Republic of the Philippines
COURT OF TAX APPEALS
Quezon City

En Banc

CS GARMENTS, INC.,
Petitioner,

-versus-

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

EB CASE NO. 287
(CTA Case No. 6520)

Members:
ACOSTA, PJ,
CASTAÑEDA, JR.,
BAUTISTA,
UY,
CASANOVA, and
PALANCA-ENRIQUEZ, JJ.

Promulgated:

JAN 14 2008

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DECISION

CASANOVA, J.:

This is an appeal to the Court of Tax Appeals (CTA) *En Banc* by way of a verified Petition for Review, filed by herein petitioner, **CS Garments, Inc.**, under Section 18 of R.A. 9282. The petition is praying that the Decision[1] (*Assailed Decision*) dated January 4, 2007 rendered by the Second Division of this Court (*Second Division*) in CTA Case No. 6520 entitled, "***CS Garments, Inc. vs. Commissioner of Internal Revenue***" as well as the Resolution[2] (*Assailed Resolution*) dated May 25, 2007 promulgated also by the *Second Division* be reversed and set aside in part. In both the assailed Decision and Resolution, the *Second Division* cancelled the respondent-Commissioner of Internal Revenue's assessment for deficiency expanded withholding taxes for calendar year (CY)

[1] *Division Rollo., pp. 372-403.*
[2] *Division Rollo. pp. 421-423.*

1998 amounting to P47,880.00, and partially cancelled the deficiency documentary stamp tax (DST) assessment amounting to P1,963.00. However, the *Second Division* upheld the validity of the other tax assessments against petitioner amounting to a total of P2,029,570.12, plus 20% delinquency interest pursuant to Section 249(C)(3) of the Tax Code, computed as follows:

DEFICIENCY TAX		VAT		DST		INCOME TAX at 5%		INCOME TAX at 34%		Total
Basic Tax Due	P	314,194.00	P	145.00	P	817,573.94	P	1,789.44		
25% Surcharge		78,548.50		36.25		204,393.49		447.36		
20% Interest		188,516.00	P	102.02		422,898.52		925.6		
	P	**581,258.50**		**283.27**	P	**1,444,865.95**	P	**3,162.40**	P	**2,029,570.12**

THE FACTS

The facts of the case, as culled from the records, are as follows:

"Petitioner is a domestic corporation duly organized and existing under and by virtue of the laws of the Philippines with principal office at Road A, Cavite Ecozone, Rosario, Cavite.[3] On the other hand, respondent is the duly appointed Commissioner of Internal Revenue of the Philippines authorized under law to perform the duties of said office, including, *inter alia*, the power to assess taxpayers for allegedly deficiency internal revenue tax liabilities and to act upon administrative protests or requests for reconsideration/reinvestigation of such assessments.[4]

Petitioner is registered with the Philippine Economic Zone Authority (PEZA) under Certificate of Registration No. 89-064, duly approved on December 18, 1989. As such, it is engaged in the business of manufacturing garments for sale abroad.[5]

On November 24, 1999, petitioner received from respondent Letter of Authority No. 00012641 dated November 10, 1999, authorizing the examination of petitioner's books of accounts and

[3] *par. 1, Facts Admitted, Division Rollo, p. 125.*
[4] *par. 2, Facts Admitted, Division Rollo, p. 125.*
[5] *par. 3, Facts Admitted, Division Rollo, p. 125.*

other accounting records for all internal revenue taxes covering the period January 1, 1998 to December 31, 1998.[6]

On October 23, 2001, petitioner received five (5) formal demand letters with accompanying Assessment Notices from respondent, through the Office of the Revenue Director of Revenue Region No. 9, San Pablo City, requiring it to pay the alleged deficiency VAT [Value Added Tax], Income, DST and withholding tax assessments for taxable year 1998 in the aggregate amount of P2,046,580.10,[7] broken down as follows:

Deficiency VAT		
Basic tax due	P	314,194.00
Add: Surcharge		157,097.00
Interest		188,516.00
	P	**659,807.00**
Total Amount Payable		
Deficiency Income Tax (at Normal Rate of 34%)		
Basic tax due	P	78,639.00
Add: Surcharge		39,320.00
Interest		43,251.00
Total Amount Payable	**P**	**161,210.00**
Deficiency Income Tax (at Special Rate of 5%)		
Basic tax due	P	742,574.10
Add: Surcharge		-
Interest		408,416.00
Compromise Penalty		25,000.00
Total Amount Payable	**P**	**1,175,990.10**
Deficiency DST		
Basic tax due	P	806.00
Add: Surcharge		403.00
Interest		484.00
Total Amount Payable	**P**	**1,693.00**
Deficiency EWT		
Basic tax due		22,800.00
Add: Surcharge		11,400.00

