REPUBLIC OF THE PHILIPPINES
Court of Tax Appeals
QUEZON CITY

SECOND DIVISION

CS GARMENTS, INC.,
Petitioner,

C.T.A. CASE NO. 6520

Members:

- versus -

CASTAÑEDA, JR., *Chairperson*
UY, *and*
PALANCA-ENRIQUEZ, *JJ.*

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Promulgated:

JAN 0 4 2007

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DECISION

CASTAÑEDA, JR., *J*.:

This case is an appeal for the cancellation of the five (5) assessments issued by respondent against petitioner covering alleged deficiency value-added tax (VAT) on other income (local sales and sale of motor vehicle), income tax at normal rate on other income (local sales), documentary stamp tax (DST) on lease agreements, expanded withholding tax (EWT) on rentals and income tax at special rate on disallowed expenses for taxable year 1998 in the aggregate amount of P2,046,580.10.

Petitioner is a domestic corporation duly organized and existing under and by virtue of the laws of the Philippines with principal office at Road A, Cavite Ecozone, Rosario, Cavite.[1] On the other hand, respondent is the duly appointed Commissioner of Internal Revenue of the Philippines authorized under law to perform the duties of said office, including, *inter alia*, the power to assess taxpayers for allegedly deficiency internal revenue tax liabilities and to act upon administrative protests or requests for reconsideration/reinvestigation of such assessments.[2]

Petitioner is registered with the Philippine Economic Zone Authority (PEZA) under Certificate of Registration No. 89-064, duly approved on December 18, 1989. As such, it is engaged in the business of manufacturing garments for sale abroad.[3]

On November 24, 1999, petitioner received from respondent Letter of Authority No. 00012641 dated November 10, 1999, authorizing the examination of petitioner's books of accounts and other accounting records for all internal revenue taxes covering the period January 1, 1998 to December 31, 1998.[4]

On October 23, 2001, petitioner received five (5) formal demand letters with accompanying Assessment Notices from respondent, through the Office of the Revenue Director of Revenue Region No. 9, San Pablo City, requiring it to pay the alleged deficiency VAT, Income, DST and withholding tax

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[1] par. 1, Facts Admitted, Records, p. 125
[2] par. 2, Facts Admitted, Records, p. 125
[3] par. 3, Facts Admitted, Records, p. 125
[4] page 129, BIR Records

assessments for taxable year 1998 in the aggregate amount of P2,046,580.10,[5] broken down as follows:

Deficiency VAT		
Basic tax due		P 314,194.00
Add:	Surcharge	157,097.00
	Interest	188,516.00
		P 659,807.00
Total Amount Payable		
Deficiency Income Tax (at Normal Rate of 34%)		
Basic tax due		P 78,639.00
Add:	Surcharge	39,320.00
	Interest	43,251.00
Total Amount Payable		**P 161,210.00**
Deficiency Income Tax (at Special Rate of 5%)		
Basic tax due		P 742,574.10
Add:	Surcharge	-
	Interest	408,416.00
	Compromise Penalty	25,000.00
Total Amount Payable		**P 1,175,990.10**
Deficiency DST		
Basic tax due		P 806.00
Add:	Surcharge	403.00
	Interest	484.00
Total Amount Payable		**P 1,693.00**
Deficiency EWT		
Basic tax due		22,800.00
Add:	Surcharge	11,400.00
	Interest	13,680.00
Total Amount Payable		**P 47,880.00**
GRAND TOTAL		**P 2,046,580.10**

On November 20, 2001, or within the 30-day period prescribed under Section 228 of the Tax Code, as amended, petitioner filed a formal written protest with the respondent assailing the above assessments.[6]

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[5] par. 4, Facts Admitted, Records, pp. 125-126
[6] par. 5, Facts Admitted, Records, p. 126

On January 11, 2002, or within the sixty-day period after the filing of the protest, petitioner submitted to the Assessment Division of Revenue Region No. 9, San Pablo City, additional documents in support of its protest.[7]

Respondent failed to act with finality on the protest filed by petitioner within the period of one hundred eighty (180) days from January 11, 2002 or until July 10, 2002. Hence, petitioner appealed before this Court via a Petition for Review filed on August 6, 2002 or within thirty (30) days from the last day of the aforesaid 180-day period.

The issues posed for this Court's resolution are:

1. Whether or not the formal assessment notices comply with the requirements of law;

2. Whether or not sale of petitioner's vehicle to its President should be assessed for VAT;

3. Whether or not petitioner is liable for VAT on local sales which were generated by petitioner in 1998 from its participation in the trade fairs conducted by the Cavite EPZA, or if the same is regarded as technical importation;

4. Whether or not petitioner reported all its sales, export and domestic, for taxable year 1998 and paid the corresponding taxes thereof;

5. Whether or not petitioner is subject to Documentary Stamp Taxes on the lease agreements it entered into;

6. Whether or not petitioner is liable for deficiency expanded withholding tax on its rental payments to the PEZA; and

7. Whether or not the examiners were correct in disallowing expenses of petitioner, as listed in stipulation of fact, par. 7, and if petitioner is liable for deficiency income tax thereon.

The first issue relates to the requirement under Section 228 of the National Internal Revenue Code (NIRC) of 1997 that the taxpayer should be

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[7] par. 6, Facts Admitted, Records, p. 126

informed in writing of the law and the facts on which the assessment is made, otherwise, the assessment shall be void.

Petitioner maintains that the five (5) formal assessment notices (FANs) issued by the respondent against it are void for failure to state the facts and the law which gave rise to the deficiency tax assessments. The FANs merely gave a brief rundown of figures which petitioner allegedly failed to pay and the corresponding total amount.

We disagree.

