REPUBLIC OF THE PHILIPPINES
COURT OF TAX APPEALS
QUEZON CITY

FIRST DIVISION

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MITSUBISHI CORPORATION – MANILA BRANCH, Petitioner,	**C.T.A. CASE NO. 7040**
	Members:
- versus -	**ACOSTA,** *Chairperson* **BAUTISTA,** and **CASANOVA,** *JJ.*
COMMISSIONER OF INTERNAL REVENUE, Respondent.	**Promulgated:** NOV 24 2009, 10:30am

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DECISION

CASANOVA, *J.*:

Nature of the Case

The *Petition for Review* prays for the cancellation and withdrawal of *Assessment Notices* issued for deficiency expanded withholding tax in the amount of P1,743,965.62, deficiency value-added tax in the amount of P96,151,087.88, and deficiency income tax in the amount of P306,788.00; or in the aggregate amount of P98,201,841.50.

Statement of the Facts

The following are recited in the parties' *Stipulation of Facts*:

Petitioner is the branch office of Mitsubishi Corporation, a corporation duly organized and existing under and by virtue of the laws of Japan, legally authorized by the Philippine Securities and Exchange Commission to operate as branch office in the Philippines with office address located at the 14th Floor, Locsin Building, Makati Avenue corner Ayala Avenue.[1]

While respondent is the Commissioner of Internal Revenue who is duly appointed and empowered to perform the duties of his office, including, among others, the duty to act on and approve claims for refund or tax credit of overpaid internal revenue taxes as provided by law, with office at the BIR National Office Building, Diliman, Quezon City.[2]

Through an *Exchange of Notes*[3] between the Government of Japan and the Government of the Philippines dated June 11, 1987, it was agreed that a loan amounting to Y40,400,000,000 will be extended to the Republic of the Philippines by the then Overseas Economic Cooperation Fund (OECF), now the Japan Bank for International Cooperation for the implementation of the Calaca II Project. In paragraph 5(2) of the said Exchange of Notes, it was stated that:[4]

> "The Government of the Republic of the Philippines, will, itself or through its instrumentalities, assume all fiscal levies or taxes imposed in the Republic of the Philippines on Japanese firms and nationals operating as suppliers, contractors or consultants on and/or in connection with any income that may accrue from the supply of products of Japan and services of Japanese national to be provided under the Loan."

Subsequently, the OECF and the Government of the Republic of the Philippines entered into a *Loan Agreement (Loan Agreement No. PH-P76)*[5] dated

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[1] Joint Stipulation of Facts and Issues (JSFI), paragraph 1, Division Docket, page 142
[2] JSFI, par. 2, Division Docket, p. 143
[3] Exhibit "EE"
[4] JSFI, par. 3, Division Docket, p. 143
[5] Exhibit "FF"

September 25, 1987 for Y40,400,000,000.00 for the implementation of the "Calaca II Project".[6]

On June 21, 1991, the National Power Corporation (NPC) and Mitsubishi Corporation (MC), petitioner's head office in Japan, entered into a *Contract for the engineering, supply, construction, installation, testing and commissioning of one (1) x 300 MW Batangas Coal-Fired Thermal Power Project II at Calaca, Batangas (Calaca II Coal-Fired Thermal Power Project).*[7] Article VI of the Contract provided that:[8]

> "The Foreign Currency Portion of the Contract Price for Phase I is funded by OECF Loan No. PH-P76. Any Foreign Currency Portion of the Contract which is not covered by OECF Loan No. PH-P76 shall constitute as Phase II of the Contract. Corporation (NPC) shall secure additional financing from OECF for Phase II within one (1) year after the date of Contract effectively."

Thus, a second *Loan Agreement (Loan Agreement No. PH-P141)*[9] dated December 20, 1994 for the amount of Y5,513,000,000.00 was entered into between the OECF and the Government of the Republic of the Philippines for the additional funding of the "Calaca II Project".[10]

From 1994 to 1998, during the construction of the project, petitioner incurred input Value-Added Taxes for its domestic purchases and importations of goods related to the construction and implementation of "Calaca II Project" reflected in the following Quarterly VAT Returns filed on the dates specified as follows:[11]

Quarter	**Date Filed**
3rd Quarter 1994	October 21, 1994
4th Quarter 1994	January 20, 1995
1st Quarter 1995	April 20, 1995
2nd Quarter 1995	July 19, 1995
3rd Quarter 1995	October 19, 1995
4th Quarter 1995	January 22, 1996

