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THIRD DIVISION

[G.R. No. 178788, September 29, 2010]

UNITED AIRLINES, INC., PETITIONER, VS. COMMISSIONER OF INTERNAL REVENUE, RESPONDENT.

D E C I S I O N

VILLARAMA, JR., J.:

Before us is a petition for review on certiorari under Rule 45 of the 1997 Rules of Civil Procedure, as amended, of the Decision[1] dated July 5, 2007 of the Court of Tax Appeals *En Banc* (CTA *En Banc*) in C.T.A. EB No. 227 denying petitioner's claim for tax refund of P5.03 million.

The undisputed facts are as follows:

Petitioner United Airlines, Inc. is a foreign corporation organized and existing under the laws of the State of Delaware, U.S.A., engaged in the international airline business.

Petitioner used to be an online international carrier of passenger and cargo, *i.e.*, it used to operate passenger and cargo flights originating in the Philippines. Upon cessation of its passenger flights in and out of the Philippines beginning February 21, 1998, petitioner appointed a sales agent in the Philippines -- Aerotel Ltd. Corp., an independent general sales agent acting as such for several international airline companies.[2] Petitioner continued operating cargo flights from the Philippines until January 31, 2001.[3]

On April 12, 2002, petitioner filed with respondent Commissioner a claim for income tax refund, pursuant to Section 28(A)(3)(a)[4] of the National Internal Revenue Code of 1997 (NIRC) in relation to Article 4(7)[5] of the Convention between the Government of the Republic of the Philippines and the Government of the United States of America with respect to Income Taxes (RP-US Tax Treaty). Petitioner sought to refund the total amount of P15,916,680.69 pertaining to income taxes paid on gross passenger and cargo revenues for the taxable years 1999 to 2001, which included the amount of P5,028,813.23 allegedly representing income taxes paid in 1999 on passenger revenue from tickets sold in the Philippines, the uplifts of which did not originate in the Philippines. Citing the change in definition of Gross Philippine Billings (GPB) in the NIRC, petitioner argued that since it no longer operated passenger flights originating from the Philippines beginning February

21, 1998, its passenger revenue for 1999, 2000 and 2001 cannot be considered as income from sources within the Philippines, and hence should not be subject to Philippine income tax under Article 9[6] of the RP-US Tax Treaty.[7]

As no resolution on its claim for refund had yet been made by the respondent and in view of the two (2)-year prescriptive period (from the time of filing the Final Adjustment Return for the taxable year 1999) which was about to expire on April 15, 2002, petitioner filed on said date a petition for review with the Court of Tax Appeals (CTA).[8]

Petitioner asserted that under the new definition of GPB under the 1997 NIRC and Article 4(7) of the RP-US Tax Treaty, Philippine tax authorities have jurisdiction to tax only the gross revenue derived by US air and shipping carriers from outgoing traffic in the Philippines. Since the Bureau of Internal Revenue (BIR) erroneously imposed and collected income tax in 1999 based on petitioner's gross passenger revenue, as beginning 1998 petitioner no longer flew passenger flights to and from the Philippines, petitioner is entitled to a refund of such erroneously collected income tax in the amount of **P5,028,813.23**.[9]

In its Decision[10] dated May 18, 2006, the CTA's First Division[11] ruled that no excess or erroneously paid tax may be refunded to petitioner because the income tax on GPB under Section 28(A)(3)(a) of the NIRC applies as well to gross revenue from carriage of cargoes originating from the Philippines. It agreed that petitioner cannot be taxed on its 1999 passenger revenue from flights originating outside the Philippines. However, in reporting a cargo revenue of P740.33 million in 1999, it was found that petitioner deducted two (2) items from its gross cargo revenue of P2.84 billion: P141.79 million as commission and P1.98 billion as other incentives of its agent. These deductions were erroneous because the gross revenue referred to in Section 28(A)(3)(a) of the NIRC was total revenue before any deduction of commission and incentives. Petitioner's gross cargo revenue in 1999, being P2.84 billion, the GPB tax thereon was P42.54 million and not P11.1 million, the amount petitioner paid for the reported net cargo revenue of P740.33 million. The CTA First Division further noted that petitioner even underpaid its taxes on cargo revenue by P31.43 million, which amount was much higher than the P5.03 million it asked to be refunded.