[6] *BIR Rollo, p. 129.*
[7] *par. 4, Facts Admitted, Division Rollo, pp. 125-126.*

Interest	13,680.00
Total Amount Payable	P 47,880.00
GRAND TOTAL	**P 2,046,580.10**

On November 20, 2001, or within the 30-day period prescribed under Section 228 of the Tax Code, as amended, petitioner filed a formal written protest with the respondent assailing the above assessments.[8]

On January 11, 2002, or within the sixty-day period after the filing of the protest, petitioner submitted to the Assessment Division of Revenue Region No. 9, San Pablo City, additional documents in support of its protest.[9]

Respondent failed to act with finality on the protest filed by petitioner within the period of one hundred eighty (180) days from January 11, 2002 or until July 10, 2002. Hence, petitioner appealed before this Court via a Petition for Review filed on August 6, 2002 or within thirty (30) days from the last day of the aforesaid 180-day period."[10]

The case was raffled to the *Second Division* of this court for decision. After trial on the merits, the *Second Division* rendered the Assailed Decision on January 4, 2007 upon which the *Second Division* cancelled respondent's assessment against CS Garments for deficiency expanded withholding taxes for CY 1998 amounting to P47,880.00, and partially cancelled the deficiency DST assessment amounting to P1,963.00. However, the *Second Division* upheld the validity of the deficiency income tax assessments by subjecting the disallowed expenses in the amount of P14,851,478.83 and a portion of the undeclared local sales P1,541,936.60 (amounting to P1,500,000.00) to income tax at the special rate of 5%. The remainder of undeclared local sales of P1,541,936.06 (amounting to P41,936.60) was subjected to income tax at the rate of 34%. The *Second Division* found that total tax liability of CS Garments amounted to

[8] *par. 5, Facts Admitted, Division Rollo, p. 126*
[9] *par. 6, Facts Admitted, Division Rollo, p. 126*
[10] *Page 2 – 4 of January 4, 2007 Decision.*

P2,029,570.12, plus 20% delinquency interest pursuant to Section 249(C)(3), and computed the same as follows:

DEFICIENCY TAX		VAT	DST		INCOME TAX at 5%		INCOME TAX at 34%		Total
Basic Tax Due	P	314,194.00 P	145.00	P	817,573.94	P	1,789.44		
25% Surcharge		78,548.50	36.25		204,393.49		447.36		
20% Interest		188,516.00 P	102.02		422,898.52		925.6		
	P	**581,258.50**	**283.27**	**P**	**1,444,865.95**	**P**	**3,162.40**	**P**	**2,029,570.12**

On January 29, 2007, CS Garments filed its "Motion for Partial Reconsideration"[11] of the said decision. On May 25, 2007, in a resolution[12], the *Second Division* denied CS Garments' motion for lack of merit.

On June 20, 2007, CS Garments filed before the Court *En Banc* a "Motion for Extension of Time to File Petition for Review" which was granted by the Court *En Banc* in a Resolution dated June 20, 2007. On July 5, 2007, CS Garments filed the instant Petition for Review[13] before the Court *En Banc*.

THE ASSIGNED ERRORS

On the instant petition, CS Garments submits that the *Second Division* erred in its conclusion that:

I. Respondent's Formal Assessment Notices ("FAN") comply with the requirements of law.

II. The sales generated by petitioner from its participation in the trade fairs conducted by the Cavite Export Processing Zone, and its sales to employees, are subject to 10% VAT.

III. The isolated sale of petitioner's company vehicle to its General Manager is subject to 10% VAT.

IV. Petitioner had undeclared local sales in the amount of ₱1,541,936.60 which is subject to normal income tax at the rate of 34%.

[11] *Division Rollo. pp. 405-418.*
[12] *Ibid.*
[13] *E.B. Rollo. pp. 9-30.*

V. The expenses incurred by petitioner in connection with advertising, clinic and office supplies, representation, commissions, transportation, freight and handling, professional fees, export fees, taxes and licenses and fringe benefit taxes are unallowable under Rule XX, Section 2 of the PEZA Rules and Regulations.