[6] JSFI, par. 4, Division Docket, p. 143
[7] Exhibit "DD"
[8] JSFI, par. 5, Division Docket, pp. 143-144
[9] Exhibit "GG"
[10] JSFI, par. 6, Division Docket, p. 144
[11] JSFI, par. 7, Division Docket, pp. 144-145

1st Quarter 1996	April 22, 1996
2nd Quarter 1996	July 22, 1996
3rd Quarter 1996	October 21, 1996
4th Quarter 1996	January 20, 1997
1st Quarter 1997	April 21, 1997
2nd Quarter 1997	July 17, 1997
3rd Quarter 1997	October 15, 1997
4th quarter 1997	January 16, 1998
1st Quarter 1998	April 27, 1998

Petitioner received on December 22, 2003, more than eight (8) years from the completion and turn-over of the "Calaca II Project", the Bureau of Internal Revenue's *Formal Letter of Demand*[12] dated November 28, 2003 and *Formal Assessment Notices* dated November 4, 2003 for fiscal year ending March 31, 1998 regarding the alleged internal revenue tax liabilities:[13]

Tax Type	**Assessment Number**	**Amount (including increments)**
Expanded Withholding Tax	TFD-98-WT-176-03	P1,743,965.62
	TFD-98-WT-177-03	
Value-Added Tax	TFD-98-VT-173-03	96,151,087.88
	TFD-98-VT-174-03	
Income Tax	TFD-98-IT-175-03	306,788.00
Grand Total		**P98,201,841.50**

Respondent's reasons for these assessments are as follows:

a) Expanded Withholding Tax (P1,743,965.62):

i) Failure to comply Sec. 2.57 of RR #2-98, per Sec. 57 of the NIRC, as amended, on certain income payments;

ii) Penalty for late remittance of taxes withheld for failure to remit taxes withheld from KTK Fujiwara arising from Visayas Project within time required by Sec. 58 of the Tax Code.

b) Value Added Tax (P96,151,087.88)
i) Failure to comply with Sec. 108 of the Tax Code, as amended on your receipts from Philippine Automotive Chemical;

ii) Failure to comply with Sec. 4.104.1, par. 2 RR No. 7-95 per Sec. 110 (A)(3)(b) on transactions involving Batangas Project, a certain portion of which is OECF funded, exempt from VAT

[12] Exhibit "W"
[13] JSFI, par. 8, Division Docket, p. 145

under international agreement to which the Philippines is a signatory, as provided by Sec. 109 of the National Internal Revenue Code;

iii) Penalty for late payment of VAT on receipts from Batangas Project within the time required by Sec. 114 of the Tax Code.

c) Income tax (P306,788.00)

i) Failure to include income from Philippine Automotive Chemical as part of taxable income subject to tax per Sec. 31 of the Tax Code.

On January 21, 2004, petitioner filed its *Formal Protest* to the aforementioned assessments to the Bureau of Internal Revenue. The protest cited the following grounds:[14]

a) The assessments are barred by prescription since they were made beyond the period of three (3) years from the date the corresponding VAT returns were filed;

b) The total accumulated input VAT amount used as basis of the disallowance of the input VAT attributable to the OECF-funded portion of the Project by the examiner is incorrect;

c) OECF-funded projects are not exempt from VAT; and

d) The Philippine government has committed not to utilize the proceeds of the OECF loan for the payment of taxes.

Despite the lapse of the 180-day period from its receipt on January 21, 2004 of the protest, the Bureau of Internal Revenue has not granted or denied petitioner's protest.[15] Hence, petitioner filed the *Petition for Review*[16] on August 8, 2004.

Respondent in its *Answer*[17] filed on October 26, 2004, interposed the following *Special and Affirmative Defenses*:

"7. The assessment notices for Deficiency Income Tax in the amount of P306,788.00, Deficiency Withholding Tax in the amount of P1,743,965.62, and Deficiency VAT in the amount of P96,151,087.88 were issued in accordance with law and regulations;

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[14] JSFI, par. 9, Division Docket, p. 146
[15] JSFI, par. 10, Division Docket, p. 146
[16] Division Docket, pp. 1-10
[17] Division Docket, pp. 93-97

8. Petitioner failed to comply with the provisions of Section 2.57.2 of Revenue Regulations No. 2-98 in relation to Section 57 of the Tax Code, as amended, on certain income payments. Thus, an assessment for Deficiency Expanded Withholding Tax in the amount of P1,743,965.62;

9. Petitioner failed to remit taxes withheld from KTK Fujikura arising from Visayas Project within the period provided for by Section 58 of the Tax Code, as amended. Hence, a penalty for late remittance of taxes withheld was imposed.

