REPUBLIC OF THE PHILIPPINES
COURT OF TAX APPEALS
QUEZON CITY

AIR INDIA,
Petitioner,

- versus -

C.T.A. CASE NO. 3441

THE COMMISSIONER OF INTERNAL REVENUE,
Respondent.

x - - - - - - - - - - x

6/27/85

D E C I S I O N

This is an appeal from the decision of respondent Commissioner of Internal Revenue holding petitioner, AIR INDIA, liable for the payment of ₱142,471.68 representing deficiency income tax, inclusive of 50% surcharge and interests, for willful neglect to file a return as provided under Section 72 of the Tax Code for the fiscal year ending March 31, 1976, as international carrier, computed as follows:

Gross Philippine Billings - - - -	₱ 2,968,156.00
Income tax due thereon - - - - -	74,204.00
Add: 50% surcharge - - - - - - - -	37,102.00
14% interest per annum (42% maximum) - - - - - - - - - -	31,165.68
TOTAL AMOUNT DUE & COLLECTIBLE -	₱ 142,471.68

Petitioner AIR INDIA, is a foreign corporation, engaged in the business as international carrier. It is not licensed to do business in the Philippines as an international carrier. Its airplanes do not operate within the Philippine territorial jurisdiction, or otherwise, its airplanes do not service passengers embarking from Philippine ports. Its sales activity in the Philippines during the fiscal year 1976 in question, and covered by the aforesaid assessment, was the sale, through PAL, of airplane tickets which were serviced by its airplanes entirely outside the Philippines. Its status in the Philippines is that of an off-line international carrier, which as aforesaid, is not engaged in the business of air transportation in the Philippines.

During the fiscal year ending March 31, 1976, the total sales of airplane tickets sold by PAL for petitioner amounted to ₱2,968,156.00. During the period for which the PAL sold tickets for petitioner AIR INDIA, the latter did not have a single airplane which operated within Philippine territory, or had otherwise lifted passenger and cargo anywhere in the world as an international carrier and doing business in the Philippines. Petitioner never engaged itself in business in the Philippines, as it did not sell passage documents of passenger, baggage or mail originating from the Philippines. Petitioner not being engaged in business in the Philippines as an international carrier, it had no income in the form of "Gross Philippine Billings." All the purchases of airplane tickets, through PAL, in the total value of ₱2,968,156.00 were in fact for AIR INDIA airplane serviced outside of the Philippines. These bare facts were undisputed by respondent.

The two (2) issues raised in this case are:

> 1. Whether or not petitioner, as an off-line international carrier, is taxable under Section 24 (b)(2) of the Revenue Code; and
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> 2. Whether or not petitioner is liable for the surcharge of 50% for failure to file an income tax return.

The first issue is not without precedent and we totally agree with distinguished counsel, an authority in taxation, when he cited correctly the proper application, which are in all fours with the case at bar, of our decisions in the previous cases of Japan Airlines, Inc. vs Commissioner of Internal Revenue, C.T.A. Case No. 2480, Jan. 15, 1982; British Overseas Airways Corp. vs Commissioner of Internal Revenue, C.T.A. Cases Nos. 2373 and 2561, Jan. 26, 1983; and American Airlines vs Commissioner of Internal Revenue, C.T.A. Case No. 3046, April 16, 1984, which uniformly held that off-line international carriers selling tickets in the Philippines but serviced outside thereof, the income from which are derived from such sales, are incomes derived exclusively from services outside the Philippines and is not taxable under Section 24 (b) (2) of the National Internal Revenue Code. We quote at length the scholarly presentation of distinguished counsel of petitioner in his reply memorandum (pp. 106, 108-116, CTA rec.) on the matter regarding the first issue, wherein counsel said, and which we fully agree with and adopt as our own.

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By way of preliminary, foreign corporations are of two kinds, viz.: (1) resident foreign corporations, those engaged in trade or business in the Philippines; and (2) non-resident foreign corporations, those not engaged in trade or business in the Philippines. Under the law, all foreign corporations, residents or non-residents, are subject to income tax only with respect to income derived from sources within the Philippines. /See Sec. 24(b), sub-paragraphs (1) and (2); Secs. 16 and 60 Rev. Regs. No. 2./

As regards foreign corporations, income from sources within the Philippines consists of two items, viz.: (1) income derived exclusively from sources within the Philippines, and (2) that portion of the income derived partly within and partly without the Philippines which is allocable to sources within the Philippines. (Sec. 152, Rev. Reg. No. 2)