A motion for reconsideration was filed by petitioner but the First Division denied the same. It held that petitioner's claim for tax refund was not offset with its tax liability; that petitioner's tax deficiency was due to erroneous deductions from its gross cargo revenue; that it did not make an assessment against petitioner; and that it merely determined if petitioner was entitled to a refund based on the undisputed facts and whether petitioner had paid the correct amount of tax.[12]

Petitioner elevated the case to the CTA *En Banc* which affirmed the decision of the First Division.

Hence, this petition anchored on the following grounds:

I. THE CTA *EN BANC* GROSSLY ERRED IN DENYING THE PETITIONER'S CLAIM FOR REFUND OF ERRONEOUSLY PAID INCOME TAX ON GROSS PHILIPPINE BILLINGS [GPB] BASED ON ITS FINDING THAT PETITIONER'S UNDERPAYMENT OF [P31.43 MILLION] GPB TAX ON CARGO REVENUES IS A LOT HIGHER THAN THE GPB TAX OF [P5.03 MILLION] ON PASSENGER REVENUES, WHICH IS THE SUBJECT OF THE INSTANT CLAIM FOR REFUND. THE DENIAL OF PETITIONER'S CLAIM ON SUCH GROUND CLEARLY AMOUNTS TO AN OFF-SETTING OF TAX LIABILITIES, CONTRARY TO WELL-SETTLED JURISPRUDENCE.

II. THE DECISION OF THE CTA *EN BANC* VIOLATED PETITIONER'S RIGHT TO DUE PROCESS.

III. THE CTA *EN BANC* ACTED IN EXCESS OF ITS JURISDICTION BY DENYING PETITIONER'S CLAIM FOR REFUND OF ERRONEOUSLY PAID INCOME TAX ON GROSS PHILIPPINE BILLINGS BASED ON ITS FINDING THAT PETITIONER UNDERPAID GPB TAX ON CARGO REVENUES IN THE AMOUNT OF [P31.43 MILLION] FOR THE TAXABLE YEAR 1999.

IV. THE CTA *EN BANC* HAS NO AUTHORITY UNDER THE LAW TO MAKE ANY ASSESSMENTS FOR DEFICIENCY TAXES. THE AUTHORITY TO MAKE ASSESSMENTS FOR DEFICIENCY NATIONAL INTERNAL REVENUE TAXES IS VESTED BY THE 1997 NIRC UPON RESPONDENT.

V. ANY ASSESSMENT AGAINST PETITIONER FOR DEFICIENCY INCOME TAX FOR THE TAXABLE YEAR 1999 IS ALREADY BARRED BY PRESCRIPTION.[13]

The main issue to be resolved is whether the petitioner is entitled to a refund of the amount of **P5,028,813.23** it paid as income tax on its passenger revenues in 1999.

Petitioner argues that its claim for refund of erroneously paid GPB tax on off-line passenger revenues cannot be denied based on the finding of the CTA that petitioner allegedly underpaid the GPB tax on cargo revenues by P31,431,171.09, which underpayment is allegedly higher than the GPB tax of P5,028,813.23 on passenger revenues, the amount of the instant claim. The denial of petitioner's claim for refund on such ground is tantamount to an offsetting of petitioner's claim for refund of erroneously paid GPB against its alleged *tax liability*. Petitioner thus cites the well-entrenched rule in taxation cases that internal revenue taxes cannot be the subject of set-off or compensation.

