REPUBLIC OF THE PHILIPPINES
COURT OF TAX APPEALS
QUEZON CITY

SPECIAL THIRD DIVISION

SHINKO ELECTRIC INDUSTRIES CO., LTD.,
Petitioner,

- versus-

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

CTA Case No. 8213

Members:

Bautista, *Chairperson*
Cotangco-Manalastas, *JJ.*

Promulgated:

FEB 10 2014 3:39 p.m.

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DECISION

COTANGCO-MANALASTAS, *J.:*

This is a Petition for Review filed on January 4, 2011 by Shinko Electric Industries Co., Ltd. (petitioner) to seek the cancellation of the Formal Assessment Notice and the Assessment Notices[1] dated May 12, 2010 assessing petitioner for alleged deficiency income tax, value-added tax (VAT), and compromise penalty for the fiscal year ending March 31, 2007 in the aggregate amount of P1,129,201.69.

FACTS

Petitioner is a Philippine-registered representative office of Shinko Electric Industries Co., Ltd., a company organized and existing under the laws of Japan, with S.E.C. Reg. No. AF095-164. As a representative office in the Philippines, it is licensed to "undertake activities such as but not limited to information dissemination, promotion of the parent company's products, quality control of products as well as all other

[1] Exhibits "S" to "W", docket, pp. 670 to 677.

activities which may be legally undertaken by a representative office".[2] It is registered with the Bureau of Internal Revenue (BIR), with Taxpayer Identification No. 004-824-812-000, as evidenced by its Certificate of Registration No. OCN9RC0000101346.[3]

On the other hand, respondent is the duly appointed Commissioner of the Bureau of Internal Revenue, vested under appropriate laws with the authority to carry out the functions, duties and responsibilities of said office, including, *inter alia*, the power to decide disputed assessments, cancel, and abate tax liabilities, pursuant to the provisions of the National Internal Revenue Code (NIRC) of 1997 and other tax laws, rules and regulations. She holds office at the BIR National Office Building, Agham Road, Diliman, Quezon City.

On October 16, 2009, petitioner received a Letter of Authority (LOA) No. 2009 00003693 dated October 9, 2010 for the examination of petitioner's books of accounts and other accounting records for all internal revenue taxes for the period from April 1, 2006 to March 31, 2007.[4]

Thereafter, respondent issued a Post Reporting Notice[5] (PRN) dated February 22, 2010.

In a letter[6] dated March 16, 2010, respondent issued its resolution on petitioner's protest to the PRN. On March 26, 2010, petitioner filed a letter-reply thereto.[7]

On April 12, 2010, petitioner received a Preliminary Assessment Notice (PAN)[8] dated April 8, 2010 from respondent for alleged deficiency income tax and VAT covering the fiscal year ending March 31, 2007, together with the Details of Discrepancies[9] dated April 8, 2010 and a letter[10] dated April 8, 2010 from the BIR addressed to petitioner which states that, after investigation, it was disclosed that petitioner failed to file

[2] Exhibit "A", docket, p. 631.
[3] Exhibit "C", docket, p. 637.
[4] Exhibit "I", docket, p. 643.
[5] Exhibit "L", docket, p. 647.
[6] Exhibit "M", docket, pp. 652 to 656.
[7] Exhibit "N", docket, pp. 657 to 659.
[8] Par. 4, Admitted Facts, Joint Stipulation of Facts and Issues (JSFI), docket, p. 124; Exhibit "O", docket, pp. 660 to 661; Exhibit "10", BIR Records, pp. 395 to 396.
[9] Exhibit "P", docket, pp. 662 to 664.
[10] Exhibit "Q", docket, p. 665.

VAT returns and quarterly income tax returns and pay the taxes due thereon, as required by existing revenue laws, rules and regulation in relation to Section 255 of the NIRC of 1997, as amended. However, in lieu of instituting criminal action, respondent is amenable to settle the same extra-judicially, subject to condition that petitioner pay the corresponding compromise penalty amounting to P19,000.00 for the said violations pursuant to the schedules of suggested compromise penalties prescribed under Revenue Memorandum Order (RMO) No. 1-90 and Revenue Regulations (RR) No. 8-2002, as amended.