10. Petitioner's receipts from Philippine Automotive Chemical were not subjected to VAT in violation of Section 108 of the Tax Code, as amended;

11. Petitioner failed to comply with the provisions of Section 4.104.1, paragraph 2 of Revenue Regulations No. 7-95 in relation to Section 110 (A)(3)(b), on transaction involving Batangas Project, a certain portion of which is Overseas Economic Cooperation Funds (OECF) funded. The said transactions are exempt from VAT under international agreement to which the Philippine is a signatory, as provided by Section 109 (g) of the National Internal Revenue Code, as amended. Accordingly, a proportionate amount of input VAT applicable to the said transaction was disallowed;

12. A penalty for late payment of VAT on receipts from Batangas Project was imposed against the petitioner, pursuant to the provisions of Section 114 in relation to Section 248 of the National Internal Revenue Code, as amended;

13. Petitioner failed to include income from Philippine Automotive Chemical as part of taxable income subject to as provided by Section 31 of the Tax Code. Hence, an assessment for the Deficiency Income Tax in the amount of P306,788.00;

14. Petitioner's VAT returns being erroneous are deemed false returns. As such, the right to assess is ten (10) years from the discovery of the falsity of said returns pursuant to Section 222 of the Tax Code, as amended. The falsity of the returns was discovered when the BIR examiners submitted their report of investigation on July 16, 2001. Hence, the right to assess has not prescribed.

15. Finally, it is well-settled rule in taxation that assessments are *prima facie* presumed correct and made in good faith. The taxpayer has the duty of proving otherwise, and in the absence of proof of any irregularities in the performance of official duties, an assessment will not be disturbed."

Notice of Pre-Trial Conference[18] issued on November 12, 2004, which set the Pre-trial Conference on January 14, 2005 was received by petitioner on November 17, 2004 and by respondent on November 22, 2004.

Petitioner filed its *Pre-Trial Brief*[19] on January 11, 2005, while Respondent's Pre-Trial Brief[20] was filed on March 1, 2005. Pre-Trial was held on March 4, 2005.[21]

In a *Resolution*[22] dated May 5, 2005, the parties' *Joint Stipulation of Facts and Issues*[23] filed on April 29, 2005 were approved. Hence, the parties were ordered to proceed with the trial on the merits.

On November 15, 2006, petitioner filed a *Motion for Judicial Notice*[24] which prayed that this Court take judicial notice of the records of CTA Case No. 6139.

After presentation of its evidence, petitioner filed its *Formal Offer of Evidence*[25] on April 27, 2007, which the Court resolved to admit in a *Resolution*[26] dated June 18, 2007.

While respondent's *Formal Offer of Evidence*[27] filed on April 3, 2008 was resolved in a *Resolution*[28] dated May 30, 2008.

Petitioner's *Memorandum*[29] was posted on July 9, 2008 and which was received on July 15, 2008.

However, on July 16, 2008, petitioner filed a *Motion for the Suspension of the Collection of Taxes.*[30] Respondent filed its *Comment/Opposition*[31] of August 7, 2008.

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[18] Division Docket, p. 99
[19] Division Docket, pp. 100-114
[20] Division Docket, pp. 125-132
[21] Division Docket, p. 135
[22] Division Docket, p. 151
[23] Division Docket, pp. 142-149
[24] Division Docket, pp. 196-204
[25] Division Docket, pp. 364-378
[26] Division Docket, pp. 380-381
[27] Division Docket, pp. 419-421
[28] Division Docket, p. 426
[29] Division Docket, pp. 483-522
[30] Division Docket, pp. 524-534
[31] Division Docket, pp. 550-559

Petitioner filed its *Reply (Re: Comment/Opposition dated 5 August 2008)*[32] on August 26, 2008

Respondent's *Memorandum*[33] was filed on August 5, 2008 and was received on August 11, 2008.

On September 3, 2008, petitioner filed a *Motion for Leave to File and Admit Reply (To Respondent's Memorandum)*[34], with attached *Reply (Re: Respondent's Memorandum dated 4 August 2008)*[35]. The Court in an *Order*[36] dated September 9, 2008, granted the same and accordingly admitted it to the records of the case.

In a *Resolution*[37] dated September 30, 2008, the Court granted petitioner's *Motion for the Suspension of the Collection of Taxes*, subject to the posting of a bond.

Hence, petitioner filed its *Compliance*[38] on October 27, 2008. In a *Resolution*[39] dated December 5, 2008, the Court approved the same.