[14]

According to petitioner, the offsetting of the liabilities is very clear in the instant case because the amount of petitioner's claim for refund of erroneously paid GPB tax of P5,028,813.23 for the taxable year 1999 is being offset against petitioner's alleged deficiency GPB tax liability on *cargo revenues* for the same year, which was not even the subject of an investigation nor any valid assessment issued by respondent against the petitioner. Under Section 228[15] of the NIRC, the "taxpayer shall be informed in writing of the law and the facts on which the assessment is made; otherwise, the assessment shall be void." This administrative process of issuing an assessment is part of procedural due process enshrined in the 1987 Constitution. Records do not show that petitioner has been assessed by the BIR for any deficiency GBP tax for 1999, nor was there any finding or investigation being conducted by respondent of any liability of petitioner for GPB tax for the said taxable period. Clearly, petitioner's right to due process was violated.[16]

Petitioner further argues that the CTA acted in excess of its jurisdiction because the exclusive appellate jurisdiction of the CTA covers only decisions or inactions of the respondent in cases involving disputed assessments. The CTA has effectively assessed petitioner with a P31.43 million tax deficiency when it concluded that petitioner underpaid its GPB tax on cargo revenue. Since respondent did not issue an assessment for any deficiency tax, the alleged deficiency tax on its cargo revenue in 1999 cannot be considered a disputed assessment that may be passed upon by the CTA. Petitioner stresses that the authority to issue an assessment for deficiency internal revenue taxes is vested by law on respondent, not with the CTA.[17]

Lastly, petitioner argues that any assessment against it for deficiency income tax for taxable year 1999 is barred by prescription. Petitioner claims that the prescriptive period within which an assessment for deficiency income tax may be made has prescribed on April 17, 2003, three (3) years after it filed its 1999 tax return.[18]

Respondent Commissioner maintains that the CTA acted within its jurisdiction in denying petitioner's claim for tax refund. It points out that the objective of the CTA's determination of whether petitioner correctly paid its GPB tax for the taxable year 1999 was to ascertain the latter's entitlement to the claimed refund and not for the purpose of imposing any deficiency tax. Hence, petitioner's arguments regarding the propriety of the CTA's determination of its deficiency tax on its GPB for gross cargo revenues for 1999 are clearly misplaced.[19]

The petition has no merit.

As correctly pointed out by petitioner, inasmuch as it ceased operating passenger flights to or from the Philippines in 1998, it is not taxable under Section 28(A)(3)(a) of the NIRC for gross passenger revenues. This much was also found by the CTA. In *South African*

Airways v. Commissioner of Internal Revenue,[20] we ruled that the correct interpretation of the said provisions is that, if an international air carrier maintains flights to and from the Philippines, it shall be taxed at the rate of 2½% of its GPB, while international air carriers that do not have flights to and from the Philippines but nonetheless earn income from other activities in the country will be taxed at the rate of 32% of such income.

Here, the subject of claim for tax refund is the tax paid on passenger revenue for taxable year 1999 at the time when petitioner was still operating cargo flights originating from the Philippines although it had ceased passenger flight operations. The CTA found that petitioner had underpaid its GPB tax for 1999 because petitioner had made deductions from its gross cargo revenues in the income tax return it filed for the taxable year 1999, the amount of underpayment even greater than the refund sought for erroneously paid GPB tax on passenger revenues for the same taxable period. Hence, the CTA ruled petitioner is not entitled to a tax refund.

Petitioner's arguments regarding the propriety of such determination by the CTA are misplaced.

Under Section 72 of the NIRC, the CTA can make a valid finding that petitioner made erroneous deductions on its gross cargo revenue; that because of the erroneous deductions, petitioner reported a lower cargo revenue and paid a lower income tax thereon; and that petitioner's underpayment of the income tax on cargo revenue is even higher than the income tax it paid on passenger revenue subject of the claim for refund, such that the refund cannot be granted.

Section 72 of the NIRC reads:

> SEC. 72. **Suit to Recover Tax Based on False or Fraudulent Returns**. - When an assessment is made in case of any list, statement or return, which in the opinion of the Commissioner was false or fraudulent or contained any understatement or undervaluation, no tax collected under such assessment shall be recovered by any suit, unless it is proved that the said list, statement or return was not false nor fraudulent and did not contain any understatement or undervaluation; but this provision shall not apply to statements or returns made or to be made in good faith regarding annual depreciation of oil or gas wells and mines.

