REPUBLIC OF THE PHILIPPINES
COURT OF TAX APPEALS
QUEZON CITY

SECOND DIVISION

LUFTHANSA GERMAN AIRLINES – PHILIPPINE BRANCH,
Petitioner,

CTA CASE NO. 8601

- versus-

Members:

Castañeda, Jr., *Chairperson*
Casanova, and
Cotangco-Manalastas, *JJ.*

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Promulgated:

MAR 2 1 2016

4:05 p.m.

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D E C I S I O N

COTANGCO-MANALASTAS, *J.:*

The Petition for Review filed by Lufthansa German Airlines-Philippine Branch prays for the reversal and setting aside of the Final Decision on Disputed Assessment (FDDA) issued by the Commissioner of Internal Revenue and for the cancellation and setting aside of the alleged deficiency income tax assessment, inclusive of interest and penalties, in the amount of ₱10,599,262.63 for taxable year 2008.[1]

FACTS

Petitioner Lufthansa German Airlines-Philippine Branch is a duly registered Philippine Branch of Deutsche Lufthansa Aktiengesellschaft, which is a corporation organized and existing under the laws of the Federal Republic of Germany.[2] It is licensed to engage in air travel transport business in the Philippines.[3] Petitioner is also a registered taxpayer with Tax Identification No. 000-592-425-000.[4]

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[1] Par. 1, Pre-Trial Order, docket, p. 1184.
[2] Exhibit "B", docket, pp. 1980 to 2003.
[3] Exhibits "A" and "A-1", docket, p. 1976.
[4] Exhibits "C" and "D" docket, pp. 1640 and 1641, respectively.

Respondent is the duly appointed Commissioner of the Bureau of Internal Revenue (BIR), who is responsible for the assessment and collection of all national internal revenue taxes, fees and charges and the enforcement of all forfeitures, penalties and fines connected with such taxes. She holds office at the BIR National Office Building, Agham Road, Diliman, Quezon City.

Petitioner filed its Annual Income Tax Return (ITR) for calendar year 2008 on June 8, 2009.[5]

On July 6, 2009, respondent served the Letter of Authority dated July 1, 2009[6] and the Letter Request for submission of documents dated July 2, 2009[7] to petitioner through its Accounts Executive, Wynvie Lee.[8]

Subsequently, respondent served a Final Notice for Presentation of Books of Accounts and Other Accounting Records on August 11, 2009.[9] Respondent again requested the submission of complete documents on August 3, 2010.[10]

On September 30, 2011, the Notice of Informal Conference on Partial Assessment (on Income Tax based on Gross Philippine Billings for On-line Carrier from January to December 31, 2008) dated September 29, 2011 was served to petitioner.[11]

The Notice of Informal Conference dated October 10, 2011 was faxed and personally served to petitioner on October 12, 2011 and October 13, 2011, respectively.[12]

Subsequently, the Preliminary Assessment Notice (PAN)[13] with Details of Discrepancies[14] issued on March 7, 2012, was served to petitioner on March 23, 2012.[15]

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[5] Exhibit "H", docket, p. 1651.
[6] Exhibit "1", BIR records, folder I, p. 4.
[7] Exhibit "2", BIR records, folder I, p. 3.
[8] Par. 1, Joint Stipulation, docket, p. 818.
[9] Par. 2, Joint Stipulation, docket, p. 818; Exhibit "3", BIR records, folder I, p. 2.
[10] Par. 3, Joint Stipulation, docket, p. 818.
[11] Par. 5, Joint Stipulation, docket, p. 819; Exhibit "I", docket, pp. 1659 to 1661; Exhibit "7", BIR records, folder II, pp. 125 to 127.
[12] Par. 6, Joint Stipulation, docket, p. 819; Exhibits "J" and "8", BIR records, folder II, p. 150.
[13] Exhibit "K", docket, pp. 1673 to 1674.

Petitioner filed its Protest Letter to the said PAN, with attached supporting documents, on April 4, 2012.[16]

Thereafter, petitioner received the Formal Letter of Demand[17] (FLD) dated April 10, 2012, with Details of Discrepancies[18] and Audit Result/Assessment Notice (FAN) on April 12, 2012, assessing petitioner for alleged deficiency income tax for taxable year 2008 in the total amount of ₱43,002,601.23, inclusive of interest and penalties.[19]

On May 3, 2012, petitioner paid ₱3,951,990.11 as additional income tax for taxable year 2008.[20]

On May 4, 2012, petitioner protested the FLD.[21]

Respondent issued the FDDA[22] on November 20, 2012, which petitioner received on December 11, 2012, upholding the deficiency income tax assessment against petitioner in the reduced amount of ₱10,599,262.63, inclusive of interest computed up to December 31, 2012 and penalties.[23]

As a result, petitioner filed the present Petition for Review[24] on January 10, 2013 before this Court.

In the Answer[25] filed on April 2, 2013, respondent interposed her special and affirmative defenses, namely:

> "6. The assessment for 2008 deficiency income tax was issued in accordance with law, jurisprudence and relevant administrative issuances.
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[14] Exhibit "K-1", docket, pp. 1675 to 1684.
[15] Par. 8, Joint Stipulation, docket, p. 819; Exhibit "12", BIR records, folder II, pp. 551 to 562.
[16] Exhibits "L", "L-1", and "L-2", docket, pp. 494 to 503.
[17] Exhibit "M", docket, pp. 526 to 527.
[18] Exhibit "M-1", docket, pp. 528 to 537.
[19] Par. 9, Joint Stipulation, docket, p. 819; Exhibit "16", BIR records, folder II, pp. 621 to 640.
[20] Exhibits "P" and "Q", docket, pp. 1744 and 1745, respectively.
[21] Par. 10, Joint Stipulation, docket, p. 819; Exhibits "N", "N-1", "N-1-a", "N-2", and "N-3", docket, pp. 553 to 566.
[22] Exhibit "O", docket, pp. 576 to 585; Exhibit "18", BIR records, folder II, pp. 773 to 785.
[23] Par. 11, Joint Stipulation, docket, p. 819.
[24] Docket, pp. 6-22.
[25] Docket, pp. 82 to 95.

