REPUBLIC OF THE PHILIPPINES
COURT OF TAX APPEALS
QUEZON CITY

SUBIC POWER CORPORATION,
Petitioner,

- versus -

C.T.A. CASE NO. 6059

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Promulgated:

MAY 08 2003

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D E C I S I O N

This case involves tax deficiency assessments in the aggregate amount of P70,920,718.00, comprising of deficiency 5% income tax in the amount of P3,335,543.00 and deficiency expanded withholding tax in the amount of P67,585,175.00 covering the taxable year 1994.

Petitioner is a domestic corporation duly organized and existing under the laws of the Republic of the Philippines, duly registered with the Securities and Exchange Commission (SEC) and with the Subic Bay Metropolitan Authority (SMBA) as an SBF Enterprise *(Joint Stipulation of Facts, par. 1)*.

Petitioner was formed for the purpose of engaging in the business of generation and sale of electric power in Subic, Zambales, by converting the diesel bunker fuel supplied

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by the National Power Corporation (NAPOCOR) into energy or electric power *(TSN, August 14, 2000, page 9)*.

To enable petitioner to construct its power plant and other related facilities and to operate and maintain the said power plants and facilities, petitioner allegedly entered into several agreements with different entities *(Exhibits E, H, I, J and K)*.

On April 17, 1995, petitioner filed its Annual Income Tax Return (ITR) for the taxable year 1994. Petitioner's ITR showed a gross income of P813,901,719.00 and deductions amounting to P577,568,309.00, resulting in a taxable income of P236,333,410.00. Petitioner applied the preferential tax rate of 5% and the tax due was computed at P11,816,671.00 before tax credits. After deducting petitioner's declared tax credits of P6,600,830.00, the net tax payable was P5,215,841.00 which was paid by petitioner *(Exhibit M; TSN, August 14, 2000, page 20; TSN, November 11, 2000, pages 15-16)*.

On August 17, 1999, petitioner received from respondent, two (2) Final Assessment Notices (both numbered 019-1B4-94-000135), dated July 26, 1999 and covering the taxable year 1994, which alleged that petitioner had deficiency taxes due to the Government in the total amount of P70,920,718.00, broken down as follows:

Deficiency 5% Tax Assessment

1. Tax Due			P	1,655,271.00
2. Add: Surcharge	P	413,818.00		
Interest		1,241,454.00		
Compromise Penalty		25,000.00		1,680,272.00
3. Total Amount Payable			P	3,335,543.00

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Deficiency EWT Assessment

1. Tax Due			P 33,767,587.00
2. Add: Surcharge	P	8,441,897.00	
Interest		25,325,691.00	
Compromise Penalty		50,000.00	33,817,588.00
3. Total Amount Payable			P 67,585,175.00
TOTAL			P 70,920,718.00

(Exhibits A to A-2, B to B-2, Joint Stipulation of Facts, par. 3).

Pursuant to the Audit Report sent to the petitioner by respondent through the Revenue Officer who conducted the examination on the petitioner's books, the respondent disallowed as deduction from gross income the total amount of P33,105,453.00, which is composed of the following:

		Per ITR		Per BIR		Disallowed
O & M Expenses	P	64,767,115.00	P	64,628,988.00	P	138,127.00
O & M Supervisory Reimbursement		16,288,255.00		14,624,215.00		1,664,040.00
Depreciation Expense		195,573,841.00		189,672,576.00		5,901,265.00
Interest on Long-Term Debt		252,769,966.00		233,264,236.00		19,505,750.00
Plant Insurance Expense		5,899,251.00		-		5,899,251.00
Total	P	535,298,428.00	P	502,190,015.00	P	33,105,453.00

(Ibid., par. 9)

The computation of the total deficiency 5% tax assessment in the total amount of P3,335,543.00 per the findings of the revenue examiner in the Audit Report consisted of the disallowance of the following:

(1) O & M Supervisory Reimbursement in the amount of P1,662,040.00
(2) Depreciation expense in the amount of P5,901,285.00
(3) Interest on long-term debt in the amount of P19,504,750.00
(4) Insurance expense in the amount of P5,899,251.00
(Id., par. 10).

Likewise, pursuant to the Audit Report sent to the petitioner by the respondent through the Revenue Officer who conducted the examination on the petitioner's books, the respondent computed the proposed deficiency EWT assessment as follows:

		1% W/T on Contractors		5% W/T on Professional Fee
Billings from EPOC - (Foreign Corp.)	P	2,903,215,876.00		
- Heat Rate Bonus		171,892,238.00		
Compensation paid to Enron Corp. (Foreign)		130,062,717.00		
Development Service Fees - RCBC		31,136,000.00		
- HOI		23,352,000.00		
Administrative and Advisory Services paid to EPPOC (foreign)			P	14,478,550.00
Service Fees paid to ESPC Makati				8,941,439.00
Total Tax Base	P	3,259,658,831.00	P	23,419,989.00
Basic Tax	P	32,596,588.00	P	1,170,999.00
25% Surcharge		8,149,147.00		292,750.00
20% Interest per annum (60%)		24,447,441.00		878,250.00
Compromise		25,000.00		25,000.00
Total	P	65,218,176.00	P	2,366,999.00

(Id., par. 11).

On September 14, 1999, petitioner, through its external auditors, filed with respondent, through the Regional Director of Revenue Region No. 4 in San Fernando, Pampanga, its protest letter dated September 10, 1999 *(Exhibits C to C-1; Joint Stipulation of Facts, par. 4).*

As of March 12, 2000, which is the one hundred eightieth (180^{th}) day from the date petitioner filed its protest letter, respondent had not yet acted on the protest *(Joint Stipulation of Facts, par. 5).*

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Section 228 of the Tax Code, as amended, provides that:

> "If the protest is denied in whole or in part or is not acted upon within one hundred eighty (180) days from submission of documents, the taxpayer adversely affected by the decision or inaction may appeal to the Court of Tax Appeals within thirty (30) days from receipt of the said decision, or from the lapse of the one hundred eighty (180)-day period; otherwise, the decision shall become final, executory and demandable." *(Joint Stipulation of Facts, par. 6)*.

In the case of ***Lascona Land, Inc. vs. Commissioner of Internal Revenue***, CTA Case No. 5777, January 4, 2000, this court had the occasion to explain the options available to the taxpayer, in cases of BIR inaction on protested assessments, thus:

> "Verily, in cases of inaction, Section 228 of the Tax Code merely gave the taxpayer an option: first, he may appeal to the Court of Tax Appeals within thirty (30) days from the lapse of the one hundred eighty (180) day period provided under the said section, or second, he may wait until the Commissioner decides on his protest before he elevates the case." *(Ibid., par. 7)*.

Consequently, petitioner filed the instant petition on April 11, 2000.

The parties agreed that the issues to be resolved by this court are:

(1) Whether or not the requirement under Section 228 of the Tax Code, that the taxpayer shall be informed of the law and the facts on which the assessment is made, has been complied with;

(2) Whether or not the O & M Supervisory Reimbursement in the amount of P1,662,040.00 is substantiated by documentary evidence;

(3) Whether or not the depreciation expenses in the amount of P5,901,285.00 is deductible;

(4) Whether or not the interest on long-term debt in the amount of P19,504,750.00 is deductible;

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(5) Whether or not the insurance expense on the petitioner's plant in the amount of P5,899,257.00 is deductible;

(6) Whether or not the Billings from Enron Power Operating Company (EPOC) for 1994 in the total amount of P3,075,108,114.00 are subject to creditable 1% EWT;

(7) Whether or not the amount of P130,062,717.00 which petitioner paid to Enron Corporation (EC) as compensation for the latter's assistance in coordinating and directing the development construction and pre-operation activities of the facility of petitioner in Subic, Zambales is subject to 1% creditable EWT;

(8) Whether or not the amounts of P31,136,000.00 and P23,362,000.00 representing the Development Service Fees paid by petitioner to Rizal Banking Corporation (RCBC) and House of Investments (HOI), respectively, are subject to 1% creditable EWT;

(9) Whether or not the Administrative and Advisory Service Fees paid by petitioner to Enron Power Philippines Operating Corporation (EPPOC) in the amount of P14,478,550.00 are subject to 5%EWT; and

(10) Whether or not the Service Fees paid by petitioner to Enron Subic Power Corporation (ESPC) in the amount of P8,941,439.00 are subject to 5% EWT.

