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SECOND DIVISION

[G.R. No. 151135, July 02, 2004]

CONTEX CORPORATION, PETITIONER, VS. HON. COMMISSIONER OF INTERNAL REVENUE, RESPONDENT.

D E C I S I O N

QUISUMBING, J.:

For review is the Decision[1] dated September 3, 2001, of the Court of Appeals, in CA-G.R. SP No. 62823, which reversed and set aside the decision[2] dated October 13, 2000, of the Court of Tax Appeals (CTA). The CTA had ordered the Commissioner of Internal Revenue (CIR) to refund the sum of ₱683,061.90 to petitioner as erroneously paid input value-added tax (VAT) or in the alternative, to issue a tax credit certificate for said amount. Petitioner also assails the appellate court's Resolution,[3] dated December 19, 2001, denying the motion for reconsideration.

Petitioner is a domestic corporation engaged in the business of manufacturing hospital textiles and garments and other hospital supplies for export. Petitioner's place of business is at the Subic Bay Freeport Zone (SBFZ). It is duly registered with the Subic Bay Metropolitan Authority (SBMA) as a Subic Bay Freeport Enterprise, pursuant to the provisions of Republic Act No. 7227.[4] As an SBMA-registered firm, petitioner is exempt from all local and national internal revenue taxes except for the preferential tax provided for in Section 12 (c)[5] of Rep. Act No. 7227. Petitioner also registered with the Bureau of Internal Revenue (BIR) as a non-VAT taxpayer under Certificate of Registration RDO Control No. 95-180-000133.

From January 1, 1997 to December 31, 1998, petitioner purchased various supplies and materials necessary in the conduct of its manufacturing business. The suppliers of these goods shifted unto petitioner the 10% VAT on the purchased items, which led the petitioner to pay input taxes in the amounts of ₱539,411.88 and ₱504,057.49 for 1997 and 1998, respectively.[6]

Acting on the belief that it was exempt from all national and local taxes, including VAT, pursuant to Rep. Act No. 7227, petitioner filed two applications for tax refund or tax credit of the VAT it paid. Mr. Edilberto Carlos, revenue district officer of BIR RDO No. 19, denied the first application letter, dated December 29, 1998.

Unfazed by the denial, petitioner on May 4, 1999, filed another application for tax refund/credit, this time directly with Atty. Alberto Pagabao, the regional director of BIR Revenue Region No. 4. The second letter sought a refund or issuance of a tax credit certificate in the amount of ₱1,108,307.72, representing erroneously paid input VAT for the period January 1, 1997 to November 30, 1998.

When no response was forthcoming from the BIR Regional Director, petitioner then elevated the matter to the Court of Tax Appeals, in a petition for review docketed as CTA Case No. 5895. Petitioner stressed that Section 112(A)[7] if read in relation to Section 106(A)(2)(a)[8] of the National Internal Revenue Code, as amended and Section 12(b)[9] and (c) of Rep. Act No. 7227 would show that it was not liable in any way for any value-added tax.

In opposing the claim for tax refund or tax credit, the BIR asked the CTA to apply the rule that claims for refund are strictly construed against the taxpayer. Since petitioner failed to establish both its right to a tax refund or tax credit and its compliance with the rules on tax refund as provided for in Sections 204[10] and 229[11] of the Tax Code, its claim should be denied, according to the BIR.

On October 13, 2000, the CTA decided CTA Case No. 5895 as follows:

> WHEREFORE, in view of the foregoing, the Petition for Review is hereby PARTIALLY GRANTED. Respondent is hereby ORDERED to REFUND or in the alternative to ISSUE A TAX CREDIT CERTIFICATE in favor of Petitioner the sum of ₱683,061.90, representing erroneously paid input VAT.
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> SO ORDERED.[12]

In granting a partial refund, the CTA ruled that petitioner misread Sections 106(A)(2)(a) and 112(A) of the Tax Code. The tax court stressed that these provisions apply only to those entities registered as VAT taxpayers whose sales are zero-rated.

Petitioner does not fall under this category, since it is a non-VAT taxpayer as evidenced by the Certificate of Registration RDO Control No. 95-180-000133 issued by RDO Rosemarie Ragasa of BIR RDO No. 18 of the Subic Bay Freeport Zone and thus it is exempt from VAT, pursuant to Rep. Act No. 7227, said the CTA.