7. Availment of Tax Treaty provision are not ipso facto granted just to anyone who wishes to avail of the benefits of the tax treaty. Certain procedures must be complied with to be entitled to the benefits of the said tax treaty. Thus, the Commissioner of Internal Revenue issued RMO 1-2000 to streamline the processing of tax treaty applications in order to improve efficiency and service to the taxpayers.

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9. RMO 01-2000 was not issued to supersede a tax law or treaty, but it was issued for proper and orderly implementation thereof. It must be implemented hand in hand with tax laws and tax treaties, and must complement each other.

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12. Petitioner must be subjected to a rate of 2.5% pursuant to Section 28 (A) (3) (a) of the National Internal Revenue Code (NIRC) and not the 1.5% rate as stated in the Tax Treaty since petitioner failed to file an application to avail the benefit of the tax treaty provisions as required under RMO 1-2000, which provides:

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13. It is clear from the foregoing that anyone who wishes to avail of the benefit of a tax treaty must file an Application for Relief from Double Taxation fifteen (15) days prior to the transaction or payment of services. Undoubtedly, the law requires the filing of the appropriate BIR Form before any transaction will be undertaken by the taxpayer.

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16. It is worthy to emphasize that RMO 01-2000 provides that any availment of tax treaty must be preceded by an application, BIR Form No. 0901 (Application for Relief From Double Taxation) with ITAD at least fifteen days before the transaction, accompanied by supporting documents justifying the relief sought.

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17. Section 28 of the NIRC states that resident foreign corporations are taxable at the rate of 35% from income within the Philippines. As expounded by the Supreme Court in Commissioner of Internal Revenue vs. British Overseas Airways Corporation (G.R. No. L-65773-7, April 31, 1987),

income of off-line air carrier from sources within the Philippines are tickets sold within the Philippines.

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19. The Gross Revenue in the amount of Php 468,616,159.51 was computed using the IATA Bank Settlement Plan Participant Billing Statement which shows the name of the ticket agent, the amount of ticket sold and the agent's commission. Considering the bare allegations of petitioner are unsupported by any documents, the findings of the Commissioner should be upheld.

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21. Verification disclosed that there were expenses included in the operating expenses per audited financial statements of the Lufthansa Group that are not deductible under Philippine tax law. Write down on receivables cannot be claimed as deduction. Only bad debts which complied with the above requisites can be claimed as valid deduction from gross income.

22. Losses on Current available for sale financial assets were not allowed as deductions for these are not actual losses as required in Section 34 (1) (a) and (b) of the NIRC. As stated in the Financial Statement, the financial assets are recognized at fair market value. Thus any decrease in fair market value is recognized as gain or loss per financial statement.

23. Verification disclosed that some expenses included under 'other charges and credits' per audited financial statement of the Lufthansa Group that are not deductible under NIRC of 1997. Said expenses are as follows:

a. Results of Equity Investment Accounted for using Equity Method\Results from other equity investments

24. Verification disclosed that these items are the result of investment activities as stated in the audited financial statement. These items are not directly attributable to generation of income within the Philippines, thus, disallowed in compliance with Section 42 (B) of the NIRC. Under Philippine Tax Law these items are adjustments to income per books to arrive at taxable income tax, thus, not included in the computation of income tax.

b. Other Financial Items

25. Explanations from the Audited Financial Statement states that this consists of write-downs on

available for sale financial assets. As previously stated in the preceding paragraphs, these are not allowed because these are not actual losses as required in Section 31 (A) (1) (a) and (b) of the NIRC.

26. Petitioner failed to register its books of accounts in violation of Section 232 and 235 of the NIRC. Thus a penalty of Php 50,000.00 was imposed based on RMO 19-2007.

27. Verification disclosed that the tickets issued by Lufthansa to its passengers are not registered with the Bureau in violation of Section 238 of the NIRC. This act was not merely due to negligence, thus a penalty of Php 50,000.00 was imposed based on RMO 19-2007.

28. Based on the foregoing discussions, respondent respectfully submits that the subject assessment was issued in accordance with law, having the presumption of correctness and regularity.

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Respondent's Pre-Trial Brief[26] and petitioner's Amended Pre-Trial Brief[27] were submitted on May 31, 2013 and October 7, 2013, respectively.

The parties submitted their Joint Stipulation[28] on November 6, 2013, which the Court approved on November 18, 2013.[29]

Petitioner presented Kathleen Mae Guerrero and Moises M. Visperas as its witness. Thereafter, petitioner formally offered its documentary evidence and the deposition of Ms. Ana Maria Thomsen. Petitioner's submitted exhibits were all subsequently admitted by the Court.[30]

On the other hand, respondent called to the witness stand Revenue Officer Fatima Sarrosa as her sole witness. Subsequently, the documentary evidence of respondent was formally offered. The Court admitted all of respondent's exhibits via Resolution dated January 23, 2015.[31]

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[26] Docket, pp. 117 to 121.
[27] Docket, pp. 646 to 664.
[28] Docket, pp. 818 to 822.
[29] Pre-Trial Order, docket, pp. 1184 to 1197.
[30] Resolutions, dated August 8, 2014 and October 27, 2014; docket, pp. 2006-2007, and pp. 2034-2035.
[31] Docket, pp. 2067-2068.

The instant case was declared submitted for decision on April 13, 2015,[32] considering petitioner's Memorandum[33] filed on March 13, 2015 and respondent's Manifestation[34] filed through registered mail on March 30, 2015 and received by the Court on April 8, 2015, stating that respondent would adopt the arguments raised in the Answer filed on April 2, 2013 as her Memorandum.

ISSUES

The following issues[35] were submitted by the parties for the Court's consideration:

1. Whether petitioner is liable for deficiency income tax for the taxable year ended December 31, 2008 in the amount of ₱10,599,262.63 as well as interest and surcharges provided in Sections 248 and 249 of the National Internal Revenue Code (NIRC) of 1997, as amended; and

2. Whether respondent should have deducted the amount of ₱3,951,990.11 which petitioner paid on May 3, 2012 from her computation of the alleged income tax deficiency in the FDDA.