Petitioner based its judicial appeal on the provisions of Section 228 of the 1997 Tax Code, among others, partly quoted hereunder:

SEC. 228. ***Protesting an 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 pre-assessment notice shall not be required in the following cases:

xxx xxx xxx

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.

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xxx xxx xxx

> If the protest is denied in whole or in part, or is not acted upon within one hundred eighty (180) days from submission of documents, the taxpayer adversely affected by the decision or inaction may appeal to the Court of Tax Appeals within thirty (30) days from receipt of the said decision, or from the lapse of the one hundred eighty (180)-day period; otherwise, the decision shall become final, executory and demandable."

To further bolster its case, petitioner presented documentary and testimonial evidence.

Respondent likewise presented evidence to support his stand.

(1)

Whether or not the requirement under Section 228 of the Tax Code, that the taxpayer shall be informed of the law and the facts on which the assessment is made has been complied with.

Petitioner alleges that the assessments are void for failure on the part of the respondent to provide the written bases of the law and facts on which they were made. Both the preliminary assessment notice (PAN) and final assessment notices sent to the petitioner merely indicated the alleged basic tax due, surcharge, interest and penalties thereon without any explanation as to how the amounts were arrived at.

Respondent, for his part, counters that prior to the issuance of the assessments, petitioner was notified of the proposed deficiency assessments and the basis thereof which petitioner protested. Hence, the requirement under Section 228 of the Tax Code that the taxpayer shall be informed of the law and the facts on which the assessment is made is deemed to have been complied with.

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After a circumspect evaluation of the records in this case, we agree with the respondent that the requirement under Section 228 of the Tax Code, as amended, has been sufficiently met. Hence, the assessment for 5% deficiency tax is valid.

It must be pointed out that as early as the proposed assessment, petitioner was already informed of the 5% deficiency tax amounting to P3,335,543.00 and that in arriving at the proposed deficiency 5% tax assessment, the examiner proposed to disallow as deductions from petitioner's gross income certain expenses. Besides, it cannot be argued that the very basis for the disallowed expenses were the figures supplied by petitioner to the respondent *(see petitioner's Trial Balance, Balance Sheet, Income Statement, BIR Records, pages 198-219; petitioner's Details of Expenses, BIR Records, pages 187-192)*. That is why in its protest to the proposed assessment filed on December 1, 1998, petitioner was able to comprehensively contest the proposed assessment based on factual and legal grounds *(Exhibit 3)*. This alone belied petitioner's statement that it was not informed on how the 5% deficiency tax assessment was arrived at. If there was no sufficient basis for said disallowed expenses then it could not have counter-argued in detail why said expenses should be allowed.

In its protest against the final assessments made by the respondent, petitioner alleges that by supposition it assumes that the said formal assessment insofar as the 5% tax assessment is concerned, was substantially determined in the same manner as the earlier proposed 5% tax assessment.

We hold that assumption does not come into play as regards the 5% tax assessment contrary to what petitioner would like us to believe. Petitioner never made an

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assumed/speculated computation relative thereto for the simple reason that the subject matter of disallowed deductions and the amount of deductions were the same as those appearing in the proposed deficiency 5% tax assessment. In fact, we note that petitioner merely reiterated its arguments already raised in the protest dated November 27, 1998. Furthermore, petitioner readily stipulated that:

> Pursuant to the Audit Report sent to the petitioner by respondent through the Revenue Officer who conducted the examination on the petitioner's books, the respondent disallowed as deduction from gross income the total amount of P33,105,453.00, which is composed of the following:

	Per ITR	Per BIR	Disallowed
O & M Expenses	P 64,767,115	P 64,628,988	P 138,127
O & M Supervisory Reimbursement	16,288,255	14,624,215	1,664,040
Depreciation Expenses	195,573,841	189,672,576	5,901,265
Interest on Long-Term Debt	252,769,966	233,264,236	19,505,750
Plant Insurance Expense	5,899,251	-	5,899,251
Total	P535,298,428	P502,190,015	P33,105,453

> The computation of the total deficiency 5% tax assessment in the total amount of P3,335,543.00 per the findings of the revenue examiner in the Audit Report consisted of the disallowance of the following:
>
> (1) O & M Supervisory Reimbursement in the amount of P1,662,040.00
> (2) Depreciation expense in the amount of P5,901,285.00
> (3) Interest on long-term debt in the amount of P19,504,750.00
> (4) Insurance expense in the amount of P5,899,251.00
> *(Joint Stipulation of Facts, pars. 9 & 10)*.

Thus, having knowledge of the very nature of the disallowed expenses, we find no merit in petitioner's claim that it was not informed of the law and the facts on which the said assessment was made.

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As regards the deficiency expanded withholding tax assessment, we likewise find that the requirement of Section 228 had been sufficiently met. Therefore, we hold that the assessment notice was validly issued.

The proposed tax assessment, also considered as the pre-assessment notice *(TSN, October 23, 2001, pages 41 & 42)*, was received by the petitioner on October 29, 1998 *(Exhibit 2)*. It was assessed for deficiency expanded withholding tax in the sum of P92,843,191.00. A mere glance on the said notice would enable the petitioner to determine that it was being assessed for failure to withhold 1% tax on its payments to contractors, 5% tax on interest on foreign loans and 5% tax on professional fees paid. The respondent may not have provided the specific provisions of law as bases for the assessment but the law and/or regulation has a specific provision for the withholding of 1% contractor's tax and it also has particular provisions for the withholding of 5% tax on interest on foreign loans and 5% tax on professional fees. By indicating the kind of taxes petitioner should have withheld was enough. After all, petitioner was not left in confusion and grasping in the dark for explanations thereof. This can be gleaned from petitioner's protest letter filed on December 1, 1998 *(Exhibit 3)*. While we concede that the mere filing of a protest letter does not automatically mean that the requirement of Section 228 has not been violated, if the taxpayer is able to intelligently argue its case and elucidate the reasons for the assessment, as in this case, then it cannot contradict itself by asserting that it was not informed of the law and facts on which the assessment was made. Besides, petitioner already stipulated on how the deficiency expanded withholding tax assessment had been arrived at by the Revenue Officer who conducted the examination of its books *(Joint Stipulation of Facts, par. 11)*.

Further, it is our considered opinion that the phrase "in writing" under Section 228 does not exclusively mean written words. "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.[1] Indubitably, figures are also "writings" and if the numerical presentation is understandable enough, then there is no reason why we should automatically reject the same as adequate compliance with the law. It must be stressed that the underlying reason for the law is the basic constitutional requirement that "no person shall be deprived of his property without due process of law". Parenthetically, in whatever form and manner, as long as the taxpayer is informed of how the assessment was arrived at, then Section 228 has not been violated. And if petitioner had already been informed during the preliminary stage of the bases for the assessment, then it could not insist that it was not informed of the law and the facts on which the assessment was based.

In the case at bar, the final assessment notice was not accompanied by any demand letter or other explanatory letter. However, petitioner was able to conclude that the assessment for deficiency 5% withholding tax on interest on foreign loans was cancelled thereby reducing the assessed amount for deficiency withholding tax to P67,585,175.00. In other words, petitioner was aware on how the assessment was computed or arrived at.

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[1] Black's Law Dictionary, Sixth Edition, page 1609.

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It was not left to speculate on how the assessment was computed and why was it made liable for such deficiency. In sum, the due process requirement has been satisfactorily met.

(2)

Whether or not the O & M Supervisory Reimbursement in the amount of P1,662,040.00 is substantiated by documentary evidence.

The schedule of operating expenses for income tax purposes shows the following breakdown of accounts *(page 189, BIR records)*:

1. O & M Expense	P 70,331,588.00
2. O & M Supervisory Reimbursables	10,668,857.00
3. O & M Advisory Reimbursables	5,617,398.00
4. O & M Managers fees	14,478,550.00
5. Plant Insurance Expense	5,899,251.00
Total	P106,995,644.00

The amount of P1,662,040.00 which petitioner believes to be the amount disallowed by respondent represents the difference between the amount of P14,624,215.00 (*allowed by respondent per schedule of breakdown, page 254, BIR records [in black ink mark]*) and the amount of P16,286,255.00 representing the total O & M reimbursables claimed by petitioner as an expense.