Accordingly, on February 16, 2009, the case was submitted for decision.[40]

Issues

The following are the parties' *Stipulation of Issues*:[41]

"1. Whether or not the respondent's assessment against the petitioner for deficiency VAT from the 3rd quarter of 1994 to the 1st quarter of 1998 in the amount of P96,151,087.88 is barred by prescription;

2. Assuming that the respondent's assessment is not barred by prescription whether or not the OECF-funded portion of the Calaca II Project is subject to VAT;

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[32] Division Docket, pp. 581-595
[33] Division Docket, pp. 561-578
[34] Division Docket, pp. 596-598
[35] Division Docket, pp. 599-606
[36] Division Docket, p. 607
[37] Division Docket, pp. 608-610
[38] Division Docket, pp. 612-614
[39] Division Docket, pp. 642-643
[40] Resolution dated February 16, 2009, Division Docket, p. 645
[41] JSFI, pars. 1-5, Division Docket, pp. 147-148

3. Whether or not liability for VAT on the petitioner's accumulated input VAT on its domestic purchases and its importation of goods attributable to the OECF-funded portion of the Calaca II Project shall be assumed by the Philippine Government;

   3.1. Whether or not the petitioner's accumulated input VAT on its purchases and its importation of goods pertaining to the implementation of the Calaca II Project amounts to P65,820,970.59.

4. Whether or not respondent's disallowance of petitioner's input VAT attributable to the OECF-funded portion of the Calaca II Project violates the Exchange of Notes dated June 11, 1987 executed between Japan and the Republic of the Philippines that the funds from the loan shall be used exclusively for the Calaca II Project;

5. Whether or not the petitioner has already fully paid the deficiency assessment on expanded withholding tax and income tax as well as the penalty for late remittance of VAT and tax due on receipts not subjected to VAT and, therefore, cancellation of the assessments on the foregoing taxes is in order."

DISCUSSION

Section 203 of the National Internal Revenue Code (NIRC) of 1997, as amended, provides for the period upon which the BIR can make an assessment, thus:

> "**SECTION 203.** *Period of Limitation Upon Assessment and Collection.* – Except as provided in Section 222, **internal revenue taxes shall be assessed within three (3) years after the last day prescribed by law for the filing of the return**, and no proceeding in court without assessment for the collection of such taxes shall be begun after the expiration of such period: *Provided*, That in a case where a return is filed beyond the period prescribed by law, the three (3)-year period shall be counted from the day the return was filed. For purposes of this Section, a return filed before the last day prescribed by law for the filing thereof shall be considered as filed on such last day." *(Emphasis supplied)*

As stated above, the BIR has three years, counted from the date of actual filing of the return or from the last date prescribed by law for the filing of such return, whichever comes later, to assess a national internal revenue tax or to begin a court proceeding for the collection thereof without an assessment; except in cases falling within Section 222 of the same Code.

In cases of value-added taxes (VAT), Section 114(A) of the NIRC of 1997, as amended, provides as follows:

> "**SECTION 114.** *Return and Payment of Value-added Tax.* –
>
> (A) *In General.* – Every person liable to pay the value-added tax imposed under this Title **shall file a quarterly return of the amount of his gross sales or receipts within twenty-five (25) days following the close of each taxable quarter prescribed for each taxpayer**: *Provided, however,* That VAT-registered persons shall pay the value-added tax on a monthly basis." *(Emphasis supplied)*

Unlike in corporate income tax, which is reported and paid on installment every quarter, but is eventually subjected to a final adjustment at the end of the taxable year, VAT is computed and paid on a purely quarterly basis without need for a final adjustment at the end of the taxable year.[42] Hence, each return has its own prescriptive period. To illustrate:

Period covered	Exhibit	Date of Filing	Last day of the 3-year period within which to issue an assessment
3rd Quarter 1994	"A"	October 21, 1994	October 25, 1997
4th Quarter 1994	"B"	January 20, 1995	January 25, 1998
1st Quarter 1995	"C"	April 20, 1995	April 25, 1998
2nd Quarter 1995	"D"	July 19, 1995	July 25, 1998
3rd Quarter 1995	"E"	October 19, 1995	October 25, 1998
4th Quarter 1995	"F"	January 22, 1996	January 25, 1999
1st Quarter 1996	"G"	April 22, 1996	April 25, 1999
2nd Quarter 1996	"H"	July 22, 1996	July 25, 1999
3rd Quarter 1996	"I"	October 21, 1996	October 25, 1999
4th Quarter 1996	"J"	January 20, 1997	January 25, 2000