In the afore-cited case of *South African Airways,* this Court rejected similar arguments on the denial of claim for tax refund, as follows:

> **Precisely, petitioner questions the offsetting of its payment of the tax under Sec. 28(A)(3)(a) with their liability under Sec. 28(A)(1), considering that**

there has not yet been any assessment of their obligation under the latter provision. Petitioner argues that such offsetting is in the nature of legal compensation, which cannot be applied under the circumstances present in this case.

Article 1279 of the Civil Code contains the elements of legal compensation, to wit:

Art. 1279. In order that compensation may be proper, it is necessary:

(1) That each one of the obligors be bound principally, and that he be at the same time a principal creditor of the other;

(2) That both debts consist in a sum of money, or if the things due are consumable, they be of the same kind, and also of the same quality if the latter has been stated;

(3) That the two debts be due;

(4) That they be liquidated and demandable;

(5) That over neither of them there be any retention or controversy, commenced by third persons and communicated in due time to the debtor.

And we ruled in *Philex Mining Corporation v. Commissioner of Internal Revenue*, thus:

In several instances prior to the instant case, we have already made the pronouncement that taxes cannot be subject to compensation for the simple reason that the government and the taxpayer are not creditors and debtors of each other. There is a material distinction between a tax and debt. Debts are due to the Government in its corporate capacity, while taxes are due to the Government in its sovereign capacity. We find no cogent reason to deviate from the aforementioned distinction.

Prescinding from this premise, in *Francia v. Intermediate Appellate Court*, we categorically held that taxes cannot be subject to set-off or compensation, thus:

> We have consistently ruled that there can be no off-setting of taxes against the claims that the taxpayer may have against the government. A person cannot refuse to pay a tax on the ground that the government owes him an amount equal to or greater than the tax being collected. The collection of a tax cannot await the results of a lawsuit against the government.

The ruling in *Francia* has been applied to the subsequent case of *Caltex Philippines, Inc. v. Commission on Audit*, which reiterated that:

> . . . a taxpayer may not offset taxes due from the claims that he may have against the government. Taxes cannot be the subject of compensation because the government and taxpayer are not mutually creditors and debtors of each other and a claim for taxes is not such a debt, demand, contract or judgment as is allowed to be set-off.

Verily, petitioner's argument is correct that the offsetting of its tax refund with its alleged tax deficiency is unavailing under Art. 1279 of the Civil Code.

***Commissioner of Internal Revenue v. Court of Tax Appeals*, however, granted the offsetting of a tax refund with a tax deficiency** in this wise:

> Further, it is also worth noting that the Court of Tax Appeals erred in denying petitioner's supplemental motion for reconsideration alleging bringing to said court's attention the existence of the deficiency income and business tax assessment against Citytrust. The fact of such deficiency assessment is intimately related to and inextricably intertwined with the right of respondent bank to claim for a tax refund for the same year. To award such refund despite the existence of that deficiency assessment is an absurdity and a polarity in conceptual effects. Herein private respondent cannot be entitled to refund and at the same time be liable for a tax deficiency assessment for the same year.
>
> **The grant of a refund is founded on the assumption that the tax return is valid, that is, the facts stated therein are true and correct. The deficiency assessment, although not yet final, created a doubt as to and constitutes a challenge against the truth and accuracy of the facts stated in said return which, by itself and without unquestionable evidence, cannot be the basis for the grant of the refund.**
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> **Section 82, Chapter IX of the National Internal Revenue Code of 1977,** which was the applicable law when the claim of Citytrust was filed, provides that "(w)hen an assessment is made in case of any list, statement, or return, which in the opinion of the Commissioner of Internal Revenue was false or fraudulent or contained any understatement or undervaluation, no tax collected under such assessment shall be recovered by any suits unless it is proved that the

said list, statement, or return was not false nor fraudulent and did not contain any understatement or undervaluation; but this provision shall not apply to statements or returns made or to be made in good faith regarding annual depreciation of oil or gas wells and mines."