This Court is convinced that respondent duly apprised petitioner of the factual and legal bases in finding the latter liable to the deficiency income tax on disallowed expenses pursuant to Section 228 of the National Internal Revenue Code (NIRC) of 1997, as amended. As can be seen in the letter of demand dated October 15, 2001 and the attached Schedule of Discrepancies, respondent provided a detailed breakdown of the disallowed expenses which resulted to the said assessment. Likewise, respondent cited Rule XX, Section 2 of the Rules and Regulations of Republic Act No. 7916 as legal basis for the disallowances.

At a glance, respondent likewise complied with Section 228 of the 1997 NIRC, as amended, in arriving at the assessments for deficiency EWT, DST and VAT for taxable year 1998. Although in the letters of demand respondent may not have specified the legal provisions supporting his conclusion, it is sufficient that the nature of taxes allegedly unpaid by petitioner is indicated therein. One would know with certainty the applicable provisions of law pertaining to DST on lease agreements, 10% VAT on local sales, 5% EWT on rental expenses with reference to the figures in the form of numerical representations stated in the letters of demand.

The phrase "in writing" under Section 228 is not exclusively confined to written words but includes figures. "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.[8] In whatever form and manner, as long as the taxpayer is informed how the assessment was made, then, there is no violation of Section 228 of the 1997 NIRC, as amended.

It bears stressing that in the protest, petitioner did not question the infirmity of the assessment notice and letter of demand involving the 10% VAT on local sales. Well-settled is the rule that the Court cannot take cognizance of matters raised for the first time on appeal.[9]

Further, the Court cannot give credence to petitioner's assertion that the deficiency income tax assessment on the alleged undeclared local sales is devoid of factual and legal bases.

It must be pointed out that it was petitioner who offered the Schedule of Other Income[10] demonstrating the breakdown thereof giving rise to the assessment for deficiency income tax on local sales of P1,541,936.60 at the rate of 34%. Without the supporting documents proffered by petitioner, respondent would not have ascertained its liabilities pertaining to income tax on local sales and the other tax deficiencies.

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[8] Black' Law Dictionary, Sixth Edition, page 1609 cited in Subic Power Corporation vs. Commissioner of Internal Revenue, CTA Case No. 6059, May 8, 2003
[9] Victorias Milling Company, Inc. vs. Court of Appeals, 333 SCRA 663
[10] Exhibit I1

Considering that in its protest, petitioner did not question the validity of the assessment for deficiency VAT under Section 228 of the 1997 NIRC, as amended, the Court sees no reason why it is raising the same infirmity concerning the assessment for deficiency income tax on local sales as both taxes refer to the same tax base.

Thus, the mere fact that petitioner intelligently rebutted respondent's assessments for deficiency 5% income tax on disallowed expenses, 34% income tax on local sales, EWT, DST and VAT, demonstrates respondent's compliance with Section 228 of the 1997 NIRC, as amended.

Anent petitioner's allegation that respondent arbitrarily and unjustifiably imposed 50% surcharge on all of the subject deficiency tax assessments without even stating the factual and legal bases for the imposition thereof, this Court observes that it was stated in all of the demand letters that "The 50% surcharge has been imposed to the provisions of Section 248(B) of the National Internal Revenue Code, as amended by R.A. No. 8424, which took effect on January 1, 1998." However, since the 50% surcharge has been imposed without any evidence or justification whatsoever, this Court hereby deletes the same on the deficiency taxes due on income tax on local sales, VAT, DST and EWT. Respondent, who bears the *onus* of proof, failed to establish willful neglect to file a return, fraud or falsity on the part of petitioner. Fraud is a question of fact, which must be alleged and proven. It is a serious charge and to be sustained, must be supplied by clear and convincing evidence.[11]

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[11] Republic vs. Ker & Co., Ltd., 18 SCRA 207; Commissioner of Internal Revenue vs. Ayala Securities, 70 SCRA 204

Inasmuch as We are upholding the validity of the assessments as to form (pursuant to Section 228 of the NIRC of 1997), We shall proceed to the resolution of the remaining issues which delve on the substantive aspect of the subject assessments, enumerated as follows:

	TYPE OF DEFICIENCY TAX	TOTAL TAX DUE (W/ INCREMENTS)
I.	VAT ON OTHER INCOME	P 659,807.00
II.	DST ON LEASE AGREEMENT	1,693.00
III.	EWT ON RENTAL	47,880.00
IV.	INCOME TAX	
	A. INCOME TAX AT REGULAR RATE OF 34% ON OTHER INCOME	161,210.00
	B. INCOME TAX AT SPECIAL RATE OF 5% ON DISALLOWED EXPENSES	1,175,990.10
	TOTAL	**P 2,046,580.10**

I. VAT ON OTHER INCOME – P659,807.00

In arriving at the deficiency VAT assessment of P659,807.00, respondent imposed 10% VAT on petitioner's: a) local sales in the amount of P1,541,936.60 and b) proceeds from sales of property, plant & equipment (PPE) in the amount of P1,600,000.00 computed below:

Local sales	P1,541,936.60	
Add: proceeds from sales of PPE	1,600,000.00	P3,141,936.60
rate of VAT		10%
VAT Due		P 314,194.00
Add: 50% surcharge		157,097.00
Interest		188,516.00
Total deficiency tax due & payable		P 659,807.00

A. Local Sales – P1,541,936.60

Petitioner submits that the local sales in the amount of P1,541,936.60 being subjected to VAT were generated from its participation in the trade fairs conducted by the Cavite Export Processing Zone Authority as well as from its sales to its employees. Pursuant to Section 2, Rule VIII, Part V of the PEZA

Rules and Regulations implementing Republic Act No. 7916 and as clarified in Section 5(1) of Revenue Memorandum Circular (RMC) No. 74-99, the said sales are allegedly considered technical importation of the domestic buyers located in the customs territory (i.e., outside of the ECOZONE). In which case, the buyers and not herein petitioner (seller) are the ones liable for the corresponding customs duties and VAT.

