REPUBLIC OF THE PHILIPPINES
DEPARTMENT OF FINANCE
BUREAU OF INTERNAL REVENUE

Section 32 (B)(6) of the Tax Code of 1997, as amended; RMC No. 39-2012; RR No. 2-98, as amended
BIR Ruling No. OT-005-21
OT-411-2022
OCT 07 2022

PONCIANO R. AGUIRRE

Sir:

This refers to your request for clarification on the tax rate applicable to the backwages and the amount representing unpaid salaries, and interest income accumulated in relation thereto which were granted by the Supreme Court to you in the case entitled "*NPC Drivers and Mechanics Association (NPC DAMA) vs. National Power Corporation (NPC)*"[1].

It is represented that you are a retired employee of the NPC and was illegally terminated along with some two thousand (2,000) co-employees in 2003 due to the enactment of the EPIRA Law[2]. However, the Supreme Court in the above-mentioned case, ordered that the terminated employees be reinstated from work commencing March 1, 2003 to February 2007. Consequently, your length of service was extended by about fifty-four (54) months which have entitled you to receive salary differentials plus interests for the period covered from 2003 to 2007. Hence, this request.

On the outset, the Bureau reckons this opinion on the Resolution of the Supreme Court dated November 21, 2017 relative to the above-cited case for consistency of the terms, *viz*:

> *"Clarifiying the Main Decision*
>
> *Subsequently, We clarified the effect of Our Decision in our Resolution dated September 17, 2008 to wit:*
>
> *1. The Court's Decision does not preclude the NPB from passing another resolution, in accord with law and jurisprudence, approving a new separation program from its employees.*
>
> ***2. The termination of the petitioners' employment on January 31, 2003 was illegal.***
>
> ***3. Due to the illegal dismissal, as a general rule, the petitioners are entitled to reinstatement. However, reinstatement has become impossible because NPC was still able to proceed with its reorganization prior to the promulgation of the Decision dated September 26, 2006.***

[1] G.R. No. 156208 dated September 26, 2006
[2] Republic Act (RA) No. 9136 otherwise known as the "Electric Power Industry Reform Act of 2001"

4. Thus, the petitioners are entitled to the following:

a. Separation pay in lieu of reinstatement, based on a validly approved separation program of the NPC; and

b. Back wages together with wage adjustments and all other benefits which they would have received had it not been for the illegal dismissal, computed from January 31, 2003 until actual reinstatement or payment of separation pay.

5. However, any amount of separation benefits already received by the petitioners under NPB Resolution Nos. 2002-124 and 2002-125 shall be deducted from their total entitlement.

xxx xxx xxx"
(Emphasis supplied)

Award of Backwages and Unpaid Salaries

Backwages and the amount representing unpaid salaries are remuneration for services which are subject to income tax, and, consequently, to the withholding tax on wages. The employer is required to withhold the income tax corresponding to the income to be received as backwages by an employee found to be illegally dismissed. However, the illegally dismissed employee is accorded special treatment i.e., he is allowed to allocate or spread his backwages, allowances and benefits through the years he was dismissed from service, having been denied payment of his wages when they were due because of circumstances not of his own making and, therefore, beyond his control.

Section 2.57 (B) of Revenue Regulations (RR) No. 2-98, as amended, provides:

"Section 2.57. Withholding of Tax at Source. –

xxx xxx xxx

(B) Creditable Withholding Tax. — Under the creditable withholding tax system, taxes withheld on certain income payments are intended to equal or at least approximate the tax due of the payee on said income. The income recipient is still required to file an income tax return, as prescribed in Sections 51 and 52 of the NIRC, as amended, to report the income and/or pay the difference between the tax withheld and the tax due on the income. ***Taxes withheld on income payments covered by the expanded withholding tax (referred to in Sec. 2.57.2 of these regulations) and compensation income (referred to in Sec. 2.78 also of these regulations) are creditable in nature.*** " (Emphasis supplied)

Whether an employee found to be illegally dismissed is reinstated or opts for separation, he is required to report such income (backwages) for the years he was dismissed from service, as he files and pays his corresponding income tax thereon by allocating or spreading his backwages, allowances and benefits through the years from the time of his dismissal to actual reinstatement or actual separation (if he opts for separation instead of reinstatement), as the case may be, crediting in the process the corresponding income tax withheld from said wage payments.