It is the proposition of the petitioner that the disallowed amount of P1,662,040.00 falls under the category of "Service Supervision Salaries" which is an allowable deduction pursuant to Section 3(o) of Revenue Regulations No. 1-95. This expense arose from the "Operation and Maintenance Supervision Agreement" with Enron Subic Power

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Corporation wherein petitioner agreed to reimburse the expenses incurred by latter in its supervision and management of day-to-day operation and maintenance of the plant *(Exhibits D, D-2 & D-3)*.

We agree with the petitioner that the salaries paid for supervision are allowable deduction under the implementing rules as service supervision costs. However, records show that petitioner failed to establish that the excess amount indeed represents "Service Supervision Salaries". In its Details of Expenses *(BIR records, page 192)* and Worksheet *(BIR Records, pages 201 to 202)*, the O & M Supervisory Reimbursement account amounts only to P14,624,215.89, to wit:

O & M Advisory Reimbursable-TSG	P 5,617,398.28
O & M Supervisor Reimbursable	9,006,817.61
Total O & M Supervisory Reimbursement	P 14,624,215.89

Clearly, there is a discrepancy of P1,662,040.00 between the amount of O & M reimbursable for income tax purposes of P16,268,255.00 as compared with the itemized reimbursable listed on the details of expenses of P14,624,215.89. Petitioner did not explain why it increased its reimbursable for income tax purposes by P1,662,040.00 without showing any reclassification of accounts from its details of expenses. The said discrepancy could have been allowed had petitioner presented evidence such as vouchers and official receipts establishing the total amount of reimbursable paid. In absence thereof, we believe that respondent is correct in allowing the lesser sum of P14,624,215.89 as petitioner's O & M reimbursable for the year 1994 *(BIR records, page 254 [in black ink mark])*.

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Corollary thereto, we delve on the disallowed O & M Expenses amounting to P138,127.00.

The amount of P138,127.00 is comprised of:

Operating and Maintenance Expense:	
Warehouse Supplies and Expenses	P 133,777.00
Regulatory Commissioner Expense	4,350.00
Total	P 138,127.00

The amount of P133,777.00 was disallowed by the examiner for the reason that it was not used in the production of electricity while the amount of P4,350.00 was disallowed for the reason that it is "not allowable under RR 1-95" *(BIR records, page 254 [in black ink mark])*.

The court noted that petitioner failed to include this item of expense in its administrative protest *(Exhibit 6)*. In the case of ***3M Philippines vs. Commissioner of Internal Revenue***, *C.T.A. Case No. 3856, August 14, 1987*, it was held that:

> "Since petitioner did not protest or dispute administratively the disallowance of this pre-operational expense as capital expenditure, petitioner cannot raise this issue for the first time on appeal in this Court. This cannot be permitted, for the same reason that underlies the requirement of prior exhaustion of administrative remedies to give administrative authorities the prior opportunity to decide controversies within their competence, and in much the same way that, on the judicial level issues not raised in the lower court cannot be raised for the first time on appeal. To sanction such a procedure whereby the court — which is supposed to review administrative determinations — would not review, but determine and decide for the first time, a question not raised at the administrative forum. *(Aguinaldo Industries Corporation vs. Commissioner of Internal Revenue and the Court of Tax Appeals, L-29790, February 25, 1982, 112 SCRA 136.)*

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In the absence of proof of any irregularities in the performance of duties, an assessment duly made by a Bureau of Internal Revenue examiner and approved by his superior officers will not be disturbed. All presumptions are in favor of the correctness of tax assessments (***Bonifacio Sy Po vs. Court of Tax Appeals and Commissioner**, 164 SCRA 524*). Failure to present proof of error in the assessment will justify judicial affirmance of said assessment (***Delta Motors Co. vs. Commissioner**, CTA Case No. 3782, May 21, 1986*).

Therefore, said disallowance is presumed to be proper.

(3)

Whether or not the depreciation expenses in the amount of P5,901,285.00 are deductible.

In the Schedule of Breakdown of Costs/Expenses, the examiner computed the disallowance as follows *(BIR records, page 254, in black ink mark)*:

ACCOUNT/PARTICULARS	TOTAL	ALLOWABLE	UNALLOWABLE	**REASON FOR DISALLOWANCE**
Depreciation and Amortization	P196,037,460.00	P189,672,578.00	P 6,364,882.00	
Dep. Expense –Furn and Fixt			P 81,344.00	Not used in production
- Computer and Hardware			336,267.00	- do -
- Computer Equip. and Acc.			120,294.00	- do -
- Other Office Furn.			33,645.00	- do -
- Household Furn.			42,874.00	- do -
- Clinical Equipments			2,150.00	- do -
Amortization – Pre-operating Exp.			5,748,308.00	Not a direct cost - incurred prior to operations.

It is to be observed from the above table that there is another discrepancy in the sum of P463,619.38 between the disallowed depreciation and amortization expense of

P6,364,882.00 as compared to the amount of P5,901,263.44 being accounted for by petitioner as its net disallowed depreciation and amortization expense. The discrepancy is reconciled below:

	Balances per Income Statement	Claimed by Petitioner in ITR	Allowed by the Examiner	Disallowed/ (Allowed) Exp.
Dep. Expense				
-Building & Const'n	P188,642,042.98	P188,642,042.98	P188,642,042.98	-
-Furn and Fixture	81,343.98	81,343.98		P 81,343.98
-Machine & Transp Eq	56,829.37	56,829.37	56,829.37	-
-Computer and Hardware	336,267.43	336,267.43		336,267.43
-Comm Equip. and Acess	120,293.95	120,293.95		120,293.95
-Other Tools & Equipt	245,611.52	245,611.52	245,611.52	-
-Other Office Furnishg	33,645.38	33,645.38		33,645.38
-Household Furnishings	42,874.10	42,874.10		42,874.10
-Clinical Equipments	2,149.50	2,149.50		2,149.50
-Development	*463,619.38*		*463,619.38*	*(463,619.38)*
-Office Impr/Renvtn	81,996.46	81,996.46	81,996.46	-
-Warehouse & Imp	121,810.36	121,810.36	121,810.36	-
-Plant Improvement	60,667.41	60,667.41	60,667.41	-
-Pre-Operatg Exp	5,748,308.48	5,748,308.48		5,748,308.48
T o t a l s	P196,037,460.30(	P195,573,840.92	P 189,672,577.48	P 5,901,263.44

The difference of P463,619.38 (*P6,364,882.00 less P5,901,263.44*) obviously came from the allowed 'Depreciation Expense on Development' which is more or less of the same amount. This amount was not claimed by petitioner as a deduction from its gross income for the year 1994 but was allowed by the respondent's examiner.

Respondent, on the other hand, disallowed the depreciation expenses for two reasons: (1) for "not used in production" in the total amount of P616,574.00; and (2) for "not a direct cost - incurred prior to its operation" in the amount of P5,748,308.00.

Petitioner maintains that the sum of P616,574.00 is a depreciation expense related to machinery and equipment, hence, should be allowed as a deduction from its gross income. Petitioner cited the Section 2(o) of Revenue Regulations No. 1-95 and Section 57(b) IRR of the SMBA as its legal bases, to wit:

Section 2(o) of Revenue Regulations No. 1-95 states:

o. *Gross income earned* — refers to gross sales or gross revenues derived from the business activity within the zone, net of sales discounts and sales returns and allowances and minus costs of sales or direct costs <u>but before any deduction for administrative expenses</u> or incidental losses during a given taxable period. For financial enterprises, gross income shall include interest income, gains from sales, and other income, net of allowable deductions. The following deductions shall be allowable for the calculation of gross income earned for specific types of enterprises:

1) x x x
2) Service enterprises

Direct salaries, wages or labor expense
Service supervision salaries
Direct Materials, supplies used or resold to another SBMA registered enterprise
Depreciation of machineries, equipment and buildings owned and/or constructed
Financing Charges associated with fixed assets
Rent and utility charges for buildings and capital equipment
(Underlining supplied)

SECTION 57. ***Obligations and Liabilities.***

a. x x x
b. "Gross Income Earned" for purposes of these Rules refers to gross sales or gross revenues derived from any business activity, net of returns, discounts and allowances, less costs of sales, cost of production or direct costs of services (depending on the nature of business) <u>but before any deduction for administrative expenses</u> and incidental losses during a given taxable period.