Respondent argues that petitioner failed to consider that goods destined for use or consumption within the Philippines shall be subject to the 10% VAT. Thus, in its sale of goods within the customs territory, petitioner became liable for the VAT, which formed part of the goods during the said trade fair.

We agree with the respondent.

In its protest-letter dated November 19, 2001 *(Exhibit "V"),* petitioner stated that "[t]he alleged local sales being subject to VAT were generated by the company for the year 1998 from its participation in the trade fairs conducted by the Cavite Export Processing Zone Authority as well as its sales to its employees". Furthermore, petitioner admitted that "[t]hese sales were made to buyers located in the Customs Territory". Although a Zone Export Enterprise, like the petitioner, is generally engaged in exporting its finished product, it is not prohibited from making domestic sales pursuant to Section 26 of Republic Act No. 7916 entitled *"An Act Providing For The Legal Framework And Mechanisms For The Creation, Operation, Administration, And Coordination Of Special Economic Zones In The Philippines, Creating For This Purpose, The Philippine Economic Zone Authority (PEZA), And For Other Purposes",* which provides as follows:

"SECTION 26. *Domestic Sales.* – Goods manufactured by an ECOZONE enterprise shall be made available for immediate retail sales in the domestic market, **subject to payment of corresponding taxes on the raw materials and other regulations** that may be adopted by the Board of the PEZA.

However, in order to protect the domestic industry, there shall be a negative list of industries that will be drawn up by the PEZA. Enterprises engaged in the industries included in the negative list shall not be allowed to sell their products locally. Said negative list shall be regularly updated by the PEZA.

The PEZA, in coordination with the Department of Trade and Industry and the Bureau of Customs, shall jointly issue the necessary implementing rules and guidelines for the effective implementation of this section." *(Emphasis supplied)*

Pursuant to the above-quoted provision of Republic Act No. 7916, the Board of Directors of the Philippine Economic Zone Authority (PEZA) promulgated the *"Rules and Regulations to Implement Republic Act No. 7916, otherwise known as the Special Economic Zone Act of 1995".* Section 5 of Rule VIII thereof provides that *domestic sales* shall be subject to all applicable rules and regulations including the payment of customs duties and internal revenue taxes, thus:

"SECTION 5. *Domestic Sale.* – Finished products of registered Export or Free Trade Enterprises not included in the negative list shall be made available for domestic sale in the customs territory or retail stores/shopping malls within the commercial/tourist or other authorized areas of the ECOZONES, **subject to all applicable rules and regulations including the payment of customs duties and internal revenue taxes**, to the applicable provisions of the Retail Trade Nationalization Law, as amended, and to such other regulations or limitations as may be adopted by the Board." *(Emphasis supplied)*

Moreover, the aforementioned rules and regulations further provides, in Section 3 of Rule X thereof that "[m]erchandise or goods may be taken into or brought out of the restricted areas of the ECOZONES only upon *prior approval or permit* by the PEZA in accordance with its documentation and security procedures".

Indeed, domestic sales are allowed subject to certain conditions to be complied with by the Zone Export Enterprise particularly regarding the payment of internal revenue taxes and customs duties and the documents required for the entry and exit of goods to and from the "restricted areas" of the ECOZONES. More particularly, Section 4 of Rule X requires the accomplishment of PEZA prescribed forms and the submission of the documents relative to the importation, exportation or entry of the goods into the customs territory:

> "SECTION 4. *Prescribed Forms.* – The application for the entry or exit permit of goods shall be filed by the ECOZONE Export or Free Trade Enterprise or entity concerned in the form prescribed by the PEZA. The PEZA shall require the submission of shipping, commercial and other pertinent documents relative to the **importation**, **exportation**, or **entry** into the customs territory of said goods." *(Emphasis supplied)*

Finished products of a Zone Export Enterprise, such as herein petitioner, may therefore be introduced into the customs territory in three (3) different ways, these are: (1) importation, (2) exportation, or (3) entry.

The finished goods locally sold by petitioner in the Cavite Export Processing Zone Trade Fair and its finished goods sold to its employees were introduced into the customs territory by *"entry"*. It is not disputed that the finished goods were sold at the trade fair to the public at large. Consequently, such sales are "domestic sales".

Parenthetically, petitioner attached photocopies of an Informal Import Entry Declaration (Bureau of Customs Form 177), BOC official receipt for the duties and taxes paid on the importation, and Application for permit to bring goods from the zone into the customs territory (PEZA Form 8106) to its Supplemental Protest dated January 9, 2002 *(Exhibit W)* to prove that the alleged local sales were in fact importations made by the buyers from the Customs Territory. However, the Informal Import Declaration and Entry is undated and in the name of PEZA TRADE FAIR, the BOC Official Receipt is in the name of the petitioner and dated 3/5/01 and the Application for Permit to Bring Goods From the Zone Into the Customs Territory dated 09 November 2000 shows petitioner as the Consignee/Importer. It is significant to note that the documents submitted do not correspond to the taxable year in question which is 1998 only.

Similarly, the sales made by the petitioner to its employees cannot be considered as an "importation" because the PEZA Rules and Regulations has a particular provision regarding "sales to employees" requiring prior written permission from the PEZA. However, petitioner failed to show proof that it was authorized by the PEZA to sell its finished goods to its employees pursuant to Section 9 of Rule X of the PEZA Rules and Regulations which provides:

> "SECTION 9. *Written Permission.* – Products made in the restricted areas of the ECOZONES, samples thereof and/or imported raw materials **shall not be given nor sold by an Export or Free Trade Enterprise to its visitors, workers, or employees** without prior written permission from the PEZA." *(Emphasis supplied)*

Since petitioner violated the above-quoted provision requiring a written permission from the PEZA before it can sell its finished product to its visitors, workers, or employees, its sales to its employees shall likewise be considered as "domestic sales" that is subject to the payment of internal revenue taxes in the same way as petitioner's sales at the local trade fairs. It both cases, petitioner was not able to show that it is exempt from the payment of the value-added tax. It is well-settled that exemptions from taxation are not favored and tax statutes are to be construed in *strictissimi juris* against the taxpayer and liberally in favor of the taxing authority.

