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THIRD DIVISION

[G.R. No. 163835, July 07, 2010]

COMMISSIONER OF INTERNAL REVENUE, PETITIONER, VS. EASTERN TELECOMMUNICATIONS PHILIPPINES, INC., RESPONDENT.

D E C I S I O N

BRION, J.:

Through a petition for review on *certiorari*,[1] petitioner Commissioner of Internal Revenue (*CIR*) seeks to set aside the decision dated October 1, 2003[2] and the resolution dated May 26, 2004[3] of the Court of Appeals (*CA*) in CA G.R. SP No. 61157. The assailed CA rulings affirmed the decision dated July 17, 2000[4] of the Court of Tax Appeals (*CTA*) in CTA Case No. 5551, partially granting respondent Eastern Telecommunications Philippines, Inc.'s (*Eastern's*) claim for refund of unapplied input tax from its purchase and importation of capital goods.

THE FACTUAL ANTECEDENTS

Eastern is a domestic corporation granted by Congress with a telecommunications franchise under Republic Act (*RA*) No. 7617 on June 25, 1992. Under its franchise, Eastern is allowed to install, operate, and maintain telecommunications system throughout the Philippines.

From July 1, 1995 to December 31, 1996, Eastern purchased various imported equipment, machineries, and spare parts necessary in carrying out its business activities. The importations were subjected to a 10% value-added tax (*VAT*) by the Bureau of Customs, which was duly paid by Eastern.

On September 19, 1997, **Eastern filed with the CIR a written application for refund or credit of unapplied input taxes** it paid on the imported equipment during the taxable years 1995 and 1996 amounting to P22,013,134.00. In claiming for the tax refund, Eastern principally relied on Sec. 10 of RA No. 7617, which allows Eastern to pay 3% of its gross receipts in lieu of all taxes on this franchise or earnings thereof.[5] In the alternative, Eastern cited Section 106(B) of the National Internal Revenue Code of 1977[6] (*Tax Code*) which authorizes a VAT-registered taxpayer to claim for the issuance of a tax credit certificate or a tax refund of input taxes paid on capital goods imported or purchased locally to the extent that such input taxes[7] have not been applied against its output taxes.[8]

To toll the running of the two-year prescriptive period under the same provision, Eastern filed an appeal with the CTA on September 25, 1997 without waiting for the CIR's decision on its application for refund. The CIR filed an Answer to Eastern's

appeal in which it raised the following special and affirmative defenses:

> 6. [Eastern's] claim for refund/tax credit is pending administrative investigation;
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> x x x x
>
> 8. [Eastern's] exempting clause under its legislative franchise x x x should be understood or interpreted as written, meaning, the 3% franchise tax shall be collected as substitute for any internal revenue taxes x x x imposed on its franchise or gross receipts/earnings thereof x x x;
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> 9. The [VAT] on importation under Section 101 of the [1977] Tax Code is neither a tax on franchise nor on gross receipts or earnings thereof. It is a tax on the privilege of importing goods whether or not the taxpayer is engaged in business, and regardless of whether the imported goods are intended for sale, barter or exchange;
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> 10. The VAT under Section 101(A) of the Tax Code x x x replaced the advance sales tax and compensating tax x x x. Accordingly, the 3% franchise tax did not substitute the 10% [VAT] on [Eastern's] importation of equipment, machineries and spare parts for the use of its telecommunication system;
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> 11. Tax refunds are in the nature of tax exemptions. As such, they are regarded in derogation of sovereign authority and to be construed in *strictissimi juris* against the person or entity claiming the exemption. The burden is upon him who claims the exemption in his favour and he must be able to justify his claim by the clearest grant of organic or statute law and cannot be permitted to exist upon vague implication x x x;
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> 12. Taxes paid and collected are presumed to have been made in accordance with the laws and regulations; and
>
> 13. It is incumbent upon the taxpayer to establish its right to the refund and failure to sustain the burden is fatal to the claim for refund.[9]

Ruling in favor of Eastern, the **CTA found that Eastern has a valid claim for the refund/credit of the unapplied input taxes**, not on the basis of the *"in lieu of all taxes"* provision of its legislative franchise,[10] but rather, on Section 106(B) of the Tax Code, which states:

> **SECTION 106.** ***Refunds or tax credits of input tax.***
>
> x x x x
>
> (b) Capital goods. - A **VAT-registered person** may apply for the

issuance of a tax credit certificate or refund of **input taxes paid on capital goods imported or locally purchased, to the extent that such input taxes have not been applied against output taxes**. The application may be **made only within two (2) years after the close of the taxable quarter when the importation or purchase was made.**[11] [Emphases supplied.]

The CTA ruled that Eastern had satisfactorily shown that it was entitled to the claimed refund/credit as all the elements of the above provision were present: (1) Eastern was a VAT-registered entity which paid 10% input taxes on its importations of capital equipment; (2) this input VAT remained unapplied as of the first quarter of 1997; and (3) Eastern seasonably filed its application for refund/credit within the two-year period stated in the law. However, the CTA noted that Eastern was able to substantiate only P21,487,702.00 of its claimed amount of P22,013,134.00. The difference represented input taxes that were allegedly paid but were not supported by the corresponding receipts, as found by an independent auditor. Moreover, it excluded P5,360,634.00 in input taxes on imported equipment for the year 1995, even when these were properly documented as they were already booked by Eastern as part of the cost. Once input tax becomes part of the cost of capital equipment, it necessarily forms part of depreciation. Thus, to grant the refund of the 1995 creditable input tax amounts to twice giving Eastern the tax benefit. Thus, in its July 17, 2000 decision, the CTA granted in part Eastern's appeal by declaring it entitled to a tax refund of P16,229,100.00, representing unapplied input taxes on imported capital goods for the taxable year 1996.[12]

The CIR filed, on August 3, 2000, a motion for reconsideration[13] of the CTA's decision. About a month and a half later, it filed a supplemental motion for reconsideration dated September 15, 2000.[14] The CTA denied the CIR's motion for reconsideration in its resolution dated September 20, 2000.[15] The CIR then elevated the case to the CA through a petition for review under Rule 43 of the Rules of Court. **The CA affirmed the CTA ruling** through its decision dated October 1, 2003[16] and its resolution dated May 26, 2004,[17] denying the motion for reconsideration. Hence, the present petition.