In arriving at the base for which the five (5%) percent final tax stated in the proceeding section shall be applied, the following deductions shall be allowable/unallowable:

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1. x x x
2. For Services Enterprises

Allowable Deductions
- Direct salaries, wages or labor expense
- Services supervision salaries
- Raw materials, goods in process or finished goods used or re-sold
- Supplies and fuels used in rendering services
- **Depreciation, lease payments or other expenditures on buildings and equipment**
- **Financing charges associated with fixed assets**
- Rent and utility charges associated with buildings and equipment

Unallowable Deductions
- Administrative salaries
- Corporate management salaries
- Marketing and sales salaries
- **Interest & financial charges on working capital**
- Loss on foreign exchange translation
- Loss on disposal of assets
- **Insurance**
- Advertising
- **Miscellaneous supplies and expenses**
- Entertainment expense

(Emphasis supplied.)

As regards the amortization of pre-operating expense of P5,748,308.00, petitioner insists that the same is related to the construction of its power plant facilities and therefore should likewise be allowed as an expense. To prove that the aforesaid sum were expended for the power plant construction and formed part of its pre-operating expenses, petitioner presented its general ledger detailing its pre-operating expenses *(Exhibits L-1 to L-3)*.

After an examination of the documents submitted and taking into consideration the arguments of both parties, we agree with the findings of the respondent.

Petitioner failed to show that the depreciation expense in the total amount of P616,574.00 was actually used in the operation of its power plant facilities. A careful scrutiny of the specific account titles (i.e., Depreciation Expense – Furniture & Fixtures, Computer and Hardware, Computer Equipment and Accessory, Other Office Furniture, Household Furniture and Clinical Equipment) suggests that the sources of the depreciation expenses are more related to the office administration rather than in the actual operation of the power plant. It can be argued though that computers and equipment are also used in the operation of the power plant. However, nowhere in the records did petitioner segregate the items for proper allocation – which is for the plant and which is for the administration. Hence, we are inclined to favor the correctness of the disallowance made.

Likewise, the items listed in the schedule of pre-operating expenses show expenditures for helicopter rentals, withholding taxes, accumulated Batangas Bills, interest income, electric bill, gasoline charges, salaries and the like. These expenses cannot be capitalized as part of the construction of the power plant. There is nothing to indicate that these are capital expenditures. Pre-operating expenses are subject to amortization and not to depreciation. If petitioner wanted to capitalize the above expenses related to plant construction, it should have reclassified the "pre-operating expense" account to "power plant complex" account. Thus, the expenses claimed should be disallowed.

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(4)

Whether or not the interest on long-term debt in the amount of P19,504,750.00 is deductible.

On page 253 of the BIR records (*in black ink mark*), the BIR examiner computed the disallowance of interest and bank charges as follows:

ACCOUNT/PARTICULARS	TOTAL	ALLOWABLE	UNALLOWABLE	REASON FOR DISALLOWANCE
Interest and Bank Charges	P249,323,619.00	P233,264,236.00	P 16,059,383.00	
Final Taxes on Bank Charges			P 29,598.00	Not allowable under RR 1-95
Interest on Working Capital Advance			2,974,446.00	- do -
Interest on Performance/HRB			13,055,339.00	- do -

However, the total interest and bank charges claimed by petitioner in its income tax return amounted to P252,769,986.00 *(BIR records, page 15)*. Inasmuch as the respondent concentrated only on the above three specific disallowances, we will also limit our verification on such items.

Petitioner's interest and bank charges account shows the following details (*BIR Records, page 190*):

	Per Income Statement	Per ITR
Interest Revenue	P (6,449,410.75)	
Final Taxes on Bank Interest	P 29,598.15	
Interest on:		
Long-term Debt	239,713,647.29	P239,713,647.29
Working capital advance	2,974,445.79	
Performance/heat rate bonus	13,055,338.97	13,055,338.97
subtotal	P255,773,030.20	
Total Interest & Bank Charges	P249,323,619.45	P252,768,986.26

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From the above listed interest and bank charges, petitioner only claimed as its 'Financing Charges' for the year 1994 the amounts of P239,713,647.00 and P13,055,338.97 *(or a total of P252,768,986.00)* representing interest on long-term debt and interest on performance/heat rate bonus *(BIR records, page 15)* while the rest were not taken up by petitioner, to wit *(BIR records, page 190)*:

	Per Income Statement	Per ITR
Interest Revenue	P 6,449,410.75	
Final Taxes on Bank Interest	P 29,598.15	
Interest on Long-term Debt	239,713,647.29	P 239,713,647.29
Interest on Working Capital Advance	2,974,445.79	
Interest on Performance/HRB	13,055,338.97	**13,055,338.97**
Subtotal	P 255,773,030.20	
Total Interest and Bank Charges	P 249,323,619.45	P 252,768,986.26

If we compare the above computation of petitioner with those of the disallowed items by the examiner, we can deduce that only the sum of P13,055,338.97 is under dispute because the other two components of respondent's disallowance (working capital advance and final taxes on bank interest) were not claimed as an expense by petitioner.

Respondent posits that the sum of P13,055,338.97 is being disallowed because "some of these charges are from loans, the proceeds of which were not used in connection with the acquisition of fixed assets. RR 1-95 provides that financing charges, to be deductible, should be associated with fixed assets" *(BIR records, page 257)*.

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Contrariwise, petitioner explained that the interest expenses on performance and heat rate bonus are its obligations arising from its contract with Enron Power Operating Company (EPOC) and should be allowed as an expense.

The contract for the construction of petitioner's power plant *(Exhibit E, inclusive of submarkings)* stipulated, among others, that:

> (a) Net Power Output Bonus – Once the power plant has been completed, a Net Power Output Test will be conducted to determine whether the power plant meets the Net Power Output Guarantee committed by EPOC. If the Net Power Output of the plant exceeds the Net Power Output Guarantee, EPOC shall receive a Net Power Bonus equivalent to a certain amount for each kilowatt of such excess over the Net Power Output Guarantee.
>
> (b) Heat Rate Bonus – As soon as the construction of the power plant shall have been completed, a Heat Rate Test will be conducted to determine whether the plant meets the Heat Rate Guarantee committed by EPOC. If the Heat Rate of the plant is less than the Heat Rate Guarantee, EPOC shall receive a Heat Rate Bonus equivalent to a certain amount for each Btu/Kwh by which the HEAT Rate is less than the Heat Rate Guarantee.

From the above stipulation, the interest paid on performance and heat rate bonus is a necessary expense incurred in relation to the construction of petitioner's power plant. This expenditure may be capitalized to cost of the power plant account pursuant to No. 3(g) of the Statement of Financial Accounting Standards No. 6, which states:

> (g) As to machinery and equipment, cost would include costs of installation, in addition to all costs of purchase and manufacture. Installation costs would include such items as transportation borne by the company as well as labor charges, materials and other ***expenditures incurred in placing the equipment in readiness for operation. Direct costs incurred to test or adjust the equipment or facilities before they are ready for productive use during a reasonable experimental period may be included in the cost of the asset being tested or adjusted*** in which case, any returns received from sale of

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> production during such test period are reductions to costs. (*Emphasis supplied*).

Indubitably, pursuant to Revenue Regulations No. 1-95 and the Implementing Rules and Regulations of RA 7227, "Performance/heat rate bonus" is allowable business expense.

(5)
Whether or not the insurance expense on petitioner's plant in the amount of P5,899,257.00 is deductible.

In his Memorandum to the Regional Director, the examiner, Mr. Noel F. Miranda disallowed this expense on the following reason *(BIR records, page 257)*:

> Consistent with the position taken on ENRON's case, undersigned Revenue Officer is of the opinion that SPC's operations (same as that of ENRON's) is more of a manufacturing concern (with power/electricity as the finished product). As such only those costs and expenses which go directly to the production process as well as those expressly allowable under RR 1-95 (though not direct ones) should form part of the allowable deductions. "Plant Insurance", while it may be necessary in the operations, does not go directly to production neither it is one of those expressly allowable under RR 1-95.

On the contrary, petitioner postulates that the insurance on the plant is a direct cost and should be allowed as a deduction from its gross income for purposes of computing the 5% preferential tax. Petitioner cited as bases the afore-quoted Section 57(b) and BIR Ruling No. 159-94.

