Republic of the Philippines
COURT OF TAX APPEALS
Quezon City

EN BANC

COMMISSIONER OF INTERNAL REVENUE, Petitioner,	**CTA EB CASE NO. 1346** (CTA Case Nos. 8421 & 8561)
-versus-	Present: DEL ROSARIO, P.J., CASTAÑEDA, JR. BAUTISTA UY CASANOVA FABON-VICTORINO MINDARO-GRULLA COTANGCO-MANALASTAS RINGPIS-LIBAN, JJ.
LEAR AUTOMOTIVE SERVICES (NETHERLANDS) B.V. PHILIPPINE BRANCH, Respondent.	Promulgated: JUN 02 2016 3:52 p.m.

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DECISION

MINDARO-GRULLA, J.:

Submitted for decision is a Petition for Review for the Court *En Banc* under Rule 4, Section 2(a)(1), in relation to Rule 8, Section 4(b) of the 2005 Revised Rules of the Court of Tax Appeals (RRCTA)[1], as amended, of the Decision[2] dated May 21, 2015, rendered by the Second Division of this

[1] Sec. 2. *Cases within the jurisdiction of the Court en banc.*- The Court en banc shall exercise exclusive appellate jurisdiction to review by appeal the following:

(a) Decisions or resolutions on motions for reconsideration or new trial of the Court in Division in the exercise of its exclusive appellate jurisdiction over:

(1) Cases arising from administrative agencies- Bureau of Internal Revenue, Bureau of Customs, Department of Finance, Department of Trade and Industry, Department of Agriculture;

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Sec. 4. *Where to appeal; mode of appeal.*-
(a) xxx.
(b) An appeal from a decision or resolution of the Court in Division on a motion for reconsideration or new trial shall be taken to the Court by petition for review as provided in Rule 43 of the Rules of Court. The Court en banc shall act on the appeal.
(c) xxx.

[2] En banc Docket, pp. 18-34.

Court in CTA Case Nos. 8421 & 8561, and its Resolution[3] dated July 29, 2015. The Second Division of this Court cancelled the 2008 deficiency income tax assessment and modified the 2007 deficiency income tax assessment on the ground that royalty payments should be considered as allowable deduction for purposes of computing the 5% tax on gross income.

Petitioner partially assailed both the aforesaid Decision and Resolution, the dispositive portions of which, respectively, read as follows:

Decision dated May 21, 2015:

*"**WHEREFORE**, premises considered, the instant Petition for Review is hereby **PARTIALLY GRANTED.** Accordingly, the deficiency income tax assessment for taxable year 2008 in the amount of P21,138,104.97 is hereby **CANCELLED**, while the deficiency income tax assessment for taxable year 2007 is **PARTIALLY UPHELD**. Petitioner is **ORDERED TO PAY** basic deficiency gross income tax for the year 2007 in the amount of **THREE MILLION THREE HUNDRED SEVENTY-EIGHT THOUSAND SIX HUNDRED TWENTY-THREE AND 95/100 PESOS** (P3,378,623.95), inclusive of the twenty-five percent (25%) surcharge imposed under Section 248 (A)(3) of the NIRC of 1997, as amended, computed as follows:*

	Basic Tax	*25% Surcharge*	*Total*
Deficiency Income Tax (5%)	*P2,702,899.16*	*P675,724.79*	*P3,378,623.95*

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

a. Deficiency interest at the rate of twenty percent (20%) per annum on the basic deficiency income tax of P2,702,899.16 computed from April 15, 2008 until full payment thereof pursuant to Section 249(B) of the NIRC of 1997; and

b. Delinquency interest at the rate of 20% per annum on the amount of the P3,378,623.95, representing the basic deficiency income tax of P2,702,899.16 and 25% surcharge of P675,724.79, computed from January 4, 2012

[3] En banc Docket, pp. 35-37.

until full payment thereof pursuant to Section 249(C)(3) of the NIRC of 1997, as amended.

SO ORDERED."

Resolution dated July 29, 2015:

"***WHEREFORE***, *premises considered, the instant Motion for Partial Reconsideration is hereby* ***DENIED*** *for lack of merit.*

SO ORDERED."