Moreover, **to grant the refund without determination of the proper assessment and the tax due would inevitably result in multiplicity of proceedings or suits.** If the deficiency assessment should subsequently be upheld, the Government will be forced to institute anew a proceeding for the recovery of erroneously refunded taxes which recourse must be filed within the prescriptive period of ten years after discovery of the falsity, fraud or omission in the false or fraudulent return involved. This would necessarily require and entail additional efforts and expenses on the part of the Government, impose a burden on and a drain of government funds, and impede or delay the collection of much-needed revenue for governmental operations.

Thus, to avoid multiplicity of suits and unnecessary difficulties or expenses, it is both logically necessary and legally appropriate that the issue of the deficiency tax assessment against Citytrust be resolved jointly with its claim for tax refund, to determine once and for all in a single proceeding the true and correct amount of tax due or refundable.

In fact, as the Court of Tax Appeals itself has heretofore conceded, it would be only just and fair that the taxpayer and the Government alike be given equal opportunities to avail of remedies under the law to defeat each other's claim and to determine all matters of dispute between them in one single case. It is important to note that in determining whether or not petitioner is entitled to the refund of the amount paid, it would [be] necessary to determine how much the Government is entitled to collect as taxes. This would necessarily include the determination of the correct liability of the taxpayer and, certainly, a determination of this case would constitute res judicata on both parties as to all the matters subject thereof or necessarily involved therein. (Emphasis supplied.)

Sec. 82, Chapter IX of the 1977 Tax Code is now Sec. 72, Chapter XI of the 1997 NIRC. The above pronouncements are, therefore, still applicable today.

Here, **petitioner's similar tax refund claim assumes that the tax return that it filed was correct. Given, however, the finding of the CTA that petitioner, although not liable under Sec. 28(A)(3)(a) of the 1997 NIRC, is liable under**

> **Sec. 28(A)(1), the correctness of the return filed by petitioner is now put in doubt. As such, we cannot grant the prayer for a refund.**[21] (Additional emphasis supplied.)

In the case at bar, the CTA explained that it merely determined whether petitioner is entitled to a refund based on the facts. On the assumption that petitioner filed a correct return, it had the right to file a claim for refund of GPB tax on passenger revenues it paid in 1999 when it was not operating passenger flights to and from the Philippines. However, upon examination by the CTA, petitioner's return was found erroneous as it understated its gross cargo revenue for the same taxable year due to deductions of two (2) items consisting of commission and other incentives of its agent. Having underpaid the GPB tax due on its cargo revenues for 1999, petitioner is not entitled to a refund of its GPB tax on its passenger revenue, the amount of the former being even much higher (P31.43 million) than the tax refund sought (P5.2 million). The CTA therefore correctly denied the claim for tax refund after determining the proper assessment and the tax due. Obviously, the matter of prescription raised by petitioner is a non-issue. The prescriptive periods under Sections 203[22] and 222[23] of the NIRC find no application in this case.

We must emphasize that tax refunds, like tax exemptions, are construed strictly against the taxpayer and liberally in favor of the taxing authority.[24] In any event, petitioner has not discharged its burden of proof in establishing the factual basis for its claim for a refund and we find no reason to disturb the ruling of the CTA. It has been a long-standing policy and practice of the Court to respect the conclusions of quasi-judicial agencies such as the CTA, a highly specialized body specifically created for the purpose of reviewing tax cases.[25]

WHEREFORE, we **DENY** the petition for lack of merit and **AFFIRM** the Decision dated July 5, 2007 of the Court of Tax Appeals *En Banc* in C.T.A. EB No. 227.

With costs against the petitioner.

SO ORDERED.

Carpio Morales, (Chairperson), Brion, Bersamin, Villarama, Jr., and Sereno, JJ.

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[1] *Rollo*, pp. 64-77.

[2] Id. at 48, 78-79.

[3] Id. at 80.

