REPUBLIC OF THE PHILIPPINES
Court of Tax Appeals
QUEZON CITY

THIRD DIVISION

PENN PHILIPPINES, INC.,
Petitioner,

-versus-

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

C.T.A. CASE NO. 7686

Members:

BAUTISTA, Chairperson,
PALANCA-ENRIQUEZ, and
COTANGCO-MANALASTAS, JJ.

Promulgated:
DEC 11 2012
AOFernando 11:53 a.m.

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DECISION

PALANCA-ENRIQUEZ, J.:

THE CASE

This is a Petition for Review filed by Penn Philippines, Inc. (hereafter "petitioner") praying for the cancellation and withdrawal of the deficiency - tax assessment against petitioner for the year 2002 in the aggregate amount of P76,034,555.22.

THE PARTIES

Petitioner Penn Philippines, Inc. is a domestic corporation duly organized and existing under the laws of the Republic of the Philippines, with Securities and Exchange Commission Registration No. 7266. Petitioner was originally registered as Goldzack Philippines, Inc., then it was changed to Penn Gold-Zack Philippines, Inc. until it was finally changed to Penn Philippines, Inc. on November 15, 1995. Petitioner may be served with summons and other court processes at Puno and Puno, counsel for petitioner, at 12th Floor, East Tower, Philippine Stock Exchange Center, Exchange Road, Ortigas Center, Pasig City.

On the other hand, respondent Commissioner of Internal Revenue (hereafter "CIR") is a public officer duly appointed by the President of the Republic of the Philippines and is the head of the Bureau of Internal Revenue ("BIR"), the government agency officially responsible for the assessment and collection of all national and internal revenue taxes, as well as the cancellation of disputed assessments, with office address at the BIR National Office Building, Diliman, Quezon City.

THE FACTS

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

On November 7, 2003, petitioner received a Letter of Authority, dated October 30, 2003, from respondent, authorizing the BIR representatives to examine the books of accounts and other accounting records of petitioner, for all internal revenue taxes for taxable year 2002.

On October 18, 2005, a Waiver of the Defense of Prescription under the Statute of Limitations of the NIRC ("Waiver") was executed between petitioner and respondent extending the assessment to June 30, 2006.

On March 30, 2006, another Waiver was executed by the parties, extending the assessment to December 31, 2006.

On September 7, 2006, petitioner received a Notice to Taxpayer from the BIR requesting petitioner to appear for an informal conference from receipt thereof.

On November 20, 2006, petitioner received a Preliminary Assessment Notice, together with the "Details of Discrepancies", dated March 28, 2006, representing deficiency income tax, expanded withholding tax, deficiency final tax, deficiency final tax on Non-resident Alien Engaged in Trade or Business (NRAETB), deficiency withholding tax on compensation, penalty for late filing of BIR Form 1603 for the 2nd quarter of 2002 and improperly accumulated earnings tax in the total amount of P73,954,576.49 for taxable year 2002.

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On December 4, 2006, petitioner filed its Preliminary Reply to the Preliminary Assessment Notice.

On December 12, 2006, petitioner received a Final Assessment Notice/Formal Letter of Demand, together with Details of Discrepancies for the afore-said deficiency taxes and penalties in the aggregate amount of P76,034,555.22 for taxable year 2002.

On January 11, 2007, petitioner seasonably filed a Formal Letter of Protest, and subsequently, a Supplemental Letter, dated March 12, 2007, attaching thereto all relevant documents in support of the protest, praying for the cancellation of the deficiency tax assessments for lack of factual and legal basis.

Despite the filing of the Formal Letter of Protest, respondent has not acted on petitioner's protest, within one hundred eighty (180) days from the filing of the documentary evidence in support of the protest.

Hence, the instant petition, filed within thirty (30) days from the lapse of the 180-day period for the respondent to decide.

In her answer, respondent, by way of special and affirmative defenses, alleged that: the assessment in question were made and issued in accordance with law, rules and regulations; verification disclosed that petitioner failed to support with sufficient evidence the deductions claimed hence, were disallowed, pursuant to *Section 34(A)(1)(b) of the NIRC, as amended*; it was discovered that petitioner's "Management & Consultancy Fees" in the amount of P23,123,444.00 and 'Rental & Professional Fees' in the amount of P1,635,104.32 were not subjected to the corresponding withholding taxes, hence were disallowed, pursuant to *Revenue Regulations No. 2-98, as amended*; petitioner was assessed of deficiency final withholding tax in the amount of P15,068,187.73 for failure to withhold on its 'management & consultancy' income payment claimed as deduction in its income tax return; petitioner was assessed of deficiency final withholding tax on 'Non-resident Alien Engaged in Trade or Business' in the Philippines in the amount of P3,068,623.65 for failure to remit the corresponding withholding tax thereon; and for deficiency withholding tax on compensation in the amount of P468,486.02 for failure to withhold the corresponding withholding tax thereon; and petitioner was assessed of deficiency improperly accumulated earnings tax in the amount of P5,665,333.81 for permitting company's earnings and profits to accumulate instead of being divided or distributed to its shareholders in the form of dividends.

