REPUBLIC OF THE PHILIPPINES
COURT OF TAX APPEALS
QUEZON CITY

EN BANC

KEPCO PHILIPPINES CORPORATION,
Petitioner,

-versus-

THE COMMISSIONER OF INTERNAL REVENUE,
Respondent.

CTA EB No. 1155
(CTA Case No. 8319)

Members:

Del Rosario, *P.J.*,
Castañeda, Jr.,
Bautista,
Uy,
Casanova,
Fabon-Victorino,
Mindaro-Grulla,
Cotangco-Manalastas, and
Ringpis-Liban, *JJ.*

Promulgated:
NOV 03 2014
4:10 p.m.

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D E C I S I O N

CASTAÑEDA, JR., *J.*:

On appeal are a) the Decision dated November 7, 2013 finding KEPCO Philippines Corporation liable in the amount of P57,038,200.98 representing 2007 value added tax deficiency arising from income interest on loans extended to affiliates, and surcharges exclusive of interests; and b) the Resolution dated March 17, 2014 denying its Motion for Reconsideration for lack of merit issued by the Court of Tax Appeals First Division in the case docketed as CTA Case No. 8319.

THE FACTS

Kepco Philippines Corporation ("petitioner") is a corporation duly organized and existing under and by virtue of the laws of the Republic of the Philippines; while the Commissioner of Internal Revenue ("respondent") is a public official tasked to decide disputed assessments, collection, refund of erroneously or excessively paid internal revenue taxes, fees or other charges, penalties, or other matters under the 1997 National Internal Revenue Code ("NIRC"), as amended, or other laws administered by the Bureau of Internal Revenue ("BIR").[1]

Petitioner's primary business is to rehabilitate, operate, maintain and manage the Malaya Power Complex in Pililia, Rizal, Philippines and other power generating plants and related facilities for the conversion into electricity of fuel.[2]

Through loan agreements executed separately on November 10, 2000 and February 10, 2006, petitioner extended financial assistance with interest to its affiliates, namely: Kepco Ilijan Corporation (KEILCO) and Kepco Philippines Holdings, Inc. (KPHI).[3]

In the letter of authority no. 2007-00017814, respondent ordered the examination of petitioner's books of accounts and other accounting records for all internal revenue taxes for the period from January 1, 2007 to December 31, 2007.[4]

On December 6, 2010, respondent issued the preliminary assessment notice ("PAN") and details of discrepancies finding petitioner liable for alleged 2007 value added tax ("VAT"), income tax, withholding tax on compensation, expanded withholding tax, final withholding tax, capital gains tax and fringe benefits tax deficiencies, including compromise penalties.[5]

On December 22, 2010, petitioner received a final demand letter, formal assessment notice ("FAN") and details of discrepancies from the BIR demanding payment of P461,263,595.00 representing

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[1] See Docket, CTA Case No. 8319, p. 141.
[2] Exhibit "M-1", Docket, CTA Case No. 8319, p. 443.
[3] Exhibits "C" and "G", Docket, CTA Case No. 8319,pp. 9, 372 & 406.
[4] Exhibit "1", BIR Records, p. 53.
[5] Exhibits "7" and "8", BIR Records, pp. 30 & 27.

various 2007 internal revenue tax deficiencies, compromise penalties and interests.[6]

In the letter dated January 21, 2011, petitioner through its Treasurer Jung Ju Kim protested the FAN.[7]

On July 13, 2011, respondent, through Assistant Commissioner Zenaida G. Garcia, issued a final decision on disputed assessment ("FDDA") with attached audit result/assessment notice and further discovered 2007 deficiency VAT of P75,901,681.19 arising from interest income on loans extended to KEILCO and KPHI on the ground that these transactions were not subject to output tax under Section 108 of the 1997 NIRC, as amended.[8]

Dissatisfied, on August 11, 2011, petitioner sought recourse before the Court in Division by way of a petition for review premised on the cancellation of the FDDA for lack of legal and factual bases.[9]

In partially granting the petition, the Court in Division issued a Decision dated November 7, 2013, cancelling the compromise penalty of P50,000, but affirming with modifications the assessment on 2007 deficiency VAT and surcharge in the reduced amount of P57,038,200.98 exclusive of interests, the dispositive portion reads:

> WHEREFORE, premises considered, the instant Petition for Review is hereby **PARTIALLY GRANTED**. Accordingly, the compromise penalty imposed by respondent for taxable year 2007 in the amount of P50,000.00 is hereby **CANCELLED AND WITHDRAWN**. The deficiency VAT assessment for taxable year 2007 is however **AFFIRMED WITH MODIFICATIONS**. Petitioner is hereby ORDERED TO PAY respondent the amount of **FIFTY-SEVEN MILLION THIRTY-EIGHT THOUSAND TWO HUNDRED PESOS** and 98/100 (P57,038,200.98), inclusive of the twenty-five percent (25%) surcharge imposed under Section 248(A)(3) of the NIRC of1997, as amended, computed as follows: ge

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[6] Exhibit "A", Docket, CTA Case No. 8319, p. 348; BIR Records, Exhibit "9", p. 36.
[7] Exhibit "B", Docket, CTA Case No. 8319, p.362.
[8], Exhibit "25", BIR Records, p. 140.
[9] Docket, CTA Case No. 8319, p. 6.