"Laws must receive sensible interpretation to promote the ends for which they are enacted. They should be so given reasonable and practical construction as will give life to them, if it can be done without doing violence to reason. Conversely, a law should not be so construed as to allow the doing of an act which is prohibited by law nor so interpreted as to afford an opportunity to defeat compliance with its terms, create an inconsistency, or contravene the plain words of the law. *Interpretatio fienda est ut res magis valeat quam pereat* or that interpretation as will give the thing efficacy is to be adopted."[12] *(Citations omitted)* To agree with the petitioner's argument that it is not liable because it is not the importer would result to an absurdity. It could not be the intention of the law to run after all buyers of petitioner's finished goods at a trade fair because it is impracticable.

B. Proceeds from sale of property, plant and equipment – P1,600,000.00

Petitioner asserts that the amount of P1,600,000.00 representing proceeds from the sale of its motor vehicle, a Mercedes Benz, to its General Manager, Mr. Claus Sudhoff, as shown by the Deed of Absolute Sale executed by petitioner and Mr. Sudhoff,[13] cannot be subject to VAT pursuant to Section 105 of the NIRC of 1997, as amended, which applies to transactions made in the ordinary course of business of a taxpayer. Petitioner's sale of the motor vehicle to Mr. Sudhoff was not made in the

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[12] AGPALO, Statutory Construction, Third Edition, 1995, p. 202.
[13] Exhibit D

ordinary conduct of its trade or business because the former is primarily engaged in the manufacture and sale of garments for export. The sale of the Mercedez Benz was an isolated transaction and undertaken only once in order to dispose petitioner's capital asset.

We disagree.

Section 105 of the NIRC of 1997, as amended, states that:

> "SEC. 105. *Persons Liable.* – Any person who, in the course of trade or business, sells, barters, exchanges, leases goods or properties, renders services, and any person who imports goods shall be subject to value-added tax (VAT) imposed in Sections 106 to 108 of this Code.
>
> x x x xxx xxx
>
> "The phrase 'in the ordinary course of trade or business' means the regular conduct or pursuit of a commercial or an economic activity, **including transactions incidental thereto**, by any person regardless of whether or not the person engaged therein is a non-stock, non-profit private organization (irrespective of the disposition of its net income and whether or not it sells exclusively to members or their guests), or government entity. *(Emphasis supplied)*

Based on the foregoing, the VAT is imposed on a sale or transaction entered into by a person in the course of any trade or business. A transaction will be characterized as having been entered into by a person in the course of trade or business if it is: (1) regularly conducted; and (2) undertaken in pursuit of a commercial or economic activity. Likewise, transactions that are made incidental to the pursuit of a commercial or economic activity are considered as entered into in the course of trade or business. "Incidental" means something else as primary; something necessary, appertaining to, or depending upon another, which is termed the principal.[14] Hence, an isolated transaction is not necessarily disqualified from being made incidentally in the course of trade or business.

Here, petitioner's primary business is the manufacturing of garments for sale abroad. In carrying-out its business, petitioner acquired and eventually sold a Mercedes Benz to its General Manager Mr. Sudhoff. Prior to the sale, the motor vehicle formed part of petitioner's capital assets, specifically under the account, "Property, Plant and Equipment". The Rules on International Accounting Standards (IAS)16 defines Property, Plant and Equipment as follows:

> "6. Definitions
>
> Property, plant and equipment are tangible assets that:
>
> (a) are held by an enterprise **for use in the production or supply of goods or services**, for rental to others, or **for administrative purposes**; and
>
> (b) are expected to be used during more than one period." (Emphasis supplied)

Therefore, the sale of the motor vehicle is an incidental transaction because the said vehicle was purchased and used in furtherance of petitioner's business.

Once an activity has been identified as a business, any supply[sales] made while carrying it on is likely to be made in the course or furtherance of business. No distinction is made between capital and revenue items. Thus, a supply[sales] in the course or furtherance of business includes: (1) *the*

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[14] DEOFERIO, JR. AND MAMALATEO, The Value Added Tax In The Philippines, First Edition, pp. 81-82.

disposition of the assets and liabilities of a business; (2) the disposition of a business as going concern; and (3) anything done in connection with the termination or intended termination of a business.[15]

Moreover, under Rule XV of the PEZA Rules and Regulations, petitioner is prohibited from selling or otherwise disposing of capital equipment acquired under the incentives granted to an ECOZONE Export and Free Trade Enterprise. Section 1 (A) (2) of Rule XV provides as follows:

> "SECTION 1. Exemption from Duties and Taxes on Merchandise. – xxx
>
> A. Importation of Capital Equipment
>
> 1. xxx xxx xxx
>
> 2. Sale or Disposition of Capital Equipment – Any sale, transfer, assignment, donation or other form of disposition of originally imported capital equipment/machinery including spare parts, brought into the ECOZONE duty and tax-free, within five (5) years from date of acquisition shall require prior approval of the Board. xxx xxx xxx
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> xxx xxx xxx
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> If the ECOZONE Export or Free Trade Enterprise sells, transfers or disposes of these machinery, equipment and spare parts without prior approval of the Board within five (5) years from date of acquisition , the ECOZONE Export or Free Trade Enterprise and the vendee, transferee, or assignee shall be solidarily liable **to pay twice the amount of the tax exemptions granted**.
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> Any sale, transfer, assignment, donation or other form of disposition of capital equipment, brought into the ECOZONE duty and tax-free, after five (5) years from date of acquisition shall require prior approval of the PEZA Director-General." *(Emphasis supplied)*

The Deed of Absolute Sale *(Exhibit D)* covering the subject vehicle shows that the vehicle is a 1996 model of Mercedes Benz E-320 and that the

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[15] *Ibid.*, p. 83.