Petitioner presented Benedicto Horca III and Emmanuel Mendoza, as witnesses, and documentary evidence, marked as *Exhibits "E", "J", "N"* to *"P", "R", "U"* to *"V", "X"* to *"CC", "FF"* to *"GG", "II", "JJ" "EE"* , inclusive of their submarkings, which were all admitted by the Court in a Resolution dated August 9, 2010.

On January 11, 2010, the Second Division transferred this case to the Third Division, pursuant to *CTA Administrative Circular No. 01-2010,* dated January 5, 2010, entitled "Implementing the Fully Expanded Membership in the Court of Tax Appeals".

On the other hand, respondent presented Edenny Lingan, as witness, and documentary evidence, marked as *Exhibit "1"* to *"24"*, inclusive of their submarkings, which were all admitted by the Court in a Resolution dated February 6, 2012.

Thereafter, both parties were granted thirty (30) days from notice within which to file their simultaneous memoranda, after which the case shall be deemed submitted for decision.

Petitioner filed its "Memorandum", while respondent failed to file her "Memorandum".

On April 26, 2012, the case was deemed submitted for decision.

ISSUES

As stipulated upon by the parties, the issues for this Court's consideration are:

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I

WHETHER THE ASSESSMENT FOR DEFICIENCY TAXES FOR TAXABLE YEAR 2002 IS VOID FOR FAILING TO STATE THE LAW AND FACTS UPON WHICH IT IS MADE.

II

WHETHER PETITIONER'S MANAGEMENT FEES IN THE AMOUNT OF PHP23,123,444.00, WHICH IT PAID TO DIF, IS SUBJECT TO FINAL WITHHOLDING TAX UNDER SECTION 28 (B) (1) OF THE NIRC.

III

WHETHER THE ASSESSMENT ISSUED AGAINST PETITIONER FOR DEFICIENCY IMPROPERLY ACCUMULATED EARNINGS TAX IN THE AMOUNT OF P5,665,333.81 IS VALID.

IV

WHETHER THE ASSESSMENT ISSUED AGAINST PETITIONER FOR DEFICIENCY FINAL WITHHOLDING TAX ON A "NON-RESIDENT ALIEN ENGAGED IN TRADE OR BUSINESS" IN THE PHIILIPPINES IN THE AMOUNT OF P3,068,623.65 IS VALID.

V

WHETHER PETITIONER FAILED TO WITHHOLD THE CORRESPONDING WITHHOLDING TAX ON ITS "RENTAL & PROFESSIONAL FEES" IN THE AMOUNT OF P1,635,104.32 CLAIMED AS DEDUCTION IN ITS INCOME TAX RETURN.

VI

WHETHER PETITIONER IS LIABLE FOR DEFICIENCY WITHHOLDING TAX ON COMPENSATION IN THE AMOUNT OF P468,486.02.

The foregoing issues boil down to whether or not the assessment for deficiency taxes for taxable year 2002 is void for lack of factual and legal basis, and if the assessment is valid, whether or not petitioner is liable for said deficiency taxes.

THE COURT'S RULING

The petition is partly meritorious.

Section 228 of the NIRC of 1997, as amended, provides:

> "SEC. 228. Protesting of Assessment. – When the Commissioner or his duly authorized representative finds that proper taxes should be assessed, he shall first notify the taxpayer of his findings: Provided, however, That a preassessment notice shall not be required in the following cases:
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> xxx xxx.
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> The taxpayer shall be informed in writing **of the law and the facts on which the assessment is made; otherwise the assessment shall be void**." *(Emphasis supplied)*

Corollary thereto, *Section 3.1.4 of Revenue Regulations 12-99*, provides:

> "3.1.4 Formal Letter of Demand and Assessment Notice. — The formal letter of demand and assessment notice shall be issued by the Commissioner or his duly authorized representative. The letter of demand calling for payment of the

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taxpayer's deficiency tax or taxes shall state the facts, the law, rules and regulations, or jurisprudence on which the assessment is based, otherwise, the formal letter of demand and assessment notice shall be void xxx"

The Formal Letter of Demand shows that petitioner is assessed of the following deficiency taxes, to wit:

KIND OF TAX	ASSESSMENT NO	BASIC	SUR-CHARGE	INTEREST	COMPROMISE	TOTAL
Income Tax	LTDO-122-IT-2002-00013	29,405,538.11		22,292,338.44		51,697,876.55
EWT	LTDO-122-WE-2002-00010	25,945.95	6,486.49	20,315.68	6,000.00	58,748.12
Final Tax	LTDO-122-WF-2002-00007	7,399,502.08	1,849,875.52	5,793,810.13	25,000.00	15,068,187.73
Final Tax-NRAETB	LTDO-122-WG-2002-00008	1,497,109.52	374,277.38	1,172,236.75	25,000.00	3,068,187.73
Wtax-compensation	LTDO-122-WC-2002-00004	222,570.60	55,642.65	174,272.78	16,000.00	468,486.03
Penalty for late filing 1603	LTDO-122-PEN-2002-00001		3,291.44	7.90	4,000.00	7,299.34
IAET	LTDO-122-IE-2002-00001	3,231,879.30		2,433,454.51		5,665,333.81
GRAND TOTA L						**76,034,555.23**

Please note that the interest and the total amount due will have to be adjusted if paid beyond January 31, 2007.