THE COURT EN BANC'S RULING

After a careful and thorough evaluation and consideration of the records of the case, including CS Garments' arguments and allegations, the Court *En Banc* found that the *Second Division* did not commit any error in their appreciation of facts and evidence as well as their application of laws and jurisprudence in the Assailed Decision. The conclusion laid down by the *Second Division*, finding CS Garments liable to the aforementioned deficiency taxes including penalties and interest, was correct.

Regarding the *first* assignment of error, CS Garments alleged that respondent's Formal Assessment Notices failed to comply with the requirements laid down in Section 228 of the Tax Code and Section 3.1.4 of Revenue Regulations No. 12-99. CS Garments claimed that the notices do not state the law nor the facts which gave rise to the deficiency tax assessments and that the same merely gave a brief rundown of figures which CS Garments allegedly failed to pay as well as the total amount for each assessment.

We do not agree.

After scrutinizing the five (5) assessment notices[14], the Court *En Banc* found that the *Second Division* was correct when it ruled the following, to wit:

> "This Court is convinced that respondent duly apprised petitioner of the factual and legal bases in finding the latter liable to the deficiency income tax on disallowed expenses pursuant to Section 228 of the National Internal Revenue Code (NIRC) of 1997, as amended. As can be seen in the letter of demand dated

[14] *Exhibits X, Y, ZZ, AA and BB.*

October 15, 2001 and the attached Schedule of Discrepancies, respondent provided a detailed breakdown of the disallowed expenses which resulted to the said assessment. Likewise, respondent cited Rule XX, Section 2 of the Rules and Regulations of Republic Act No. 7916 as legal basis for the disallowances.

At a glance, respondent likewise complied with Section 228 of the 1997 NIRC, as amended, in arriving at the assessments for deficiency EWT, DST and VAT for taxable year 1998. Although in the letters of demand respondent may not have specified the legal provisions supporting his conclusion, it is sufficient that the nature of taxes allegedly unpaid by petitioner is indicated therein. One would know with certainty the applicable provisions of law pertaining to DST on lease agreements, 10% VAT on local sales, 5% EWT on rental expenses with reference to the figures in the form of numerical representations stated in the letters of demand.

The phrase "in writing" under Section 228 is not exclusively confined to written words but includes figures. "Writings" consist of letters, words, or numbers, or their equivalent, set down by handwriting, typewriting, printing, photostating, photographing, magnetic impulse, mechanical or electronic recording, or other form of data compilation.[15] In whatever form and manner, as long as the taxpayer is informed how the assessment was made, then, there is no violation of Section 228 of the 1997 NIRC, as amended.

It bears stressing that in the protest, petitioner did not question the infirmity of the assessment notice and letter of demand involving the 10% VAT on local sales. Well-settled is the rule that the Court cannot take cognizance of matters raised for the first time on appeal.[16]

Further, the Court cannot give credence to petitioner's assertion that the deficiency income tax assessment on the alleged undeclared local sales is devoid of factual and legal bases.

It must be pointed out that it was petitioner who offered the Schedule of Other Income[17] demonstrating the breakdown thereof giving rise to the assessment for deficiency income tax on local sales of P1,541,936.60 at the rate of 34%. Without the supporting

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[15] *Black' Law Dictionary, Sixth Edition, page 1609 cited in Subic Power Corporation vs. Commissioner of Internal Revenue, CTA Case No. 6059, May 8, 2003*

[16] *Victorias Milling Company, Inc. vs. Court of Appeals, 333 SCRA 663*

[17] *Exhibit 11.*

documents proffered by petitioner, respondent would not have ascertained its liabilities pertaining to income tax on local sales and the other tax deficiencies.

Considering that in its protest, petitioner did not question the validity of the assessment for deficiency VAT under Section 228 of the 1997 NIRC, as amended, the Court sees no reason why it is raising the same infirmity concerning the assessment for deficiency income tax on local sales as both taxes refer to the same tax base.

Thus, the mere fact that petitioner intelligently rebutted respondent's assessments for deficiency 5% income tax on disallowed expenses, 34% income tax on local sales, EWT, DST and VAT, demonstrates respondent's compliance with Section 228 of the 1997 NIRC, as amended."

Anent the *second* assignment of error, CS Garments claimed that the deficiency VAT assessment arising from the sales generated by it in trade fairs as well as its sales to employees are devoid of legal basis. CS Garments argued that since it is a PEZA-registered enterprise, its local sales to buyers from Customs Territory are considered *technical importations* made by buyers who are the ones liable for the corresponding taxes on such sales.