[4] SEC. 28. Rates of Income Tax on Foreign Corporations. -

(A) *Tax on Resident Foreign Corporations*. -

x x x x

(3) *International Carrier.* - An international carrier doing business in the Philippines shall pay a tax of two and one-half percent (2 1/2%) on its "*Gross Philippine Billings*" as defined hereunder:

(a) *International Air Carrier* - "*Gross Philippine Billings*" refers to the amount of gross revenue derived from carriage of persons, excess baggage, cargo and mail originating from the Philippines in a continuous and uninterrupted flight, irrespective of the place of sale or issue and the place of payment of the ticket or passage document: xxx.

[5] **Article 4**

Source of Income

For the purpose of this Convention:

x x x x

(7) Gross revenues from the operation of ships in international traffic shall be treated as from sources within a Contracting State to the extent they are derived from international traffic originating in that State.

x x x x

[6] **Article 9**
Shipping and Air Transport

1) Notwithstanding any other provision of this Convention, profits derived by a resident of one of the Contracting States from sources within the other Contracting State from the operation of ships in international traffic may be taxed by both Contracting States; however, the tax imposed by the other Contracting State may be as much as, but shall not exceed, the lesser of -

a) one and one-half percent of the gross revenues derived from sources in that State; and
b) the lowest rate of Philippine tax that may be imposed on profits of the same kind derived under similar circumstances by a resident of a third State.

2) Nothing in the Convention shall affect the right of a Contracting State to tax, in

accordance with its domestic laws, profits derived by a resident of the other Contracting State from sources within the first-mentioned Contracting State from the operation of aircraft in international traffic.

3) The provisions of paragraphs 1) and 2) shall also apply to profits derived from the participation in a pool, a joint business or in an international operating agency.

[7] *Rollo*, pp. 80-84.

[8] Id. at 95.

[9] Id. at 90-95.

[10] Id. at 47-60.

[11] Composed of Presiding Justice Ernesto D. Acosta as Chairman, and Associate Justices Lovell R. Bautista and Caesar A. Casanova as Members.

[12] *Rollo*, pp. 61-63.

[13] Id. at 32-33.

[14] Id. at 33-36.

[15] SEC. 228. **Protesting of Assessment**. - When the Commissioner or his duly authorized representative finds that proper taxes should be assessed, he shall first notify the taxpayer of his findings: *Provided, however*, That a preassessment notice shall not be required in the following cases:

x x x x

The taxpayer shall be informed in writing of the law and the facts on which the assessment is made; otherwise, the assessment shall be void.

x x x x

[16] *Rollo,* pp. 34, 36-39.

[17] Id. at 39-40.

[18] Id. at 42-43.

[19] Id. at 199.

[20] G.R. No. 180356, February 16, 2010, pp. 9-10.

[21] Id. at 10-13. Citations omitted.

[22] SEC. 203. **Period of Limitation Upon Assessment and Collection.** - Except as provided in Section 222, internal revenue taxes shall be assessed within three (3) years after the last day prescribed by law for the filing of the return, and no proceeding in court without assessment for the collection of such taxes shall be begun after expiration of such period: *Provided*, That in a case where a return is filed beyond the period prescribed by law, the three (3)-year period shall be counted from the day the return was filed. For purposes of this Section, a return filed before the last day prescribed by law for the filing thereof shall be considered as filed on such last day.

[23] SEC. 222. **Exceptions as to Period of Limitation of Assessment and Collection of Taxes. -**

(a) In the case of a false or fraudulent return with intent to evade tax or of failure to file a return, the tax may be assessed, or a proceeding in court for the collection of such tax may be filed without assessment, at any time within ten (10) years after the discovery of the falsity, fraud, or omission: xxx.

[24] *Far East Bank and Trust Company v. Court of Appeals*, G.R. No. 129130, December 9, 2005, 477 SCRA 49, 57, citing *Paseo Realty & Development Corporation v. Court of Appeals*, G.R. No. 119286, October 13, 2004, 440 SCRA 235.

[25] *Commissioner of Internal Revenue v. General Food (Phils.), Inc.*, G.R. No. 143672, April 24, 2003, 401 SCRA 545, 553.