The complete details covering the aforementioned discrepancies established during the investigation of this case are in the accompanying SCHEDULE I of this letter of demand.

The 25% surcharge has been imposed pursuant to the Provisions of Section 248(A) of the National Internal Revenue Code, as amended by RA 8424, which took effect on January 1, 1998.

The 20% interest per annum has been imposed pursuant to the provisions of Section 249(B) of the said code.

In view thereof, you are requested to pay your aforesaid compromise penalty through the duly authorized agent bank in which you are enrolled within the time shown in the enclosed assessment notice."

Schedule 1 thereof reads:

"SCHEDULE I
DETAILS OF DISCREPANCIES
CALENDAR YEAR ENDING DECEMBER 31, 2002

ASSESSMENT NO. LTDO-122-IT-2002-00013

I.DEFICIENCY INCOME TAX			
Net Income per return			47,252,115.00
Add: disallowances			
Purchases-unsupported	426,335,562.00	363,793,583.00	62,541,979.00
Mgnt. & Consultancy fee-no EWT			23,123,444.00
Unaccounted expenses			3,422,592.90
Rental & Prof. fees			1,635,104.32
Losses			1,169,187.00
Total			91,892,307.22
Net income per review			139,144,422.22
Tax due per return			44,526,215.11
Less: tax paid			15,120,677.00
Deficiency Income tax			29,405,538.11
Add: interest up to 1-31-07			22,292,338.44
Total			51,697,876.55

Sec. 34(A)(1)(b) of the NIRC states that no deduction from gross income shall be allowed unless the taxpayer shall substantiate with sufficient evidence such as official receipts or other adequate records. RR No. 2-98 as amended provides that any income payment which is otherwise deductible under the Code shall be allowed as a deduction from the payor's gross income only if it is shown that the income tax required to be withheld has been paid to the Bureau in accordance with Secs. 57 and 58 of the Code.

ASSESSMENT NO. LTDO-122-WE-00010

II. DEFICIENCY EWT	
Basic	25,945.95
Add: 25% Surcharge	6,486.49
20% interest up to 1-31-07	20,315.68
Compromise	6,000.00
Total	58,748.12

ASSESSMENT NO. LTDO-122-WF-2002-00007

III. DEFICIENCY FINAL TAX	
Management & Consultancy fee	23,123,444.00
Basic	7,399,502.08
Add: 25% Surcharge	1,849,875.52

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20% Interest up to 1-31-07	5,793,810.13
Compromise	25,000.00
Total	15,068,187.73

ASSESSMENT NO. LTDO-122-WG-2002-00008

FINAL TAX ON NRAETB-not remitted to BIR	1,497,109.52
Add: 25% Surcharge	374,277.38
20% Interest	1,172,236.75
Compromise	25,000.00
Total	3,068,623.65

ASSESSMENT NO. LTDO-122-WC-00004

IV. DEFICIENCY TAX ON WITHHOLDING ON COMPENSATION	
Basis	695,533.11
Basic (32%)	222,570.60
Add: 25% Surcharge	55,642.65
20% Interest up to 1-31-07	174,272.78
Compromise	16,000.00
Total	468,486.02

RR No. 2-98 as amended, provides for the withholding of creditable and final tax on some income payments subject to tax.

ASSESSMENT NO. LTDO-122-PEN-2002-00001

V. PENALTY-LATE FILING OF 2ND QTR 1603	
Basic	13,165.77
Add: 25% Surcharge	3,291.44
20% Interest (4 days)	7.90
Compromise	4,000.00
Total	7,299.34

For failure to file any return and pay the tax due thereon as required by law, Sec. 248 (A) provides for the imposition of penalty equivalent to twenty-five percent (25%) of the amount due. And in addition to the above penalty there shall be assessed and collected on any unpaid amount of tax, interest at the rate of twenty percent (20%) per annum, or such higher rate as may be prescribed by rules and regulations. (Sec 249(A).