On April 26, 2010, petitioner filed its protest to the PAN addressed to former BIR Commissioner Joel L. Tan-Torres.[11]

On May 14, 2010[12], petitioner received the subject Formal Assessment Notice[13] dated May 12, 2010, together with Assessment Notices[14] and Details of Discrepancies[15] from respondent, requesting it to pay the following assessed deficiency tax liabilities for the fiscal year ending March 31, 2007:

1. Assessment Notice No. IT-TVN50190-FY07-10-0320 for deficiency income tax in the amount of P766,271.65, inclusive of interest;

2. Assessment Notice No. VT-TVN50190-FY07-10-0320 for deficiency value-added tax in the amount of P343,930.04, inclusive of twenty-five percent (25%) surcharge and interest; and

3. Assessment Notice No. MC-TVN50190-FY07-10-0320 for compromise penalty in the amount of P19,000.00.

Respondent assessed petitioner for deficiency income tax in the amount of P766,271.65, inclusive of interest, as a result of the adjustments/disallowances made on petitioner's taxable loss per return for alleged unsupported expenses, over-claimed

[11] Exhibit "R", docket pp. 666 to 669.
[12] Exhibit "11-a", BIR Records, p. 452; Exhibit "PP", docket, p. 141.
[13] Exhibit "S", docket, pp. 670 to 671.
[14] Exhibits "T", "U", and "V", docket, pp. 672 to 674.
[15] Exhibit "W", docket, pp. 675 to 677.

representation and entertainment, disallowed expenses for non-withholding, non-withholding of dues and subscription, undeclared income, and net operating loss carry-over (NOLCO).

Respondent likewise assessed petitioner for deficiency VAT of P343,930.04 as a result of the "unexplained source of funds resulting to undeclared income" which "is also subject to VAT under Title IV, Section 105 and 108 of the NIRC."[16]

On June 11, 2010, petitioner duly protested the said FAN and Assessment Notices and filed the documents necessary to support its protest.[17]

Due to respondent's inaction on the said protest, petitioner filed the instant Petition for Review with this Court on January 4, 2011.

Respondent filed her Answer[18] on February 14, 2011, interposing the following Special and Affirmative Defenses:

"**SPECIAL AND AFFIRMATIVE DEFENSES**

<u>Income Tax</u>

12) Verification disclosed that Petitioner has unsupported purchases and expenses in the amount of P243,745.00. Pursuant to Section 34(A)(1)(b) of the 1997 Tax Code, as amended, no deductions from the gross income shall be allowed unless the taxpayer shall substantiate with sufficient evidence, such as official receipts or other adequate records, the expenses being deducted;

13) Verification disclosed that Petitioner has representation and entertainment expense in the amount of P2,513,685.00. It claims that it is merely a representative office of a foreign corporation, which does not derive income from sources within the Philippines, however, Petitioner's Articles of Incorporation shows that it is engage in the promotion of the parent company's products, which is among the qualifying services that would allow it to be taxed as a Regional Operating Headquarters pursuant to BIR Ruling No. DA-092-03. Hence, the whole amount of the

[16] Par. 18, Answer, docket, p. 83; Exhibit "S", docket, pp. 670 to 671; Exhibit "W", docket, p. 677.
[17] Exhibit "X", docket, pp. 678 to 682.
[18] Docket, pp. 79 to 84.

representation and entertainment expense was disallowed considering that Revenue Regulation (RR) No. 10-02 dated 10 July 2002 prescribing a ceiling for the deduction of representation and entertainment expense only applies to domestic or resident foreign corporation;

14) Comparison of Petitioners income payments subject to Withholding Tax claimed per financial statement/Income Tax return as against the Alphalist disclosed that the professional fee in the amount of P222,998.00 was not subjected to Withholding Tax, hence, disallowed pursuant to Section 34(K) of the 1997 Tax Code, as amended;

15) Likewise, comparison of Petitioner's income payments subject to fringe benefit tax claimed per financial statement/income tax return as against the Quarterly Remittance Return of Final Income Taxes Withheld On Fringe Benefits Paid to Employees Other than Rank and File (BIR Form 1603) disclosed that dues and subscription was not subjected to Withholding Tax, hence disallowed, pursuant to Section 34(K) of the 1997 Tax Code, as amended;