[42] *Atlas Consolidated Mining and Development Corporation vs. Commissioner of Internal Revenue*, G.R. No. 141104 & 148763, June 8, 2007

1st Quarter 1997	"K"	April 21, 1997	April 25, 2000
2nd Quarter 1997	"L"	July 17, 1997	July 25, 2000
3rd Quarter 1997	"M"	October 15, 1997	October 25, 2000
4th Quarter 1997	"N"	January 16, 1997	January 25, 2001
1st Quarter 1998	"O"	April 27, 1998	April 27, 2001

Based on the records of the case, petitioner received on December 22, 2003, the *Formal Letter of Demand*[43] dated November 28, 2003 and *Assessment Notice* dated November 4, 2003 for the fiscal year ending March 1998:

Value Added Tax

	Findings	Tax Due
Receipts not subjected to VAT	P 400,000.00	P 40,000.00
Disallowed Input on Exempt Activity	44,642,248.57	44,642,248.57
Total	P45,042,248.57	44,682,248.57
Add: 20% Interest (4/20/98 – 12/30/03)		50,887,272.43
Penalty for late remittance of VAT on Batangas Project		561,566.88
Compromise Penalty		20,000.00
Total Deficiency VAT		**P96,151,087.88**

From the *Details of Discrepancy*, petitioner's deficiency VAT assessments were arrived as follows:

> "a) Verification showed that you failed to comply with Section 108 of the Tax Code, as amended, on your receipts from Philippine Automotive Chemical;
>
> b) Disallowed Input on exempt activities
>
> Your records showed that you failed to comply with Sec. 4.104.1, par. 2, Rev. Reg. No. 7-95 in pursuance with the provisions of Section 110 (A)(3)(b) on transactions involving Batangas Project, a certain portion of which is OECF funded, exempt from VAT under international agreement to which the Philippines is a signatory, as provided by Section 109 (q) of the National Internal Revenue Code.
>
> c) Penalty for late payment of VAT on receipts from Batangas Project
>
> Verification showed that you failed to pay VAT on receipts from Batangas Project within the time required by Section 114 of the Tax Code."

[43] Exhibit "W"

As correctly discussed by petitioner, it is immediately apparent that the assessment for deficiency VAT was issued beyond the prescriptive period provided in Section 203 of the NIRC of 1997, as amended. Respondent, on the latest, can issue an assessment only until April 27, 2001.

However, respondent raised that petitioner's VAT returns being erroneous are deemed false returns. As such, the right to assess is ten (10) years from the discovery of the falsity of said returns pursuant to Section 222 of the Tax Code, as amended. The falsity of the returns was discovered when the BIR examiners submitted their report of investigation on July 16, 2001. Hence, the right to assess has not prescribed.

Section 222 of the NIRC of 1997, as amended, provides:

> "**Section 222.** *Exceptions as to Period of Limitation of Assessment and Collection of Taxes.*
>
> (a) In the case of a **false or fraudulent return with intent to evade tax or of failure to file a return, the tax may be assessed, or a proceeding in court for the collection of such tax may be filed without assessment, at any time within ten (10) years after the discovery of the falsity, fraud or omission**: Provided, That in a fraud assessment which has become final and executory, the fact of fraud shall be judicially taken cognizance of in the civil or criminal action for the collection thereof." *(Emphasis supplied)*

To quote from the *Judicial Affidavit*[44] of respondent's witness, Ruby Ann B. Oradia:

> "MC – Manila, on its construction income, adopted the 'Completed Contract Method' of recognizing income. It is a method where income and expenses for a certain project is recognized only upon the time that the project is completed. In the case of MC-Manila, the project started in 1994 and was completed in February 4, 1998, thus, it was only in 1998 that the complete financial report was presented.

[44] Exhibit "1"

> Financial report for the fiscal year 1998, showed that the gross income upon completion of the project subjected to income tax was P1,416,829,241.00 while gross receipts per VAT from the start of operations in 1994 up to the end of the project was P640,907,792.39. The difference was established to be pertaining to the OECF funded project."

In the case of *Aznar vs. Court of Tax Appeals*,[45] a false return is that which contains wrong information due to mistake, carelessness or ignorance. The word "false" is defined as an adjective which means not true or not correct.[46]

From the foregoing, the discrepancy, a deviation from the truth or facts, whether intentional or not, resulted to the false return; as it did not reflect the true or actual amount.

Perusal of the records, however, belied the findings of falsity. Thus, the ten (10) year period to assess does not apply.