Thus, in computing your net income tax, the amount deducted and withheld for the taxable years you were illegally dismissed from service by NPC shall be allowed as a credit against the tax imposed under Section 24 (A) of the National Internal Revenue Code (Tax Code) of 1997, as amended, in relation to Section 79 (C) (2) of the same Code. Moreover, you are likewise allowed to deduct personal and additional exemptions during the years you were illegally dismissed in accordance with Section 35 (A) and (B) also of the aforesaid Code.

Such being the case, said backwages and amount representing your unpaid salaries are subject to income tax and consequently, to withholding tax on wages pursuant to Section 79, Chapter XIII, Title II of the Tax Code of 1997, as amended, as implemented by RR No. 2-98, as amended. NPC shall apply the withholding tax rate as provided thereunder for the years 2003-2007.

On the other hand, the amount representing the 13th month pay of the employees received from the years 2003-2007 is exempt from income tax, the same being treated as an exclusion from the gross income under Section 32 (B) (7) (e) of the Tax Code of 1997, as amended.

Interest accumulated in relation to the Judgment Award

Interest income, while accumulated in relation to the award of backwages, cannot be considered as compensation because the remuneration is not for services rendered. The imposition thereof is to ensure prompt payment by the judgment debtor and is justified only when the delay in payment has been sufficiently established. The Civil Code provisions governing these concepts read as follows:

> *"ART. 2209. If the obligation consists in the payment of a sum of money, and the debtor incurs in delay, the indemnity for damages, there being no stipulation to the contrary, shall be the payment of the interest agreed upon, and in the absence of stipulation, the legal interest, which is [6%] per annum.*
>
> *ART. 2210. Interest may, in the discretion of the court, be allowed upon damages awarded for breach of contract.*
>
> *ART. 2211. In crimes and quasi-delicts, interest as a part of the damages may, in a proper case, be adjudicated in the discretion of the court.*
>
> *ART. 2212. Interest due shall earn legal interest from the time it is judicially demanded, although the obligation may be silent upon this point.*
>
> *ART. 2213. Interest cannot be recovered upon unliquidated claims or damages, except when the demand can be established with reasonable certainty."*

Compensatory interest (*i.e.*, interest awarded as damages under Articles 2209 to 2213 of the Civil Code) is that which is allowed in actions for breach of contract or tort for the unlawful detention of money already due. As the governing provisions indicate, compensatory interest may be imposed by law or by the courts as penalty or indemnity for damages.[3]

[3] Philippine Commercial and International Bank vs. William Golangco Construction Corporation, G.R. No. 195372 dated April 10, 2019

Since the nature of the interest in question is in the nature of damages, the same, therefore shall not be subject to withholding tax pursuant to Section 2.78.1 (B) (6) of RR No. 02-98, as amended, which provides:

> *"SEC. 2.78 WITHHOLDING TAX ON COMPENSATION INCOME. –*
>
> *xxx xxx xxx*
>
> *(B) Exemptions from withholding tax on compensation. – The following income payments are exempted from the requirement of withholding tax on compensation:*
>
> *xxx xxx xxx*
>
> *(6) Damages. – Actual, moral exemplary and nominal damages received by an employee or his heirs pursuant to a final judgment or compromise agreement arising out of or related to an employer-employee relationship."*

Nevertheless, the interest income in question shall still be subject to income tax. The definition of Gross Income under Section 32 of the Tax Code of 1997, as amended, discloses a legislative policy to include all income not expressly exempted as within the class of taxable income under our laws.[4] The peculiarity surrounding the circumstances is not enough to extricate the interest stemmed from the awarded backwages on the broad definition and scope of compensation income.

Accordingly, you are required to report the interest income as you file and pay your corresponding income tax thereon subject to the graduated rates under the Tax Code of 1997, as amended.

Please be guided accordingly.

Very truly yours,

LILIA CATRIS GUILLERMO
Commissioner of Internal Revenue

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[4] Banco de Oro vs. The Republic of the Philippines, G.R. No. 198756 dated January 13, 2015