16) Comparison of Petitioner's income payments subject to Withholding Tax claimed on its financial statement/Income Tax Return as against the Alphalist disclosed that there were expenses reported in the Alphalist, which were more than that declared in the financial statements/Income Tax Return in the amount of P1,524,401.50. The discrepancy was considered as undeclared revenue pursuant the Court of Tax Appeals vs. Perez and the Commissioner of Internal Revenue, L-10507 dated 30 May 1958;

17) Lastly, verification disclosed that Petitioner's operation resulted to a net loss in the amount of P240,390.00 as claim in its Income Tax Return. However, audit investigation disclosed that Petitioner has a Taxable Income of P4,591,834.50, thus, considering that the tax benefit of the net loss has already been forwarded to the succeeding periods as provided under Section 34(D)(3) of the 1997 Tax Code, as amended, the same must be added back to arrive at the adjusted taxable income;

Value Added Tax

18) The unexplained source of funds resulting to undeclared income, as discussed in the Income Tax, is also subject to VAT under Sections 105 and 108 of the 1997 Tax Code, as amended;

> 19) Finally, Assessments are prima facie presumed correct and made in good faith. The taxpayer has the duty of proving otherwise. In the absence of proof of any irregularities in the performance of official duties, an assessment will not be disturbed. All presumptions are in favor of tax assessments (Interprovincial Autobus Co. Inc. vs. Collector, 98 Phil 290; Cecilia Teodoro Dayrit vs. Hon. Fernando Cruz and Commissioner, L-39910, 26 September 1988; Bonifacia Sy Po vs. CTA and Commissioner, G.R. No. 81445, 18 August 1988;"

A Notice of Pre-Trial Conference was issued by the Court on March 1, 2011, setting the case for pre-trial conference on March 17, 2011.[19] Accordingly, Respondent's Pre-Trial Brief[20] and Petitioner's Pre-Trial Brief[21] were filed on March 14, 2011.

On April 6, 2011, the parties filed their Joint Stipulation of Facts and Issues.[22] A Pre-trial Order[23] was accordingly issued by the Court on April 29, 2011.

On October 24, 2011, upon motion of counsel for petitioner, this Court appointed Michael L. Aguirre, the Founding Partner of M.L. Aguirre and Co., CPAs, as Independent Certified Public Accountant (CPA) in the present case.[24]

During trial, petitioner presented the following as witnesses: Cristita A. Obaob[25], its accountant; Cresencio Mariano Rioja[26], its Assistant Manager for Customer Service; Kazuyuki Sekiguchi[27], its General Manager; and Michael L. Aguirre[28], the Court-commissioned Independent CPA. Thereafter, petitioner filed its Formal Offer of Evidence[29], submitting Exhibits "A" to "JJ" and "MM" to "KKK", inclusive of sub-markings and Supplemental Formal Offer of Evidence[30], submitting Exhibits "A-ICPA" to "T-ICPA-1", inclusive of sub-markings, on March 7, 2012. In the Resolution dated May 8,

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[19] Docket, p. 86.
[20] Docket, pp. 87 to 90.
[21] Docket, pp. 91 to 103.
[22] Docket, pp. 123 to 128.
[23] Docket, pp. 278 to 283.
[24] Minutes of Hearing dated October 24, 2011, docket, p. 533.
[25] Minutes of Hearing dated May 2, 2011, docket, p. 284.
[26] Minutes of Hearing dated June 27, 2011, docket, p. 375.
[27] Minutes of Hearing dated August 1, 2011, docket, p. 516.
[28] Minutes of Hearing dated February 1, 2012, docket, p. 606.
[29] Docket, pp. 614 to 630.
[30] Docket, pp. 804 to 865.

2012, this Court admitted in evidence Exhibits "A" to "KKK" and "A-ICPA" to "Q-36-ICPA", inclusive of sub-markings.[31]

On the other hand, respondent presented as her sole witness Jose Eric Almosara.[32] Thereafter, respondent filed her Formal Offer of Evidence[33] on November 28, 2012, submitting Exhibits "1" to "12", inclusive of sub-markings, which this Court admitted in the Resolution[34] dated January 31, 2013, except Exhibit "2".