Deed of Absolute Sale is dated 30 September 1998. Clearly, the subject vehicle was sold by the petitioner within the five-year period from acquisition date without any proof that said sale was with the approval of the Board. Petitioner should have been made liable for twice the amount of tax exemptions granted pursuant to the afore-quoted provision, in addition to the deficiency value added tax.

In sum, this Court finds the deficiency VAT assessment related to the local sales of petitioner as proper except for the imposition of the 50% fraud surcharge. Respondent was not able to prove the existence of fraud. As ruled by the Supreme Court, the 50% fraud surcharge cannot be imposed on a mere presumption of fraud, thus:

> "The lower court's conclusion regarding the existence of fraudulent intent to evade payment of taxes was based merely on a presumption and not on evidence establishing a willful filing of false and fraudulent returns so as to warrant the imposition of the fraud penalty. 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 the law. It must amount to intentional wrong-doing with the sole object of avoiding the tax. It necessarily follows that a mere mistake cannot be considered as fraudulent intent, and if both petitioner and respondent Commissioner of Internal Revenue committing mistakes in making entries in the returns and in the assessment, respectively, under the inventory method of determining tax liability, it would be unfair to treat the mistakes of the petitioner as tainted with fraud and those of the respondent as made in good faith."[16]

Therefore, petitioner is liable to pay the amount of P581,258.50 representing deficiency VAT on petitioner's domestic sales and sale of its vehicle, computed as follows:

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[16] *Aznar vs. Court of Tax Appeals, et al.*, G.R. No. L-20569, August 23, 1974 *(* 58 SCRA 519)

Local sales	P1,541,936.60	
Add: proceeds from sales of PPE	1,600,000.00	P3,141,936.60
rate of VAT		10%
VAT Due		P 314,194.00
Add: 25% Surcharge[17]		78,548.50
Interest		188,516.00
Total deficiency tax due & payable		P 581,258.50

II. DST ON LEASE AGREEMENTS – P1,693.00

Petitioner points out respondent's erroneous assessment in the amount of P1,693.00 representing DST deficiency for taxable year 1998. Said DST arose from the two (2) lease agreements executed with lessors Mrs. Felisa B. De los Reyes and Casico Realty Holdings, Inc..[18] As wrongfully observed by the respondent, petitioner paid the said tax and therefore, the assessed DST deficiency is without any basis in fact and in law.

Respondent argues however that petitioner did not proffer any evidence of payment of its deficiency DST in the amount of P1,693.00.

The Court finds petitioner partly liable to the subject DST deficiency.

Records disclose that the deficiency DST of P1,693.00 was imposed on two lease agreements: One lease agreement entered with Casico Realty Holdings, Inc. pertaining to a monthly rental of P110,000.00 or P1,320,000.00 for year 1998;[19] and the other refers to a lease agreement with Ms. De los Reyes[20] with a monthly rental of P12,000 or annual rental of P144,000.00.

As further shown in the records, the house and lot leased by petitioner for P1,320,000.00 was used by its General Manager, Mr. Claus Sudhoff and the housing benefit availed of by the latter was subjected to fringe benefits

[17] Imposed pursuant to Section 248(A)(3) of the NIRC of 1997, as amended
[18] Exhibits H, I & J
[19] Exhibit J
[20] Exhibits H and I

tax.[21] This only proves that the said rental payments incurred by petitioner were in connection with its registered business activity of manufacturing and sale of garments.

Section 24 of R.A. No. 7916 or the PEZA Law provides:

> SECTION 24. Exemption from Taxes Under the National Internal Revenue Code. — Any provision of existing laws, rules and regulations to the contrary notwithstanding, no taxes, local and national, shall be imposed on business establishments operating within the ECOZONE. **In lieu of paying taxes**, five percent (5%) of the gross income earned by all businesses and enterprises within the ECOZONE shall be remitted to the national government. xxx *(Emphasis supplied)*

Likewise, Section 1, Rule XX of the PEZA Rules states:

> RULE XX
>
> Gross Income Taxation
>
> SECTION 1. Special Tax Rate. — Pursuant to Section 24 of the Act, ECOZONE Enterprises, except ECOZONE Service Enterprises, shall**, in lieu of payment of national and local taxes**, be liable to the payment of a five per cent (5%) final tax on gross income earned xxx. *(Emphasis supplied)*

Based on the foregoing, PEZA-registered enterprises like herein petitioner are only liable to pay 5% tax on gross income earned on their registered activities which is in lieu of payment of national and local taxes. The phrase "in lieu of payment of national and local taxes" means that petitioner, after paying a 5% final tax on gross income earned, is exempt from payment of local and national taxes which includes the documentary stamp tax imposed under Section 194 of the NIRC of 1997, as amended.

Notwithstanding the failure of petitioner to present proof of payment as regards the DST on its rentals P1,320,000.00, the Court holds that petitioner

[21] Page 31, BIR Records

is not liable to pay the same because of the "in lieu" proviso of Section 24 of R.A. No. 7916 or the PEZA Law, as implemented by Section 1, Rule XX of the PEZA Rules. But with reference to the DST deficiency tax assessment on the other lease agreement pertaining to the annual rental of P144,000.00, the Court finds petitioner liable thereto. Nowhere is it found in the records that petitioner actually paid the DST thereon nor is it established that petitioner is exempt from paying the DST. Accordingly, this Court finds petitioner liable for deficiency DST in the amount of P283.27, computed as follows:

Deficiency DST on Lease Contract w/ De los Reyes		
First P2,000.00	at P3.00	P 3.00
Next P142,000.00	at P1.00/P1,000.00	142.00
Total DST Due		P145.00
Add: 25% Surcharge[22]		36.25
20% Interest		102.02
Total Amount Due and Payable		**P283.27**

III. EWT ON RENTAL – P47,880.00

Petitioner contends that its rental payments to PEZA for its lease of land where it is situated are not subject to withholding tax. Being a government agency, PEZA, is exempt from income taxes and consequently from withholding taxes under Section 2.57.5(A) of Revenue Regulations (RR) No. 2-98, as amended.