The pertinent facts as narrated by this Court's Division in its Decision are as follows:

"Petitioner[4] *Lear Automotive Services (Netherlands) B.V. - Philippine Branch is a duly registered Philippine branch of Lear Automotive Services (Netherlands) B.V. (hereinafter referred to as "Lear"), a corporation organized and existing under the laws of the Netherlands and duly authorized to do business in the Philippines. Petitioner is registered with the Bureau of Internal Revenue (BIR), with Tax Identification No. 221-676-124-000. Its principal office in the Philippines is at Mactan Export Processing Zone, 3rd Street, Mactan, Lapu-Lapu City.*

Petitioner[5] *is engaged in the business of manufacturing, assembling, processing, designing, exporting, buying and selling wholesale automotive wiring harnesses, electric wire assemblies, electric motors, electric switches, terminals and connectors, and other automotive assemblies and fittings. It is also engaged in warehousing and logistic service operations that include consolidating, storing, packaging, exporting, buying and selling automotive parts and components, and ensuring the suitable logistics requirements of its customers. As a Philippine Economic Zone Authority (PEZA)-registered enterprise, petitioner is entitled to the five percent (5%) special tax on gross income under Section 24 of Republic Act (RA) No. 7916, as amended by RA No. 8748 (PEZA Law, as amended).*

[4] Lear Automotive Services (Netherlands) B.V. - Philippine Branch was the petitioner while the Commissioner of Internal Revenue(CIR) was the respondent in the Division. Before the Court en banc, Lear Automotive Services (Netherlands) B.V. - Philippine Branch. is the respondent while the Commissioner of Internal Revenue (CIR) is the petitioner.
[5] Ibid.

Respondent[6] Commissioner of Internal Revenue is the head of the Bureau of Internal Revenue, the government agency officially responsible for the assessment and collection of all national internal revenue taxes, fees and charges. She holds office at the BIR National Office Building, Diliman, Quezon City.

Petitioner and Lear entered into an Intangibles Licensing Agreement, whereby petitioner shall use the intangible property of Lear; which is required for the manufacturing and marketing of automotive wire harness products. As consideration, petitioner shall pay royalties to Lear.

On April 6, 2005, petitioner, through Joaquin Cunanan & Co., sent a letter to the BIR to confirm whether the royalties paid by petitioner to Lear are deductible from the former's gross sales for purposes of computing its taxable Income subject to 5% tax under the PEZA law, as amended.

In response, the BIR, through then Deputy Commissioner Jose Mario C. Buñag, held in BIR Ruling DA-147-2005 dated April 13, 2005, that:

> *'Thus, the treatment of royalties depends on the consideration for which such fees were paid. When the royalties relate to a system or license, royalties are treated as general administrative expenses, which are not inventoriable costs. When, however, royalties are connected with a product design, logo, formula, or process, the payment is capitalized as part of inventories. Therefore, payments for royalties related to the transfer of technical information and manufacturing know-how should be considered as part of the cost of manufacturing the products. (BIR Ruling No. DA-147-04 dated March 29, 2004; and DA-017-05 dated January 19, 2005). In view of the foregoing, this Office holds that the royalty payments made by LASN to Lear in consideration for the transfer of technology necessary for the continued production of LASN's products are part of the cost of finished goods and are deductible from gross sales for purposes of computing its taxable gross income subject to 5% tax under Republic Act No. 7916.'*

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[6] Ibid.

CTA Case No. 8421

On August 14, 2008, by virtue of Letter of Authority (LOA) No. 200700007073 dated July 1, 2008, the BIR sent its First Notice to petitioner requesting the submission of petitioner's documents in relation to its investigation.

Petitioner received a Notice of Informal Conference from the BIR on January 19, 2011.

On March 24, 2011, the BIR sent a Preliminary Assessment Notice (PAN) to petitioner, finding it liable to pay deficiency income tax and value-added tax (VAT) in the total amount of P241,677,782.37. Subsequently, petitioner received a Final Assessment Notice (FAN) from the BIR on April 13, 2011, finding it liable for deficiency income tax and VAT for taxable year 2007 in the total amount of P241,677,782.37. Consequently, petitioner protested the FAN on May 11, 2011.

On January 4, 2012, petitioner received the Final Decision on Disputed Assessment (FDDA) from the BIR, finding it liable only for deficiency income tax in the amount of P33,139,425.51 for taxable year 2007. As a consequence, petitioner filed a Petition for Review before this Court on February 1, 2012, later docketed as CTA Case No. 8421.

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CTA Case No. 8561

Petitioner likewise received two notices from the BIR, pursuant to Letter of Authority (LOA) No. 200900007522 dated April 15, 2010, requesting the submission of petitioner's documents in relation to the BIR's examination of petitioner's books of accounts and other accounting records for all internal revenue taxes for taxable year 2008.

On February 6, 2012, petitioner received a Preliminary Assessment Notice (PAN) from the BIR, informing it that it was found liable for deficiency taxes in the total amount of P1,691,740,832.09. Petitioner then contested the PAN on February 21, 2012 via letter dated February 20, 2012 addressed to the BIR Large Taxpayers District Office-Cebu.

