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SECOND DIVISION

[G.R. NO. 150154, August 09, 2005]

COMMISSIONER OF INTERNAL REVENUE, PETITIONER, VS. TOSHIBA INFORMATION EQUIPMENT (PHILS.), INC., RESPONDENT.

D E C I S I O N

CHICO-NAZARIO, J.:

In this Petition for Review under Rule 45 of the Rules of Court, petitioner Commissioner of Internal Revenue (CIR) prays for the reversal of the decision of the Court of Appeals in CA-G.R. SP No. 59106,[1] affirming the order of the Court of Tax Appeals (CTA) in CTA Case No. 5593,[2] which ordered said petitioner CIR to refund or, in the alternative, to issue a tax credit certificate to respondent Toshiba Information Equipment (Phils.), Inc. (Toshiba), in the amount of P16,188,045.44, representing unutilized input value-added tax (VAT) payments for the first and second quarters of 1996.

There is hardly any dispute as to the facts giving rise to the present Petition.

Respondent Toshiba was organized and established as a domestic corporation, duly-registered with the Securities and Exchange Commission on 07 July 1995,[3] with the primary purpose of engaging in the business of manufacturing and exporting of electrical and mechanical machinery, equipment, systems, accessories, parts, components, materials and goods of all kinds, including, without limitation, to those relating to office automation and information technology, and all types of computer hardware and software, such as HDD, CD-ROM and personal computer printed circuit boards.[4]

On 27 September 1995, respondent Toshiba also registered with the Philippine Economic Zone Authority (PEZA) as an ECOZONE Export Enterprise, with principal office in Laguna Technopark, Biñan, Laguna.[5] Finally, on 29 December 1995, it registered with the Bureau of Internal Revenue (BIR) as a VAT taxpayer and a withholding agent.[6]

Respondent Toshiba filed its VAT returns for the first and second quarters of taxable year 1996, reporting input VAT in the amount of P13,118,542.00[7] and P5,128,761.94,[8] respectively, or a total of P18,247,303.94. It alleged that the said input VAT was from its purchases of capital goods and services which remained unutilized since it had not yet engaged in any business activity or transaction for which it may be liable for any output VAT.[9] Consequently, on 27 March 1998, respondent Toshiba filed with the One-Stop Shop Inter-Agency Tax Credit and Duty Drawback Center of the Department of Finance (DOF) applications for tax credit/refund of its unutilized input VAT for 01 January to 31 March 1996 in the

amount of P14,176,601.28,[10] and for 01 April to 30 June 1996 in the amount of P5,161,820.79,[11] for a total of P19,338,422.07. To toll the running of the two-year prescriptive period for judicially claiming a tax credit/refund, respondent Toshiba, on 31 March 1998, filed with the CTA a Petition for Review. It would subsequently file an Amended Petition for Review on 10 November 1998 so as to conform to the evidence presented before the CTA during the hearings.

In his Answer to the Amended Petition for Review before the CTA, petitioner CIR raised several Special and Affirmative Defenses, to wit -

> 5. Assuming without admitting that petitioner filed a claim for refund/tax credit, the same is subject to investigation by the Bureau of Internal Revenue.
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> 6. Taxes are presumed to have been collected in accordance with law. Hence, petitioner must prove that the taxes sought to be refunded were erroneously or illegally collected.
>
> 7. Petitioner must prove the allegations supporting its entitlement to a refund.
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> 8. Petitioner must show that it has complied with the provisions of Sections 204(c) and 229 of the 1997 Tax Code on the filing of a written claim for refund within two (2) years from the date of payment of the tax.
>
> 9. Claims for refund of taxes are construed strictly against claimants, the same being in the nature of an exemption from taxation.[12]

After evaluating the evidence submitted by respondent Toshiba,[13] the CTA, in its Decision dated 10 March 2000, ordered petitioner CIR to refund, or in the alternative, to issue a tax credit certificate to respondent Toshiba in the amount of P16,188,045.44.[14]

In a Resolution, dated 24 May 2000, the CTA denied petitioner CIR's Motion for Reconsideration for lack of merit.[15]

The Court of Appeals, in its Decision dated 27 September 2001, dismissed petitioner CIR's Petition for Review and affirmed the CTA Decision dated 10 March 2000.