Going now to the second issue, respondent disputed that the OECF-funded portion of the Calaca II Project is not subject to value-added tax by virtue of the Exchange of Notes between the Government of the Philippines and the Government of Japan dated June 11, 1987, hence, by nature a transaction exempt from VAT under Section 109 (q) of the 1997 NIRC, as amended. However, under Section 110 (A)(3)(b) specifically provides to wit:

> "(3) A VAT-registered person who is also engaged in transaction not subject to the value-added tax shall be allowed tax credit as follows:
>
> xxx
>
> (b) A ratable portion of any input tax which cannot be directly attributed to either activity."

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[45] 58 SCRA 519, August 23, 1974
[46] Dictionary of Law, 2nd ed., Peter Collin Publishing (1997)

Therefore, the input taxes amounting to P81,523,463.43 should be apportioned and only that ratable portion for the taxable activity should be deducted as tax credit. To compute:

Carried Forward for Jan 1997		30,389,953.15
Less: Total Carried forward for Mar 1996		7,780,921.91
		22,609,031.24
		58,914,432.17
		P 81,523,463.41
Disallowed Input VAT	**54.76%**	**44,642,248.56**

As the input taxes derived from project cost per financial report could not be directly attributed to the exempt or vatable portion, only the ratable portion of exempt activity amounting to P44,642,248.56 was properly disallowed resulting to a deficiency assessment thereto.

Respondent further argued, however, that the Exchange of Notes cannot validly grant tax exemption as it is merely an agreement between the governments involved.

Petitioner, on the other hand, asserted that there is nothing in the Exchange of Notes which exempted the Calaca II Project from the coverage of the VAT. Petitioner contended all the taxes imposed on the OECF-funded portion of the Calaca II Project would be shouldered by the NPC. To further quote from petitioner's witness, Mr. Dennis M. Villasper in its *Sworn Statement*[47]:

> "Q: Based on your familiarity with the contract, what portion of the contract, if any, governs the payment of taxes in connection with the project?
>
> A: That is Article VIII of the contract, which is divided into the offshore portion and the onshore portion. The offshore portion generally involves taxes imposed by foreign countries and taxes on the importation of materials and equipment used in the project. All other taxes imposed by the Philippine Government fall under the onshore portion.

[47] Exhibit "AA"

Q: What does the contract state regarding the onshore portion?

A: As stated in Article VIII (B) of the contract –

'(1) CORPORATION shall, subject to the provisions under the Contract Documents on Taxes, pay any and all forms of taxes, which are directly imposable under the Contract including VAT, that may be imposed by the Philippine Government, or any of its agencies and political subdivisions.

(2) CORPORATION shall also assume payment for the VAT of the CONTRACTOR'S Local subcontractors."

To elucidate the issue, the case of *Commissioner of Internal Revenue vs. Mitsubishi Corporation – Manila Branch*[48], enunciated as follows:

"It is undisputed that the Exchange of Notes did not grant any tax exemption in favor of the Japanese firms or nationals. No less than the respondent itself has admitted that the Exchange of Notes is not a grant of tax exemption.

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The aforequoted ruling coached in clear and unequivocal terms states that the Exchange of Notes grants no tax exemption. It merely provides for the assumption of tax liabilities by the Philippine Government through its government executing agency.

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Before delving with the constitutional proscriptions against the grant of tax exemption, We look into the nature of 'Exchange of Notes', the relationship it creates between or among the parties thereto, as compared to a treaty.

'Exchange of Notes', is defined as 'an informal method whereby States subscribe to certain understandings or recognize certain obligations as binding upon them. Agreements on matters of minor importance are frequently made by means of formal notes exchanged between the Minister for Foreign Affairs, acting for his government, and the resident diplomatic representative of the other country, similarly authorized'.

'A treaty, as defined by the Vienna Convention on the Law of Treaties, is 'an international instrument concluded between States in

[48] CTA E.B. No. 5, May 24, 2006

written form and governed by international law, whether embodied in a single instrument or in two or more related instruments, and whatever its particular designation'. There are many other terms used for a treaty or international agreement, some of which are: act, protocol, agreement, compromis d' arbitrage, concordat, convention, declaration, exchange of notes, pact, statute, charter and modus vivendi. . . .'

Thus, it could readily be observed that a treaty could take the form of a mere agreement or even an 'Exchange of Notes'.

Moreover, the Supreme Court had the occasion to express:

> 'Thus, in international law, there is no difference between treaties and executive agreements in their binding effect upon states concerned, as long as the negotiating functionaries have remained within their powers. . . .'