This case was submitted for decision on March 20, 2013, considering petitioner's Memorandum filed on March 8, 2013 by registered mail and respondent's Manifestation (In Lieu of Submission of Memorandum) filed on February 11, 2013 by registered mail.[35]

ISSUES

The following are the parties' jointly stipulated issues[36] submitted for this Court's consideration:

"**D. ISSUES TO BE RESOLVED**

I. WHETHER OR NOT PETITIONER AS A LOCAL REPRESENTATIVE OFFICE OF SHINKO ELECTRIC INDUSTRIES CO., LTD, A CORPORATION ORGANIZED AND EXISTING UNDER THE LAWS OF JAPAN, DERIVE INCOME FROM ITS OPERATIONS AS SUCH REPRESENTATIVE OFFICE.

II. WHETHER OR NOT PETITIONER'S BUSINESS ACTIVITY IN THE PHILIPPINES FALLS WITHIN THE AMBIT OF THE TERM 'REPRESENTATIVE OR A LIAISON OFFICE' UNDER PARAGRAPH (C), SECTION 1, RULE 1 OF THE IMPLEMENTING RULES AND REGULATIONS OF THE FOREIGN INVESTMENTS ACT OF 1991.

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[31] Docket, pp. 1314 to 1315.

[32] Minutes of Hearing dated September 10, 2012, October 4, 2012, and October 24, 2012, docket, pp. 1335, 1338, and 1339; Exhibit "12", docket, pp. 1350 to 1357.

[33] Docket, pp. 1346 to 1349.

[34] Docket, pp. 1373 to 1374.

[35] Docket, p. 1433.

[36] Docket, pp. 126 to 127.

III. WHETHER OR NOT PETITIONER'S SEC REGISTERED ACTIVITY OF 'PROMOTION OF THE PARENT COMPANY'S PRODUCT' RENDERS PETITIONER LIABLE TO BE TAXED AS A REGIONAL OPERATION HEADQUARTERS DERIVING INCOME FROM THE PHILIPPINES.

IV. WHETHER OR NOT PETITIONER IS LIABLE FOR THE DEFICIENCY INCOME TAX COVERED BY ASSESSMENT NOTICE NO. IT-TVN50190-FY07-10-0320 FOR THE FISCAL YEAR ENDING MARCH 31, 2007 INCLUSIVE OF INTEREST UNTIL JUNE 18, 2010 IN THE AMOUNT OF PHP766,271.65.

V. WHETHER OR NOT PETITIONER IN RELATION TO ITS INCOME TAX DECLARATION:

A. HAS UNSUPPORTED EXPENSE IN THE AMOUNT OF PHP243,754.00

B. HAS UNDECLARED INCOME IN THE AMOUNT OF PHP1,524,401.50

C. WHETHER PETITIONER'S REPRESENTATION AND ENTERTAINMENT IN THE AMOUNT OF PHP2,513,685 SHOULD BE ALLOWED AS DEDUCTION FROM ITS GROSS INCOME.

D. WHETHER PETITIONER'S INCOME PAYMENTS COMPRISING OF INSURANCE AND PROFESSIONAL FEES IN THE AMOUNT OF PHP222,998.00 AND DUES AND SUBSCRIPTION IN THE AMOUNT OF PHP327,386 SHOULD BE ALLOWED AS DEDUCTION FROM THE GROSS INCOME.

VI. WHETHER OR NOT PETITIONER IS LIABLE FOR DEFICIENCY VALUE-ADDED TAX COVERED BY ASSESSMENT NOTICE NO. VT-TVN50190-FY07-10-0320 FOR THE FISCAL YEAR ENDING MARCH 31, 2007 INCLUSIVE OF INTEREST UNTIL JUNE 18, 2010 IN THE AMOUNT OF PHP343,930.04.

VII. WHETHER OR NOT PETITIONER IS LIABLE FOR COMPROMISE PENALTY IN THE AMOUNT OF PHP19,000.00."

The above-enumerated issues can be summarized as follows: L

"Whether or not petitioner is entitled to its prayer for the cancellation of the subject assessments for alleged deficiency income tax, VAT and compromise penalty in the aggregate amount of P1,129,201.69, inclusive of surcharge and interest, for fiscal year ending March 31, 2007."

