1,687.22

Respondent's investigation revealed that petitioner failed to impose DST on rental income amounting to ₱777,500.00, thus, assessed pursuant to Section 194 of NIRC of 1997, as implemented by RR No. 13-2004.

> "SEC. 194. *Stamp tax on Lease and Other Hiring Agreements.* – On each lease, agreement, memorandum, or contract for hire, use or rent of any lands or tenements, or portions thereof, there shall be collected a documentary stamp tax of Three pesos (P3.00) for the first Two thousand pesos (P2,000), or fractional part thereof, and an additional One peso (P1.00) for every One Thousand pesos (P1,000) or fractional part thereof, in excess of the first Two thousand pesos (P2,000) for each year of the term of said contract or agreement."

Again, petitioner's activity is outside that registered with the PEZA. Accordingly, petitioner is not entitled to the fiscal incentives provided for under RA No. 7916. More so, petitioner is not exempt from any national internal revenue taxes. Thus, the respondent's assessment shall be sustained.

In fine, petitioner is liable for basic deficiency DST in the amount of ₱778.50, as shown below:

Rental expense per FS	₱ 777,500.00
Tax due thereon	₱ 778.50
Less: Payments	-
Basic Deficiency DST	**₱ 778.50**

VI. Compromise Penalty – ₱36,000.00

The compromise penalties in the total amount of ₱36,000.00 are hereby cancelled, there being no mutual agreement between the parties. Settled is the rule that the imposition of the same without the conformity of the taxpayer is illegal and unauthorized.[68] RMO No. 1-90 expressly provides that "compromise penalties are only amounts suggested in settlement of criminal liability, and may not therefore be imposed or exacted on the taxpayer in the event that a taxpayer refuses to pay the suggested compromise penalty". Considering petitioner did not pay the compromise penalty imposed by the respondent, it clearly did not agree to settle the same.

WHEREFORE, premises considered, the Petition for Review is **PARTIALLY GRANTED**. The assessments issued by respondent

[68] *Commissioner of Internal Revenue vs. Lianga Bay Logging Co., Inc. and the Court of Tax Appeals*, G.R. No. L-35266, January 21, 1991.

against petitioner for taxable year 2009 covering deficiency Income Tax, Value-Added Tax, Expanded Withholding Tax, Improperly Accumulated Earnings Tax and Documentary Stamp Tax are **PARTIALLY UPHELD**. Accordingly, petitioner is ordered to pay respondent the amount of **TWO MILLION NINE HUNDRED NINETY TWO THOUSAND THREE HUNDRED NINETY FOUR PESOS AND NINETY THREE CENTAVOS (₱2,992,394.93)**, representing basic deficiency Income tax, Value-Added Tax, Expanded Withholding Tax, Improperly Accumulated Earnings Tax and Documentary Stamp Tax and the 25% surcharge imposed under Section 248(A)(3) of the NIRC of 1997, as amended, computed as follows:

Tax Type	**Basic**	**25% Surcharge**	**Total**
Income Tax	₱ 424,026.41	₱ 106,006.60	₱ 530,033.01
Value-Added Tax	128,838.72	32,209.68	161,048.40
Expanded Withholding Tax	17,802.03	4,450.51	22,252.54
Improperly Accumulated Earnings Tax	1,822,470.28	455,617.57	2,278,087.85
Documentary Stamp Tax	778.50	194.63	973.13
Total	**₱ 2,393,915.94**	**₱ 598,478.99**	**₱ 2,992,394.93**

In addition, petitioner is ordered to pay:

(a) Deficiency interest at the rate of twenty percent (20%) per annum on the basic deficiency income tax, VAT, EWT and IAET computed from the dates indicated below until full payment thereof pursuant to Section 249(B) of the NIRC of 1997, as amended:

Tax Type	**Basic Tax**	**Deficiency Interest Computed From**
Income Tax	₱ 424,026.41	April 15, 2010
Value-Added Tax	128,838.72	January 25, 2010
Expanded Withholding Tax	17,802.03	January 15, 2010
Improperly Accumulated Earnings Tax	1,822,470.28	January 15, 2011
Documentary Stamp Tax	778.50	January 5, 2010

(b) Delinquency interest at the rate of twenty percent (20%) per annum on the total amount of ₱2,992,394.93, and on the 20%

deficiency interest which have accrued as aforestated in (a), computed from November 17, 2014 until full payment thereof pursuant to Section 249(C) of the NIRC of 1997, as amended.

SO ORDERED.

CAESAR A. CASANOVA
Associate Justice

WE CONCUR:

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

Catherine T. Manahan
CATHERINE T. MANAHAN
Associate Justice

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.

Juanito C. Castañeda, Jr.
JUANITO C. CASTAÑEDA, JR.
Acting Presiding Justice