

August 22, 2005

Ms. Alva Marasigan
Assistant Vice President - Finance
National Transmission Corporation
Power Center
BIR Road corner Quezon Avenue
Diliman Quezon City

Dear Ms. Marasigan,

Further to our meeting last August 20, 2005, below is a discussion on additional queries raised during said meeting, such as the timing on payment of income tax on the part of the Concessionaire and the liability to local business taxes of the National Transmission Corporation ("TRANSCO") and the Concessionaire.

Summary of Opinion

A. Income Tax

The Concessionaire will be subject to income tax at the rate 32% (or 35%, under Republic Act No. 9337 if the Temporary Restraining Order is lifted, to be reduced to 30% effective January 1, 2009) on its net taxable income from sources within and without the Philippines. The Concessionaire will however be subject to the minimum corporate income tax ("MCIT") whenever it has zero or negative taxable income or whenever the amount of MCIT is greater than the normal income tax. The MCIT is levied at the rate of 2% of the gross income and is imposed as of the end of the taxable year beginning on the fourth taxable year immediately following the year in which such corporation commenced its business operations.

TRANSCO will be required to withhold a creditable withholding tax ("CWT") at 2% on the gross Concession Fee paid to the Concessionaire. The CWT is required to be withheld at the time it is either (1) paid; (2) payable; or (3) accrued or recorded as an expense or asset, whichever is applicable, in TRANSCO's books whichever comes first.

TRANSCO will be required to issue a withholding tax statement (BIR Form No. 2307) to the Concessionaire showing the amount of taxes withheld on the

Concession Fee and an annual information return (BIR Form No. 1604E) on all income tax withheld on income payments subject to CWT.

The Concession Fee received by the Concessionaire will form part of Concessionaire's gross income for income tax purposes. In computing its income tax payable, the Concessionaire may deduct the CWT withheld by TRANSCO from the income tax liability of the Concessionaire in the period the CWT was withheld.

The Concessionaire will be required to file a quarterly income tax return and a final adjustment return.

B. Local Business Tax

TRANSCO will be subject to local business tax based on its gross receipts, including its Free Cash Flow, which will eventually be paid as Concession Fee to its Concessionaire. The Concessionaire will likewise be subject to local business tax based on its gross receipts, which includes the Concession Fee received from TRANSCO.

Discussion

1. Payment of Concession Fee by TRANSCO

a. *Creditable withholding tax*

(i) Rate of Tax

Government-owned or -controlled corporations are required to withhold a CWT on income payments pertaining to their purchases of goods and services. Section 2.57.2(N) of Revenue Regulations ("Rev. Regs.") No. 2-98, as amended, provides that -

(N) Income payments made by the government to its local/resident supplier of goods and local/resident supplier of services other than those covered by other rates of withholding tax.

- Income payments, except any single purchase which is P10,000 and below, which are made by a government office, national or local, including *barangays*, or their attached agencies or bodies, and government-owned or controlled corporations, on their

purchases of goods and purchases of services from local/resident

—

Supplier of goods	—	One percent (1%)
Supplier of services	—	Two percent (2%)

A government-owned or controlled corporation shall withhold the tax in its capacity as a government-owned or controlled corporation rather than as a corporation stated in Subsection (M)¹ hereof.

Thus, TRANSCO will be required to withhold CWT on its payment of the Concession Fee to the Concessionaire at the rate of two percent (2%) of the gross income payment.

(ii) Time of Withholding and Remittance

The CWT shall be withheld at the time the income payment is paid or payable, or when the income payment is accrued or recorded as an expense or asset, whichever is applicable, in the payor's books, whichever comes first. Section 2.57.4 of Rev. Regs. No. 2-98, as amended, states the rule on the time of withholding of the CWT -

SECTION 2.57.4. *Time of Withholding.* — The obligation of the payor to deduct and withhold the tax under Section 2.57 of these regulations arises at the time an income payment is paid or payable, or the income payment is accrued or recorded as an expense or asset, whichever is applicable, in the payor's books, whichever comes first. The term "payable" refers to the date the obligation becomes due, demandable or legally enforceable.