Basic Deficiency VAT	P	45,630,560.78
25% Surcharge		11,407,640.20
Total	**P**	**57,038,200.98**

In addition, petitioner is likewise **ORDERED TO PAY**:

(a) Deficiency interest at the rate of twenty percent (20%) per annum on the basic deficiency VAT of P45,630,560.78 computed from January 25, 2008 until full payment thereof pursuant to Section 249(B) of the NIRC of 1997, as amended; and

(b) Delinquency interest at the rate of 20% per annum on the total amount of P57,038,200.98 and on the 20% deficiency interest which have accrued as afore-stated, computed from July 13, 2011 until full payment thereof pursuant to Section 249(C) of the NIRC of 1997, as amended.

SO ORDERED.[10]

Acting on petitioner's motion for reconsideration questioning the Decision dated November 7, 2013, the Court denied the same for lack of merit as shown in the Resolution dated March 17, 2014.[11]

Unfazed, petitioner appealed before the Court *En Banc* on April 15, 2014. On the other hand, respondent filed her comment to the petition on June 16, 2014.[12]

After the parties have signified that they are adopting the arguments incorporated in the petition and comment as their memoranda, the case was submitted for decision.

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[10] Penned by Presiding Justice Roman G. Del Rosario and concurred in by Associate Justices Erlinda P. Uy and Cielito N. Mindaro-Grulla. Rollo, pp. 19-33.
[11] Rollo, pp. 13-17
[12] Rollo, pp. 1 & 42.

THE ISSUE

The focal point of the controversy is whether or not petitioner is liable to pay 2007 deficiency VAT on interest income on loans extended to affiliates.

THE COURT'S RULING

Petitioner alleges that when one imposes or pays an interest, it is not because of the service rendered but for the use of the money in the time being. The concept of what is a fee and interest is totally different in terms of its source. Only the former is subject to VAT arising in the performance of a service, while the latter refers to the amount paid for the borrower's use of money during the term of the loan. The fact that there was an act of lending money is not vital since this is not the source of income or the "sale of service" being contemplated under the VAT law.

In Revenue Memorandum Circular No. 42-2003, interest income on loan is subject to VAT if the taxpayer qualifies as a lending investor, dealer in securities, financial institution as defined in Revenue Regulations No. 12-2003, or another entity performing similar financing activities. Thus, if the taxpayer is not a lending investor, VAT shall not be imposed.

Petitioner's primary purpose of business is limited to rehabilitation, operation, maintenance and management of the Malaya Power Plant or other power generating plants. It is established for the purpose of selling electricity. Extending two loans to its affiliates cannot be considered as incidental to petitioner's main business as a power generation company. Conversely, petitioner does not have a hand in the management, operation and maintenance of the power plants of the affiliates despite the loans extended to them. Simply stated, petitioner is in the business of generating power and not lending money.

At the time the loans were extended to KEILCO in 2000 and KPHI in 2006 and during the covered year of the case (2007), the BIR issued four rulings and consistently ruled that loans extended to affiliates are not acts of a lending investor, thus, not subject to VAT.

In the business world, parent companies usually have the necessary credit lines for their own needs, but they also extend financial assistance to their subsidiaries.

Respondent argues that petitioner is liable for 2007 deficiency VAT on interest income earned from loans extended to its affiliates.

Under the law, VAT is imposable on transactions incidental to taxpayer's main business activity.

Interest income on loan assistance extended by petitioner to its affiliates, being incidental to its business, is deemed a transaction "in the course of trade and business". Thus, subject to VAT.

When petitioner extended interest bearing loans to its affiliates, it provided financial assistance for a fee or remuneration or consideration, regardless of whether petitioner has realized profit or not. Such financial assistance is considered sale of service covered by VAT.

We sustain respondent's posture.

INTEREST BEARING LOAN TRANSACTIONS EXTENDED TO AFFILIATES ARE INCIDENTAL TO PETITIONER'S BUSINESS AND ARE COVERED BY VAT.