ASSESSMENT NO. LTDO-122-IE-2002-00001

VI. IMPROPERLY ACCUMULATED EARNINGS TAX	
Taxable income	47,252,115.00

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Add: Income exempt from tax	-
Income excluded from gross income	-
Income subjected to final tax	191,705.00
NOLCO	-
Total	47,443,820.00
Less: Dividends actually received	4,350.00
Income tax paid	15,120,677.00
Improperly accumulated earnings	32,318 ,793.00
Tax	3,231,879.30
Less: IAET already assessed	-
Basic tax due	3,231,879.30
Add: interest until 1-31-07	2,433,454.51
Deficiency IAET	5,665,333.81
GRAND TOTAL	76,034,555.22

Sec. 29(A) of the NIRC provides for the imposition of improperly accumulated earnings tax of 10% on improperly accumulated taxable income of each corporation in addition to other taxes imposed by the Code." *(Exhibit "J")*

Deficiency Income Tax

A careful examination of the deficiency income tax (Assessment No. LTDO-122-IT-2002-00013) shows that there were disallowances made by respondent from petitioner's net income, among which are (1) purchases-unsupported in the amount of P62,541,979.00, as a result of the difference of (P426,335,562.00 – P363,793,583.00); (2) Management & Consultancy Fee-no EWT in the amount of P23,123,444.00; (3) unaccounted expenses in the amount of P3,422,592.90; (4) rental and profession fees in the amount of P1,635,104.32; and (5) losses in the amount of P169,187.00.

Though respondent provided the legal basis of said deficiency income tax assessment, respondent, however, failed to provide some factual basis of said disallowances. Respondent failed to indicate the basis why the amount of P363,793,583.00 is being deducted from the amount of P426,335,562.00 Respondent also did not indicate where the said amount came from, nor provided any reason why said amount was disallowed from petitioner's purchases. Said assessment details are not sufficient to afford petitioner the opportunity to intelligently answer the assessment, as well as prepare the documentary evidence in support of its protest.

In fact, in the initial Report of the Court-Commissioned ICPA, dated March 30, 2009, the ICPA himself was not able to reconcile the difference between the raw materials per 2002 Audited Financial Statements and the amount deducted by the BIR, because the BIR did not provide supporting documents or details of the amount of P363,793,583.00 *(Findings and Observations III.1.A, p. 4 thereof)*. If the ICPA himself was not able to reconcile respondent's assessment with those appearing in petitioner's Audited Financial Statements, then how can we expect petitioner to have understood and contest said assessment?

Petitioner was able to obtain the details of the amount of P363,793,583.00 only after it requested the same from the Chief LTDO of Makati in a Letter dated September 20, 2006 *(Exhibit "14")*.

In the case of *Commissioner of Internal Revenue vs. Enron Subic Power Corporation, 576 SCRA 218 ("Enron case")*, the Supreme Court ruled, as follows:

> "The law requires that the legal and factual bases of the assessment be stated in the formal letter of demand and assessment notice. Thus, such cannot be presumed. Otherwise, the express provisions of Article 228 of the NIRC and RR No. 12-99 would be rendered nugatory. The alleged 'factual bases' in the advice, preliminary letter and 'audit working papers' did not suffice. There was no going around the mandate of the law that the legal and factual bases of the assessment be stated in writing in the formal letter of demand accompanying the assessment notice.
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> We note that the old law merely required that the taxpayer be notified of the assessment made by the CIR. This was changed in 1998 and the taxpayer must now be informed not only of the law but also of the facts on which the assessment is made. Such amendment is in keeping with the constitutional principle that no person shall be deprived of property without due process. In view of the absence of a fair opportunity for Enron to be informed of the legal and factual bases of the assessment against it, the assessment in question was void. We reiterate our ruling in *Reyes v. Almanzor, et al.*:"

Pursuant to the ruling, we consider the disallowance of the amount of P62,541,979.00 from net income as without factual basis, and is therefore void, pursuant to *Section 228 of the NIRC of 1997, as amended,* and the Enron case.

The same is true as regards the unaccounted expenses in the amount of P3,422,592.90 and the rental and professional fees in the amount of P1,635,104.32. The Formal Letter of Demand does not show any factual bases on how the amounts were arrived at and why said amounts should be deducted from petitioner's net income. Said figures indicated in the Details of Discrepancies are not sufficient to afford petitioner the opportunity to intelligently answer the assessment, as well as prepare the documentary evidence in support of its protest. In fact, in petitioner's Letter to the Chief-LTDO of Makati, dated September 20, 2006, petitioner was requesting for the list of the Unaccounted expense of P3,422,593.00 in order that it may be able to verify why said amount was deducted from petitioner's net income *(Exhibit "14")*. The Supreme Court has ruled that the alleged 'factual bases' in the advice, preliminary letter and 'audit working papers' will not suffice as there was no going around the mandate of the law that the legal and factual bases of the assessment be stated in writing in the formal letter of demand accompanying the assessment notice *(Enron case, supra)*. For failure to comply with the provisions of *Section 228 of the NIRC of 1997, as amended*, said disallowances are also void.

But, as regards the disallowance of Management & Consultancy Fee for no EWT in the amount of P23,123,444.00 and losses in the amount of

P1,169,187.00, records show that both amounts were taken from the figures appearing in petitioner's Annual Income Tax Return for the year ended December 12, 2002 *(BIR Records, p. 29)* and in the Audited Financial Statements for Management and Consultancy Fee *(Exhibit "E");* hence, it cannot be said that petitioner is at loss how said amounts were arrived at and what are the factual bases of said disallowances.