Provided, however, that where income is not yet paid or payable but the same has been recorded as an expense or asset, whichever is applicable, in the payor's books, the obligation to withhold shall arise in the last month of the return period in which the same is claimed as an expense or amortized for tax purposes.

A withholding tax return will be filed together with remittance of the CWT withheld on the income payments within ten (10) days after the end of each

¹ Subsection (M) refers to the CWT on income payments made by the top ten thousand private corporations to their local/resident suppliers of goods and services.

month, except for taxes withheld for the month of December of each year, which shall be filed on or before January 15 of the following year.²

Thus, TRANSCO will be required to withhold the 2% CWT on the payment of the Concession Fee at the time it is either (1) paid; (2) payable; or (3) accrued or recorded as an expense or asset, whichever is applicable, in TRANSCO's books; whichever comes first. TRANSCO will report the CWT on the Concession Fee in a withholding tax return (BIR Form No. 1601E) and will file this return, together with the remittance of the CWT withheld, within ten (10) days after the end of each month, except for taxes withheld for the month of December of each year, which shall be filed on or before January 15 of the following year.

(iii) Compliance

TRANSCO will be required to issue a withholding tax statement (BIR Form No. 2307) to the Concessionaire showing the amount of taxes withheld on the Concession Fee under Section 2.58(B) of Rev. Regs. No. 2-98, as amended -

(B) Withholding tax statement for taxes withheld - Every payor required to deduct and withhold taxes under these regulations shall furnish each payee, whether individual or corporate, with a withholding tax statement, using the prescribed form (BIR Form 2307) showing the income payments made and the amount of taxes withheld therefrom, for every month of the quarter within twenty (20) days following the close of the taxable quarter employed by the payee in filing his/its quarterly income tax return. The payor, nonetheless, should always retain a copy of duly issued BIR Form No. 2307. Failure to furnish the same shall be a ground for the mandatory audit of payor's income tax liabilities (including withholding tax) upon verified complaint of the payee.

For final withholding taxes, the statement should be given to the payee on or before January 31 of the succeeding year.

Upon request of the payee, however, the payor must furnish such certificate simultaneously with the income payment.

Furthermore, TRANSCO will also be required to file an annual information return (BIR Form No. 1604E) on income tax withheld pursuant to Section 2.58(C) of Rev. Regs. No. 2-98, as amended -

² Section 2.58(A), Rev. Regs. No. 2-98, as amended.

(C) *Annual information return for income tax withheld at source.* — The payor is required to file with the BIR-Large Taxpayers Assistance Division, Large Taxpayers District Office or the Excise Taxpayers Assistance Division, or the Revenue District Office where the payor/employer is registered as Withholding Agent, on or before March 1 of the following year in which payments were made, an Annual Information Return of Creditable Income Taxes Withheld (Expanded)/Income Payments Exempt from Withholding Tax (BIR Form No. 1604-E) and on or before January 31 of the said year an Annual Information Return of Income Taxes Withheld on Compensation and Final Withholding Taxes (BIR Form No. 1604-CF), showing among others, the following information:

- (1) Name, address and taxpayer's, identification number (TIN); and
- (2) Nature of income payments, gross amount and amount of tax withheld from each payee and such other information as may be required by the Commissioner.

If the payor is the Government of the Philippines or any political subdivision or agency thereof, or any government-owned or controlled corporation, the return shall be made by the officer or employee having control of the payments or by any designated officer or employee.

Finally, TRANSCO is required to maintain the CWT withheld on the Concession Fee, as well as other income payments subject to CWT, in separate accounts pursuant to Section 2.58.1 of Rev. Regs. No. 2-98, as amended, which provides -

SECTION 2.58.1. *Income of Recipient.* — x x x

The taxes withheld by the withholding agents shall be maintained in separate accounts and should not be commingled with any other funds of the withholding agent. They shall be considered as a trust fund held for government until they are remitted.