DISCUSSION/RULING

a. Income Tax (P766,271.65)

In the Formal Assessment Notice[37] dated May 12, 2010, respondent assessed petitioner for deficiency income tax in the aggregate amount of P766,271.65, detailed as follows:

Taxable Income (Loss) per return		P (240,390.00)
Add: Adjustments/Disallowances		
a. Unsupported Expenses (Schedule 1)	P 243,754.00	
b. Overclaimed Representation and Entertainment	2,513,685.00	
c. Disallowed Expenses for Non-withholding (Schedule 2)	222,998.00	
d. Non-withholding of Dues and Subscription (Schedule 3)	327,386.00	
e. Undeclared Income (Schedule 4)	1,524,401.50	4,832,224.50
Taxable Income (Loss) per Audit		P4,591,834.50
Add: Net Operating Loss Carry Over (NOLCO)		240,390.00
Adjusted Taxable Income per Investigation		P4,832,224.50
Income Tax Due Per Investigation (10%)		P 483,222.45
Less: Tax Credits		-
Basic Tax Still Due		P 483,222.45
Add: Interest (7.16.07 to 06.18.10)		283,049.20
Total Amount Due		**P766,271.65**

Petitioner argues that it is a representative office of a foreign corporation, Shinko Electric Industries Co., Ltd., under the Foreign Investments Act of 1991 and does not derive any direct income from its operations as such. Corollarily, its promotion of the parent company's product does not render it liable as a regional operating headquarters subject to tax.

Petitioner claims that it does not sell the products of the head office, and its participation in the business of the head office is only limited to information dissemination and as liaison between the local client and the head office; its

[37] Exhibit "S", docket, pp. 670 to 671.

operational expenses are funded from Japan head office's regular remittances based on a budget that is approved by said head office; and as a representative office, it is considered as a non-resident foreign corporation not engaged in income-generating business in the Philippines, and is not subject to income tax under Section 23(F) of the NIRC of 1997, as amended.

Respondent, on the other hand, alleges that petitioner is liable for income tax based on Section 34(A)(1)(b) of the NIRC of 1997, as amended. As alleged by respondent, petitioner's Articles of Incorporation shows that it is engaged in the promotion of the parent company's products, which is among the qualifying services that would allow it to be taxed as a Regional Operating Headquarters pursuant to BIR Ruling No. DA-092-03. As a result, the whole amount of the representation and entertainment expense was disallowed considering that RR No. 10-02 dated July 10, 2002, which prescribes a ceiling for the deduction of representation and entertainment expense, only applies to domestic or resident foreign corporation.

Respondent also points out that professional fee and dues and subscriptions were not subjected to Withholding Tax, hence, disallowed pursuant to Section 34(K) of the 1997 Tax Code, as amended; that there were expenses reported in the Alphalist, which were more than that declared in the Financial Statements/Income Tax Return, and the discrepancy was considered as undeclared revenue as a consequence.

Respondent contends that while petitioner declared a net loss in the amount of P240,390.00 in its Income Tax Return, the audit investigation disclosed that petitioner has a Taxable Income of P4,591,834.50, thus, considering that the tax benefit of the net loss has already been forwarded to the succeeding periods as provided under Section 34(D)(3) of the NIRC of 1997, as amended, the same must be added back to arrive at the adjusted taxable income.

Section 23(F) of the NIRC of 1997, as amended, provides that a foreign corporation, whether engaged or not in trade or business in the Philippines, is taxable only on income derived from sources within the Philippines.

While the NIRC of 1997, as amended, did not define the term "representative office" as a distinct type of foreign corporate taxpayer, Section 1(c), Rule I of the Implementing Rules and Regulations of Republic Act (R.A.) No. 7042[38], as amended by R.A. No. 8179, provides a definition, *to wit*:

> "*Representative or liaison office* deals directly with the clients of the parent company **but does not derive income from the host country** and is **fully subsidized by its head office**. It undertakes activities such as but not limited to information dissemination and promotion of the company's products as well as quality control of products." (*Emphasis supplied*)

The closest to such entity under the NIRC of 1997, as amended, is called "regional or area headquarters" (RHQ or AHQ), which shall mean a branch established in the Philippines by multinational companies and which headquarters do not earn or derive income from the Philippines and which act as supervisory, communications and coordinating center for their affiliates, subsidiaries, or branches in the Asia-Pacific Region and other foreign markets.[39] Pursuant to Section 28(A)(6)(a) of the NIRC of 1997, as amended, RHQ or AHQ shall not be subject to income tax.