In fact, in petitioner's Protest, dated January 11, 2007 *(BIR Records, pp. 604 to 620)*, petitioner was able to argue exhaustively why the amount of P23,123,444.00 should not be disallowed from petitioner's net income.

However, we agree with petitioner that the Management and Consultancy Fee in the amount of P23,123,444.00 paid to Dogi International Fabrics, S.A. ("DIF"), pursuant to an Agreement dated January 1, 2002 *(Exhibit "P")*, is not taxable.

DIF is a company based in Barcelona, with business address at Calle Domenech Farré n° 13-15 08320 El Masnou, Barcelona, Spain *(Agreement dated January 1, 2002, p. 1, Exhibit "P"),* whose entire capital stock is listed on the stock exchange of Barcelona, Spain *(Exhibit "O-4").*

Article 7 of the Convention Between the Republic of the Philippines and Spain for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income ("RP-Spain Tax Treaty"), on the taxability of business profits of an enterprise of the Contracting State, provides:

"ARTICLE 7

BUSINESS PROFITS

> 1. The profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other State but only so much of them as are attributable to that permanent establishment or are derived within such other Contracting State from sales of goods or merchandise of the same or similar kind as those sold, or from other business transactions of the same or similar kind as those effected through the permanent establishment. The competent authorities of the Contracting States shall consult each other on the similarity of goods sold or business transactions.
>
> xxx xxx."

Hence, pursuant to the above provision, the profits of an enterprise of a contracting state shall be taxable only in that state, unless the enterprise has a business in the other contracting state, through a permanent establishment situated therein.

Article 5 of the said RP-Spain Tax Treaty defines "permanent establishment", as follows:

"ARTICLE 5

PERMANENT ESTABLISHMENT

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

2. The term 'permanent establishment' includes, but is not limited to:

(a) a place of management;

(b) a branch;

(c) an office;

(d) a factory;

(e) a workshop;

(f) a warehouse, in relation to a person providing storage facilities for others;

(g) a store or premises where sales are performed;

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

(i) a building site or construction, installation or assembly project or supervisory activities in connection therewith, where such site, project or activity continues for more than six (6) months;

(j) the furnishing of services including consultancy services by an enterprise through an employee or other personnel provided where activities of that nature (for the same or connected project) within the other Contracting States continue within a Contracting State for a period or periods exceeding 180 days within any twelve-month period.

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> 7. The fact that a corporation of a Contracting State controls or is controlled by a corporation of the other Contracting State or a corporation which carries on business in that other Contracting State (whether through a permanent establishment or otherwise), shall not of itself constitute either corporation a permanent establishment of the other."

Considering that the services enumerated in Article I.2 of the Agreement dated January 1, 2002 rendered by DIF to petitioner will be rendered in Spain, Hongkong and the United Kingdom, where DIF has its satellite offices responsible for monitoring its operations in the Asia Pacific region *(Exhibit "P"),* and none of said services are rendered in the Philippines, then DIF has no "permanent establishment" in the Philippines, as defined above.

The fact that petitioner is a wholly-owned subsidiary of DIF (*Exhibit "O-3")* would not constitute either corporation a permanent establishment of the other as provided in *paragraph 7 of Article 5.*

Thus, in the case of *Commissioner of Internal Revenue vs. Smart Communication, Inc., 629 SCRA 358*, the Supreme Court ruled, as follows:

> "In the instant case, it was established during the trial that Prism does not have a permanent establishment in the Philippines. Hence, 'business profits' derived from Prism's dealings with respondent are not taxable."

Since DIF has no permanent establishment in the Philippines, it is clear that the management and consultancy fee that DIF received from

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petitioner by virtue of the Agreement dated January 1, 2002 is not taxable, pursuant to *Section 7(1) of the RP-Spain Tax Treaty* and the above ruling of the Supreme Court. Accordingly, petitioner has no obligation to withhold taxes on the management and consultancy fee paid to DIF. Thus, respondent cannot disallow as a deduction from net income the payment of management and consultancy fee to DIF for the reason that no Expanded Withholding Tax was withheld thereof by petitioner.

However, as regards the losses in the amount of P1,169,187.00, considering that petitioner failed to substantiate with clear and sufficient evidence why it should be allowed as a deduction from petitioner's net income, we sustain respondent's disallowance of the amount of P1,169,187.00 from petitioner's net income. Settled is the rule that the burden of proof is upon the complaining party to show clearly that the assessment is erroneous. Failure to present proof of error in the assessment will justify the judicial affirmance of said assessment *(Commissioner of Internal Revenue vs. Gonzalez, 633 SCRA 171, citing the case of Marcos II v. Court of Appeals 273 SCRA 66-67).*

Petitioner, therefore, is liable to pay basic deficiency income tax in the amount of P374,139.64, computed, as follows:

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Net Income per return	P	47,252,115.00
Add: Losses (disallowances)		1,169,187.00
Taxable Income per Investigation	P	48,421,302.00
Income Tax Due Thereon	P	15,494,816.64
Less: Tax paid		15,120,677.00
Basic Deficiency Income Tax Due	**P**	**374,139.64**

Deficiency Expanded Withholding Tax

In the Assessment No. LTDO-122-WE-00010, petitioner was assessed of basic deficiency Expanded Withholding Tax ("EWT") in the amount of P25,945.95, or for a total amount of P58,748.12, inclusive of 25% surcharge, interest and compromise penalty.