THE PETITIONER'S ARGUMENTS

The CIR takes exception to the CA's ruling that Eastern is entitled to the *full* amount of unapplied input taxes paid for its purchase of imported capital goods that were substantiated by the corresponding receipts and invoices. The CIR posits that, applying Section 104(A) of the Tax Code on apportionment of tax credits, Eastern is entitled to a tax refund of only P8,814,790.15, instead of the P16,229,100.00 adjudged by the CTA and the CA. Section 104(A) of the Tax Code states:

SEC. 104. ***Tax Credits. -***

(a) ***Creditable Input tax. -***

x x x x

A VAT-registered person who is also engaged in transactions not subject to the value-added tax shall be allowed input tax credit as follows:

(A) Total input tax which can be directly attributed to transactions subject to value-added tax; and

(B) A ratable portion of any input tax which cannot be directly attributed to either activity.[18] [Emphases supplied.]

To be entitled to a tax refund of the full amount of P16,229,100.00, the CIR asserts that Eastern must prove that (a) it was engaged in purely VAT taxable transactions and (b) the unapplied input taxes it claims as refund were directly attributable to transactions subject to VAT. **The VAT returns of Eastern for the 1st, 2nd, 3rd, and 4th quarters of 1996, however, showed that it earned income from both transactions subject to VAT and transactions exempt from VAT**;[19] **the returns reported income earned from taxable sales, zero-rated sales, and exempt sales** in the following amounts:

1996	Taxable Sales	Zero-Rated Sales	Exempt Sales
1st Quarter	820,673.70	---	---
2nd Quarter	3,361,618.59	225,088,899.07	140,111,655.85
3rd Quarter	2,607,168.96	169,821,537.80	187,712,657.16
4th Quarter	1,134,942.71	162,530,947.40	147,717,028.53
TOTAL	***7,924,403.96***	***557,441,384.27***	**475,541,341.54**
		Total Amount of Sales	**1,040,907,129.77**

The taxable sales and zero-rated sales are considered transactions subject to VAT,[20] while exempt sales refer to transactions not subject to VAT.

Since the VAT returns clearly reflected income from exempt sales, the CIR asserts that this constitutes as an admission on Eastern's part that it engaged in transactions not subject to VAT. Hence, the proportionate allocation of the tax credit to VAT and non-VAT transactions provided in Section 104(A) of the Tax Code should apply. Eastern is then entitled to only P8,814,790.15 as the ratable portion of the tax credit, computed in the following manner:

$$\frac{\textit{Taxable Sales + Zero-rated Sales}}{\textit{Total Sales}} \times \textit{Input Tax as found by the CTA} = \textbf{\textit{Refundable input tax}}$$

Total Sales

$$\frac{7{,}924{,}403.96 + 557{,}445{,}384.97}{1{,}040{,}907{,}129.77} \times 16{,}229{,}100.00 = \textbf{P8,814,790.15}$$

THE RESPONDENT'S ARGUMENTS

Eastern objects to the arguments raised in the petition, alleging that these have not been raised in the Answer filed by the CIR before the CTA. In fact, **the CIR only raised the applicability of Section 104(A) of the Tax Code in his supplemental motion for reconsideration of the CTA's ruling** which, notably, was filed a month and a half after the original motion was filed, and thus beyond the 15-day reglementary period.[21] Accordingly, **the applicability of Section 104(A) was never validly presented as an issue before the CTA**; this, Eastern presumes, is the reason why it was not discussed in the CTA's resolution denying the motion for reconsideration. Eastern claims that for the CIR to raise such an issue now would constitute a violation of its right to due process; following settled rules of procedure and fair play, the CIR should not be allowed at the appeal level to change his theory of the case.

Moreover, in raising the question of whether Eastern was in fact engaged in transactions not subject to VAT and whether the unapplied input taxes can be directly attributable to transactions subject to VAT, Eastern posits that the CIR is effectively raising factual questions that cannot be the subject of an appeal by *certiorari* before the Court.

Even if the CIR's arguments were considered, Eastern insists that the petition should nevertheless be denied since the CA found that there was no evidence in the claim that it was engaged in non-VAT transactions. The CA has ruled that:

> The following requirements must be present before [Section 104(A)] of the [1977 Tax Code] can be applied, to wit:
>
> 1. The person claiming the creditable input tax must be VAT-registered;
> 2. Such person is engaged in a transaction subject to VAT;
> 3. The person is also engaged in other transactions not subject to VAT; and
> 4. The ratable portion of any input tax cannot be directly attributed to either activity.
>
> In the case at bar, the third and fourth requisites are not extant. It is undisputed that [Eastern] is VAT-registered and the importation of [Eastern's] telecommunications equipment, machinery, spare parts, fiber