We agree.

Section 2.57.5(A) of RR No. 2-98, provides as follows:

> ***Sec. 2.57.5 Exemption from withholding*** – The withholding of creditable withholding tax prescribed in these regulations shall not apply to income payments made to the following:

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[22] Imposed pursuant to Section 248(A)(3) of the NIRC of 1997, as amended

> (A) National government and its instrumentalities, including provincial, city or municipal governments; xxx

Pursuant to Chapter II, Section 11 of R.A. No. 7916, PEZA is a government agency performing regulatory and administrative functions. It is attached to the Department of Trade and Industry by specific mandate of the law and its board shall have a director with the rank of a department undersecretary who is appointed by the President.

Since PEZA is a government agency, exempt from payment of income taxes, the rentals petitioner paid to PEZA are also exempt from withholding taxes.

In addition, Presidential Decree No. 66 or also known as the law creating PEZA's predecessor, the Export Processing Zone Authority (EPZA), explicitly states that EPZA is exempt from the payment of income taxes and all other kinds of taxes payable to the National Government:

> Non-profit Character of the Authority; Exemption from Taxes – The authority shall be non-profit and shall devote and use all of its returns from its capital investment, as well as excess revenues from its operations, for the development, improvement and maintenance and other related expenditures of the authority to pay its indebtedness and obligations and in furtherance and effective implementation of the policy enunciated in Section 1 of this Decree. In consonance therewith, the authority is declared exempt:
>
> x x x
>
> (b) From all income taxes, franchise taxes, realty taxes and all other kinds of taxes and licenses to be paid to the National Government, its provinces, cities, municipalities and other government agencies and instrumentalities; x x x

Clearly, it is the intention of the framers of the law that EPZA, and its successor, PEZA, are exempt from national and local taxes. Notably, the

Registration Agreement dated December 18, 1989 covering the lease of petitioner's principal office at the Cavite Export Processing Zone[23] shows that the said contract was entered between petitioner and EPZA as the original parties to the lease agreement. Since PEZA is exempt from income taxes, then petitioner is not required to withhold tax from its rental payments to PEZA. In fact, nowhere is it stated in Republic Act No. 7196 or the law creating the PEZA, that the tax exemptions granted to EPZA have been revoked.

In view of the foregoing, respondent's assessment of expanded withholding tax assessment against petitioner for taxable year 1998 arising from the rental payments to PEZA is devoid of any legal basis.

IV. INCOME TAX

A. Income Tax at the Regular Rate of 34% on Other Income - P161,210.00

Petitioner avers that respondent erroneously imposed 34% income tax on its 1998 local sales amounting to P1,541,936.60. Contrary to respondent's finding, petitioner reported sales, inclusive of export and local sales in 1998 amounting to P188,862,864.00 as disclosed in Item No. 25 per its 1998 Annual Income Tax Return and Audited Financial Statements for the same year.[24] The revenue officer may have overlooked the fact that although the amount of P1,541,936.60 was not reported as part of petitioner's sales for VAT purposes, said amount was declared as part of its gross sales for income tax purposes. The revenue officer should have verified the aforesaid

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[23] Exhibit K
[24] Exhibit E

amount with petitioner's books of accounts, the income tax returns and the financial statements.

Respondent, for his part, contends that the undeclared sales amounting to P1,541,936.60 is subject to deficiency income tax for taxable year 1998. Petitioner failed to establish that it reported the local sales as part of its sales for the year 1998 nor did it attempt to breakdown and produce proof of inclusion of the said local sales in its declared income for taxable year 1998.

We rule against petitioner.

Relevant provisions of Section 5(1) of RMC 74-99 read as follows:

> SECTION 5. Tax Treatment Of Sales Made By A PEZA Registered Enterprise. —
> (1) Sale of goods (i.e., merchandise), by a PEZA-registered enterprise, to a buyer from the Customs Territory (i.e., domestic sales). — xxx The registered enterprise's "gross income earned" therefrom shall be subject to the 5% special tax pursuant to Sec. 24 of R.A. No. 7916: Provided, however, that its sales in the Customs Territory do not exceed the threshold allowed or permitted for such sales, pursuant to the pertinent provisions of the PEZA rules and regulations: Provided, further, that for income tax purposes, if such sales should exceed the aforesaid threshold, its income derived from such excess sales shall be imposed with the normal income tax pursuant to the provisions of Title II, NIRC: Provided, further, that in computing for the income tax due on such excess sales, its net income from such excess sales shall be determined in accordance with the method of general apportionment pursuant to the provisions of Sec. 50, NIRC, (i.e., compute its total net income from total sales, then, compute its net income from such excess sales by general apportionment, as follows: Excess sales divided by total sales times total net income from total sales equals net income from excess sales).

Per Letter of Authority No. 98-0531 issued by PEZA on August 24, 1998, petitioner's authority to sell in the local market was limited to the sale of export seconds and overruns of men's and boys' shirts, the quantity of which should not exceed one percent (1%) of its actual export volume in 1997, or 6,423 pieces or a total value of P1.5 million, whichever is lower.[25]

Since no data was available as regards petitioner's actual export volume in 1997, this Court shall consider the volume of 6,423 pieces with a total value of P1.5 million as the prescribed threshold amount for petitioner's 1998 local sales.

Following the provisions of Section 5(1) of RMC 74-99, out of the sales amount of P1,541,936.60 subject of the deficiency 34% income tax assessment, only the excess local sales amount of P41,936.60 shall be charged with a 34% income tax. The amount of P1,500,000.00 shall be imputed with the preferential income tax rate of 5%. Hence, in the absence of documentary evidence establishing it properly declared the total sales of P1,541,936.60 in its 1998 income tax return, petitioner shall be held liable to pay the corresponding income taxes due.