In its Protest Letter dated January 11, 2007, petitioner admitted its liability for deficiency EWT in the amount of P58,748.12 *(BIR Records, p. 605)*. Considering that petitioner itself admitted its tax liability for deficiency EWT and considering further that an admission made by a party in the course of the proceedings does not require proof *(Toshiba Information Equipment (Phils.), Inc., 614 SCRA 545)*, then we sustain respondent's assessment of basic deficiency EWT against petitioner in the amount of P25,945.95.

However, as regards compromise penalty of P6,000.00, the jurisprudential rule is that compromise penalties are amounts collected by the BIR in lieu of criminal prosecution for violations committed by taxpayers, the payment of which is based on compromise agreement validly entered into between the taxpayer and the CIR. Thus, the compromise penalty of P6,000.00 is hereby ordered cancelled.

Deficiency Final Tax

The total deficiency final tax of P15,068,187.73 arose as a result of the Management & Consultancy Fee in the amount of P23,123,444.00 that was disallowed by respondent in petitioner's net income, resulting to a basic deficiency final tax assessment in the amount of P7,399,502.08.

As we have heretofore ruled, the Management & Consultancy Fee in the amount of P23,123,444.00 paid by petitioner to DIF, pursuant to the Agreement dated January 1, 2002, is not taxable since DIF has no "permanent establishment" in the Philippines. Accordingly, the same is likewise not subject to final withholding tax. Thus, Assessment No. LTDO-122-WF-2002-00007 is hereby ordered cancelled and set aside.

Deficiency Final Tax on Non-Resident Alien Engaged in Trade or Business ("NRAETB")

As regards the basic deficiency assessment for final tax on NRAETB in the amount of P1,497,109.52, or the total amount of P3,068,623.65, inclusive of 25% surcharge, interest and compromise penalty, petitioner was assessed of said deficiency final tax because petitioner withheld the total

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amount of P1,497,109.52 from the following employees, but failed to remit the same to the BIR:

Name of the Employee	Amount of Income Payment	Rate of Tax	Amount of Tax Withheld
Brown, Michael James	2,631,985.79	0.25	657,996.45
Engel, Marissa Luisa Lopez	1,808,318.70	0.25	452,079.68
King, William Wright	1,548,133.54	0.25	387,033.39
Total			1,497,109.52

(Exhibit "19")

However, nowhere in the records did we find any Monthly Remittance Return of Final Income Taxes Withheld (BIR Form No. 1601-F) filed by petitioner with the BIR, which will prove that the final tax on NRAETB of P1,497,109.52 has been remitted by petitioner to the BIR. Since petitioner is being assessed of said deficiency final withholding tax on NRAETB; then, it has the burden to disprove the same considering that under the law it has the obligation to remit said final taxes. Settled is the rule that tax assessments by tax examiners are presumed correct and made in good faith. The taxpayer has the duty to prove otherwise. In the absence of proof of any irregularities in the performance of duties, an assessment duly made by a BIR examiner and approved by his superior officers will not be disturbed. All presumptions are in favor of the correctness of tax assessments *(Commissioner of Internal Revenue vs. Bank of the Philippine Islands, 521 SCRA 386)*.

Considering that petitioner failed to show that said amount has been remitted to the BIR, other than its general averments that the assessment has no factual and legal bases, then we sustain respondent's assessment for basic deficiency final withholding tax on NRAETB of P1,497,109.52.

Deficiency Tax on Withholding on Compensation

As regards the deficiency withholding tax on compensation, records show that the amount of P695,533.11 was arrived at by comparing the sum of the (1) total salaries and wages per alpha list of P33,507,585.89, (2) salaries per final withholding tax of P5,988,438.00 and (3) contribution to retirement of P3,800,000.00 or the total of P43,296,023.89 with the sum of the amount per F/S consisting of (1) cost of sales of P24,677,064.00, (2) OPEX of P12,841,969.00, and (3) P6,472,524.00, or the total of P43,991,557.00 *(Exhibit "11")*. Considering that the burden of proof is upon the complaining party to show clearly that the assessment is erroneous and failure to present proof of error in the assessment will justify the judicial affirmance of said assessment, then we sustain the basic deficiency assessment for withholding tax on compensation against petitioner in the amount of P222,570.60.