Non-resident foreign corporations are taxable on their gross income from all sources within the Philippines under Section 24 (b) (1) of the Revenue Code, while resident foreign corporations are taxable under Sec. 24 (b) (2) on their net income also from all sources within the Philippines. In order that a foreign corporation may be taxed on net income under Section 24 (b) (2) it is essential that the corporation be engaged in trade or business in the Philippines. Special provision is made in Section 24 (b) (2) with respect to foreign international carriers doing business in the Philippines which are made subject to a special tax of 2-1/2% of their "gross Philippine billings". For an international carrier to be taxed on "gross Philippine billings" it must be engaged, not in any kind of business; the business engaged in must be the business of air transportation. This is evident from the provision of Section 24 (b) (2) to the effect that the term "gross Philippine billings" refers to "gross revenue realized from uplifts anywhere in the world by any <u>international</u>

carrier doing business in the Philippines of passage documents sold therein, whether for passenger, excess baggage or mail, provided the cargo or mail originates from the Philippines." Petitioner was not and is not engaged in business in the Philippines as an international carrier and has no income therein in the form of "gross Philippine billings." And this is admitted by respondent in his memorandum by declaring that petitioner is not engaged in business as common carrier by air and, therefore, not subject to the tax on business as common carrier under Section 207 of the Revenue Code.

In the case of Japan Air Line, Inc. v. Commissioner of Internal Revenue, C.T.A. Case No. 2480, January 15, 1982, which is on all fours with the instant case, this Honorable Court, quoting from an earlier decision[1], held:

> "We find no merit in respondent's contention that international air transportation companies should be considered engaged in business wherever they derived fares or freight and are taxable as carrier in said place, that is, for purposes of taxation, the situs is said place."

As in the case of Japan Air Lines, Inc., supra, petitioner in this case is an off-line international carrier not licensed to do business in the Philippines, whose sole activity in the Philippines was and is the sale of airplane tickets which are serviced by airplanes of petitioner outside the Philippines. Therefore, the rule laid down in the case of Japan Air Lines, Inc. equally applies to the instant case. In fact, the same rule has been applied in the identical case of British Overseas Airways Corporation v. Commissioner of Internal Revenue, C.T,A. Cases Nos. 2373 & 2561, January 26, 1983.

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1 Japan Air Lines, Inc. v. Commissioner of Internal Revenue, C.T.A. Case No. 1634 Nov. 29, 1968, cert. denied in L-30041, Feb. 3, 1969.

It is contended, however, that the ruling in the cases of Japan Air Lines, Inc. and British Overseas Airways Corporation, supra, does not apply to the instant case because the said cases involved assessments prior to the effectivity of Republic Act No. 5455 which enlarged the definition of the term "doing business" in the Philippines. While respondent admits that off-line international carriers are not engaged in business for purposes of the business taxes imposed by Secs. 192(1) and 207 of the National Internal Revenue Code, it is alleged that they are nevertheless considered engaged in business for purposes of the tax on income. This proposition is unwarranted, illogical. How can an off-line international carrier be considered engaged in business for purposes of the income tax and at the same time not engaged in business for purposes of the business taxes? The resulting conflict arising from respondent's stanch is beyond comprehension. It is submitted that neither Republic Act No. 5455 nor Rev. Regulation No. 3-76 has altered the character of off-line international carriers as foreign corporations not engaged in the business of air transportation in the Philippines.

The pertinent portion of Republic Act No. 5455 reads as follows:

> "Sec. 1 - - - and the phrase, 'doing business' shall include soliciting orders, purchase, service contracts, opening offices, whether called 'liaison' offices or branches; appointing representatives or distributors who are domiciled in the Philippines or who in any calendar year stay in the Philippines for a period or periods totalling one hundred eighty days or more; participating in the management, supervision or control of any domestic business firm, entity or corporation in the Philippines; and any other act or acts that imply a continuity of commercial dealings or arrangements and contemplates to that extent the performance of acts or works, or the exercise of some of, the functions normally incident to, and in progressive prosecution of, commercial gain or of the purpose and object of the business organization."

The definition of the term "doing business" was further enlarged by Revenue Regulations No. 3076 by providing that -

> "For purposes of this definition, the phrase 'doing business in the Philippines' includes the regular sale of tickets in the Philippines by off-line airlines by themselves or through their agents."