DISCUSSION/RULING

In the FDDA[36] dated November 20, 2012, the deficiency income tax assessment was upheld against petitioner in the reduced amount of ₱10,599,262.63, as follows:

ON SPECIAL RATE			
Gross Philippine Billing per Return		₱423,187,190.95	
Variance in the Number of Passengers and Average Airfare		47,932,334.73	
"Continuous and Uninterrupted Flight" Discrepancy		11,531,181.22	

[32] Resolution, docket, p. 2117.
[33] Docket, pp. 2084 to 2112.
[34] Docket, pp. 2114 to 2115.
[35] Joint Stipulation, docket, p. 820.
[36] Exhibit "O", docket, pp. 576 to 585; Exhibit "18", BIR records, folder II, pp. 773 to 785.

Gross Philippine Billing per Audit		482,650,706.90	
Add: Audit Adjustments			
Per Return using RP-German Treaty Rate	0.015		
Per Audit using Regular Rate - No ITAD Application	0.025	0.025	
Income tax per audited based on Gross Philippine Billing			**₱12,066,267.67**
ON REGULAR RATE			
Net income per return		8,266,981.88	
Add: Audit Adjustments			
Net effect of discrepancy in revenue, cost of sales and other charges		10,357,131.84	
Taxable income per return		18,624,113.72	
Tax Rate		0.35	
Tax Due on Regular Rate			**6,518,439.80**
Tax Due per Audit prior to Tax Credits			**18,584,707.47**
Less: Payment and Other tax credits		13,078,146.84	
Payment after issuance of Informal Conference on issues agreed upon		892,604.91	
Payment after issuance of FAN		2,454,025.78	16,424,777.53
Tax Due per Audit			**2,159,929.94**
Tax credit carried over per return			3,836,895.31
Basic deficiency income tax			**5,996,825.25**
Interest			4,452,437.38
Compromise penalty for unregistered books		50,000.00	
Compromise penalty for unregistered ticketing system		50,000.00	
Compromise penalty for deficiency taxes		50,000.00	150,000.00
Total Deficiency income tax			**₱10,599,262.63**

ON SPECIAL RATE

Respondent's legal basis in imposing 2.5% tax rate on petitioner's GPB for the latter's on-line activities from January to March 2008 is Revenue Memorandum Order (RMO) No. 1-2000. According to respondent, since petitioner failed to submit an application for tax treaty relief to the BIR International Tax Affairs Division (ITAD) in violation of the said RMO, the application of the 1.5% tax rate on GPB under the RP-Germany Treaty cannot be availed of by petitioner.

On the other hand, petitioner contends that respondent erred in upholding the GPB tax assessment based on its failure to file a tax treaty relief application in accordance with RMO No. 1-2000. In insisting that the proper tax rate should be 1.5% under the RP-Germany Treaty and not 2.5%, petitioner cites the cases of *Deutsche Bank* and *CBK* stating that the obligation on the part of the Philippines to comply with a tax treaty must take precedence over the objective of

RMO No. 1-2000 and a tax treaty relief application should merely operate to confirm the entitlement of the taxpayer to tax treaty relief. Petitioner also asserts that RMO No. 1-2000 was never published in the Official Gazette or in a newspaper of general circulation; thus, it should not be enforced against taxpayers.

The Philippine Constitution provides for adherence to the general principles of international law as part of the law of the land. The time-honored international principle of *pacta sunt servanda* demands the performance in good faith of treaty obligations on the part of the states that enter into the agreement. In this jurisdiction, treaties have the force and effect of law.[37]

The RP-Germany Tax Treaty provides:

> "The Republic of the Philippines
> and
> the Federal Republic of Germany,
>
> Desiring to conclude an Agreement for the Avoidance of Double Taxation with Respect to Taxes on Income and Capital,
>
> Have agreed as follows:
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> **ARTICLE 1**
> *Personal scope*
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> This Agreement shall apply to persons who are residents of one or both of the Contracting States.
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> xxx xxx xxx
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> **ARTICLE 8**
> *Shipping and Air Transport*
>
> 1. Profits from the operation of ships or aircraft in international traffic derived by an enterprise of a Contracting State may be taxed in that State.
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> 2. However, such profits may be taxed in the other Contracting State, but the tax so charged shall not exceed the lesser of

[37] *CBK Power Company Limited vs. Commissioner of Internal Revenue*, G.R. Nos. 193383-84, and *Commissioner of Internal Revenue vs. CBK Power Company Limited*, G.R. Nos. 193407-08, January 14, 2015.

(a) the rate of 1 1/2 per cent applied on the gross revenue derived from sources within that State; or

(b) the lowest rate of Philippine tax applied on such profits derived by an enterprise of a third State.

3. The provisions of paragraphs 1 and 2 shall likewise apply in respect of participations in pools, in a joint business or in an international operation of ships or aircraft in international traffic."

It is clear that either or both residents of the Philippines and the Federal Republic of Germany may avail of the afore-stated tax treaty on income and capital.

In the case of *Deutsche Bank AG Manila Branch vs. Commissioner of Internal Revenue*[38] *(Deutsche Bank case)*, the Supreme Court explained that the laws and issuances must ensure that the reliefs granted under tax treaties are accorded to the parties entitled thereto, but the BIR must not impose additional requirement that would negate the availment of the reliefs provided for under international agreements, to wit:

"Tax treaties are entered into 'to reconcile the national fiscal legislations of the contracting parties and, in turn, help the taxpayer avoid simultaneous taxations in two different jurisdictions.' *CIR v. S.C. Johnson and Son, Inc.* further clarifies that 'tax conventions are drafted with a view towards the elimination of international juridical double taxation, which is defined as the imposition of comparable taxes in two or more states on the same taxpayer in respect of the same subject matter and for identical periods. The apparent rationale for doing away with double taxation is to encourage the free flow of goods and services and the movement of capital, technology and persons between countries, conditions deemed vital in creating robust and dynamic economies. Foreign investments will only thrive in a fairly predictable and reasonable international investment climate and the protection against double taxation is crucial in creating such a climate.' Simply put, tax treaties are entered into to minimize, if not eliminate the harshness of international juridical double taxation, which is why they are also known as double tax treaty or double tax agreements.