B. Income Tax at Special Rate of 5% on disallowed expenses – P1,175,990.10

Relying on Section 2, Rule XX of the PEZA Rules, respondent disallowed petitioner's claimed deductions in the total amount of P14,851,478.83 resulting to an alleged 5% deficiency income tax in the amount of P1,175,990.10, computed as follows:

Net income per return		P29,080,558.00
Add:	Disallowances per examiner's recommendation	
	Advertising	P 201,900.00
	Clinic Supplies	13,998.30
	Office Supplies	597,562.03
	Representation and Entertainment	550,265.03
	Commission	6,852,410.60

[25] BIR Records, page 2

	Transportation & Travel	1,176,994.72
	Freight & Handling	4,471,804.09
	Professional Fee	61,177.00
	Export Fees	126,103.66
	Taxes & Licenses	493,122.70
	Fringe Benefit Tax	306,140.70
		P14,851,478.83
Net taxable income per audit		P43,932,036.83
Tax due (at 5% PEZA)		P 2,196,602.00
Less:	tax paid	1,454,027.90
Deficiency basic tax		P 742,574.10
Add:	interest	408,416.00
	compromise penalty	25,000.00
Total deficiency tax due & payable		P 1,175,990.10

Petitioner avers that respondent erred in disallowing the said expenses on the following grounds:

A. **Freight and Handling** is a direct cost deductible under the category of handling of goods pursuant to Rule XX, Section 2(2), Rule XIX, Part VII of the Rules and Regulations.

B. **Clinic and Office Supplies** represent legitimate business expenses incurred in connection with petitioner's trade or business. These expenses fall under the category of "supplies" which are allowable deductions from gross income.

C. **Professional Fees** are part of sales cost of the company. It is settled that all cost of sales or direct costs paid or incurred during the taxable year and in furtherance of the taxpayer's trade or business are deductible for the purpose of computing the taxable income for the year.

D. **Export Fees**, **Taxes and Licenses** represent legitimate and direct business expense which should be allowed as a deduction from gross income under the law.

E. **Fringe Benefit Taxes** are classified as payments forming part of direct salaries, wages or labor expenses. The BIR implementing rules and regulations regard the said taxes as allowable deduction because they form part of the direct labor cost granted by the company to its employees. Thus, there is no valid reason why the expense item should be treated as a non-allowable deduction as a valid operational expense of petitioner.

F. **Advertising, Representation and Entertainment Expenses** form part of the cost of sales or business expenses, which are allowable deductions from gross income as mandated by law.

G. Dealers who are not petitioner's employees purchase products from the company and are granted remuneration in the form of **commissions.** These commissions and rebates are akin to discounts and allowances from the regular price of petitioner's products bought by dealers for resale to the latter's customers. These expense items are reduction fees from the gross sales of the company. Thus, they should not be included in the computation of petitioner's gross income.

We rule against petitioner.

Pursuant to Section 24 of Republic Act No. 7916, the preferential tax rate of 5% is imposed on Gross Income earned by an ECOZONE enterprise. Gross Income is in turn defined in Section 2(nn), Rule I of the "Rules and Regulations to Implement Republic Act No. 7916, otherwise known as The Special Economic Zone Act of 1995" [PEZA Rules], as follows:

> "**Gross Income**" for purposes of computing the special tax due under Section 24 of the Act refers to gross sales or gross revenues derived from business activity within the ECOZONE, net of sales discounts, sales returns and allowances and minus costs of sales or direct costs but before any deduction is made for administrative expenses or incidental losses during a given taxable period. The allowable deductions from "gross income" are specifically enumerated under Section 2, Rule XX of these Rules.

Section 2, Rule XX of the PEZA Rules enumerates the specific deductions for ECOZONE Export Enterprises as follows:

> **SECTION 2. Gross Income Earned; Allowable Deductions**. — For purposes of these Rules, Gross Income earned shall be as defined in Section 2(nn), Rule I of these Rules subject to the following allowable deductions for specific types of enterprises:
>
> 1. **ECOZONE Export Enterprises**, Free Trade Enterprises and Domestic Market Enterprises- Direct salaries, wages or labor expenses
>
> - Production supervision salaries
> - Raw materials used in the manufacture of products

- Goods in process (intermediate goods)
- Finished goods
- Supplies and fuels used in production
- Depreciation of machinery and equipment used in production, and buildings owned or constructed by an ECOZONE Enterprise
- Rent and utility charges associated with building, equipment and warehouses, or handling of goods
- Financing charges associated with fixed assets

Based on the foregoing, for purposes of computing the 5% preferential tax, gross sales/revenues may be reduced only by sales discounts, sales returns and allowances, costs of sales or direct costs or any of the enumerated allowable deductions under Section 2, Rule XX of the PEZA Rules.

Apparently, petitioner's claimed deductions for advertising, representation and entertainment, transportation and travel, professional fee, export fees, taxes and licenses should be disallowed because these expenses do not qualify as direct costs nor are they among the specified allowable deductions under the PEZA Rules.

The same holds true with respect to petitioner's claimed deductions for clinic and office supplies. Contrary to petitioner's assertion, the supplies referred to under the PEZA Rules relate to those utilized in the production of goods.

Regarding the claimed deduction for commissions in the amount of P6,852,410.60, the same shall likewise be denied. Commissions are entirely different from sales discounts. The word "commission" involves the meaning that a sum of money is paid to an agent for effecting a sale to a third person or defined as a percentage or allowance to a factor or agent for transacting business for another.[26] Clearly, for a commission to be due, there must be a service rendered. On the other hand, discounts are generally classified as either cash or trade. Trade discounts are given to induce purchases by volume and cash discounts are offered to induce prompt payment. Volume and time are therefore the factors considered to enjoy discounts.