This therefore leads Us to the question of whether the subject Exchange of Notes under the facts obtaining could validly grant a tax exemption to respondent.

Again, We rule in the negative.

The power of taxation is inherently a legislative power and a legislative prerogative. This is based upon the principle that 'taxes are a grant of the people who are taxed, and the grant must be made by the immediate representatives of the people. And where the people have laid the power, there it must remain and be exercised.'

This principle finds a stronghold in no less than our fundamental law. The constitutional provisions relevant to the case before Us are Section 21 of Article VII (Executive Department) and Section 28 (4) of Art. VI (Legislative Department) of the 1987 Constitution of the Philippines, quoted hereunder to wit:

Section 21 of Article VII:

> 'No treaty or international agreement shall be valid and effective unless concurred in by at least two-thirds of all the Members of the Senate.'

Section 28 (4) of Article VI:

'No law granting any tax exemption shall be passed without the concurrence of a majority of all the Members of the Congress.'

Pursuant thereto Revenue Memorandum Circular No. 42-99 is hereby quoted:

"Under the Exchange of Notes between the Japanese Government and the Republic of the Philippines for OECF Funded Projects undertaken in the Philippines, the following are the standard clauses pertaining to the tax treatment of participating Japanese contractors and nationals:

'The government of the Republic of the Philippines will exempt the Fund from all fiscal levies or taxes imposed in the Republic of the Philippines on and/or in connection with the Project Loan, the Engineering Service Package Loan and the Commodity Loan as well as interest accruing therefrom.'

'The Government of the Republic of the Philippines will, itself or through its executing agencies or instrumentalities, assume all fiscal levies or taxes imposed in the Republic of the Philippines on Japanese firms and: nationals operating as suppliers, contractors or consultants on and/or in connection with any income that may accrue from the supply of products and/or services to be provided under the Project Loan.'

The foregoing provisions of the Exchange of Notes mean that the Japanese contractors or nationals engaged in OECF-funded projects in the Philippines shall not be required to shoulder all fiscal levies or taxes associated with the project. Instead, **the taxes shall be shouldered and borne by the executing government agencies**. Hence, for the comprehensive treatment of the tax implications arising therefrom, the following rulings are hereby promulgated:

A) VALUE-ADDED TAX:

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2. **The suppliers and sub-contractors of the Japanese contractors shall bill and pass on the 10% VAT to the said Japanese contractors. The Japanese contractors, in turn, shall bill and pass on the 10% VAT to the concerned executing agencies of the Philippine government. Thus, billings to the executing government agencies shall be deemed**

> **inclusive of VAT**. Since, under the Exchange of Notes, the OECF Fund shall not be used to pay for the tax, then the VAT is to be paid out of the Philippine counterpart fund.
>
> 3. **The Japanese contractors shall file the prescribed VAT returns on gross receipts derived from OECF-funded projects, claim their input taxes from their purchases of goods, properties and services from their suppliers or sub-contractors, and shall pay the VAT thereon, after offsetting the allowable input taxes, considering that the amount intended for payment of the VAT has already been collected and received by the Japanese contractors or nationals from the executing government agencies as part of the total invoice price**." *(Emphasis supplied)*

Clearly, the taxes shall be shouldered and borne by the executing government agencies, the NPC in this case. Hence, billings to the NPC shall be deemed inclusive of VAT.

Considering that the amount intended for payment of the VAT has already been collected and received by the Japanese contractors or nationals, from the NPC as part of the total invoice price, the Japanese contractors, like herein petitioner, shall hence file the prescribed VAT returns on gross receipts derived from OECF-funded projects, claim their input taxes from their purchases of goods, properties and services from their suppliers or sub-contractors, and shall pay the VAT thereon, after offsetting the allowable input taxes.

The consequent payment of petitioner does not violate any provision from the Exchange of Notes for it is only the Government of the Philippines who assumed the burden of the tax. Petitioner remains the person primarily and legally liable for the payment of the tax. Nowhere in the foregoing did a tax exemption have been considered.