'A state that has contracted valid international obligations is bound to make in its legislations those modifications that may be necessary to ensure the fulfillment of the obligations undertaken.' **Thus, laws and issuances**

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

must ensure that the reliefs granted under tax treaties are accorded to the parties entitled thereto. The BIR must not impose additional requirements that would negate the availment of the reliefs provided for under international agreements. More so, when the RP-Germany Tax Treaty does not provide for any pre-requisite for the availment of the benefits under said agreement." *(Emphasis supplied)*

The Supreme Court further declared in the said *Deutsche Bank case*[39] that the application for a tax treaty relief from the BIR should merely operate to confirm the entitlement of the taxpayer to the tax treaty relief, *viz*:

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

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

The obligation to comply with a tax treaty must take precedence over the objective of RMO No. 1-2000. Logically, noncompliance with tax treaties has negative implications on international relations, and unduly discourages foreign investors. While the consequences sought to be prevented by RMO No. 1-2000 involve an administrative procedure, these may be remedied through other system management processes, e.g., the imposition of a fine or penalty. But we cannot totally deprive those who are entitled to the benefit of a treaty for failure to strictly comply with an administrative

[39] G.R. No. 188550, August 19, 2013; see also *CBK Power Company Limited vs. Commissioner of Internal Revenue*, G.R. Nos. 193383-84, *Commissioner of Internal Revenue vs. CBK Power Company Limited*, G.R. Nos. 193407-08, January 14, 2015.

> issuance requiring prior application for tax treaty relief." *(Emphasis supplied)*

Clearly, respondent's denial of petitioner's availment of the special tax rate of 1.5% on the latter's GPB under the RP-Germany Tax Treaty for failure of the latter to file a tax treaty relief application is without basis.

However, since petitioner failed to file such tax treaty relief application, the Court shall carefully scrutinize the evidence presented whether the former is indeed entitled to the special tax rate on GPB or the regular rate.

Based on the Articles of Association of Lufthansa German Airlines[40] and the Securities and Exchange Commission (SEC) License No. 365[41], petitioner has sufficiently proven that it is a resident of the Federal Republic of Germany and it is licensed to engage in air travel transport. Thus, petitioner is entitled to the special 1.5% tax rate under the RP-Germany Tax Treaty for its on-line activities.

Records show that petitioner paid the corresponding income tax on its ₱423,187,190.96[42] GPB in the amount of ₱6,347,807.86[43] for the period of January to March 2008.[44]

With respect to the other items on special rate such as the variance in the number of passengers and average fare in the amount of ₱47,932,334.73 and the continuous and uninterrupted flight discrepancy in the amount of ₱11,531,181.22, respondent admitted that those were not contested issues since petitioner already paid the same.[45]

<u>ON REGULAR RATE</u>

The Court shall now proceed to determine the propriety of the deficiency income tax assessment covering the period of April to December 2008, where petitioner's income within the

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[40] Exhibits "B" and "B-1", docket, pp. 1980 to 2003.
[41] Exhibits "A" and "A-1", docket, p. 1976.
[42] As per respondent's investigation, petitioner's GPB is ₱423,187,190.95.
[43] ₱423,187,190.96 x 1.5% = ₱6,347,807.86
[44] Exhibit "H", docket, p. 1651.
[45] FDDA, docket, pp. 577 to 578.

Philippines from its off-line carrier activities was subjected to regular income tax rate of 35%.

The following remaining items of respondent's assessment shall be tackled below:

I. Net effect of discrepancy in revenue, cost of sales, and other charges	₱10,357,131.84
II. Disallowed tax credit carried over per return	₱ 3,836,895.31
III. Compromise penalties	₱ 150,000.00

I. Net effect of discrepancy in revenue, cost of sales, and other charges - ₱10,357,131.84

Respondent assessed petitioner for the alleged net effect of the discrepancy in revenue, cost of sales, and other charges in the amount of ₱10,357,131.84. However, as shown in respondent's detailed computation, the net effect of the discrepancy in revenue, cost of sales, and other charges has amounted only to ₱10,339,682.24, to wit:

Net income per audit		
Gross revenue per IATA Billing Analysis		₱468,616,159.51
Net income rate as per audit adjustment		0.03970555
Net income per audit		₱ 18,606,664.12
Net income per return		
Gross revenue per return	₱386,146,970.52	
Effective net income rate	0.021395	
Net income per return		8,266,981.88
Net effect of discrepancy in revenue, cost of sales, and other charges and credits		**₱10,339,682.24**

Since respondent was not able to provide any explanation for the discrepancy of ₱17,449.60[46], the Court would adopt the amount which was supported by the above computation, or in the amount of ₱10,339,682.24.

This item is comprised of the following:

A. Gross revenue per IATA Billing Analysis	₱468,616,159.51
B. Net income rate per audit	0.03970555

[46] (₱10,357,131.84 less ₱10,339,682.24)

A. Gross Revenue per IATA Billing Analysis - ₱468,616,159.51

Respondent avers that the gross revenue amounting to ₱468,616,159.51 was derived from the IATA Bank Settlement Plan (BSP) Participant Billing Statement (IATA BSP Report), which shows the name of the ticket agent, the amount of ticket sold, and the agent's commission. Respondent also claims that petitioner's gross revenues are considered taxable income within the Philippines, which must be subject to income tax rate of 35% pursuant to Section 28 of the NIRC of 1997, as amended,.

In support of the assessment, respondent relied on the ruling of the Supreme Court in *Commissioner of Internal Revenue vs. British Overseas Airways Corporation, et al.*[47] *(BOAC case)*, stating that income of off-line air carrier from sources within the Philippines are tickets sold within the Philippines.

Petitioner refutes the said assessment alleging that respondent considered the amounts of all the tickets sold by the former as indicated in the IATA BSP Report, regardless as to whether or not said tickets had been actually flown by petitioner. As such, the IATA BSP Report is not determinative of the true income of petitioner.