We do not agree.

To reiterate, in CS Garments' protest-letter[18] dated November 19, 2001, petitioner stated that "[t]he alleged local sales being subject to VAT were generated by the company for the year 1998 from its participation in the trade fairs conducted by the Cavite Export Processing Zone Authority as well as its sales to its employees". Furthermore, petitioner admitted that "[t]hese sales were made to buyers located in the Customs Territory". Although a Zone Export Enterprise, like the petitioner, is generally engaged in exporting its finished product, it is not prohibited from making domestic sales pursuant to Section 26 of Republic Act No. 7916 entitled *"An Act Providing For The Legal Framework*

[18] *Exhibit V.*

And Mechanisms For The Creation, Operation, Administration, And Coordination Of Special Economic Zones In The Philippines, Creating For This Purpose, The Philippine Economic Zone Authority (PEZA), And For Other Purposes", which provides as follows:

> "SECTION 26. *Domestic Sales.* – Goods manufactured by an ECOZONE enterprise shall be made available for immediate retail sales in the domestic market, **subject to payment of corresponding taxes on the raw materials and other regulations** that may be adopted by the Board of the PEZA.
>
> However, in order to protect the domestic industry, there shall be a negative list of industries that will be drawn up by the PEZA. Enterprises engaged in the industries included in the negative list shall not be allowed to sell their products locally. Said negative list shall be regularly updated by the PEZA.
>
> The PEZA, in coordination with the Department of Trade and Industry and the Bureau of Customs, shall jointly issue the necessary implementing rules and guidelines for the effective implementation of this section." *(Emphasis supplied)*

Pursuant to the above-quoted provision of Republic Act No. 7916, the Board of Directors of the Philippine Economic Zone Authority (PEZA) promulgated the *"Rules and Regulations to Implement Republic Act No. 7916, otherwise known as the Special Economic Zone Act of 1995".* Section 5 of Rule VIII thereof provides that *domestic sales* shall be subject to all applicable rules and regulations including the payment of customs duties and internal revenue taxes, thus:

> "SECTION 5. *Domestic Sale.* – Finished products of registered Export or Free Trade Enterprises not included in the negative list shall be made available for domestic sale in the customs territory or retail stores/shopping malls within the commercial/tourist or other authorized areas of the ECOZONES, **subject to all applicable rules and regulations including the**

> **payment of customs duties and internal revenue taxes**, to the applicable provisions of the Retail Trade Nationalization Law, as amended, and to such other regulations or limitations as may be adopted by the Board." *(Emphasis supplied)*

Moreover, the aforementioned rules and regulations further provides, in Section 3 of Rule X thereof that "[m]erchandise or goods may be taken into or brought out of the restricted areas of the ECOZONES only upon *prior approval or permit* by the PEZA in accordance with its documentation and security procedures".

Indeed, domestic sales are allowed subject to certain conditions to be complied with by the Zone Export Enterprise particularly regarding the payment of internal revenue taxes and customs duties and the documents required for the entry and exit of goods to and from the "restricted areas" of the ECOZONES. More particularly, Section 4 of Rule X requires the accomplishment of PEZA prescribed forms and the submission of the documents relative to the importation, exportation or entry of the goods into the customs territory:

> "SECTION 4. *Prescribed Forms.* – The application for the entry or exit permit of goods shall be filed by the ECOZONE Export or Free Trade Enterprise or entity concerned in the form prescribed by the PEZA. The PEZA shall require the submission of shipping, commercial and other pertinent documents relative to the **importation**, **exportation**, or **entry** into the customs territory of said goods." *(Emphasis supplied)*

Finished products of a Zone Export Enterprise, such as herein petitioner, may therefore be introduced into the customs territory in three (3) different ways, these are: (1) importation, (2) exportation, or (3) entry.

The finished goods locally sold by petitioner in the Cavite Export Processing Zone Trade Fair and its finished goods sold to its employees were introduced into the customs territory by *"entry"*. It is not disputed that the finished goods were sold at the trade fair to the public at large. Consequently, such sales are "domestic sales".