Penalty – Late Filing of BIR Form 1603 for the 2nd QTR of 2002

Petitioner was assessed of penalty for late filing of BIR Form 1603 for the 2nd quarter of 2002 in the basic amount of P3,291.44 or the total amount of P7,299.34, inclusive of 25% surcharge, interest and compromise penalty, pursuant to *Section 248(A) of the NIRC of 1997, as amended*, which provides for the imposition of penalty equivalent to twenty-five percent (25%) of the amount due. In addition, there shall be assessed and collected on any unpaid amount of tax, interest at the rate of twenty percent (20%) per annum, or such higher rate as may be prescribed by rules and regulations *(Section 249 (A))*.

In its Protest Letter dated January 11, 2007 *(BIR Records, p. 604)*, petitioner admitted its liability for late payment of penalties in the amount of P7,299.34 for late filing of its BIR Form No. 1603 for the 2nd quarter of 2002. Because of petitioner's own admission of said liability, we sustain respondent's assessment for 25% surcharge and 20% interest in the respective amounts of P3,291.44 and P7.90, in the total amount of P3,299.34.

However, as regards compromise penalty of P4,000.00, the jurisprudential rule is that compromise penalties are amounts collected by

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the BIR in lieu of criminal prosecution for violations committed by taxpayers, the payment of which is based on compromise agreement validly entered into between the taxpayer and the CIR. Thus, the compromise penalty of P4,000.00 is hereby ordered cancelled.

Deficiency Assessment for Improperly Accumulated Earnings Tax

Petitioner was assessed of improperly accumulated earnings tax in the total amount of P5,665,333.81, pursuant to *Section 29(A) of the NIRC of 1997, as amended*, which provides for the imposition of improperly accumulated earnings tax of 10% on improperly accumulated taxable income of each corporation, in addition to other taxes imposed by the Code.

Section 29 of the NIRC of 1997, as amended, provides:

> "SEC. 29. Imposition of Improperly Accumulated Earnings Tax. –
>
> (A) In General. – In addition to other taxes imposed by this Title, there is hereby imposed for each taxable year on the improperly accumulated taxable income of each corporation described in Subsection B hereof, an improperly accumulated earnings tax equal to ten percent (10%) of the improperly accumulated taxable income.
>
> (B) Tax on Corporations Subject to Improperly Accumulated Earnings Tax. –
>
> (1) In General. – The improperly accumulated earnings tax imposed in the preceding Section shall apply to every corporation formed or availed for the purpose of avoiding the income tax with respect to its

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shareholders or the shareholders of any other corporation, by permitting earnings and profits to accumulate instead of being divided or distributed.

(2) Exceptions. – The improperly accumulated earnings tax as provided under this Section shall not apply to:

(a) Publicly-held corporations;

(b) Banks and other nonbank financial intermediaries; and

(c) Insurance companies.

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Corollary thereto, *Section 7 of Revenue Regulations 02-01* provides on the determination of purpose to avoid income tax, as follows:

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

For purposes of these Regulations, the term 'holding or investment company' shall refer to a corporation having practically no activities except holding property, and collecting the income therefrom or investing the same.

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

> (a) Investment of substantial earnings and profits of the corporation in unrelated business or in stock or securities of unrelated business;
>
> (b) Investment in bonds and other long-term securities;
>
> (c) Accumulation of earnings in excess of 100% of paid-up capital, not otherwise intended for the reasonable needs of the business as defined in these Regulations."

Pursuant to the above provisions, an improperly accumulated earnings tax equivalent to 10% of the improperly accumulated earnings shall be imposed on corporations that permit its earnings and profits to accumulate, instead of being distributed as dividends. Specifically, by allowing its earnings to accumulate in excess of 100% of the paid-up capital, not otherwise intended for the reasonable needs of its business.

The provision discouraged tax avoidance through corporate surplus accumulation. When corporations do not declare dividends, income taxes are not paid on the undeclared dividends received by the shareholders. The tax on improper accumulation of surplus is essentially a penalty tax designed to compel corporations to distribute earnings so that the said earnings by shareholders could, in turn, be taxed *(Cyanamid Philippines, Inc. vs. the Court of Appeals, 322 SCRA 649)*.

Records show that petitioner did not accumulate its earnings in excess of 100% of its paid-up capital.

The Audited Financial Statements of petitioner shows that although its Stockholders Equity as of December 31, 2002 amounts to P851,065,842.00 consisting of (1) capital stock in the total amount of P332,999,500.00 (preferred stock of P296,999,500.00 and commons stock of P36,000,000.00), and (2) retained earnings of P518,066,342.00 *(Exhibit "E")*, Note 7 of the Balance Sheet provides that P323,657,843.00 of which pertains to the retained earnings of Penn Philippine Export, Inc ("PPE"), petitioner's subsidiary *(supra)*.

Petitioner's witness, Benedicto Horca III, on direct examination, testified that PPE's retained earnings was included in petitioner's retained earnings reported in the Audited Financial Statement because petitioner used the equity method of accounting for its investment in PPE *(Exhibit "N")*. Further, said witness explained that for purposes of management accounting, petitioner can recognize as income its equity in net earnings in PPE, but the same cannot be declared as dividends since it is not yet actually realized as income of petitioner unless PPE declares it as dividends *(supra)*. In Note 7 of the Balance Sheet, it is also provided that the amount of P323,657,843.00 is

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not available for dividend distribution until such time that it has been declared as dividend by PPE *(Exhibit "E")*.