Persons or entities liable to VAT are specified in Sections 105 and 108 of the 1997 NIRC, as amended, reading:

> "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 the value-added tax (VAT) imposed in Sections 106 to 108 of this Code.
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> The value-added tax is an indirect tax and the amount of tax may be shifted or passed on to the buyer, transferee

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or lessee of the goods, properties or services. This rule shall likewise apply to existing contracts of sale or lease of goods, properties or services at the time of the effectivity of Republic Act No. 7716.

The phrase "**in the 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 nonstock, nonprofit 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.

The rule of regularity, to the contrary notwithstanding, services as defined in this Code rendered in the Philippines by nonresident foreign persons shall be considered as being rendered in the course of trade or business." (Emphasis supplied)

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'SECTION 108. *Value-added Tax on Sale of Services and Use or Lease of Properties. —*

(A) Rate and Base of Tax. — There shall be levied, assessed and collected, a value-added tax equivalent to ten percent (10%) of gross receipts derived from the sale or exchange of services, including the use or lease of properties. xxx xxx xxx

The phrase 'sale or exchange of services' means the performance of all kinds of services in the Philippines for others for a fee, remuneration or consideration, including those performed or rendered by construction and service contractors; stock, real estate, commercial, customs and immigration brokers; lessors of property, whether personal or real; warehousing services; lessors or distributors of cinematographic films; persons engaged in milling, processing, manufacturing or repacking goods for others; proprietors, operators or keepers of hotels, motels, resthouses, pension houses, inns, resorts;

> proprietors or operators of restaurants, refreshment parlors, cafes and other eating places, including clubs and caterers; dealers in securities; lending investors; transportation contractors on their transport of goods or cargoes, including persons who transport goods or cargoes for hire and other domestic common carriers by land relative to their transport of goods or cargoes; common carriers by air and sea relative to their transport of passengers, goods or cargoes from one place in the Philippines to another place in the Philippines, sales of electricity by generation companies, transmission, and distribution companies, services of franchise grantees of electric utilities, telephone and telegraph, radio and television broadcasting and all franchise grantees except those under Section 119 of this Code and nonlife insurance companies (except their crop insurances), including surety, fidelity, indemnity and bonding companies; **and similar services regardless of whether or not the performance thereof calls for the exercise or use of the physical or mental faculties.** xxx (Emphasis supplied.)

A transaction is 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[13], regardless of whether or not the entity is profit-oriented.[14] In the same manner, the law treats transactions undertaken incidental to the pursuit of a commercial or economic activity as entered in the course of trade or business.[15] "Incidental" means depending upon or appertaining to something else as primary; something necessary appertaining to, or depending upon another, which is termed the principal; something incidental to the main purpose.[16]

The Supreme Court agreed with this Court in defining the phrase "in the course of trade or business "in the case of *Commissioner of Internal Revenue v. Magsaysay Lines, Inc., et al.*[17] where it was ruled that:

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[13] Victor A. Deoferio, Jr. and Victorino C. Mamalateo, The Value Added Tax in the Philippines, 2000 Edition, p. 82.
[14] *Commissioner of Internal Revenue v. Court of Appeals and Commonwealth Management and Services Corporation*, G.R. No. 125355, March 30, 2000, 329 SCRA 237.
[15] Victor A. Deoferio, Jr. and Victorino C. Mamalateo, The Value Added Tax in the Philippines, 2000 Edition, p. 82.
[16] Black's Law Dictionary, 6th ed., p. 762.
[17] G.R. No. 146984, July 28, 2006, 497 SCRA 63.

> That the sale of the vessels was not in the ordinary course of trade or business of NDC was appreciated by both the CTA and the Court of Appeals, the latter doing so even in its first decision which it eventually reconsidered, We cite with approval the CTA's explanation on this point:
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> In *Imperial v. Collector of Internal Revenue*, xxx, the term **"carrying on business" does not mean the performance of a single disconnected act, but means conducting, prosecuting and continuing business by performing progressively all the acts normally <u>incident thereof</u>; while "doing business" conveys the idea of business being done, not from time to time, but all the time.** xxx "**Course of business" is what is usually done in the management of trade or busines**s.xxx (Emphasis supplied.)

In the case of *Lapanday Foods Corporation v. Commissioner of Internal Revenue*[18], this Court treated interest bearing loan transactions extended by Lapanday to affiliates as financial assistance incidental to its business of managing, promoting, administering or assisting in any business or activity of corporations, partnerships, associations, individual or firm. These loan transactions were made in the course of Lapanday's trade or business subject to VAT. We explained that:

> In the case at bench, petitioner is a domestic corporation engaged in managing, promoting, administering or assisting in any business or activity of corporations, partnerships, associations, individual or firm (Exhibit "F-1"). When petitioner extended loans to its affiliates, it provided assistance to corporations, and thus performed services incidental to its business.
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> Furthermore, the loan assistance provided by petitioner to its affiliates, being incidental to its business, is deemed a transaction "in the course of trade and business". The phrase "in the course of trade and business" means the

[18] CTA EB Case No. 367, January 29, 2009. See also CTA Case No. 8112, December 6, 2013.