Under our VAT law, particularly, Section 106(D)(2) of the NIRC of 1997, sales discounts granted and indicated in the invoice at the time of sale and the grant of which does not depend upon the happening of a future event do not form part of the taxable base. Clearly, what the law contemplates as deductions from the gross sales are trade discounts. The same rule applies for purposes of computing the tax base for income tax either at the regular rate of 34% or special rate of 5%.[27] As earlier stated, commissions cannot be treated as trade discounts deductible from gross sales to arrive at the gross income earned by a PEZA entity.

As regards the claimed deduction for freight and handling, based on the PEZA Rules, the allowable deductions from gross sales/revenues may either be directly or indirectly related to the manufacturing of a product and form part of inventory costs. Thus, the allowable deduction for the handling of goods referred to under "rent and utility charges associated with building, equipment and warehouses, or handling of goods" applies only to costs attributed to the production of goods. Any handling expenses incurred in the sale of finished products are disallowed under the law. In the instant case, petitioner failed to offer any documentary evidence for this Court to ascertain

[26] Words and Phrases, Permanent ed. 7A
[27] COMMISSIONER OF INTERNAL REVENUE vs. CENTRAL LUZON DRUG CORPORATION, G.R. NO. 159647, APRIL 15, 2005

that indeed the amount of P 4,471,804.09 can be attributed to production costs and not to selling expenses.

As to the fringe benefit tax, the same shall be considered valid deduction for purposes of computing the 5% preferential tax if it has been paid/incurred in relation to direct labor or production employees. For petitioner's failure to establish that the fringe benefit tax of P306,140.70 was paid in relation to its direct labor cost, the same shall be denied.

To recapitulate, petitioner is liable to pay deficiency 5% income taxes on its undeclared local sales of P1,500,000.00 and on the disallowed expenses of P14,851,478.83 and deficiency 34% income tax on its remaining undeclared local sales of P41,936.60, in the aggregate amount of P1,448,028.35, computed as follows:

Deficiency Income Tax (at Special Rate of 5%)

Net income per return			P 29,080,558.00
Add:	Undeclared local sales		1,500,000.00
	Disallowances per examiner's recommendation		
	Advertising	P 201,900.00	
	Clinic Supplies	13,998.30	
	Office Supplies	597,562.03	
	Representation and Entertainment	550,265.03	
	Commission	6,852,410.60	
	Transportation & travel	1,176,994.72	
	Freight & Handling	4,471,804.09	
	Professional Fee	61,177.00	
	Export Fees	126,103.66	
	Taxes & Licenses	493,122.70	
	Fringe Benefit Tax	306,140.70	
			14,851,478.83
Net taxable income per audit			P 45,432,036.83
Income Tax Due (5%)			P 2,271,601.84
Less:	Tax payment		1,454,027.90
Deficiency Basic Tax			P 817,573.94
Add:	25% Surcharge		204,393.49
	20% Interest		422,898.52
Total Amount Due and Payable			P 1,444,865.95

Deficiency Income Tax (at Regular Rate of 34%)

Undeclared Local Sales			P 1,541,936.60
Less: Undeclared Local Sales subjected to 5% tax			1,500,000.00
Undeclared Excess Local Sales			P 41,936.60
Taxable Net Income			
Undeclared Excess Local Sales	P	41,936.60	
Divided by Total Sales		190,404,800.60	
Multiplied by Net Income		23,895,832.60	P 5,263.05
Tax Rate			34%
Deficiency Basic Tax			P 1,789.44
Add: 25% Surcharge			447.36
20% Interest			925.60
Total Amount Due and Payable			P 3,162.40
TOTAL DEFICIENCY INCOME TAX DUE AND PAYABLE			**P 1,448,028.35**

Since there was no compromise agreement between the parties, the above deficiency 5% income tax re-computation does not include the compromise penalty of P25,000.00 originally imposed by respondent. However, a 25% surcharge was imposed pursuant to Section 248(A)(3) of the NIRC of 1997, as amended.

WHEREFORE, premises considered, the Petition for Review is hereby **PARTIALLY GRANTED**. The 1998 assessments for deficiency DST on the lease agreement with Casico Realty Holdings, Inc., deficiency EWT on the rental payments to PEZA are hereby **CANCELLED AND WITHDRAWN**. However, petitioner is **ORDERED TO PAY** the respondent the deficiency VAT on its local sales and the sale of a motor vehicle, deficiency DST on the lease agreement with Mrs. Felisa B. De Los Reyes, deficiency 5% income tax on disallowed expenses and deficiency 34% income tax on local sales in the sum of **P2,029,570.12** for taxable year 1998, inclusive of 25% surcharge and 20% deficiency interest, computed as follows:

DEFICIENCY TAX	VAT	DST	INCOME TAX At 5%	INCOME TAX At 34%	Total
Basic Tax Due	P 314,194.00	P 145.00	P 817,573.94	P 1,789.44	
25% Surcharge	78,548.50	36.25	204,393.49	447.36	
20% Interest	188,516.00	102.02	422,898.52	925.60	
	P 581,258.50	P 283.27	P 1,444,865.95	P 3,162.40	P2,029,570.12

In addition, petitioner is **ORDERED TO PAY** the respondent 20% delinquency interest on P2,029,570.12 computed from November 15, 2001 until full payment thereof pursuant to Section 249(C)(3) of the NIRC of 1997, as amended.

SO ORDERED.

JUANITO C. CASTAÑEDA, JR.
Associate Justice

WE CONCUR:

ERLINDA P. UY
Associate Justice

OLGA PALANCA-ENRIQUEZ
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.

JUANITO C. CASTAÑEDA, JR.
Associate Justice
Chairperson

CERTIFICATION

Pursuant to Article VIII, Section 13 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.

ERNESTO D. ACOSTA
Presiding Justice