From the foregoing definitions, a representative office is similar to a RHQ or AHQ in that both do not derive income from the Philippines and are fully subsidized by their respective head offices. However, a representative office deals directly with the clients of the parent company as it undertakes activities such as, but not limited to, information dissemination and promotion of the company's products as well as quality control of products. On the other hand, the activities of a RHQ or AHQ are limited to acting as supervisory, communications and coordinating center for its subsidiaries, affiliates and branches in the Asia-Pacific region. It does not deal directly with clients of the parent company.

As mentioned earlier, a foreign corporation is taxable on income derived from sources within the Philippines. Income means "cash received or its equivalent". It is the amount of money coming to a person within a specific time; it means

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[38] Foreign Investments Act of 1991.
[39] Section 22(DD) of the NIRC of 1997, as amended.

something distinct from principal or capital. For, while capital is a fund, income is a flow. As used in our income tax law, "income" refers to the flow of wealth.[40]

Based on the above-quoted definition of a representative office, it is fully subsidized by its head office. Its subsidy is in the form of foreign inward remittances from its head office abroad which is utilized to cover its expenses.

In such case, the foreign inward remittances could not be considered "income" or flow of wealth, but a "subsidy", as referred to in Section 1(c) of Rule I of the Implementing Rules and Regulations of R.A. No. 7042, as amended by R.A. No. 8179. In other words, this subsidy represents a capital or fund which is distinct from income. It follows that unspent remittances, which must be considered a mere subsidy, should not be considered income subject to tax. With more reason, duly substantiated expenses paid out of the subsidy could not be considered as part of taxable gross income.

Hence, inasmuch as a representative office is not allowed to derive income from sources within the Philippines and is fully subsidized by its head office, it is not subject to Philippine income tax.

Evidence on record shows that petitioner has sufficiently established that it is a representative office, *to wit*:

1. Petitioner is duly licensed as a representative office by the Securities and Exchange Commission (SEC) to "undertake activities such as but not limited to information dissemination, promotion of the parent company's products, quality control of products as well as all other activities which may be legally undertaken by a representative office"[41];

2. Petitioner's accountant, Ms. Cristita A. Obaob, testified, by way of Judicial Affidavit[42], that petitioner's business activity is limited to information dissemination to local clients/customers of the products of Shinko Electric

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[40] *Commissioner of Internal Revenue vs. British Overseas Airways Corporation, et al.* G.R. Nos. L-65773-74, April 30, 1987

[41] Exhibit "A", docket, p. 631.

[42] Exhibit "PP", pages 3 and 8, docket, pp. 137 and 142.

Industries Co., Ltd. in Japan. While "promotion of the parent company's product" is indicated in petitioner's license, such promotion is limited to mere promotion of the products of its Japan parent company. Negotiations for price, terms of payment and delivery of the product are all undertaken by the parent company. Petitioner's task is limited only to introducing the product to its client in the Philippines based on the product specifications dictated by the parent company;

3. Petitioner's General Manager, Mr. Kazuyuki Sekiguchi, testified, by way of Judicial Affidavit[43], that petitioner was never involved in any sales transaction. Petitioner carries out activities like providing information to clients, and maintaining contacts with clients and main office. Task such as signing a contract and invoicing are never done by petitioner. As a representative office, petitioner is not allowed to determine anything regarding sales activities, including price and other conditions pertaining to obtaining an order. Theses activities are all undertaken by and contracts are entered into between the customer and the head office as seen in the Purchase Order[44] of one local client;

4. Petitioner's Assistant Manager for Customer Service, Mr. Cresencio Mariano Rioja, testified, by way of Judicial Affidavit[45], that petitioner's customer service acts as a bridge between the customer and the head office in Japan, the primary purpose of which is to provide education to the customer and help resolve any concern with regard to the products they bought from the head office. Petitioner assists the Philippine clients of the head office by coordinating their inquiries with the head office in Japan, providing information to clients as well as product demonstration, and maintaining contacts with clients and the head office. Moreover, local customers are aware that petitioner is only a representative office and not a sales office because they are given copies of Shinko Electric Industries Co., Ltd.'s Corporate Profile[46] and brochures[47]

[43] Exhibit "GGG", page 4, docket, p. 379.
[44] Exhibit "DDD", docket, pp.798 to 800.
[45] Exhibit "XX", pages 2 and 4 to 5, docket, pp. 295 and 297 to 298.
[46] Exhibit "QQ-1-a", docket, p. 764.

which clearly show that the Manila office is only a representative office; and

5. Petitioner is fully subsidized by Shinko Electric Industries Co., Ltd. in Japan[48] as evidenced by the monthly Inward Remittance Advice from its parent company[49], Audited Financial Statement of petitioner for fiscal year ended March 2007[50] and Independent CPA Report[51].