Parenthetically, petitioner attached photocopies of an Informal Import Entry Declaration (Bureau of Customs Form 177), BOC official receipt for the duties and taxes paid on the importation, and Application for permit to bring goods from the zone into the customs territory (PEZA Form 8106) to its Supplemental Protest[19] dated January 9, 2002 to prove that the alleged local sales were in fact importations made by the buyers from the Customs Territory. However, the Informal Import Declaration and Entry is undated and in the name of PEZA TRADE FAIR, the BOC Official Receipt is in the name of the petitioner and dated 3/5/01, and the Application for Permit to Bring Goods From the Zone Into the Customs Territory dated 09 November 2000 shows petitioner as the Consignee/Importer. It is significant to note that the documents submitted do not correspond to the taxable year in question which is 1998 only.

Similarly, the sales made by the petitioner to its employees cannot be considered as an "importation" because the PEZA Rules and Regulations has a particular provision regarding "sales to employees" requiring prior written permission from the PEZA. However, petitioner failed to show proof that it was authorized by the PEZA to sell its finished goods to its employees pursuant to Section 9 of Rule X of the PEZA Rules and Regulations which provides:

> "SECTION 9. *Written Permission.* – Products made in the restricted areas of the ECOZONES, samples thereof and/or imported raw materials **shall not be given nor sold by an Export or Free Trade Enterprise to its visitors, workers, or employees** without prior written permission from the PEZA." *(Emphasis supplied)*

[19] *Exhibit IV.*

Since petitioner violated the above-quoted provision requiring a written permission from the PEZA before it can sell its finished product to its visitors, workers, or employees, its sales to its employees shall likewise be considered as "domestic sales" that is subject to the payment of internal revenue taxes in the same way as petitioner's sales at the local trade fairs. It both cases, petitioner was not able to show that it is exempt from the payment of the value-added tax. It is well-settled that exemptions from taxation are not favored and tax statutes are to be construed in *strictissimi juris* against the taxpayer and liberally in favor of the taxing authority.

"Laws must receive sensible interpretation to promote the ends for which they are enacted. They should be so given reasonable and practical construction as will give life to them, if it can be done without doing violence to reason. Conversely, a law should not be so construed as to allow the doing of an act which is prohibited by law nor so interpreted as to afford an opportunity to defeat compliance with its terms, create an inconsistency, or contravene the plain words of the law. *Interpretatio fienda est ut res magis valeat quam pereat* or that interpretation as will give the thing efficacy is to be adopted."[20] To agree with the petitioner's argument that it is not liable because it is not the importer would result to an absurdity. It could not be the intention of the law to run after all buyers of petitioner's finished goods at a trade fair because it is impracticable.

As to the *third* assigned error, petitioner-CS Garments pointed out that the sale of its motor vehicle, a Mercedes Benz, to its General Manager, Mr. Claus Sudhoff amounting to P1,600,000.00, is not subject to VAT since its was not made in the ordinary course of its trade or business. Petitioner alleged that before a particular transaction may be subject to VAT, it is important to determine the taxpayer's role or link in the production chain of that particular product or service. Where the sale, barter or exchange of that particular product

[20] *AGPALO, Statutory Construction, Third Edition, 1995, p. 202.*

or service is not made in the course of trade or business, such transaction may not be made subject to VAT. It further alleged that since its primary business is to engage in the manufacture of garments for sale abroad, the sale of its used company car does not have a direct relevance to petitioner's primary business of manufacturing of garments.

The argument is without merit.

Section 105 of the NIRC of 1997, as amended, states that:

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

Based on the foregoing, the VAT is imposed on a sale or transaction entered into by a person in the course of any trade or business. 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.[21] Hence, an isolated transaction is not

[21] *DEOFERIO, JR. AND MAMALATEO, The Value Added Tax In The Philippines, First Edition, pp. 81-82.*

necessarily disqualified from being made incidentally in the course of trade or business.

Here, petitioner's primary business is the manufacturing of garments for sale abroad. In carrying-out its business, petitioner acquired and eventually sold a Mercedes Benz to its General Manager Mr. Sudhoff. Prior to the sale, the motor vehicle formed part of petitioner's capital assets, specifically under the account, "Property, Plant and Equipment". The Rules on International Accounting Standards (IAS)16 defines Property, Plant and Equipment as follows:

> "6. Definitions
>
> Property, plant and equipment are tangible assets that:
>
> (a) are held by an enterprise **for use in the production or supply of goods or services**, for rental to others, or **for administrative purposes**; and
>
> (b) are expected to be used during more than one period." *(Emphasis supplied)*

Therefore, the sale of the motor vehicle is an incidental transaction because the said vehicle was purchased and used in furtherance of petitioner's business.

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.[22]

[22] *Ibid.*, p. 83.