On May 2, 2012, petitioner received a Formal Letter of Demand from the BIR, finding it liable for deficiency taxes for taxable year 2008 in the total amount of

P35,665,416.95. Petitioner then filed a protest letter on May 30, 2012.

On September 27, 2012, petitioner received the FDDA from the BIR, finding it liable for deficiency income tax, among other deficiency taxes, for taxable year 2008. After payment by petitioner or cancellation by respondent of the other tax assessments, the deficiency tax assessment for taxable year 2008 was reduced to P21,138,104.97.

Petitioner sought judicial redress by filing a Petition for Review before this Court on October 24, 2012, later docketed as CTA Case No. 8561.

In her Answer for CTA Case No. 8561 filed on February 12, 2013, respondent argued, among others, that petitioner was properly apprised of its deficiency income tax liabilities, that BIR Ruling No. 014-2012 is applicable to the present case, and that the presumption under the law is in favor of the correctness of tax assessments.

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In the Resolution dated February 21, 2013, this Court granted petitioner's motion to consolidate CTA Case No. 8421 with CTA Case No. 8561.

During trial, petitioner presented Mr. Anthony C. Cheng - Finance Director of petitioner, Ms. Helena Agnes Valderama - professor at the Virata School of Business, University of the Philippines Diliman, and Mr. John Duncan- Tax Manager of Lear from 2001 to 2005 as its witnesses.

Petitioner likewise made its Formal Offer of Evidence. xxxxxxx.

On the other hand, respondent presented Revenue Officers Ferly Ann B. Paez and Ms. Vivian F. Pollisco as witnesses.

On April 4, 2014, respondent filed her Formal Offer of Exhibits (with Motion to Admit), and on May 23, 2014, the Court issued a Resolution admitting Exhibits "1" to "20". In the same Resolution, the Court ordered the parties to submit their respective memoranda.

The case was submitted for decision on July 15, 2014, considering petitioner's Memorandum filed on July

10, 2014 and respondent's failure to file her memorandum."

On March 17, 2015, this Court's Division ruled that "any item of cost or expense which is directly attributable to the rendition of the PEZA-registered services shall be treated as direct cost". Likewise, this Court's Division ruled that BIR Ruling DA-147-2005, which confirmed that royalties paid by respondent to Lear are considered deductions, is binding on the Commissioner of Internal Revenue (CIR). Hence, it was ruled that royalty payments to Lear was considered as allowable deduction for purposes of computing the 5% tax on gross income. Thus, the 2008 deficiency income tax assessment was cancelled and the 2007 deficiency income tax assessment was modified.

CIR filed a Motion for Partial Reconsideration which was denied for lack of merit, hence, the present petition.

CIR argued that in case of conflict between a statute and an issuance, the former must prevail. CIR claims that BIR Ruling DA-147-2005 cannot be enforced as it expanded the PEZA Law and Revenue Regulation No. 11-2005 with respect to the deductibility of royalties. Thus, CIR asserts that the assessments which are presumed correct and made in good faith were valid and lawful.

We resolve.

In case of conflict between a statute and an issuance, the statute must prevail. The administrative agency issuing the issuance and regulations may not enlarge, alter or restrict the provisions of the law it administers; it cannot engraft additional requirements not contemplated by the legislature.[7] In case of conflict, the law must prevail.[8] A regulation adopted pursuant to law is law. Conversely, a regulation or any portion thereof not adopted pursuant to law is no law and has neither the force nor the effect of law.[9]

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[7] COMMISSIONER OF INTERNAL REVENUE vs. CENTRAL LUZON DRUG CORPORATION, G.R. No. 159647, April 15, 2005.
[8] Ibid.
[9] Ibid.

Section 2 of Rule XX[10] of the Rules and Regulations implementing Republic Act No. 7916 (the PEZA Law) and Revenue Regulation No. 11-2005[11] provide the allowable deductions to gross income. Revenue Regulation No. 11-2005 revoked Section 7 of Revenue Regulation No. 2-2005.[12] Specifically, Revenue Regulation 11-2005 revoked the exclusivity of the items enumerated as direct costs under Revenue Regulation No. 2-2005. This Court's Division aptly ruled as follows:

> *"On February 15, 2005, the BIR issued Revenue Regulations (RR) No. 2-2005, the pertinent parts of which are quoted as follows:*
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> > *'SECTION 7. Gross income earned.- xxx For purposes of computing the total five percent (5%) tax rate imposed by Republic Act No. 7227, Republic Act No. 7903, Republic Act No. 7922 and Republic Act No. 7916, the cost of sales or direct cost* ***shall consist only of the following cost or expense items*** *which shall be computed in accordance with Generally Accepted Accounting Principles (GAAP):' (Emphasis supplied)*

[10] RULE XX
Gross Income Taxation
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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.