There is nothing in Republic Act No. 5455 or in Rev. Regs. No. 3-76 to show clearly that the various acts or transactions enumerated therein constitute doing business as international carrier. Rep. Act No. 5455 mentions certain acts or transactions done or performed in the Philippines which constitute doing business in general and from which income is derived. And while Rev. Regs. No. 3-76 specifically provides that the regular sale of tickets in the Philippines by off-line international carriers is considered "doing business", the same does not readily give rise to the conclusion that the sale of tickets by international carriers constitutes the business of air transportation. What may be considered as "doing business" under the regulations is the sale of airplane tickets because that is the only activity in the Philippines of off-line international carriers. If at all, the tax that can be levied on the "business" of selling tickets is a license tax for the privilege enjoyed by off-line international carriers in selling airplane tickets in the Philippines. No income tax may be imposed because no income is derived from the sale of such tickets; the income derived from the sale of such tickets is derived from the service of transporting passengers or freight outside the Philippines. And as correctly stated by this Honorable Court, the situs of the income derived by foreign corporations from labor or personal services is determined solely by the place where service is rendered. (See Japan Air Lines, Inc. v. Commissioner of Int. Rev., _supra_; British Overseas Airways Corp. v. Commissioner of Int. Rev., _supra_.) Tickets have no value except as evidence of payment. It is quite clear that off-line international carriers can not be considered engaged in the business of air transportation in the Philippines whether for purposes of the income tax

/ Sec. 23 (b) (2), Rev. Code 7 or for purposes of the business taxes / Secs. 192 (1) and 207, id 7.

If an off-line international carrier was not engaged in the business of air transportation in the Philippines solely by reason of its sales of airplane tickets in the Philippines before the effectivity of Rep. Act No. 5455 and Rev. Regs. No. 3-76, it can not be considered engaged in such business after the effectivity of said law and regulations. The fact remains that before and after the effectivity of said law and regulations, petitioner, as an off-line international carrier, did not and has never operated any airplane service in the Philippines. The character of petitioner as a non-resident foreign corporation can not be altered by fiction of law, much less by the exercise of regulatory power vested in an executive or administrative official. To construe Rep. Act No. 5455 and Rev. Regs. No. 3-76 as converting non-resident foreign corporations into resident foreign corporations would render said law and regulations oppressive, arbitrary and capricious. It has been held that a law enacted under and by virtue of the taxing power which is arbitrary and capricious violates the due process clause of the Constitution. (Heiner v. Donnan, 285, U.S. 312, 326).

Even assuming that off-line international carriers may be considered engaged in the business of air transportation in the Philippines by virtue of Rep. Act No. 5455 and Rev. Regs. No. 3-76, which is illusory, yet petitioner can not be held liable for income tax on the proceeds of the sales of airplane tickets in the Philippines because such income does not fall under the category of "gross Philippine billings". The term "gross Philippine billings" is defined in Section 24 (b) (2) of the Revenue Code as including "gross revenue realized from uplifts anywhere in the world by any international carrier doing business in the Philippines of passage documents sold therein, whether for passenger, excess baggage or mail, provided the cargo or mail originates from the Philippines." Cargo or mail originates from the Philippines with respect to a carrier that carries the cargo or mail from the Philippines to a foreign port. As far as petitioner is concerned such cargo or mail originates from the place outside the Philippines where it is loaded on board an airplane of petitioner. This is so because any leg or portion of the trips serviced by petitioner commenced outside the Philippines and terminated also outside the Philippines.

Again, the term "gross Philippine billings" implies revenue derived partly within and partly outside the Philippines. It can not include income derived exclusively outside the Philippines. It has been held that the income derived by off-line international carriers from sales of airplane tickets in the Philippines but serviced outside the Philippines is income derived exclusively outside the Philippines; the same can not even be considered income derived partly within and partly without the Philippines. (See Japan Air Lines, Inc. v. Commissioner of Int. Rev., supra; British Overseas Airways Corp. v. Commissioner of Int. Rev., supra.) It follows that whether petitioner is a resident or non-resident foreign corporation it can not be held liable for income tax on the proceeds of sales of airplane tickets sold in the Philippines but serviced outside the Philippines.