Moreover, under Rule XV of the PEZA Rules and Regulations, petitioner is prohibited from selling or otherwise disposing of capital equipment acquired under the incentives granted to an ECOZONE Export and Free Trade Enterprise. Section 1 (A) (2) of Rule XV provides as follows:

"SECTION 1. Exemption from Duties and Taxes on Merchandise. -- xxx

A. Importation of Capital Equipment

1. xxx xxx xxx

2. Sale or Disposition of Capital Equipment – Any sale, transfer, assignment, donation or other form of disposition of originally imported capital equipment/machinery including spare parts, brought into the ECOZONE duty and tax-free, within five (5) years from date of acquisition shall require prior approval of the Board. xxx xxx xxx

xxx xxx xxx

If the ECOZONE Export or Free Trade Enterprise sells, transfers or disposes of these machinery, equipment and spare parts without prior approval of the Board within five (5) years from date of acquisition , the ECOZONE Export or Free Trade Enterprise and the vendee, transferee, or assignee shall be solidarily liable **to pay twice the amount of the tax exemptions granted**.

Any sale, transfer, assignment, donation or other form of disposition of capital equipment, brought into the ECOZONE duty and tax-free, after five (5) years from date of acquisition shall require prior approval of the PEZA Director-General." *(Emphasis supplied)*

The Deed of Absolute Sale[23] covering the subject vehicle shows that the vehicle is a 1996 model of Mercedes Benz E-320 and that the Deed of Absolute Sale is dated 30 September 1998. Clearly, the subject vehicle was sold by the petitioner within the five-year period from acquisition date without any proof that said sale was with the approval of the Board. Petitioner should have been made liable for twice the amount of tax exemptions granted pursuant to the afore-quoted provision, in addition to the deficiency value added tax.

In other words, this Court *En Banc* agrees with the *Second Division* when it ruled the abovementioned discussion.

The VAT liability of CS Garments amounted to P581,258.50, computed as follows:

Local Sales		P	1,541,936.60		
Add:	proceeds from sale of PPE		1,600,000.00	P	3,141,936.60
Rate of VAT					10%
Basic Tax Due				P	314,194.00
Add:	25% Surcharge				78,548.50
	20% Interest				188,516.00
Total deficiency tax due and payable				P	581,258.50
[Excluding interest pursuant to Section 249 C (3) of the 1997 Tax Code]					

The deficiency DST in the amount of P283.27 was also correctly recomputed by the *Second Division*, hence it still stands.

With regard to petitioner's undeclared sales, which is the *fourth* issue in this case, in the amount of P1,541,936.60, We rule that the no error was committed by the *Second Division* when it decided the following and We reiterate, viz:

"Relevant provisions of Section 5(1) of RMC 74-99 read as follows:

> SECTION 5. Tax Treatment Of Sales Made By A PEZA Registered Enterprise. —

[23] *Exhibit D.*

> (1) Sale of goods (i.e., merchandise), by a PEZA-registered enterprise, to a buyer from the Customs Territory (i.e., domestic sales). — xxx The registered enterprise's "gross income earned" therefrom shall be subject to the 5% special tax pursuant to Sec. 24 of R.A. No. 7916: Provided, however, that its sales in the Customs Territory do not exceed the threshold allowed or permitted for such sales, pursuant to the pertinent provisions of the PEZA rules and regulations: Provided, further, that for income tax purposes, if such sales should exceed the aforesaid threshold, its income derived from such excess sales shall be imposed with the normal income tax pursuant to the provisions of Title II, NIRC: Provided, further, that in computing for the income tax due on such excess sales, its net income from such excess sales shall be determined in accordance with the method of general apportionment pursuant to the provisions of Sec. 50, NIRC, (i.e., compute its total net income from total sales, then, compute its net income from such excess sales by general apportionment, as follows: Excess sales divided by total sales times total net income from total sales equals net income from excess sales).

Per Letter of Authority No. 98-0531 issued by PEZA on August 24, 1998, petitioner's authority to sell in the local market was limited to the sale of export seconds and overruns of men's and boys' shirts, the quantity of which should not exceed one percent (1%) of its actual export volume in 1997, or 6,423 pieces or a total value of P1.5 million, whichever is lower.[24]

Since no data was available as regards petitioner's actual export volume in 1997, this Court shall consider the volume of 6,423 pieces with a total value of P1.5 million as the prescribed threshold amount for petitioner's 1998 local sales.