Petitioner maintains that the reported revenue in the Amended Annual Income Tax Return[48] (in Line 17C) and the Amended Audited Statement of Gross Philippine Billings and Special Purpose Income Statement[49] for the year ended December 31, 2008 amounting to ₱386,146,970.52 represents the "flown revenue", which is the revenue it derives from the flight of passengers on board a Lufthansa flight. Also, there are airlines in the Philippines selling tickets where a leg is flown on a Lufthansa leg; petitioner will invoice the respective airline for the amount paid for the leg flown by Lufthansa and will recognize said amount also as its income. On the other hand, the flown revenue does not include refunded tickets and the amount paid for the leg flown by other airlines.

[47] G.R. No. L-65773-74, April 30, 1987.
[48] Exhibit "H", docket, p. 1651.
[49] Exhibit "F", docket, pp. 1643 to 1648.

According to petitioner, income does not include "monies or receipts entrusted to the taxpayer which do not belong to [the taxpayer] and do not redound to the taxpayer's benefit; and it is not necessary that there must be a law or regulation which would exempt such monies and receipts."[50] As such, it must only be taxed on its "flown revenues". To treat the total Lufthansa ticket sales in the Philippines as petitioner's gross revenue at the point of sale, as respondent appears to suggest, would not clearly reflect the income of petitioner.[51]

Petitioner further avers that respondent misinterpreted the *BOAC case*, wherein the Supreme Court ruled on the issue of whether or not the revenue from the sale of tickets by British Overseas Airways Corporation (BOAC) in the Philippines constitutes income from Philippine sources, and taxable under our income tax laws.

Allegedly, the *BOAC case* merely lays down a "source rule" - *i.e.*, that the income that may be realized by an off-line carrier from the sale of tickets in the Philippines constitutes income from Philippine sources and is therefore subject to Philippine income tax. Thus, even as the *BOAC case* lays down that source rule, the question as to what is the amount of the income from the sale of such tickets or when that income is realized, remains to be separately answered. And as set out above, recognizing flown revenue as the amount of the income which should be taxable, and considering income from the sale of such tickets to have been realized only when the flight is actually flown clearly reflects income. The High Court in the *BOAC case* did not rule that BOAC's income or revenue from the sale of tickets in the Philippines is the entirety or the total amount of its ticket sales in the Philippines. In fact, it even noted that the fare for the whole trip was allocated to the various airline companies on the basis of their participation in the services rendered through the mode of interline settlement as prescribed by the IATA.[52]

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[50] Par. 52, Petitioner's Memorandum, docket, pp. 2105 to 2106, citing *Commissioner of Internal Revenue vs. Tours Specialists, Inc., et al.*, G.R. No. 66416, March 21, 1990.
[51] Par. 59, Petitioner's Memorandum, docket, p. 2107.
[52] Par. 66, Petitioner's Memorandum, docket, p. 2110.

In any event, the *BOAC case* does not and cannot justify the inclusion in petitioner's gross revenue of income not yet earned or realized, or which clearly does not belong to it.[53]

It is clear in the *BOAC case* that the sale of tickets in the Philippines is the activity that produces the income, to wit:

> **"The source of an income is the property, activity or service that produced the income. For the source of income to be considered as coming from the Philippines, it is sufficient that the income is derived from activity within the Philippines. In BOAC's case, the sale of tickets in the Philippines is the activity that produces the income.** The tickets exchanged hands here and payments for fares were also made here in Philippine currency. The site of the source of payments is the Philippines. The flow of wealth proceeded from, and occurred within, Philippine territory, enjoying the protection accorded by the Philippine government. In consideration of such protection, the flow of wealth should share the burden of supporting the government.
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> A **transportation ticket is not a mere piece of paper**. When issued by a common carrier, it constitutes the contract between the ticket-holder and the carrier. It gives rise to the obligation of the purchaser of the ticket to pay the fare and the corresponding obligation of the carrier to transport the passenger upon the terms and conditions set forth thereon. The ordinary ticket issued to members of the traveling public in general embraces within its terms all the elements to constitute it a valid contract, binding upon the parties entering into the relationship.
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> xxx xxx xxx
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> The absence of flight operations to and from the Philippines is not determinative of the source of income or the site of income taxation. **Admittedly, BOAC was an off-line international airline at the time pertinent to this case. The test of taxability is the 'source'; and the source of an income is that activity ... which produced the income. Unquestionably, the passage documentations in these cases were sold in the Philippines and the revenue therefrom was derived from an activity regularly pursued within the Philippines. And even if the BOAC tickets sold covered the 'transport of passengers and cargo to and from foreign cities', it cannot alter the fact that income from the sale of tickets was derived from the Philippines.** The word 'source'

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[53] Par. 68, Petitioner's Memorandum, docket, p. 2111.

> conveys one essential idea, that of origin, and the origin of the income herein is the Philippines." *(Emphasis supplied)*

Nonetheless, the afore-cited case does not clearly state how much of these revenues derived from Philippine ticket sales should be taxed.

Section 28(A)(3)(a) of the National Internal Revenue Code of 1997, as amended, states:

> "SEC. 28. *Rates of Income Tax on Foreign Corporations.*
>
> –
>
> (A) *Tax on Resident Foreign Corporations.* –
>
> xxx xxx xxx
>
> (3) *International Carrier.* – xxx
>
> (a) *International Air Carrier.* – **'Gross Philippine Billings'** refers to the amount of gross revenue derived from carriage of persons, excess baggage, cargo and mail originating from the Philippines in a continuous and uninterrupted flight, irrespective of the place of sale or issue and the place of payment of the ticket or passage document: *Provided,* That tickets revalidated exchanged and/or indorsed to another international airline form part of the Gross Philippine Billings if the passenger boards a plane in a port or point in the Philippines: *Provided, further,* That for a flight which originates from the Philippines, but transshipment of passenger takes place at any port outside the Philippines on another airline, only the aliquot portion of the cost of the ticket corresponding to the leg flown from the Philippines to the point of transshipment shall form part of Gross Philippine Billings."

Apparently, only those proceeds from ticket sales that were actually flown by petitioner form part of its GPB and should be taxed.