[11] Regulations Defining "Gross Income Earned" to Implement the Tax Incentive Provision In Section 24 of Republic Act No. 7916, otherwise known as "The Special Economic Zone Act of 1995" Revoking Section 7 of Revenue Regulations No. 2-2005 and Suspending the Effectivity of Certain Provisions of Revenue Regulations No. 2-2005.

[12] Revenue Regulation Implementing Relevant Provision of Republic Act Nos. 7227, 7916, 7903 and 7922 otherwise known as "Bases Conversion and Development Act of 1992," "Special Economic Zone Act of 1995," "Zamboanga City Special Economic Zone Act of 1995" and "Cagayan Special Economic Zone Act of 1995", respectively.

The BIR issued RR No. 11-2005 on April 25, 2005, removing the exclusivity of the items enumerated as direct costs under RR No. 2-2005, to wit:

> *'For purposes of computing the total five percent (5%) tax rate imposed, the following direct costs are included in the allowable deductions to arrive at gross income earned for specific types of enterprises:'*

Section 2 of Rule XX of the PEZA Implementing Rules enumerates the allowable deductions for purposes of computing the 5% tax rate on gross income of PEZA-registered enterprises. It is noteworthy that the Rules did not limit, but merely enumerated the allowable deductions. Subsequently, RR No. 2-2005 limited the direct costs to the enumeration of allowable deductions therein. As it stands, RR No. 11-2005 removed the exclusivity of the allowable deductions from gross income.

In East Asia Utilities Corporation vs. Commissioner of Internal Revenue, this Court discussed the PEZA Law, as amended, in relation to RR Nos. 2-2005 and 11-2005 vis-a-vis the allowable deductions, in this wise:

> *'It is clear from the amendment made under RR No. 11-05 that the list is not meant to be all-inclusive but merely enumerates the expenses that can be considered as direct costs. PEZA-registered enterprises may be allowed to deduct expenses which are in the nature of direct costs even though the same are not included in the list.*
>
> *The criteria in determining whether the item of cost or expense should be part of direct cost is the direct relation of such item in the rendition of the PEZA-registered services. If the item of cost or expense can be directly attributed in providing the PEZA-registered services, then it should be treated as direct cost.'*

Thus, there is no merit in respondent's argument that royalty fees are not considered as allowable deduction for purposes of computing the 5% tax on gross income of petitioner. Applying RR No. 11-2005 and the ruling of this Court in the East Asia case, any item of cost or expense which is directly attributable to the rendition of the PEZA-registered services shall be treated as direct cost.

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Considering the foregoing, the Court rules that petitioner's royalty payments to Lear should be considered as an allowable deduction for purposes of computing the 5% tax on gross income."

It is a cardinal rule that courts "will and should respect the contemporaneous construction placed upon a statute by the executive officers whose duty it is to enforce it x x x."[13] In the scheme of judicial tax administration, the need for certainty and predictability in the implementation of tax laws is crucial.[14] Our tax authorities fill in the details that "Congress may not have the opportunity or competence to provide."[15] The regulations these authorities issue are relied upon by taxpayers, who are certain that these will be followed by the courts.[16] Courts, however, will not uphold these authorities' interpretations when clearly absurd, erroneous or improper. We find none in this case.

In sum, there is no compelling reason to disturb the findings and conclusion of the Court in Division as it is supported by the evidence on record and is consistent with prevailing law and jurisprudence.

WHEREFORE, the Petition for Review filed by petitioner Commissioner of Internal Revenue is **DENIED,** for lack of merit. Accordingly, the Decision of the Second Division promulgated on May 21, 2015 and Resolution dated July 29, 2015, are **AFFIRMED**. No pronouncement as to costs.

SO ORDERED.

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

[13] COMMISSIONER OF INTERNAL REVENUE vs. CENTRAL LUZON DRUG CORPORATION, G.R. No. 159647, April 15, 2005.
[14] Ibid.
[15] Ibid.
[16] Ibid.

WE CONCUR:

ROMAN G. DEL ROSARIO
Presiding Justice

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

LOVELL R. BAUTISTA
Associate Justice

ERLINDA P. UY
Associate Justice

CAESAR A. CASANOVA
Associate Justice

ESPERANZA R. FABON-VICTORINO
Associate Justice

AMELIA R. COTANGCO-MANALASTAS
Associate Justice

Ma. Belen

MA. BELEN RINGPIS-LIBAN
Associate Justice

C E R T I F I C A T I O N

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 of the opinion of the Court En Banc.

ROMAN G. DEL ROSARIO
Presiding Justice