We do not agree.

While it is true that insurance was secured by petitioner because of the BOT Project Agreement with NAPOCOR, the same cannot be used as valid ground to make the said expense allowable. Section 57(b) of Implementing Rules and Regulations of RA 7227 is explicit, *i.e.*, insurance is an unallowable deduction for purposes of arriving the base of the 5% final tax. The said regulation does not distinguish or make any qualification with respect to the treatment of the insurance expense. So, whether or not the insurance expense is a direct cost of an SBF enterprise is immaterial. Insurance falls under unallowable deductions, hence, cannot be allowed.

Deductions for income tax purposes partake of the nature of tax exemptions; hence, if tax exemptions are to be strictly construed, then it follows that deductions must also be strictly construed. It must be emphasized that in the present case, petitioner availed of the 5% preferential tax rate on gross instead of the usual 35% tax rate due on corporations. Thus, it is with more reason that petitioner's deductions on gross income be strictly construed. As a matter of fact, we are being liberal in considering the interest paid on performance and heat rate bonus as necessary expense of petitioner which may be capitalized and is therefore an allowable deduction. But we agree with the respondent that the other deductions should be disallowed for reasons above stated.

To recapitulate, petitioner was assessed of deficiency income tax in the amount of P3,335,543.00, arising from the disallowed expenses for the year 1994, computed as follows (*BIR records, page 221*):

Taxable Income per Return	P236,333,410.00
Add: BIR Adjustments	

Allowable Deductions Claimed	P577,568,309.00	
Less: Allowable Deductions per Audit	544,462,874.00	
Disallowed Deductions		33,105,435.00
Adjusted Taxable Income per Audit		P269,438,845.00
Taxes Due Thereon		P 13,471,942.00
Less: Taxes paid per Return		11,816,671.00
Balance		P 1,655,271.00
Add: 25% surcharge		413,818.00
20% interest p.a. (60%)		1,241,454.00
Compromise penalty		25,000.00
Total		P 3,335,543.00

Based on all the foregoing, only the amount of P13,055,339.00 representing the interest from performance/HRB is considered as an allowable deduction pursuant to Revenue Regulations No. 1-95. Therefore, petitioner is liable for the deficiency income tax in the amount of P2,005,028.59, computed hereunder:

Taxable Income per Return		P236,333,410.00
Add: BIR Adjustments		
Allowable Deductions Claimed	P577,568,309.00	
Less: Allowable Deductions per Audit	544,462,874.00	
Disallowed Deductions	P 33,105,435.00	
Less: Allowed per Court's verification	13,055,139.00	20,050,296.00
Adjusted Taxable Income per Audit		P256,383,706.00
Taxes Due Thereon		P 12,819,185.30
Less: Taxes paid per Return		11,816,671.00
Balance		P 1,002,514.30
Add: 25% surcharge		250,628.57
Interest (60%)		751,885.72
Total		**P 2,005,028.59** *

* Plus 20% delinquency interest computed from September 16, 1999 until fully paid.

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(6)

Whether or not the Billings from Enron Power Operating Company (EPOC) for 1994 in the total amount of P3,075,108,114.00 are subject to creditable 1% EWT.

Respondent maintains that the Billings from EPOC for 1994 in the total amount of P3,075,108,114.00 (inclusive of the Heat rate Bonus of P171,892,238.00) are subject to creditable 1% EWT in the light of two considerations: (1) source of income and (2) residency of EPOC for tax purposes.

It is the position of the respondent that as to the source of income, the law provides that the "place of activity", not place of business, determines the source of income. Thus, applying this rule in determining the source of income of EPOC from its Construction Contract with petitioner (*which provides that "EPOC is to provide design, engineering, procurement and construction services for the Facility in Subic, Zambales"*), it is clear that the subject income was from the Philippine source considering that the "activity" was undertaken by EPOC in Subic, Zambales, Philippines. As a Philippine-sourced income, it is, therefore, subject to Philippine income tax.

As to EPOC's residency for tax purposes, respondent avers that since there is continuity of commercial dealings between petitioner and EPOC, which is over 183 days, the EPOC should be considered/treated as one with a "Permanent Establishment" for tax purposes which is in accordance with Article 5(j) of the RP-US Tax Treaty which provides that:

> "xxx the term fixed place of business (or "Permanent Establishment") includes xxx
>
> (j) the furnishing of services, including consultancy services, by a resident of one of the Contracting States through employees or other personnel, provided activities of that nature continue (for the same or connected project) with the other Contracting State for a period or periods aggregating more than 183 days."

Respondent opines that since EPOC has a "permanent establishment," then it is in order to treat the same as a "Resident Foreign Corporation" for tax purposes.

Petitioner disagrees. It contends that the payments it made to EPOC are not subject to Philippine income tax because EPOC is a US resident corporation without a permanent establishment in the Philippines. Besides, even if the construction period exceeded 183 days, petitioner insists that it did not actually perform any service in the Philippines because all the construction and related work/services required to be done in the Philippines were actually performed by Fluor Daniel Pacific, Inc.

We are not persuaded by petitioner's arguments.

A Turnkey Contract was entered into by and between petitioner and EPOC on June 3, 1993 *(Exhibit E)* whereby EPOC agreed to provide design, engineering, procurement and construction services in connection with petitioner's 108 MW power plant in Subic *(Exhibit E-5)*. In turn, EPOC would be paid the contract price, and in addition, the Net Power Output Bonus and Heat Rate Bonus *(Exhibits E-3 and E-6)*. If indeed all the construction and related work/services required to be done in the Philippines were not in anyway performed by EPOC, then there should be no basis for the payments made to the latter.

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It is significant to note that while the construction and related work/services may have been actually performed by Fluor Daniel Pacific, Ins. (*as subcontractor*), still it is EPOC which is fully responsible to petitioner for the acts and omissions of Fluor Daniel Pacific, Inc. and there is no contractual relationship between petitioner and the subcontractor. The terms of the contract are clear: no subcontractor is intended to be or shall be deemed a third-party beneficiary of the agreement (*Exhibit G-7*). Verily, the contract is only between petitioner and EPOC. As far as petitioner is concerned, EPOC is the one that will perform the contract. It must be pointed out that the contract was to provide design, engineering, procurement and construction services (Work) to petitioner in connection with petitioner's desire to develop, construct, own and operate a nominal 108 megawatt, heavy fuel-fired, diesel generator power plant in Subic. Therefore, the very heart of the contract is the said power plant and to develop and construct the same requires services to be performed where it is to be located. Note that it was EPOC that guaranteed the timely completion and proper performance of the subject power plant. A contract is a meeting of the minds between two persons whereby one binds himself, with respect to the other, to give something or to render some services.[1a] Thus, the parties to said contract are the petitioner and EPOC. And to give life to the contract, the services undertaken by EPOC could be rendered only in the Philippines, more particularly in Subic.

[1a] Article 1305, New Civil Code.

Respondent holds the view that the "place of activity" determines the source of income. Since the place of activity is Subic, Zambales, then it should be the situs of taxation in the present case.

We agree only up to a point. The Supreme Court held that the source of income is the property, activity or service that produced income.[2] This was cited in the case of ***Commissioner of Internal Revenue vs. British Overseas Airways Corporation (149 SCRA 395)*** wherein it was proclaimed, *viz*:

> "The source of income is the property, activity or service that produced the income. For the source of income to be considered as coming from the Philippines, it is sufficient that the income is derived from activity within the Philippines. In BOAC's case, the sale of tickets in the Philippines is the activity that produces the income. The tickets exchanged hands here and payments for fares were also made here in Philippine currency. The situs of the source of payments is the Philippines. The flow of wealth proceeded from, and occurred within, Philippine territory, enjoying the protection accorded by the Philippine government. In consideration of such protection, the flow of wealth should share the burden of supporting the government."

The case of BOAC delved on the activity of selling tickets in the Philippines, hence, the "place of activity" was considered the source of income. In the case at bench, services were required or contracted to be rendered in the Philippines. So it is only appropriate that the "place of service" determines the source of income. Where a contract for the rendition of service is involved, the income is sourced in the place where the service is rendered. Thus, services rendered in the Philippines is subject to Philippine income tax.