On the other hand, petitioner's Quarterly VAT duly supported the amount of P65,820,970.59 input VAT:

Period covered	Input VAT	Exhibit
3rd Quarter 1994	16,125,988.72	"A"
4th Quarter 1994	4,700,066.09	"B"
1st Quarter 1995	5,484,575.48	"C"
2nd Quarter 1995	5,258,586.12	"D"
3rd Quarter 1995	21,153,591.19	"E"
4th Quarter 1995	2,613,254.06	"F"
1st Quarter 1996	2,169,440.79	"G"
2nd Quarter 1996	2,535,189.22	"H"
3rd Quarter 1996	3,736957.67	"I"
4th Quarter 1996	634,391.53	"J"
1st Quarter 1997	373,171.10	"K"
2nd Quarter 1997	392,924.81	"L"
3rd Quarter 1997	287,703.51	"M"
4th Quarter 1997	282,275.47	"N"
1st Quarter 1998	72,854.83	"O"
TOTAL	**65,820,970.59**	

As earlier stated, the records are bereft of evidence as to the falsity alleged by respondent. Clearly, the issuance of the assessment for deficiency VAT falls outside of the prescriptive period.

Considering that petitioner's liability for VAT had been determined and the assessment for expanded withholding tax and income tax remained undisputed, the consequent issue is whether petitioner has fully paid the deficiency assessments on expanded withholding tax and income tax, as well as, the penalty for the late remittance of VAT and tax due on receipts not subjected to VAT.

To quote from the *Affidavit*[49] of Ms. Ruby Ann B. Oradia:

> "9. MC-Manila paid the deficiency expanded withholding tax and income tax assessment on December 23, 2003.
>
> 10. MC-Manila also paid the undisputed portion of the Deficiency VAT assessment on December 23, 2003 and January 16, 2004, broken down as follows:

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[49] Exhibit "1"

PARTICULARS	Deficiency VAT (Basic)	Date Paid
1) Receipts Philippine Automotive Chemical not subjected to VAT	P 40,000.00	January 16, 2004
2) Disallowed Input on Exempt Activity of Calaca/Batangas Project	44,642,248.57	
3) Penalty for late remittance of VAT on Batangas Project	561,566.88	Dec. 23, 2004
Agreed and paid deficiency VAT portion	601,566.88	

11. The remaining deficiency VAT unpaid and disputed amounted to P95,549,521.00 shown hereunder:"

PARTICULARS	Deficiency VAT
Deficiency VAT per Final Assessment/Letter of Demand	P96,151,087.88
Deficiency VAT agreed and paid	601,566.88
Unpaid and disputed deficiency VAT	P95,549,521.00

While petitioner proffered the following:

Exhibits	
BIR Payment Form in the amount of P1,527,938.31	"P"
DBP BIR Tax Payment Deposit Slip in the amount of P1,527,938.31	"P-1"
BIR Payment Form in the amount of P216,027.31	"Q"
DBP BIR Tax Payment Deposit Slip in the amount of P216,027.31	"Q-1"
BIR Payment Form in the amount of P561,566.68	"R"
DBP BIR Tax Payment Deposit Slip in the amount of P561,566.68	"R-1"
BIR Payment Form in the amount of P306,788.00	"S"
DBP BIR Tax Payment Deposit Slip in the amount of P306,788.00	"S-1"
BIR Payment Form in the amount of P97,933.33	"T"
DBP BIR Tax Payment Deposit Slip in the amount of P97,933.33	"T-1"

Apparently from the foregoing, petitioner had paid its deficiency expanded withholding tax in the amount of P1,743,965.62[50]; deficiency income tax in the amount of P306,788.00[51]; the amount of P40,000.00 pertaining to receipts not subjected to VAT; and the interest in the amount of P45,933.33 and compromise penalty of P12,000.00.[52]

In summary, the assessment for petitioner's deficiency VAT in the amount of P96,151,087.88, having been issued beyond the prescriptive period, is already barred. As for petitioner's deficiency income tax assessment in the amount of

[50] Exhibits "P" and "P-1"
[51] Exhibits "S" and "S-1"
[52] Exhibits "T" and "T-1"

P307,788.00 and deficiency expanded withholding tax assessment in the amount of P1,743,965.62, the same having been fully paid are already cancelable.

WHEREFORE, in view of the foregoing, the *Petition for Review* is hereby **GRANTED**. The following assessments are deemed **CANCELLED**:

Tax Type	Assessment Number	Amount (including increments)
Expanded Withholding Tax	TFD-98-WT-176-03	P1,743,965.62
	TFD-98-WT-177-03	
Value-Added Tax	TFD-98-VT-173-03	96,151,087.88
	TFD-98-VT-174-03	
Income Tax	TFD-98-IT-175-03	306,788.00
Grand Total		**P98,201,841.50**

SO ORDERED.

CAESAR A. CASANOVA
Associate Justice

WE CONCUR:

ERNESTO D. ACOSTA
Presiding Justice

LOVELL R. BAUTISTA
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's Division.

ERNESTO D. ACOSTA
Presiding Justice
Chairman, First Division