2. Receipt of Concession Fee by the Concessionaire

a. *Income tax*

(i) Tax Rate

The Concessionaire will be subject income tax at the rate of 32% (or 35% should the Temporary Restraining Order on the implementation of Republic Act No. 9337 be lifted, to be reduced to 30% effective January 1, 2009) on the net taxable income derived during each taxable year from all sources within and without the Philippines.³

It is possible for the Concessionaire to be subject to the payment of the 2% MCIT instead of the ordinary corporate income tax. Section 27(E) of the Tax Code provides for the imposition of the minimum corporate income tax under the following conditions:

- (1) Imposition of tax. - A minimum corporate income tax of two percent (2%) of the gross income as of the end of the taxable year, as defined herein, is hereby imposed on a corporation taxable under this Title, beginning on the fourth taxable year immediately following the year in which such corporation commenced its business operations, when the minimum income tax is greater than the tax computed under subsection (A) of this Section for the taxable year.

For purposes of the imposition of the MCIT, the term "normal tax" means the income tax rate of 32%, to be increased to 35% under Republic Act No. 9337, and to be reduced to 30% effective January 1, 2009.⁴ Since the Concessionaire is engaged in the sale of service, its gross income shall mean "gross receipts less sales returns, allowances, discounts and cost of services".⁵ "Cost of services" shall mean all direct costs and expenses necessarily incurred to provide the services required by the customers and clients including: (a) salaries and employee benefits of personnel, consultants and specialists directly rendering the service; and (b) cost of facilities directly utilized in providing the service such as depreciation of rental of equipment used and cost of supplies.⁶

³ Section 27(A), Tax Code.

⁴ The implementation of R.A. No. 9337 has been temporarily suspended pursuant to a Temporary Restraining Order issued by the Supreme Court pending its resolution on the validity of the law.

⁵ Section 27(E)(4), Tax Code.

⁶ *Ibid.*

(ii) Tax Base for the 32%/35%/30% Income Tax

The Concession Fee received by the Concessionaire will form part of its gross income for income tax purposes. The net taxable income of the Concessionaire, that is, items of gross income under Section 32 of the Tax Code less allowable deductions under Section 34 of the Tax Code, will be subject to the normal income tax, or minimum corporate income tax, whichever is applicable.

The CWT withheld by TRANSCO will be deducted from the income tax liability of the Concessionaire in the period the CWT was withheld. Section 2.58.1 of Rev. Regs. No. 2-98, as amended, provides -

SECTION 2.58.1. *Income of Recipient.* — Income upon which any creditable tax is required to be withheld at source shall be included in the return of its recipient. The excess of the withheld tax over the tax due on his return shall be refunded to him subject to the authority of the Commissioner to refund taxes under Sec. 204 of the NIRC. If the income tax collected at source is less than the tax due on his return, the difference shall be paid in accordance with the provisions of Sec. 56 of the Code.

x x x

(iii) Compliance

The Concessionaire will be required to file a quarterly income tax return and a final adjustment return.⁷ The quarterly income tax return shall be filed within sixty (60) days following the close of each of the first three (3) quarters of the taxable year. The final adjustment return shall be filed on or before the fifteenth (15th) day of April following the close of the calendar year, or on or before the fifteenth (15th) day of the fourth (4th) month following the close of the fiscal year, as the case may be.⁸

3. Local Business Taxes

We understand that under the new Concession Agreement, any Free Cash Flow of TRANSCO, *i.e.*, transmission revenue less expenses, will be paid to the Concessionaire as a Concession Fee.

⁷ Section 52(A), Tax Code.

⁸ Section 77(B), Tax Code. Under Section 52(B) of the Tax Code, a corporation may employ either a calendar year or fiscal year as a basis for filing its annual income tax return.

As previously mentioned in our report dated August 16, 2005, Sections 143 and 151 of the Local Government Code of 1991 ("LGC") authorize municipalities and cities to impose local business taxes on contractors based on their gross receipts for the preceding calendar year. As enunciated by the Supreme Court in a number of cases, the exemption from all taxes enjoyed by the NPC, including local business taxes, have been withdrawn by the LGC. Hence, TRANSCO and the Concessionaire may be subject to local business tax imposed by an appropriate ordinance.