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[2] Howden & Co., Ltd. vs. Collector of Internal Revenue, 13 SCRA 601.

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Nonetheless, under Article 8(1) of the RP-US Tax Treaty, the business profits of a US resident will be subject to income tax in the Philippines only if the said US resident has a permanent establishment in the Philippines and only so much of the business profits as are attributable to that permanent establishment, to wit:

> **Article 8**
>
> ***Business Profits***
>
> 1. Business profits of a resident of one of the Contracting States shall be taxable only in that State, unless the resident has a permanent establishment in the other Contracting State. If the resident has a permanent establishment in that other Contracting State, tax may be imposed by that other Contracting State on the business profits of the resident but only on so much of them as are attributable to the permanent establishment.
>
> xxx xxx xxx
>
> 6. The term "business profits" means income derived from any trade or business whether carried on by an individual, corporation or any other person, or group of persons, including the rental of tangible (movable) property."

In connection thereto, Article 5 of the RP-US Tax Treaty defines a permanent establishment as a "fixed place of business through which a resident of one of the Contracting States engages in a trade or business."

Petitioner manifests that while the agreement for the construction of its power plant was entered into with EPOC and while the construction period may have exceeded longer than 183 days, EPOC did not actually perform any service in the Philippines because all the construction and related work/services were actually performed by Fluor Daniel Pacific, Inc..

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Still, we are not satisfied. Granting that herein petitioner agrees that ***some or portions*** of the Work shall be accomplished by subcontractors, nevertheless, petitioner would like us to blindly accept that all of the Work was performed by a third party, not EPOC. Because as per its allegation, "all the construction and related work/services required to be done in the Philippines were actually performed by Fluor Daniel Pacific, Inc.". Yet, we already discussed that the Work could only be performed in Subic, Zambales, Philippines where the power plant is to be located and any service to be performed outside the Philippines, if at all, would only be minimal. Further, petitioner failed to prove what portion of the Work was performed outside the Philippines and if the portion performed in the Philippines did not actually exceed 183 days. It is worth reiterating that the Work consisted of providing for design, engineering, procurement and construction services for a facility to be located in Subic. The burden of proof is upon the petitioner to show that EPOC, notwithstanding its undertaking, was able to comply with its obligations without performing services in the Philippines. Or if ever any service was done by EPOC, it did not exceed 183 days. Failure to convince us otherwise is fatal to its claim.

Petitioner based its stand on Article 2.2 of the contract, hereunder quoted for easy reference:

> 2.2. Subcontractors. Owner acknowledges and agrees that Contractor intends to have portions of the Work accomplished by Subcontractors pursuant to written subcontracts between Contractor and such Subcontractors. Owner further acknowledges that to the extent of the Work requires services to be performed inside the Philippines, such services will be performed by Subcontractors and Contractor's affiliate(s), and that Contractor's direct

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> services with respect to the Work will be performed by Contractor's home office in Houston, Texas. All contracts with Subcontractors shall be consistent with and in no way contrary or inconsistent with any of the terms or provisions hereof. No contractual relationship shall exist between Owner and any Subcontractor with respect to the Work to be performed hereunder. No Subcontractor is intended to be or shall be deemed a third-party beneficiary of this Agreement. Nothing herein shall preclude Owner or any affiliate of Owner from entering into a subcontract with Contractor. Contractor agrees that it shall be fully responsible to Owner for the acts and omissions of Subcontractors and of persons directly or indirectly employed by them, as it is for the acts or omissions of persons directly employed by Contractor. Nothing contained herein shall (i) create any contractual relationship between Subcontractor and Owner or (ii) oblige Owner to pay or see to the payment of any Subcontractor. (Emphasis supplied.)

Pursuant to the above stipulation which particularly provides that "to the extent the work requires services to be performed inside the Philippines, such services will be performed by Subcontractors and Contractor's affiliate(s) and that Contractor's direct services with respect to the Work will be performed by Contractor's home office in Houston, Texas", petitioner now alleges it was Fluor Daniel Pacific, Inc., (Fluor Daniel, for brevity) a subcontractor, which performed all services inside the Philippines and that the services EPOC rendered were performed outside the Philippines. Hence, the payments it made to EPOC are not subject to income tax.

We do not agree.

A reading of the above section leads us to the conclusion that regardless of the existence of a subcontractor, the contractual relationship between petitioner and EPOC was not affected. Stated otherwise, the subcontractor is considered an agent of EPOC and all the services it rendered were for EPOC. The reason is simple and clear. The said Article 2.2 provides that "no contractual relationship shall exist between Owner and any

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Subcontractor with respect to the Work to be performed hereunder." *Ergo*, EPOC remained responsible for whatever undertakings of the subcontractor, Fluor Daniel. In fact, it readily engaged that "Contractor agrees that it shall be fully responsible to Owner for the acts and omissions of Subcontractors and of persons directly or indirectly employed by them, as it is for the acts or omissions of persons directly employed by Contractor." Indubitably, from such agreements, the subcontractor Fluor Daniel, cannot but be considered as an agent of EPOC. And regardless of the existence of a subcontractor, EPOC and only EPOC had a contractual agreement with petitioner considering the following provisions of the Turnkey Contract: first, petitioner is not obligated to pay or see to the payment of any subcontractor; second, the "Contractor shall be solely responsible for all construction, means, methods, sequences, procedures, safety and security programs in connection with the performance of the Work"; third, the Contractor shall "provide and pay for all labor, utilities, supervision, inspection and Equipment and all other goods and services as may be necessary to complete the performance of the Work, whether by Contractor or Subcontractors"; fourth, in the event of any emergency endangering life or property, Contractor shall take such action as may be reasonable and necessary to prevent, avoid or mitigate injury, damage or loss and shall, as soon as possible, report any such incidents, including Contractor's response thereto, to Owner; fifth, EPOC "shall be responsible for the security and protection of the Site, the Facility and all Equipment located thereon, incorporated therein or stored or warehoused off the Site; sixth, prior to any instance of Start Up, EPOC "shall provide or cause to be provided to qualified personnel of Owner of Owner's designee orientation and training for the education in the safe, efficient and economical operation and maintenance of the system, unit or component with respect to which Start-Up shall occur"; and, prior to Facility Completion, EPOC covenanted to "provide to personnel of Owner or Owner's designee orientation and training for the purpose of education in the safe, efficient and economical operation and maintenance of the Facility and all component Equipment." Logically, fulfillment of these obligations could only be made when EPOC was within the subject site for these services could only be rendered where the facility and equipment are located, which is in Subic. And, it is worth mentioning that the law refers to an aggregate period of more than 183 days and not necessarily for a continuous 184 days or more.

All the said undertakings defeat petitioner's claim that EPOC did not actually perform services in the Philippines but only Fluor Daniel. The agreement between Enron Power Corporation-U.S. and Fluor Daniel *(Exhibit Z-3)* alleged to be transferred to EPOC *(Exhibit BB)*, specifically refers to a Construction Management Services Agreement *(Exhibit Z)* wherein Fluor Daniel, as the contractor, will furnish Enron Power Corporation-U.S. the <u>construction management services</u> as may be requested by the latter from time to time. These construction management services cover only a portion of the Work needed for petitioner's power plant. Noteworthy is a provision of Tasking Letter #3, to wit:

> "Services under this Tasking Letter and Agreement (referring to Exhibit Z) will commence on January 5, 1993. The parties anticipate that the majority of the Services under this Tasking Letter shall be completed upon mechanical completion of the Subic Bay Power Project; however, the parties agree that

> Contractor shall provide personnel as requested by Company to assist with those construction management services necessary for commissioning, start up and associated post construction administration activities, unless sooner terminated or suspended in accordance with the provisions of this Agreement. The written details of the Scope of Services under this Tasking Letter will be added to this Tasking Letter by mutual agreement. The intent of the Parties is that Contractor shall perform all construction management services to oversee the timely, efficient and effective construction (but excluding the actual commissioning and startup) of the plant thru to commercial operations."[3] (Underscoring ours.)