Further, respondent acknowledged in one of her rulings the legislative intent in treating the flown revenues as GPBs of international air carriers, to wit:

> "The legislative intent in changing the definition of 'Gross Philippine Billings' is manifest in the deliberation of the Bicameral Conference Committee on House Bill No. 9077 (Comprehensive Tax Reform Program), which eventually

became the 1997 Tax Code. According to Senator Enrile, **'The gross Philippine billings of international air carriers must refer to flown revenue because this is an income from services and this will make the determination of the tax base a lot easier** by following the same rule in determining the liability of the carrier for common carrier's tax.' (Minutes of the Bicameral Conference Committee on House Bill No. 9077 [Comprehensive Tax Reform Program), 10 October 1997, pp. 19–20] (Emphasis supplied).

Senator Enrile's ratiocination that gross Philippine billings must refer to 'flown revenue because this is an income from services' clearly expenses the legislative intent to treat the gross revenue derived from air carriage as income from services and the carriage of passenger or cargo as the activity or service that generates the income."[54] *(Emphasis supplied)*

Accordingly, petitioner has the duty to sufficiently prove that the amount of ₱386,146,970.52 as declared in the Annual ITR and Income Statement is petitioner's flown revenue for taxable year 2008.

To prove its claim, petitioner presented Ms. Ana Maria Thomsen, a Business Intelligence Consultant of Lufthansa Revenue Services (a wholly-owned subsidiary of Lufthansa German Airlines, responsible for processing sales data and flight information and determining the monthly flown revenue achieved with such sales for all Lufthansa regional sales worldwide, including the Philippine Branch), through her Deposition[55], to explain the peculiarities in the revenue recognition system of petitioner.

As summarized by petitioner in its Memorandum[56]:

"5. Petitioner sells passenger tickets in the Philippines. Being a member of IATA, some of these tickets have legs (portions of the passenger's journey indicated on the ticket) which are flown by Lufthansa itself, while other separate legs are flown by other airlines. In turn, other airlines may sell passenger tickets in the Philippines with some legs to be flown by said airlines, while another leg or legs may be flown by Lufthansa. Given this, Lufthansa (like other IATA members) settles accounts with other airlines under which, on a netting basis, Lufthansa pays these other airlines the

[54] BIR Ruling DA-209-04 dated April 12, 2004.
[55] Exhibit "TT", docket, pp. 764 to 771.
[56] Pars. 5, 7, 9, 10, and 11, Petitioner's Memorandum, docket, pp. 2086 to 2088.

amounts received by Lufthansa on tickets sold by Lufthansa but corresponding to flights on these other airlines, and vice-versa.

xxx xxx xxx

7. To record and account for its flight revenues, Lufthansa uses a computerized revenue accounting system called 'Sirax,' which stands for System of Integrated Revenue Accounting. Lufthansa uses Sirax for all Lufthansa sales regions all over the world or in all countries where Lufthansa has a presence.

xxx xxx xxx

9. Sirax was programmed to specifically address IATA interline settlement procedures, or the procedures under which, because airlines sell tickets with legs not only to be flown by themselves, but also by other airlines, airline members of IATA settle accounts among themselves, with respect to flights flown on a particular airline, but sold as a portion of a ticket of another airline. Sirax pro-rates or allocates the ticket fare in any particular ticket among its various components, *i.e.*, the amount corresponding to the leg planned to be flown by Lufthansa and the amount corresponding to the leg planned to be flown by other airlines. The formulas for such pro-rating, which are determined in accordance with Lufthansa's agreements with the relevant airlines, are embedded into the system.

10. In all countries including the Philippines, **consistent with the IATA interline settlement procedures applicable to all airlines which are members of IATA**, under its Sirax accounting system, Lufthansa recognizes as its income only its 'flown revenue,' which is the revenue it derives from the actual or 'flown' flights of passengers on board a Lufthansa plane. Consistent with this, Petitioner's flown revenue includes the amount paid **for the legs flown by Lufthansa** for **both**, (1) tickets sold by Lufthansa and (2) tickets sold by other airlines, but excluding the amounts paid for legs flown by other airlines.

11. Further and again consistent with its practice, Lufthansa does not recognize income at the time of its sale of a ticket. xxx. The amount of the fare allocated to a leg flown by Lufthansa will be recognized as revenue only when flight information is received that the leg has already been flown on a Lufthansa flight. Moreover, it is only when another airline's coupon (a portion of the ticket corresponding to a portion of the passenger's journey) has actually been flown on a Lufthansa leg, that Lufthansa will invoice the other airline for the amount paid for the leg flown by Lufthansa and will recognize said amount also as its income, after the flight has been flown."

Ms. Kathleen Mae Guerrero, petitioner's Finance and Administration Supervisor, further explained through her Supplemental Judicial Affidavit[57] how petitioner utilizes such process/system in determining the amount of flown revenues of petitioner for a certain period, specifically, for the year 2008.

Based on Ms. Guerrero's testimony, the Sirax generates two files: Manila Sales File and Manila Revenue File.

Allegedly, the Manila Sales File shows the list of all tickets issued by petitioner based on the IATA BSP Report. This list reflects, among others, the month of sale (SALEMONTH), airline code (AIRLCD), ticket number (SERNR), plane leg/route (CPFROM and CPTO), how a particular leg of the ticket was used (Usetype Info), month of usage (USEMONTH), ticket amount (NETNET in_EURO), and the region where ticket was sold (REGION).

In particular, Ms. Guerrero clarified that the "Usetype Info" has the following types, as applicable in petitioner's case:

1. Flown revenue – ticket actually flown by petitioner;
2. OAL flown (incoming invoice) – tickets issued by petitioner but was actually flown by another airline, hence the corresponding fees collected for such leg/route are to be remitted/paid by petitioner to the other airline;
3. Exchange – tickets with legs/routes modified by passenger resulting in issuance of new ticket which, in turn, may either be a Flown revenue, OAL flown or Refund; and
4. Refund – tickets not used by passenger, fully or partially, hence are refunded for the unused portion. Tickets are refundable within three (3) years from issuance date.