There is another point which should not be overlooked. As already adverted to, a foreign corporation is taxable only with respect to (a) income derived exclusively from sources within the Philippines, and (b) that portion of the income derived partly from sources within and partly from sources outside the Philippines which is attributable to sources within the Philippines. It is not taxable on income derived exclusively outside the Philippines. This is so not only because of the express provisions of the law (Secs. 24, 37, National Int. Rev. Code) but more on the basis of the generally accepted principle of international law binding upon all civilized nations. The reason for this principle is that the laws of one country can not have extraterritorial operation. (51 Am. Jur. 88.) And this has served as a limitation on the taxing power of the legislature; more so in this jurisdiction because our Constitution provides that the generally accepted principles of international law shall be part of the law of the land. (Sec. 3, Art. II, Constitution.) As succintly stated by the Supreme Court:

> "The approved doctrine is that no state may tax anything not within its jurisdiction without violating the due process clause of the constitution. The taxing power of a state does not extend beyond its territorial limits, but within such limits it may tax persons, property, income or business. If an interest is taxed, the situs of either the property or interest must be found within the state. If an income is taxed, the recipient thereof must have a domicile within the state or the property or business of which the income issues must be situated within the state so that the income may be said to have a situs therein." (Manila Gas Corp. vs. Collector of Int. Rev. 62 Phil. 895, 900).

Under the law, the situs of the income derived from labor or performance of service is determined by the place where the labor is performed or the service rendered, not by the place where payment is made. (Sec. 37, Nat. Int. Rev. Code.) It follows that the situs of the income derived by foreign international carriers from the business of air transportation is the place where the airplane service is rendered or performed. Accordingly, to tax the income derived by petitioner from the transportation service rendered or performed outside the Philippines would violate not only the National Internal Revenue Code but also the due process clause of the Constitution.

> "A state has power to fix the time at which property within its jurisdiction may acquire a taxable situs, but it cannot fix the taxable situs of a thing which has never come into the state or is permanently beyond its borders, and which it is without power to control. The financial exigencies of the state afford no justification

> for sustaining a tax on a transaction beyond the borders of the state." (51 Am. Jur. 457).

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Regarding the second issue, we fully agree with petitioner that it is not liable for surcharge of 50%, for which we once more quote the fine exposition of counsel in behalf of petitioner in his reply memorandum. (pp. 116-117, CTA rec.).

> The second issue whether or not petitioner is liable for the surcharge of 50% of the alleged deficiency income tax needs no extended discussion. The surcharge of 50% of the unpaid tax or deficiency tax is sought to be imposed in this case under Section 72 of the Revenue Code which provides that the said surcharge is to be imposed-
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> > "In case of willful neglect to file the return or list required under this Title within the time prescribed by law, or in case a false or fraudulent return or list is willfully made x x x." (Underscoring supplied.)
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> There is no claim or pretense that herein petitioner willfully failed to file an income tax return for the fiscal year 1976. Neither the report of the examiner nor the Amended Answer filed by respondent makes mention of any fact or circumstance to prove that the failure of petitioner to file the return was willfull. Petitioner is charged merely with failure to file a return.
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> Willful failure to file an income tax return which justifies the imposition of the 50% surcharge, or what is commonly called the fraud penalty, requires that the failure to file a return was due to an intent to evade payment of tax legally due, in other words an intention to defraud the Government of lawful revenue. Mere failure to file a return is

not in itself, standing alone, evidence of fraud. As aptly stated by the Supreme Court:

> "The fraud contemplated by law is actual and not constructive. It must be intentional fraud, consisting of deception willfully and deliberately done or resorted to in order to induce another to give up some legal right. Negligence, whether slight or gross, is not equivalent to the fraud with intent to evade the tax contemplated by law. It must be intentional wrongdoing with the sole object of avoiding the tax. It necessarily follows that a mere mistake cannot be considered as fraudulent intent, and if both taxpayer and the Commissioner of Internal Revenue committed mistakes in making entries in the return and in the assessment, it would be unfair to treat the mistakes of the tax-payer as tainted with fraud and those of the Commissioner as made in good faith." (Aznar v. Court of Tax Appeals, 58 SCRA 519.)

Petitioner can not be charged with an intention to defraud the Government because it honestly and sincerely believes that it is not liable for the tax sought to be imposed upon it."

WHEREFORE, in view of the foregoing, the decision of the respondent Commissioner of Internal Revenue appealed from holding petitioner liable for deficiency income tax of ₱142,471.68, plus surcharge and interest, is hereby set aside.

No pronouncement as to costs.

SO ORDERED.

Quezon City, Metro Manila, June 27, 1985.

CONSTANTE C. ROAQUIN
Associate Judge

WE CONCUR:

AMANTE FILLER
Presiding Judge

ALEX Z. REYES
Associate Judge