Comes now petitioner CIR before this Court assailing the above-mentioned Decision of the Court of Appeals based on the following grounds -

1. The Court of Appeals erred in holding that petitioner's failure to raise in the Tax Court the arguments relied upon by him in the petition, is fatal to his cause.
2. The Court of Appeals erred in not holding that respondent being registered with the Philippine Economic Zone Authority (PEZA) as an Ecozone Export Enterprise, its business is not subject to VAT pursuant to Section 24 of Republic Act No. 7916 in relation to Section 103 (now 109) of the Tax Code.
3. The Court of Appeals erred in not holding that since respondent's business is not subject to VAT, the capital goods and services it purchased are considered

not used in VAT taxable business, and, therefore, it is not entitled to refund of input taxes on such capital goods pursuant to Section 4.106-1 of Revenue Regulations No. 7-95 and of input taxes on services pursuant to Section 4.103-1 of said Regulations.

4. The Court of Appeals erred in holding that respondent is entitled to a refund or tax credit of input taxes it paid on zero-rated transactions.[16]

Ultimately, however, the issue still to be resolved herein shall be whether respondent Toshiba is entitled to the tax credit/refund of its input VAT on its purchases of capital goods and services, to which this Court answers in the affirmative.

I

An ECOZONE enterprise is a VAT-exempt entity. Sales of goods, properties, and services by persons from the Customs Territory to ECOZONE enterprises shall be subject to VAT at zero percent (0%).

Respondent Toshiba bases its claim for tax credit/refund on Section 106(b) of the Tax Code of 1977, as amended, which reads:

> SEC. 106. *Refunds or tax credits of creditable input tax.* -
>
> ...
>
> (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.[17]

Petitioner CIR, on the other hand, opposes such claim on account of Section 4.106-1(b) of Revenue Regulations (RR) No. 7-95, otherwise known as the VAT Regulations, as amended, which provides as follows -

> Sec. 4.106-1. *Refunds or tax credits of input tax*. -
>
> ...
>
> (b) *Capital Goods*. -- Only a VAT-registered person may apply for issuance of a tax credit certificate or refund of input taxes paid on capital goods imported or locally purchased. The refund shall be allowed to the extent that such input taxes have not been applied against output taxes. The application should be made within two (2) years after the close of the taxable quarter when the importation or purchase was made.
>
> Refund of input taxes on capital goods shall be allowed only to the extent that such capital goods are used in VAT taxable business. If it is also used in exempt operations, the input tax refundable shall only be the ratable portion corresponding to the taxable operations.
>
> "*Capital goods or properties*" refer to goods or properties with estimated useful life greater than one year and which are treated as depreciable

> assets under Section 29(f), used directly or indirectly in the production or sale of taxable goods or services. (Underscoring ours.)

Petitioner CIR argues that although respondent Toshiba may be a VAT-registered taxpayer, it is not engaged in a VAT-taxable business. According to petitioner CIR, respondent Toshiba is actually VAT-exempt, invoking the following provision of the Tax Code of 1977, as amended -

> SEC. 103. *Exempt transactions*. - The following shall be exempt from value-added tax.
>
> ...
>
> (q) Transactions which are exempt under special laws, except those granted under Presidential Decree No. 66, 529, 972, 1491, and 1590, and non-electric cooperatives under Republic Act No. 6938, or international agreements to which the Philippines is a signatory.[18]

Since respondent Toshiba is a PEZA-registered enterprise, it is subject to the five percent (5%) preferential tax rate imposed under Chapter III, Section 24 of Republic Act No. 7916, otherwise known as The Special Economic Zone Act of 1995, as amended. According to the said section, "[e]xcept for real property taxes on land owned by developers, no taxes, local and national, shall be imposed on business establishments operating within the ECOZONE. In lieu thereof, five percent (5%) of the gross income earned by all business enterprises within the ECOZONE shall be paid..." The five percent (5%) preferential tax rate imposed on the gross income of a PEZA-registered enterprise shall be in lieu of all national taxes, including VAT. Thus, petitioner CIR contends that respondent Toshiba is VAT-exempt by virtue of a special law, Rep. Act No. 7916, as amended.