Thus, it was erroneous for respondent to tax petitioner as a "regional operating headquarter" which is defined as a foreign business entity which is allowed to derive income in the Philippines by performing qualifying services[52] to its affiliates, subsidiaries or branches in the Philippines, in the Asia-Pacific Region and in other foreign markets[53].

In this case, petitioner directly deals with the clients of the parent company and does not deal with its affiliates, subsidiaries or branches; it is fully subsidized by its head office and it basically undertakes information dissemination, product promotion, and acts as a liaison/coordinating office between the local clients and the head office which are allowed activities of a representative office. It does not conclude contracts of local clients on behalf of its parent company.

Now, to determine whether petitioner was properly assessed of taxable income derived in the Philippines.

In this case, based on respondent's computation of taxable income, it appears that petitioner was assessed of deficiency income tax due to the following adjustments and disallowances, which were considered as taxable income:

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[47] Exhibit "RR-1-a", docket, p. 768; Exhibit "SS-1-a", docket, p. 770; Exhibit "TT-1", docket, p. 776; Exhibit "UU-1", docket, p. 784; and Exhibit "VV-1", docket, p. 788.

[48] Exhibit "PP", page 9, docket, p. 143; Exhibit "GGG", page 5, docket, p. 380.

[49] Exhibit "Y" to "JJ", docket, pp. 683 to 730.

[50] Exhibit "OO", docket, pp. 740 and 743.

[51] Exhibit "JJJ", docket, pp. 540 to 541 and 546.

[52] General administration and planning; business planning and coordination; sourcing/procurement of raw materials and components; corporate finance advisory services; marketing control and sales promotion; training and personnel management; logistics services; research and development services, and product development; technical support and maintenance; data processing and communication; and business development.

[53] Section 2(3) of R.A. No. 8756 (An Act Providing for the Terms, Conditions and Licensing Requirements of Regional or Area Headquarters, Regional Operating Headquarters and Regional Warehouses of Multinational Companies, Amending for the Purpose Certain Provisions of Executive Order No. 226, Otherwise Known as the Omnibus Investments Code of 1987).

a. Unsupported Expenses (Schedule 1)	P 243,754.00
b. Overclaimed Representation and Entertainment	2,513,685.00
c. Disallowed Expenses for Non-withholding (Schedule 2)	222,998.00
d. Non-withholding of Dues and Subscription (Schedule 3)	327,386.00
e. Undeclared Income (Schedule 4)	1,524,401.50
Total	**P4,832,224.50**

Except for the Undeclared Income (Schedule 4), the alleged Unsupported Expenses, Overclaimed Representation and Entertainment, Disallowed Expenses for Non-withholding, and Non-withholding of Dues and Subscription could not be directly considered as flow of wealth. At best, respondent made a mathematical computation that avers the existence of "taxable income". Here, no evidence was presented by respondent to prove that actual income was derived by petitioner in the Philippines apart from the said computation stated in the assessments. The above-mentioned expenses that were considered income by respondent were funded from petitioner's subsidy remitted by its head office abroad[54], which is actually consistent with the use of the subsidy. Petitioner's witnesses, Cristita A. Obaob[55] and Kazuyuki Sekiguchi[56], testified on the circumstances of these inward remittances from its head office in Japan to petitioner in the Philippines. Clearly, these remittances from petitioner's head office in Japan were duly established.

On the other hand, the purported Undeclared Income (Schedule 4) was likewise computed by respondent because there was a supposed discrepancy of expenses reported in petitioner's Alphalist and Financial Statements/Income Tax Return. Clearly, this is mere conjecture not valid to support the finding of taxable income.

b. Value-added Tax (P343,930.04)

Respondent assessed petitioner for deficiency VAT in the amount of P343,930.04, alleging that the unexplained source of funds resulting in petitioner's undeclared income is also subject to VAT under Sections 105 and 108 of the NIRC of 1997, as amended, computed as follows:

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[54] Exhibits "Y" to "JJ", docket, pp. 683 to 730.
[55] Exhibit "PP", page 9, docket, p. 143.
[56] Exhibit "GGG", page 5, docket, p. 380.