On the other hand, the Manila Revenue File shows a filtered list of tickets which were actually flown by petitioner or those with "Usetype Info" "Flown revenue" from the Manila Sales File. It reflects, among others, the month of usage (USEMONTH), airline code (AIRLCD), ticket number (SERNR),

[57] Exhibit "RR", docket, pp. 666 to 690.

plane route (CPFROM and CPTO), month of sale (SALEMONTH), ticket amount (NETNET_in_EURO), and the region where ticket was sold (REGION).

Ms. Thomsen presented the print outs of the Manila Sales File[58] and Manila Revenue Files[59], as extracted from Sirax, and was included in her Deposition. However, these files only indicate the transactions from May to December 2008. The April 2008 data can no longer be produced from the Sirax since more than five (5) years has lapsed when the data were requested for retrieval in June 2013. Complete and detailed revenue data are stored in the system for only five years.

Allegedly, it is based on this Manila Revenue File that petitioner determines the amount of revenue earned and declared in the Annual ITR and Audited Special Purpose Income Statement.

Based on the foregoing, the Court finds that petitioner failed to prove with sufficient evidence that its flown revenue has amounted to ₱386,146,970.52 for taxable year 2008.

The pieces of evidence presented by petitioner and the testimonies given by Ms. Thomsen and Ms. Guerrero merely establish its revenue recognition flow/process. It does not, in any way, account for the amount being claimed by petitioner as its true income. The Manila Revenue File was even lacking, pertaining only to the May to December 2008 transactions, whereas the income period being assessed was from April to December 2008.

Moreover, petitioner was not diligent enough to reconcile the amounts reflected in the IATA BSP Report and the Manila Revenue File and account for the differences.

Even assuming that there was a reconciliation, petitioner still failed to submit documents proving that the amount claimed not forming part of its flown revenue was actually invoiced by and paid/remitted to the other airline, in cases of those actually flown by other airline companies, or

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[58] Exhibit "D-Deposition".
[59] Exhibit "E-Deposition".

paid/remitted to the passenger in case of refund to ticket holders.

Hence, in the absence of any proof to the contrary, the gross value of tickets sold by petitioner in the Philippines shall be prima facie evidence of its flown revenue. As such, the assessment by respondent is sustained.

B. Net Income Rate per Audit - 0.03970555

For taxable year 2008, respondent used the Lufthansa Group audited financial statements,[60] since petitioner does not maintain a Philippine Branch Operation Financial Statements as a matter of course and industry practice, for the purpose of allocating variable cost of services and other charges. Thus, operating cost for the Philippines was based on a ratio of cost and revenue from the financial data found in the audited financial statement.

Petitioner's net income as a percentage of revenue was computed by respondent as follows:[61]

	Per Audited Consolidated Financial Statement of Lufthansa German Airlines	Rounded Amount per FS	Percentage of Revenue
	Revenue	₱19,618.00	100.00000%
	Operating Expenses		
	Cost of materials and services	11,503.00	58.63493%
	Staff costs	3,215.00	16.38801%
	Depreciation, amortization, impairment	938.00	4.78132%
	Changes in inventories and work performed by the enterprise and capitalized		
	Other operating expenses:		
1.	Write-downs on receivables	77.95	0.39734%
2.	Losses on current available for sale financial assets	68.78	0.35061%
	Other operating expenses	3,093.26	15.76747%
	TOTAL	18,896.00	96.31971%
	Gross Income/(Loss)	722.00	3.68029%
	Other charges/credits		
3.	Results of equity investments accounted for using equity method	(11.49)	-0.05854%
4.	Results from other equity investments	21.93	0.11177%

[60] Exhibit "G", docket, p. 1650.
[61] Exhibit "O", docket, p. 582; Exhibit "18".

	Interest income	105.45	0.53754%
	Interest expense	(195.25)	-0.99525%
5.	Other financial items	(222.92)	-1.13629%
	NET	(302.27)	-1.54077%
Income before tax		**₱420.00**	**2.13952%**

As can be noticed from the above table, the income before tax is 2.13952% of total revenue. However, respondent instead used the rate of 3.970555% in determining the amount of net income that should be subject to regular income tax rate of 35%.

The difference in rates was due to the re-computation made by respondent in disallowing the following items from the computation of taxable income:

1. Write-downs on receivables	₱ 77.95
2. Losses on current available-for-sale (AFS) financial assets	68.78
3. Results of equity investments accounted for using equity method	(11.49)
4. Results from other equity investments	21.93
5. Other financial items	(222.92)
NET EFFECT	₱(65.75)

The grounds in disallowing the above items were laid down by respondent as follows:[62]

1. Write Downs on Receivables - ₱77.95

These are basically estimates/provisions as explained in the financial statements. The Philippine tax law allows bad debts and not write-downs as deduction with documented proof of collection effort. Thus, this expense is not allowed based on RR No. 25-2002. Section 42(B) of the NIRC of 1997, as amended, also states that deductions from foreign countries may be allowed if all information necessary for its calculations is substantiated. Considering that these are from a global industry, it is very difficult to obtain all proof of collection effort of the said receivable in a global scale.

[62] Exhibit "O", docket, pp. 582 to 584; Exhibit "18".

2. Losses on Current AFS Financial Assets - ₱68.78

These are not actual losses as required by Section 34(A)(1)(a) and (b) of the NIRC of 1997, as amended. Per financial statements, the financial assets are stated at fair market value (FMV). Thus, decreases in FMV are recognized as gain or loss per financial statement.

3. Results of Equity Investments Accounted for Using Equity Method - ₱11.49 and

4. Results from Other Equity Investments - ₱21.93

Such items are results of investment activities which are not directly attributable to generation of income within the Philippines, thus disallowed per Section 42(B) of the NIRC of 1997, as amended. Under Philippine tax laws, these are adjustments to income per books to arrive at taxable income, thus, not included in the computation of income tax.

5. Other Financial Items - ₱222.92

This item consists of write-downs on available for sale financial assets as indicated in the financial statements. As previously stated in Item 2, these are not allowed because these are not actual losses as required in Section 34(A)(1)(a) and (b) of the NIRC of 1997, as amended.