Following the provisions of Section 5(1) of RMC 74-99, out of the sales amount of P1,541,936.60 subject of the deficiency 34% income tax assessment, only the excess local sales amount of P41,936.60 shall be charged with a 34% income tax. The amount of P1,500,000.00 shall be imputed with the preferential income tax rate of 5%. Hence, in the absence of documentary evidence

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[24] *BIR Records, page 2.*

> establishing it properly declared the total sales of P1,541,936.60 in its 1998 income tax return, petitioner shall be held liable to pay the corresponding income taxes due."[25]

With regard to the *fifth* issue, petitioner claimed that the *Second Division* committed an error when it ruled that the expenses incurred by petitioner in connection with advertising, clinic and office supplies, representation, commissions, transportations, freight and handling, professional fees, export fees, taxes and licenses and fringe benefit taxes are unallowable under Rule XX, Section 2 of the PEZA Rules and Regulations because there is no hard and fast rule on the right to a deduction which depends in each case on the particular facts and the relation of the payment to the type of business in which the taxpayer is engaged. It further argued that the intention of the taxpayer often may be the controlling fact in making the determination. It concluded that each of the disallowed items of expenses of petitioner was direct cost in the manufacture of its finished products.

We are not persuaded.

Again, We reiterate that pursuant to Section 24 of Republic Act No. 7916, the preferential tax rate of 5% is imposed on Gross Income earned by an ECOZONE enterprise. Gross Income is in turn defined in Section 2(nn), Rule I of the "Rules and Regulations to Implement Republic Act No. 7916, otherwise known as The Special Economic Zone Act of 1995" [PEZA Rules], as follows:

> "**Gross Income**" for purposes of computing the special tax due under Section 24 of the Act refers to gross sales or gross revenues derived from business activity within the ECOZONE, net of sales discounts, sales returns and allowances and minus costs of sales or direct costs but before any deduction is made for administrative expenses or incidental losses during a given taxable period. The allowable deductions from "gross income" are specifically enumerated under Section 2, Rule XX of these Rules.

[25] *Page 23-24 of January 4, 2007 Decision.*

Section 2, Rule XX of the PEZA Rules enumerates the specific deductions for ECOZONE Export Enterprises as follows:

> **SECTION 2. Gross Income Earned; Allowable Deductions.** — For purposes of these Rules, Gross Income earned shall be as defined in Section 2(nn), Rule I of these Rules subject to the following allowable deductions for specific types of enterprises:
>
> 1. **ECOZONE Export Enterprises**, Free Trade Enterprises and Domestic Market Enterprises- Direct salaries, wages or labor expenses
>
> - Production supervision salaries
> - Raw materials used in the manufacture of products
> - Goods in process (intermediate goods)
> - Finished goods
> - Supplies and fuels used in production
> - Depreciation of machinery and equipment used in production, and buildings owned or constructed by an ECOZONE Enterprise
> - Rent and utility charges associated with building, equipment and warehouses, or handling of goods
> - Financing charges associated with fixed assets

Based on the foregoing, for purposes of computing the 5% preferential tax, gross sales/revenues may be reduced only by sales discounts, sales returns and allowances, costs of sales or direct costs or any of the enumerated allowable deductions under Section 2, Rule XX of the PEZA Rules.

Apparently, petitioner's claimed deductions for advertising, representation and entertainment, transportation and travel, professional fee, export fees, taxes and licenses should be disallowed because these expenses do not qualify as direct costs nor are they among the specified allowable deductions under the PEZA Rules.

The same holds true with respect to petitioner's claimed deductions for clinic and office supplies. Contrary to petitioner's assertion, the supplies referred to under the PEZA Rules relate to those utilized in the production of goods.

Regarding the claimed deduction for commissions in the amount of P6,852,410.60, the same shall likewise be denied. Commissions are entirely different from sales discounts. The word "commission" involves the meaning that a sum of money is paid to an agent for effecting a sale to a third person or defined as a percentage or allowance to a factor or agent for transacting business for another.[26] Clearly, for a commission to be due, there must be a service rendered. On the other hand, discounts are generally classified as either cash or trade. Trade discounts are given to induce purchases by volume and cash discounts are offered to induce prompt payment. Volume and time are therefore the factors considered to enjoy discounts.