Article 221 of the Implementing Rules and Regulations of the LGC ("IRR of the LGC") defines "gross receipts" as follows:

(n) *Gross Sales or Receipts* include the total amount of money or its equivalent representing the contract price, compensation or service fee, including the amount charged for materials supplied with the services and deposits or advance payment actually or constructively received during the taxable quarter for the services performed or to be performed for another person excluding discounts if determinable at the time of sales, sales return, excise tax, and value added tax (VAT).

Based on the foregoing definition, the following are the only deductions allowed from gross receipts:

- (a) discounts determinable at the time of sale;
- (b) sales return;
- (c) excise tax; and
- (d) value added tax.

With respect to construction contractors, Department of Finance ("DOF") Local Finance Circular No. 3-95⁹ allows the deduction of amounts paid to sub-contractors in the computation of the taxable gross receipts to the local government unit. Section 3 thereof provides in part:

x x x

The taxable gross receipts shall be the amounts received by the principal contractor as the total contract price less the amount paid

⁹ Prescribing Guidelines Governing the Power of Cities and Municipalities to Impose Business Tax on Construction Contractors Pursuant to Section 143(e), Republic Act No. 7160, Otherwise Known as the Local Government Code of 1991, and its Implementing Rules and Regulations.

to a subcontractor under a subcontract arrangement, if there is any. The said sub-contractor, however, shall also be subject to the business tax imposed herein.

x x x

It bears stressing that DOF Local Finance Circular No. 3-95 finds application only to contractors defined to "include persons, natural or juridical, not subject to professional tax under Sec. 139 of the LGC, whose activity consists essentially of the sale of all kinds of construction services for a fee, regardless of whether or not the performance of the service calls for the exercise or use of the physical or mental faculties of such construction contractor or his employees". Clearly, neither TRANSCO nor the Concessionaire falls within the above definition. There is no similar issuance by the DOF allowing contractors engaged in services other than construction to deduct amounts paid to their sub-contractors.

Furthermore, well-settled is the rule that tax exemptions are construed *strictissimi juris* against the taxpayer and liberally in favor of the taxing power. In fact Section 5(b), LGC provides:

In case of doubt, any tax ordinance or revenue measure shall be construed strictly against the local government unit enacting it, and liberally in favor of the taxpayer. Any tax exemption, incentive or relief granted by any local government unit pursuant to the provisions of this code shall be construed strictly against the person claiming it.

While DOF Local Finance Circular No. 3-95 does not grant any tax exemption, it effectively lowers the tax liability of taxpayers falling under its scope. Absent any specific ordinance allowing TRANSCO to deduct payments made to the Concessionaire, we believe that TRANSCO's taxable gross receipts will include such payments to its Concessionaire.

Neither will the cases of *Collector of Internal Revenue v. Manila Jockey Club*¹⁰ (hereafter the "Manila Jockey Club case") nor *Commissioner of Internal Revenue v. Tours Specialists, Inc. and CTA*¹¹ apply to TRANSCO. These cases involve the collection of money by the taxpayer which legally belongs to some other entity. As we understand it, the Concessionaire collects the transmission charges on

¹⁰ G.R. No. 13789, June 30, 1960.

¹¹ G.R. No. 66416, March 21, 1990.

behalf of TRANSCO. The Concession Fee, consisting of the Free Cash Flow of TRANSCO, thereafter paid to the Concessionaire is distinct and separate from the gross receipts of TRANSCO. Even in the Manila Jockey Club case, the Supreme Court qualified that their ruling does not apply where the owner of an enterprise, by a private contract with its employees or partners, agrees to reserve for them a portion of the proceeds of the establishment.¹²

Hence, TRANSCO may be subject to local business tax based on its gross receipts, which includes the Free Cash Flow. The Concessionaire, on the other hand, may also be subject to local business tax based on its gross receipts, which includes the Concession Fee it receives from TRANSCO.

We trust you will find the foregoing useful. Should you have any questions, please let us know.

Very truly yours,


Edmundo P. Guevara

¹² Footnote 2 citing the cases of Wong & Lee v. Collector 104 Phil 469, Sy Chuico v. Collector 107 Phil 428.