Plainly, the duty of Fluor Daniel, as the contractor, involved construction management services, *i.e.*, overseeing the timely, efficient and effective construction of the plant through commercial operations and not the construction of the power plant itself. Inasmuch as the obligation did not include the actual commissioning and startup of the plant and clearly dealt only on the management of the construction thereof, we are not convinced that all the construction and related work/services in the Philippines were performed solely by Fluor Daniel. Providing construction management services would not cover the undertaking of EPOC to provide design, engineering, procurement and construction services to petitioner. Besides, we cannot understand how EPOC subcontracted Fluor Daniel to provide services to petitioner starting January 5, 1993 when its contract with petitioner was executed only on June 3, 1993. We also noticed that the Assignment, Assumption and Release Agreement between EPOC and Enron Power Corporation-U.S. was executed only on February 18, 1993.

More importantly, petitioner did not present documents like the billing statements or invoices, to enable us to determine what services EPOC actually rendered to the

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[3] Exhibit AA-3.

petitioner and the period involved to be entitled to the payment of a huge sum of money totaling P3,075,108,114.00.

Article 5 of the RP-US Tax Treaty defines permanent establishment as a "fixed place of business through which a resident of one of the Contracting States engages in a trade or business". The term "fixed place of business" includes but is not limited to the following:

> (j) the furnishing of services, including consultancy services, by a resident of the Contracting States through employees or other personnel, provided activities of that nature continue (for the same or connected project) within the other Contracting State for a period or periods aggregating more than 183 days.

There is no question that the construction period exceeded 183 days. Further, we find that there was a continuity of commercial dealings between petitioner and EPOC that exceeded an aggregate period of 183 days. Inasmuch as we already ruled that the "place of service" which determines the source of income in this case is the Philippines, then EPOC should be considered or treated as one with a "permanent establishment" for tax purposes in accordance with Article 5 par. 2(j) of the RP-US Tax Treaty. In other words, we find merit in respondent's claim that the income derived by EPOC for the services rendered in the Philippines is a Philippine-sourced income. Thus, we uphold respondent's stand that the income payments made by petitioner to EPOC in relation to its power plant project in the total amount of P3,075,108,114.00 should be subject to 1% EWT.

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(7)

Whether or not the amount of P130,062,717.00 which petitioner paid to Enron Corporation as compensation for the latter's assistance in coordinating and directing the development construction and pre-operation activities of the facility of petitioner in Subic, Zambales is subject to 1% creditable EWT.

In accordance with the Development Agreement *(Exhibit H)* between petitioner and Enron Corp., petitioner paid compensation in the total amount of P130,062,717.00 in 1994 to Enron Corp. for the latter's coordinating and directing the development, construction and pre-operation activities of the facility of petitioner in Subic, Zambales. Respondent subjected this income payment to the 1% EWT for the same reasons he subjected petitioner's payments made to EPOC.

As in the case of EPOC, petitioner maintains that the payment it made to Enron Corporation (Enron, for short) is not subject to Philippine income tax because Enron is a US resident corporation without a permanent establishment in the Philippines. Under Section 1.1 of the Development Agreement, "Enron will be responsible for the overall coordination and direction of the development, construction, and pre-operations management of the Project as set forth in the Shareholders Agreement. Enron will perform and/or supervise these activities from its offices in the United States." By virtue of said provision, petitioner claims that the compensation it paid to Enron is not subject to 1% contractor's tax.

Notwithstanding the said agreement, we find that Enron could only render the services it contracted with petitioner within the site of the power plant project. Enron's services were engaged by petitioner to assist it in coordinating and directing the development, construction and pre-operations activities of petitioner's power plant project. Enron's responsibilities included responsibility for overall coordination and direction of the development, construction and pre-operations activities of the project; oversight of all existing project contracts; negotiation for, and oversight of, all additional project contracts necessary for the development of the project, including but not limited to the term financing for the project.[4] Enron may utilize affiliated or third party Philippine, American or other companies to perform tasks in the Philippines to the extent necessary.[5] Yet, there is no showing that Enron did hire any affiliate or third party to perform tasks necessary in the Philippines to carry out its obligation to petitioner. Undoubtedly it could never render any useful assistance to the petitioner if it did not have any first hand knowledge on the developments concerning the power plant project. Aside from the contract submitted for this court's perusal which is insufficient, petitioner did not show proof to support its claim. Nor did petitioner present any document to give us an inkling of the nature of services performed by Enron to receive the payment of P130,062,717.00. As we have already ruled, the burden of proof is upon petitioner to prove that Enron did not perform any service in the Philippines. We find that the source of income is the "place of service" which is Subic. It follows, that the income derived by Enron for the services rendered to petitioner is taxable. Petitioner should have withheld 1% contractor's tax on the compensation it paid to Enron amounting to P130,062,717.00.

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[4] TSN. October 5. 2000. page 16.
[5] Exhibit H-2.

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(8)

Whether or not the amounts of P31,136,000.00 and P23,362,000.00 representing Development Service Fees paid by petitioner to Rizal Banking Corporation and House of Investments, respectively, are subject to 1% creditable EWT.

On October 1, 1993, a Development Agreement was entered into by and among petitioner, Enron Corporation, Enron Power Philippines Corporation, House of Investments, Inc. (HOI) and Rizal Commercial Banking Corporation (RCBC) *(Exhibit I)* whereby Enron will direct the efforts of RCBC and HOI in the performance of their activities *(Exhibit I-2)*. For services rendered, RCBC received from petitioner the amount of P31,136,000.00 while HOI received the sum of P23,362,000.00. Respondent subjected these payments to 1% contractor's tax. Petitioner, on the other hand, argues that payee-corporations are not contractors. RCBC is a bank while HOI is a holding company. The primary purpose of the Articles of Incorporation of RCBC provides that it is formed to carry and engage in the business of expanded commercial banking *(Exhibit R-1)*. The Articles of Incorporation of HOI provides that its primary purpose is to carry on the business of holding and management of a company *(Exhibit S-1)*. Therefore, payments they received from the petitioner should not be subject to 1% EWT.

However, respondent theorized that the Development Service Fees paid to RCBC and HOI in the amounts of P31,136,000.00 and P23,362.00, respectively, are subject to 1% creditable EWT pursuant to Revenue Regulations No. 6-85, Section 1(e)(2)(c) "persons engaged in the installation of water system and gas or electric light, heat or power". According to respondent, whatever term or label these income payments may be called is immaterial. The fact is that said payments are part of the Construction Service Agreement for the Facility of the petitioner in Subic, Zambales and, therefore, classifiable as payments to certain contractors.

We concur with the respondent. Whatever term or label attached to these income payments, petitioner cannot escape the basic fact that both RCBC and HOI were involved in petitioner's power plant project.

HOI may be a holding company but it does not mean that it cannot be a contractor. One of its secondary purposes is "**d. – To enter into, make, perform, and carry out contracts and undertakings of every kind for any lawful purpose, without limit as to amount, with any individual, association or corporation**."[6] As regards RCBC, its primary purpose may be to engage in the business of expanded commercial banking but its Articles of Incorporations do not contain any prohibition to enter into a different contract. All things considered, the services rendered by RCBC under the Development Agreement were undeniably related to the Construction Service Agreement involving petitioner's power plant project in Subic, Zambales. Furthermore, as per Notes to Financial Statements [Note 5(d), BIR Records, page 5], it was explained that petitioner has entered into a Development Agreement, effective October 1, 1993 with both RCBC and HOI, whereby it agreed to pay RCBC and HOI development service fees rendered from October to December 31, 1993 to complete the power plant. In other words, the services rendered by RCBC and HOI undoubtedly relate to the construction of the power

[6] Exhibit S-1.

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plant. Thus, the services performed by RCBC and HOI in connection with the development of the subject project can be categorized as services rendered by contractors which should be subject to 1% expanded withholding tax pursuant to Section 1 (e)(2)(c) of Revenue Regulations No. 6-85.

(9)

Whether or not the Administrative and Advisory Service Fees paid by petitioner to Enron Power Philippines Operating Corporation in the amount of P14,478,550.00 are subject to 5% EWT.

Respondent likewise asserts that the Administrative and Advisory Service Fees paid to Enron Power Philippines Operating Corporation (EPPOC) in the amount of P14,478,550.00 are subject to 5% EWT because while the income recipient, EPPOC, is a foreign corporation, nevertheless, it conducts business in and derives income from the Philippines through a "Permanent Establishment" as defined under Article 5(j) of the RP-US Tax Treaty. As such, the provisions of RR 6-85 should apply.