Proceeding from such, respondent recomputed the Income before tax and determined that it must be 3.970555% of total revenues:

Per Audited Consolidated Financial Statement of Lufthansa German Airlines	**Rounded Amount per FS**	**Percentage of Revenue**
Revenue	₱19,618.00	100.00000%
Operating Expenses		
Cost of materials and services	11,503.00	58.63493%
Staff costs	3,215.00	16.38801%
Depreciation, amortization, impairment	938.00	4.78132%
Changes in inventories and work performed by the enterprise and capitalized		
Other operating expenses:		
1. Write-downs on receivables	-	0.00000%

2. Losses on current available-for-sale financial assets	-	0.00000%
Other operating expenses	3,093.00	15.76747%
TOTAL	18,749.00	96.31971%
Gross Income/(Loss)	869.00	4.42826%
Other charges/credits		
3. Results of equity investments accounted for using equity method	-	0.00000%
4. Results from other equity investments	-	0.00000%
Interest income	105.45	0.53754%
Interest expense	(195.25)	-0.99525%
5. Other financial items	-	0.00000%
NET	(89.79)	-0.45771%
Income before tax	**₱779.00**	**3.97055%**

Petitioner avers that said disallowed costs are allowable deductions for income tax purposes. However, petitioner did not present supporting documents or legal basis to support its position.

Thus, the Court finds respondent's basis/ratio for disallowing such costs proper under the circumstances. Accordingly, the above computation shall be adopted by the Court in determining the amount of deficiency income tax.

II. Disallowed tax credit carried over per return - ₱3,836,895.31

It was noted that the Net Overpayments in Line 31 of the Amended Annual ITR[63] amounting to ₱3,836,895.31 for taxable year 2008 was added by respondent to the basic deficiency income tax assessment. In effect, respondent disallowed the same but did not provide any legal and factual bases for such.

The Court finds it improper for respondent to disallow the said excess tax credits because any tax benefit derived by petitioner from the carry-over of the said amount redounds to the succeeding year 2009. Since the tax benefit will be in the

[63] Exhibit "H", docket, p. 1651.

succeeding year, at most, petitioner may only be assessed in the said succeeding year.

III. Compromise penalties - ₱150,000.00

Respondent imposed compromise penalties to petitioner in the aggregate amount of ₱150,000.00 for petitioner's alleged (1) failure to register its books of accounts in violation of Sections 232 and 235 of the NIRC of 1997, as amended; (2) use of unregistered ticketing system pursuant to Section 238 of the same Code; and (3) on deficiency taxes as assessed.

It is well-settled that the Court has no jurisdiction to compel a taxpayer to pay the compromise penalty because by its very nature, it implies a mutual agreement between the parties in respect to the thing or subject matter that is so compromised, and the choice of paying or not paying it distinctly belongs to the taxpayer.[64] Absent a showing that herein 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.[65]

The Court will now address the issue of whether respondent should have deducted the amount of ₱3,951,990.11 that petitioner paid from respondent's computation of the alleged income tax deficiency in the FDDA.

On May 4, 2012, simultaneous to the filing of its Letter-Protest, petitioner paid respondent the amount of ₱3,951,990.11 in settlement of the deficiency taxes based on its own computation relating to regular rate of ₱2,454,025.78 and corresponding interest amounting to ₱1,497,964.33.[66]

Petitioner contends that respondent only deducted the amount of ₱2,454,025.78 from the total deficiency tax in the FDDA but did not deduct the imposed interest thereon of ₱1,497,964.33.

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[64] *The Philippines International Fair, Inc. vs. The Collector of Internal Revenue, et al.*, G.R. Nos. L-12928 and L-12932, March 31, 1962.

[65] *Commissioner of Internal Revenue vs. Lianga Bay Logging Co., Inc., et al.*, G.R. No. L-35266, January 21, 1991.

[66] BIR Form No. 0605, Exhibit "N-3", docket, pp. 564 to 566.

It is the opinion of this Court that respondent properly deducted the subsequent settlement of petitioner amounting to ₱2,454,025.78 as to the basic deficiency income tax. On the other hand, the amount of ₱1,497,964.33 representing payment of deficiency interest must be considered as well in determining the total deficiency income tax, as a deduction from the total deficiency interest, upon the determination of the final amount of deficiency by the Court.

Based on the foregoing, the Court finds that petitioner did not incur any deficiency income tax for taxable year 2008; instead, the latter incurred a net overpayment amounting to ₱4,170,648.81, as re-computed herein:

ON SPECIAL RATE		
Gross Philippine Billing per Return	₱423,187,190.95	
Variance in the Number of Passengers and Average Airfare	47,932,334.73	
"Continuous and Uninterrupted Flight" Discrepancy	11,531,181.22	
Gross Philippine Billing per Audit	₱482,650,706.90	
Multiply by RP-Germany Treaty Rate	0.015	
Income tax due on Gross Philippine Billing		**₱7,239,760.60**
ON REGULAR RATE		
Net income per return	₱ 8,266,981.88	
Add: Audit Adjustments		
Net effect of discrepancy in revenue, cost of sales, and other charges	10,339,682.24	
Taxable income per return	₱ 18,606,664.12	
Tax Rate	0.35	
Tax Due on Regular Rate		**6,512,332.44**
Tax Due per this Court prior to Tax Credits		**₱13,752,093.05**
Less: Payment and Other tax credits	₱ 13,078,146.84	
Payment after issuance of Informal Conference on issues agreed upon	892,604.91	
Payment after issuance of FLD	2,454,025.78	16,424,777.53
Tax Due (Overpayment) per this Court		**₱(2,672,684.48)**
Less: Deficiency interest payment after issuance of FLD		1,497,964.33
Total tax overpayment per this Court		**₱(4,170,648.81)**

WHEREFORE, premises considered, the deficiency income tax assessment issued by respondent against petitioner covering taxable year 2008 is hereby **CANCELLED**.

SO ORDERED.

AMELIA R. COTANGCO-MANALASTAS
Associate Justice

WE CONCUR:

JUANITO C. CASTAÑEDA, JR.
Associate Justice

CAESAR A. CASANOVA
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.
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's Division.

ROMAN G. DEL ROSARIO
Presiding Justice