VALUE-ADDED TAX		
Revenue per VAT Return		-
Add: Undeclared Income (Schedule 4)		P1,524,401.50
Total VATable Receipts per Investigation		P1,524,401.50
Output Tax per Investigation		P 182,928.18
Less: Input Tax Credits		-
VAT Payable		P 182,928.18
Less: VAT paid per return		
Amount Still Due		P 182,928.18
Add: 25% Surcharge	P 45,732.05	
Interest (4.26.07 to 06.18.10)	115,269.81	161,001.86
Total Amount Due		**P343,930.04**

On the other hand, petitioner argues that it does not derive income from its activity of promoting the parent company's products; hence, it is not only exempt from payment of income tax but also of VAT, citing Sections 105 and 108 of the NIRC of 1997, as amended, and BIR Ruling No. DA (VAT-084) 529-2009 dated September 10, 2009.

VAT was assessed by respondent on the assumption that the "Undeclared Income" under "Adjustments/Disallowances" in its deficiency income tax assessment was taxable income. As discussed above, the adjustments and disallowances were not shown to be "flow of wealth" or taxable income. Hence, the same could not be subject to VAT.

VAT is imposed, *inter alia*, on sale of goods and services under Sections 105, 106 and 108 of the NIRC 1997, as amended. Here, respondent failed to establish that petitioner derived revenues from sale of goods and services.

Moreover, as discussed above, inasmuch as representative offices do not derive income from the Philippines and are fully subsidized by its head office similar to RHQ or AHQ, which are exempt from VAT under Section 109(J) of the NIRC of 1997, as amended, representative offices are likewise exempt from VAT.

c. **Compromise Penalty (P19,000.00)**

Since there is no showing that petitioner voluntarily entered into a compromise agreement with respondent, the compromise penalty of P19,000.00 shall be cancelled. /

Under Revenue Memorandum Order No. 01-90, as amended, compromise penalties are amounts suggested in settlement of criminal liability, and may not be imposed or exacted on the taxpayer in the event that a taxpayer refuses to pay the same. Therefore, compromise penalties imply mutual agreement between the taxpayer, on one hand, and the Commissioner of Internal Revenue, on the other. Absent any showing that petitioner consented to the compromise penalties, the same should not be imposed. The imposition of the same without the conformity of the taxpayer is illegal and unauthorized.[57]

The settled rule is that tax laws must be construed in favor of the taxpayer and strictly against the government; and that a tax cannot be imposed without clear and express words for that purpose.[58]

In view of the foregoing discussion, this Court deems it unnecessary to resolve the other arguments and issues raised by the parties.

WHEREFORE, premises considered, the instant Petition for Review is hereby **GRANTED**. Accordingly, the Formal Assessment Notice dated May 12, 2010 and Assessment Notice No. IT-TVN50190-FY07-10-0320 for deficiency income tax, Assessment Notice No. VT-TVN50190-FY07-10-0320 for deficiency value-added tax and Assessment Notice No. MC-TVN50190-FY07-10-0320 for the compromise penalty all dated May 12, 2010, including surcharges and interests, in the aggregate amount of P1,129,201.69, issued by respondent against petitioner covering fiscal year ending March 31, 2007 are hereby **CANCELLED** and **WITHDRAWN** for lack of factual and legal basis.

SO ORDERED.

AMELIA R. COTANGCO-MANALASTAS
Associate Justice

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[57] *Commissioner of Internal Revenue vs. Lianga Bay Logging Co., Inc., et al.*, G.R. No. L-35266, January 21, 1991.

[58] *Michel J. Lhuillier Pawnshop, Inc. vs. Commissioner of Internal Revenue*, G.R. No. 166786, May 3, 2006.

CONCURS:

LOVELL R. BAUTISTA
Associate Justice

ATTESTATION

I attest that the conclusions in the above Decision were reached in consultation before the case was assigned to the writer of the opinion of the Court's Division.

LOVELL R. BAUTISTA
Associate Justice
Chairperson

CERTIFICATION

Pursuant to Section 13, Article VIII of the Constitution and the Division Chairperson's Attestation, it is hereby certified that the conclusions in the above Decision were reached in consultation before the case was assigned to the writer of the opinion of the Court.

ROMAN G. DEL ROSARIO
Presiding Justice