As in the cases of EPOC and Enron, petitioner alleges that EPPOC is a non-resident foreign corporation[7] without a permanent establishment in the Philippines. Therefore, the income EPPOC derived from petitioner should not be subject to 5% withholding tax.

Under the Operations and Maintenance Advisory Agreement between petitioner and EPPOC, the latter will render advisory services with respect to the operation and maintenance of the former's power plant project *(Exhibit J)*. Petitioner declared that it was so agreed thereunder that EPPOC "will perform its services from its office in

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[7] Exhibit T.

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Houston, Texas".[8] Therefore, EPPOC could not have established a permanent establishment in the Philippines.

We do not agree.

A reading of the Operations, Maintenance and Advisory Agreement discloses that EPPOC could not have accomplished what it set out to do by performing its services in Houston, Texas. In the first place, the agreement involved operations and maintenance of the power plant which is located in Subic. If the advisor intends to be removed from the place of the project then its advice is not worth a cent. But EPPOC did not really intend to perform its services in Houston, Texas for the lifetime of the contract, an agreement to the contrary notwithstanding. Because during Phase I of the project,[9] EPPOC agreed to assist petitioner in an orderly transition from construction through start-up, testing and acceptance of the project. And this could only be done if EPPOC was in the vicinity of the project. Relative thereto, EPPOC undertook to perform, among others, the following tasks:

(1) Assist Owner and Contractor in the training sessions for the O&M Employees;[10]

(2) Assist Owner in monitoring performance testing and advice Owner as to the progress of the performance testing and as to whether or not the Project has successfully passed the Performance Tests as defined under the Construction Contract;[11]

(3) Prepare detailed plans and procedures for Project commissioning and start-up on a systems basis, provide technical supervision and expertise for

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[8] Exhibit J-2.
[9] Phase I (Mobilization, Start-up and Performance Testing).
[10] Article II, Section 2.2(g).
[11] *Ibid*, Section 2.2(h).

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> commissioning and start-up (with Owner providing necessary operators), to allow safe start-up and testing of the Facility, using either Advisor's personnel or personnel contracted by Advisor.[12]

Obviously, EPPOC could assist petitioner and EPOC in the training of Operations and Management Employees of petitioner only by sending employees in Subic. Nor could EPPOC assist petitioner in monitoring performance testing in Houston, Texas when the facility to be tested is in the Philippines. Moreover, EPPOC could never determine whether the power plant had passed the performance tests if it remained in Houston, Texas. Significantly, in order to provide technical supervision and expertise for commissioning and start-up, EPPOC agreed to use its personnel or personnel contracted by it.

During Phase II designated as the operating period, EPPOC undertook, among others, to "contract for and oversee the performance of periodic overhauls or unscheduled maintenance required for the Project to the extent such periodic overhauls or unscheduled maintenance cannot effectively be provided by the O&M Employees or local Philippine contractors."[13] Needless to say, EPPOC could not oversee any performance of periodic overhauling or unscheduled maintenance if it was in Houston, Texas, when said overhauls and maintenance could not be effectively provided by O&M Employees of petitioner or local Philippine contractors. Also, EPPOC agreed to maintain accounting records regarding its services in accordance with Philippine generally acceptable

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[12] Id., Section 2.2(i).
[13] Article II, Section 2.3(d).

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accounting principles.[14] If indeed income derived by EPPOC is not subject to Philippine income tax, then there would be no need for EPPOC to maintain such accounting records.

As earlier pointed out, the law requires only an aggregate period of more than 183 days, not necessarily a continuous period of more than 183 days, before a corporation can be considered as having a permanent establishment in the Philippines. Besides, petitioner did not show proof to bolster its averments that the payments made to EPPOC amounting to P14,478,550.00 consisted of services performed outside the Philippines. The billings/invoices sent by EPPOC to petitioner could have clearly enlightened us of the nature of services performed by the latter.

(10)

Whether or not the Service Fees paid by petitioner to Enron Subic Power Corporation in the amount of P8,941,439.00 are subject to 5% EWT.

Finally, respondent maintains that the Service Fees paid by petitioner to Enron Subic Power Corporation (ESPC) in the amount of P8,941,439.00 is subject to 5% EWT. Petitioner contrarily claims that ESPC is an accredited SBF enterprise and enjoys exemption from income tax and, consequently, from EWT. Respondent, however, counters that the income recipient/payee is not an accredited SBF enterprise, since ESPC-Makati, the recipient/payee, is a distinct and separate entity from ESPC-Subic. Whereas ESPC-Subic is an accredited SBF enterprise, ESPC-Makati is not. Such being the case, the income derived by ESPC-Makati from petitioner representing Professional Fees is

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[14] Ibid. Section 2.3(i).

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subject to normal income tax and thus to 5% creditable expanded withholding tax. But petitioner insists that there is no ESPC-Makati and that respondent mistakenly interpreted that the payee was a certain ESPC-Makati. Prior to its actual operations, ESPC still had to organize its company structure and still had to comply with certain requirements, documentary or otherwise, with private and government agencies, which activities petitioner undertook with the assistance of its parent company, Enron Power Philippines Corporation, a company with business address in Makati City.

We agree with the respondent since the payments were made to ESPC-Makati, consequently, the recipient/payee is ESPC-Makati and not ESPC-Subic. Based on the evidence presented by the petitioner, as early as January 29, 1993, the Subic Bay Metropolitan Authority already issued ESPC a Certificate of Registration *(Exhibit V)*. Enron Subic Power Corporation, with address at Subic Bay Freeport, Philippines was issued a Certificate of Tax Exemption on January 28, 1993 *(Exhibit W)*. Petitioner asserts that ESPC used the Makati address at the time when it still had to organize its company structure or during its pre-operating stage. But based on Exhibits V and W, as early as January of 1993, ESPC already had an address at Subic Bay Freeport. We likewise observed that the Administrative and Commercial Support Agreement between Enron Subic Power Corporation and petitioner was executed only on December 21, 1993 and effective as of January 1, 1994.[15] For having already entered into an agreement with petitioner, then it can be concluded that ESPC was no longer on a pre-operating stage by that time. If petitioner's allegation is true that ESPC-Makati is the same as ESPC-Subic

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[15] Exhibit K.

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then there should only be one address. We cannot accept petitioner's asseveration that the Makati address was used because at that time ESPC had no Subic address. As per Exhibit W, it already had a Subic Bay address as of January 28, 1993 or almost a year before the said agreement was entered into. Simply put, if ESPC-Subic had already a registered address at Subic Bay Freeport on January 28, 1993, there would be no reason for the same to be using the Makati address. It cannot be overemphasized that the services it contracted to perform under the agreement were to be rendered only on January 1, 1994. Meaning to say, payments should be made to ESPC-Subic if the services were performed by it. But considering that the payments were made by petitioner to ESPC-Makati, then it can be assumed that it was ESPC-Makati, a different corporate entity, which rendered the services subject of the income payments bearing in mind that petitioner presented only an agreement with ESPC which is inadequate evidence to support its claim. It should have presented other documents to prove the nature of the services rendered by ESPC and the period when said services were performed. Clearly, petitioner failed to prove that ESPC-Makati and ESPC-Subic are one and the same entity.

WHEREFORE, IN VIEW OF ALL THE FOREGOING, the petition for review is hereby **DENIED**. The assessment for deficiency 5% tax is hereby **UPHELD** but only in the amount of P2,005,028.59. However, the assessment issued against petitioner for deficiency expanded withholding tax in the total amount of P67,585,175.00 is **FULLY UPHELD**. Accordingly, petitioner is **ORDERED** to **PAY** the total amount of P69,590,203.59 representing deficiency 5% tax and expanded withholding tax for the year 1994. In addition, petitioner is also **ORDERED** to **PAY** 20% delinquency interest computed from September 16, 1999 until full payment thereof pursuant to Section 249(c)(3) of the 1994 Tax Code.

SO ORDERED.

Juanito C. Castañeda, Jr.
JUANITO C. CASTAÑEDA, JR.
Associate Judge

WE CONCUR:

ERNESTO D. ACOSTA
Presiding Judge

LOVELL R. BAUTISTA
Associate Judge

CERTIFICATION

I hereby certify that the above decision was reached after due consultation with the members of the Court of Tax Appeals in accordance with Section 13, Article VIII of the Constitution.

ERNESTO D. ACOSTA
Presiding Judge

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