Under our VAT law, particularly, Section 106(D)(2) of the NIRC of 1997, sales discounts granted and indicated in the invoice at the time of sale and the grant of which does not depend upon the happening of a future event do not form part of the taxable base. Clearly, what the law contemplates as deductions from the gross sales are trade discounts. The same rule applies for purposes of computing the tax base for income tax either at the regular rate of 34% or special rate of 5%.[27] As earlier stated, commissions cannot be treated as trade discounts deductible from gross sales to arrive at the gross income earned by a PEZA entity.

As regards the claimed deduction for freight and handling, based on the PEZA Rules, the allowable deductions from gross sales/revenues may either be directly or indirectly related to the manufacturing of a product and form part of inventory costs. Thus, the allowable deduction for the handling of goods

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[26] *Words and Phrases, Permanent ed. 7A*

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

referred to under "rent and utility charges associated with building, equipment and warehouses, or handling of goods" applies only to costs attributed to the production of goods. Any handling expenses incurred in the sale of finished products are disallowed under the law. In the instant case, petitioner failed to offer any documentary evidence for this Court to ascertain that indeed the amount of P 4,471,804.09 can be attributed to production costs and not to selling expenses.

As to the fringe benefit tax, the same shall be considered valid deduction for purposes of computing the 5% preferential tax if it has been paid/incurred in relation to direct labor or production employees. For petitioner's failure to establish that the fringe benefit tax of P306,140.70 was paid in relation to its direct labor cost, the same shall be denied.

Again, to recapitulate, petitioner is liable to pay deficiency 5% income taxes on its undeclared local sales of P1,500,000.00 and on the disallowed expenses of P14,851,478.83 and deficiency 34% income tax on its remaining undeclared local sales of P41,936.60, in the aggregate amount of P1,448,028.35, computed as follows:

Deficiency Income Tax (at Special Rate of 5%)

Net income per return			P 29,080,558.00
Add:	Undeclared local sales		1,500,000.00
	Disallowances per examiner's recommendation		
	Advertising	P 201,900.00	
	Clinic Supplies	13,998.30	
	Office Supplies	597,562.03	
	Representation and Entertainment	550,265.03	
	Commission	6,852,410.60	
	Transportation & travel	1,176,994.72	
	Freight & Handling	4,471,804.09	
	Professional Fee	61,177.00	
	Export Fees	126,103.66	
	Taxes & Licenses	493,122.70	
	Fringe Benefit Tax	306,140.70	
			14,851,478.83
Net taxable income per audit			P 45,432,036.83

Income Tax Due (5%)		P 2,271,601.84
Less: Tax payment		1,454,027.90
Deficiency Basic Tax		P 817,573.94
Add: 25% Surcharge		204,393.49
20% Interest		422,898.52
Total Amount Due and Payable		
		P 1,444,865.95

Deficiency Income Tax (at Regular Rate of 34%)

Undeclared Local Sales		P 1,541,936.60
Less: Undeclared Local Sales subjected to 5% tax		1,500,000.00
Undeclared Excess Local Sales		P 41,936.60
Taxable Net Income		
Undeclared Excess Local Sales	P 41,936.60	
Divided by Total Sales	190,404,800.60	
Multiplied by Net Income	23,895,832.60	P 5,263.05
Tax Rate		34%
Deficiency Basic Tax		P 1,789.44
Add: 25% Surcharge		447.36
20% Interest		925.60
Total Amount Due and Payable		P 3,162.40
TOTAL DEFICIENCY INCOME TAX DUE AND PAYABLE		**P 1,448,028.35**

In sum, the Court *En Banc* finds no cogent justification to disturb the findings and conclusion spelled out in the assailed January 4, 2007 Decision and May 25, 2007 Resolution of the *CTA Second Division*. What the instant petition seeks is for the Court *En Banc* to view and appreciate the evidence in their own perspective of things, which unfortunately had already been considered and passed upon.

WHEREFORE, the instant Petition for Review is hereby **DISMISSED** for lack of merit. Accordingly, the January 4, 2007 Decision and May 25, 2007 Resolution of the *CTA Second Division* are hereby **AFFIRMED *in toto***.

SO ORDERED.

CAESAR A. CASANOVA
Associate Justice

WE CONCUR:

ERNESTO D. ACOSTA
Presiding Justice

JUANITO C. CASTAÑEDA, JR.
Associate Justice

LOVELL R. BAUTISTA
Associate Justice

ERLINDA P. UY
Associate Justice

OLGA PALANCA-ENRIQUEZ
Associate Justice

CERTIFICATION

Pursuant to Article VIII, Section 13 of the Constitution, 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.

ERNESTO D. ACOSTA
Presiding Justice