It would seem that petitioner CIR failed to differentiate between VAT-exempt transactions from VAT-exempt entities. In the case of *Commissioner of Internal Revenue v. Seagate Technology (Philippines)*,[19] this Court already made such distinction -

> An *exempt transaction*, on the one hand, involves goods or services which, by their nature, are specifically listed in and expressly exempted from the VAT under the Tax Code, without regard to the tax status - VAT-exempt or not - of the party to the transaction...
>
> An *exempt party*, on the other hand, is a person or entity granted VAT exemption under the Tax Code, a special law or an international agreement to which the Philippines is a signatory, and by virtue of which its taxable transactions become exempt from VAT...

Section 103(q) of the Tax Code of 1977, as amended, relied upon by petitioner CIR, relates to VAT-exempt transactions. These are transactions exempted from VAT by special laws or international agreements to which the Philippines is a signatory. Since such transactions are not subject to VAT, the sellers cannot pass on any output VAT to the purchasers of goods, properties, or services, and they may not claim tax credit/refund of the input VAT they had paid thereon.

Section 103(q) of the Tax Code of 1977, as amended, cannot apply to transactions

of respondent Toshiba because although the said section recognizes that transactions covered by special laws may be exempt from VAT, the very same section provides that those falling under Presidential Decree No. 66 are not. Presidential Decree No. 66, creating the Export Processing Zone Authority (EPZA), is the precursor of Rep. Act No. 7916, as amended,[20] under which the EPZA evolved into the PEZA. Consequently, the exception of Presidential Decree No. 66 from Section 103(q) of the Tax Code of 1977, as amended, extends likewise to Rep. Act No. 7916, as amended.

This Court agrees, however, that PEZA-registered enterprises, which would necessarily be located within ECOZONES, are VAT-exempt entities, not because of Section 24 of Rep. Act No. 7916, as amended, which imposes the five percent (5%) preferential tax rate on gross income of PEZA-registered enterprises, in lieu of all taxes; but, rather, because of Section 8 of the same statute which establishes the fiction that ECOZONES are foreign territory.

It is important to note herein that respondent Toshiba is located within an ECOZONE. An ECOZONE or a Special Economic Zone has been described as -

> . . . [S]elected areas with highly developed or which have the potential to be developed into agro-industrial, industrial, tourist, recreational, commercial, banking, investment and financial centers whose metes and bounds are fixed or delimited by Presidential Proclamations. An ECOZONE may contain any or all of the following: industrial estates (IEs), export processing zones (EPZs), free trade zones and tourist/recreational centers.[21]

The national territory of the Philippines outside of the proclaimed borders of the ECOZONE shall be referred to as the Customs Territory.[22]

Section 8 of Rep. Act No. 7916, as amended, mandates that the PEZA shall manage and operate the ECOZONES as a separate customs territory;[23] thus, creating the fiction that the ECOZONE is a foreign territory.[24] As a result, sales made by a supplier in the Customs Territory to a purchaser in the ECOZONE shall be treated as an exportation from the Customs Territory. Conversely, sales made by a supplier from the ECOZONE to a purchaser in the Customs Territory shall be considered as an importation into the Customs Territory.

Given the preceding discussion, what would be the VAT implication of sales made by a supplier from the Customs Territory to an ECOZONE enterprise?

The Philippine VAT system adheres to the Cross Border Doctrine, according to which, no VAT shall be imposed to form part of the cost of goods destined for consumption outside of the territorial border of the taxing authority. Hence, actual export of goods and services from the Philippines to a foreign country must be free of VAT; while, those destined for use or consumption within the Philippines shall be imposed with ten percent (10%) VAT.[25]

Applying said doctrine to the sale of goods, properties, and services to and from the ECOZONES,[26] the BIR issued Revenue Memorandum Circular (RMC) No. 74-99, on