Considering that the amount of P323,657,843.00 of the P518,066,342.00 retained earnings of petitioner pertains to PPE, then petitioner's actual retained earnings as of December 31, 2002 is only P194,408,499.00, which is only 58.38% (P194,408,499.00 ÷ P332,999,500.00) of petitioner's capital stock (paid-up capital). Therefore, there is no accumulation in excess of 100% of petitioner's paid-up capital.

Moreover, *Section 29(B)(2)(a) of the NIRC of 1997, as amended,* provides that the improperly accumulated earnings tax do not apply to publicly-held corporations. A publicly-held corporation is a domestic corporation that is not a closely held corporation *(Section 4 of RR 02-01)*. Closely-held corporations are those corporations, at least fifty percent (50%) in value of the outstanding capital stock or at least fifty percent (50%) of the total combined voting power of all classes of stock entitled to vote, is owned directly or indirectly by or of not more than twenty (20) individuals *(supra)*.

Records show that petitioner is a wholly-owned subsidiary of DIF (*Exhibit "O-3")*. Therefore, the ownership of petitioner's stock is considered as being proportionately owned by DIF's shareholders and be ultimately traced to the individual shareholders of DIF, pursuant to *Section 4 (1) of Revenue Regulations 02-01*.

Records further show that DIF is a publicly listed company in the Barcelona, Spain Stock Exchange *(Exhibits "O-4" and V-8")*. In *Rule 3(1)(m) of the Amended Implementing Rules and Regulations of the Securities Regulations Code*, a "public company" is defined as any corporation with a class of equity securities listed on an Exchange, or with assets in excess of Fifty Million Pesos (P50,000,000.00) and having two hundred (200) or more holders, at least two hundred of which are holding at least one hundred (100) shares of a class of its equity securities. Therefore, it follows that DIF is a public company or that 50% of its outstanding capital stock or at least 50% of the total combined voting power of all classes of stock of DIF is owned by more than 20 individuals and, thus, considered a publicly-held corporation.

Accordingly, the deficiency assessment for improperly accumulated earnings tax in the amount of P5,665,333.81 is without legal basis.

WHEREFORE, premises considered, the present Petition for Review is hereby **PARTLY GRANTED**.

Accordingly, the Assessments issued by respondent against petitioner covering deficiency final tax and improperly accumulated earnings tax for

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the year 2002 in the amounts of P15,068,187.73 and P5,665,333.81, respectively are hereby ordered **CANCELLED** and **SET ASIDE**.

However, the Assessments covering deficiency Income Tax, Expanded Withholding Tax, Final Tax on NRAETB, Withholding Tax on Compensation, and Penalties on Late Filing of BIR Form No. 1603 for the 2nd Quarter of 2002 are hereby sustained with some modifications. Accordingly, petitioner is hereby **ORDERED** to pay respondent the following amounts, inclusive of surcharge imposed under *Section 248(A) of the NIRC of 1997*, as follows:

Kind of Tax	**Basic**	**25% Surcharge**	**20% Interest**	**Total**
Income Tax	P 374,139.64	P 93,534.91		P 467,674.55
Expanded Withholding Tax	25,945.95	6,486.49		32,432.44
Final Tax on NRAETB	1,497,109.52	374,277.38		1,871,386.90
Withholding Tax on Compensation	222,570.60	55,642.65		278,213.25
Penalty for late filing 1603 (Basis P13,165.77)	-	3,291.44	P 7.90	3,299.34
Total	**P 2,119,765.71**	**P 533,232.87**	**P 7.90**	**P 2,653,006.48**

In addition, petitioner is hereby **ORDERED** to pay (a) deficiency interest at the rate of twenty percent (20%) per annum on the basic deficiency Income Tax of P374,139.64, computed from April 15, 2003, EWT of P25,945.95, computed from January 25, 2003, on Final Tax on NRAETB of P1,497,109.52, computed from January 25, 2003 and Withholding Tax on Compensation of P222,570.60, computed from January 15, 2003, until full payment thereof, pursuant to *Section 249(B) of the NIRC*

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of 1997, as amended; and (b) delinquency interest at the rate of twenty percent (20%) per annum on the total amount of P2,653,006.48 and on the 20% deficiency interest which have accrued as afore-stated in (a), computed from January 31, 2007 until full payment thereof, pursuant to *Section 249 (C) of the NIRC of 1997*.

SO ORDERED.

OLGA PALANCA-ENRIQUEZ
Associate Justice

WE CONCUR:

LOVELL R. BAUTISTA
Associate Justice

AMELIA R. COTANGCO-MANALASTAS
Associate Justice

A T T E S T A T I O N

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.

LOVELL R. BAUTISTA
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.

ERNESTO D. ACOSTA
Presiding Justice