> regular conduct or pursuit of a commercial or an economic activity, including transactions incidental thereto xxx
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> Considering the foregoing, We hold that the income generated by petitioner from the loans granted to its affiliates is subject to VAT, pursuant to Section 105, in relation to Section 108 of the NIRC of 1997, as amended.
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> In addition, if the income from the main business activity is subject to VAT, the incidental income shall also be subject to VAT, provided that there is no particular provision applicable to the specific transaction xxx Considering that petitioner's income from its management services is subject to VAT, it necessarily follows then, that the interests from loan which is an incidental income, is also subject to VAT.

In the case at bar, the Court in Division correctly observed that the loans granted to its affiliates, KEILCO and KPHI are incidental to petitioner's primary business of power generation of its Malaya Power Complex in Rizal and other power generating plants justifying the imposition of VAT. Pertinent excerpts of the assailed Decision declared that:

> There is no denying that petitioner is a power generating company. **Its primary purpose is to rehabilitate, operate, maintain and manage the Malaya Power Complex in Pililia, Rizal, Philippines and other generating plants and related facilities for the conversion into electricity of fuel.**
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> **Petitioner's purpose of extending loan to its affiliate KEILCO in 2000 was to give financial assistance in order for the latter to design, construct, furnish, install, test, commission, own, operate and maintain a 1251 MW natural gas fired combined cycle generating plant with diesel fuel firing capability to be located at Ilijan, Batangas City. On the other hand, the purpose of the loan given to petitioner's affiliate KPHI on February 10, 2006 was for KPHI to purchase shares of stocks in Salcon Power Corporation (SPC), a publicly listed**

> **power generation company operating in the Province of Cebu.**
>
> Petitioner assisted its affiliate KEILCO in operating and maintaining other power generating plant located at Ilijan, Batangas. Petitioner also extended financial assistance to KPHI in order for the latter to acquire shares of stock in other generating plant (SALCON Power Corporation). **In a sense, petitioner acts through its affiliates in pursuing its primary purpose of rehabilitating, operating, maintaining and managing other power generating plants and related facilities for the conversion into electricity of fuel.**
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> Further, upon careful examination of the records, this Court finds that **one of the secondary purposes of petitioner is to "aid in any manner any corporation, association, or trust, estate, domestic or foreign, or any firm or individual. In extending loans with interest to its affiliates, petitioner performed services which are incidental to its business. The financial assistance given by petitioner, being incidental to its business, is deemed a transaction in the course of its trade or business.**[19] (Emphasis supplied.)

Here, the loans granted by petitioner to KEILCO and KPHI are intended to be allocated for the construction of the generating power plant to be located in Ilijan, Batangas and for the purchase of shares of stock in SPC, a publicly listed generation company in Cebu, respectively. Evidently, these loan transactions are in furtherance of petitioner's main line of business of rehabilitation, operation, maintenance, management not only of its power generating plants **but also "other power generating plants and related facilities for the conversion into electricity of fuel" as shown in its amended articles of incorporation.**[20]

The Court *En Banc* finds no cogent reason to reverse the findings of the Court in Division in treating interest bearing loan

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[19] Rollo, pp.28-29.
[20] Exhibit "M", Docket, CTA Case No. 8319, p. 443.

transactions granted to KEILCO and KPHI being incidental to petitioner's primary business subject to VAT.

WHEREFORE, premises considered, the petition for review is hereby **DISMISSED**. The assailed Decision dated November 7, 2013 and the Resolution dated March 17, 2014 are **AFFIRMED**.

SO ORDERED.

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

WE CONCUR:

ROMAN G. DEL ROSARIO
Presiding Justice

LOVELL R. BAUTISTA
Associate Justice

ERLINDA P. UY
Associate Justice

CAESAR A. CASANOVA
Associate Justice

ESPERANZA R. FABON- VICTORINO
Associate Justice

Cielito N. Mindaro-Grulla
CIELITO N. MINDARO-GRULLA
Associate Justice

(On Leave)
AMELIA R. COTANGCO- MANALASTAS
Associate Justice

Ma. Belen R. Li
MA. BELEN M. RINGPIS-LIBAN
Associate Justice

CERTIFICATION

Pursuant to Article VIII, Section 13 of the Constitution, it is hereby certified that the conclusions in the above Decision were reached in consultation among the members of the Court *en banc* before the case was assigned to the writer for the opinión of the Court *en banc*.

ROMAN G. DEL ROSARIO
Presiding Justice