Nonetheless, the CTA held that the petitioner is exempt from the imposition of input VAT on its purchases of supplies and materials. It pointed out that under Section 12(c) of Rep. Act No. 7227 and the Implementing Rules and Regulations of the Bases Conversion and Development Act of 1992, all that petitioner is required to pay as a SBFZ-registered enterprise is a 5% preferential tax.

The CTA also disallowed all refunds of input VAT paid by the petitioner prior to June 29, 1997 for being barred by the two-year prescriptive period under Section 229 of the Tax Code. The tax court also limited the refund only to the input VAT paid by the petitioner on the supplies and materials directly used by the petitioner in the manufacture of its goods. It struck down all claims for input VAT paid on maintenance, office supplies, freight charges, and all materials and supplies shipped or delivered to the petitioner's Makati and Pasay City offices.

Respondent CIR then filed a petition, docketed as CA-G.R. SP No. 62823, for review of the CTA decision by the Court of Appeals. Respondent maintained that the exemption of Contex Corp. under Rep. Act No. 7227 was limited only to direct taxes and not to indirect taxes such as the input component of the VAT. The Commissioner pointed out that from its very nature, the value-added tax is a burden passed on by a VAT registered person to the end users; hence, the direct liability for the tax lies with the suppliers and not Contex.

Finding merit in the CIR's arguments, the appellate court decided CA-G.R. SP No. 62823 in his favor, thus:

> WHEREFORE, premises considered, the appealed decision is hereby REVERSED AND SET ASIDE. Contex's claim for refund of erroneously paid taxes is DENIED accordingly.
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> SO ORDERED.[13]

In reversing the CTA, the Court of Appeals held that the exemption from duties and taxes on the importation of raw materials, capital, and equipment of SBFZ-registered enterprises under Rep. Act No. 7227 and its implementing rules covers only "the VAT imposable under Section 107 of the [Tax Code], which is a direct liability of the importer, and in no way includes the value-added tax of the seller-exporter the burden of which was passed on to the importer as an additional costs of the goods."[14] This was because the exemption granted by Rep. Act No. 7227 relates to the act of importation and Section 107[15] of the Tax Code specifically imposes the VAT on importations. The appellate court applied the principle that tax exemptions are strictly construed against the taxpayer. The Court of Appeals pointed out that under the implementing rules of Rep. Act No. 7227, the exemption of SBFZ-registered enterprises from internal revenue taxes is qualified as pertaining only to those for which they may be directly liable. It then stated that apparently, the legislative intent behind Rep. Act No. 7227 was to grant exemptions only to direct taxes, which SBFZ-registered enterprise may be liable for and only in connection with their importation of raw materials, capital, and equipment as well as the sale of their goods and services.

Petitioner timely moved for reconsideration of the Court of Appeals decision, but the motion was denied.

Hence, the instant petition raising as issues for our resolution the following:

> A. WHETHER OR NOT THE EXEMPTION FROM ALL LOCAL AND NATIONAL INTERNAL REVENUE TAXES PROVIDED IN REPUBLIC ACT NO. 7227 COVERS THE VALUE ADDED TAX PAID BY PETITIONER, A SUBIC BAY FREEPORT ENTERPRISE ON ITS PURCHASES OF SUPPLIES AND MATERIALS.
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> B. WHETHER OR NOT THE COURT OF TAX APPEALS CORRECTLY HELD THAT PETITIONER IS ENTITLED TO A TAX CREDIT OR REFUND OF THE VAT PAID ON ITS PURCHASES OF SUPPLIES AND RAW MATERIALS FOR THE YEARS 1997 AND 1998.[16]

Simply stated, we shall resolve now the issues concerning: (1) the correctness of the finding of the Court of Appeals that the VAT exemption embodied in Rep. Act No. 7227 does not apply to petitioner as a purchaser; and (2) the entitlement of the petitioner to a tax refund on its purchases of supplies and raw materials for 1997 and 1998.

On the *first issue*, petitioner argues that the appellate court's restrictive interpretation of petitioner's VAT exemption as limited to those covered by Section

107 of the Tax Code is erroneous and devoid of legal basis. It contends that the provisions of Rep. Act No. 7227 clearly and unambiguously mandate that no local and national taxes shall be imposed upon SBFZ-registered firms and hence, said law should govern the case. Petitioner calls our attention to regulations issued by both the SBMA and BIR clearly and categorically providing that the tax exemption provided for by Rep. Act No. 7227 includes exemption from the imposition of VAT on purchases of supplies and materials.

The respondent takes the diametrically opposite view that while Rep. Act No. 7227 does grant tax exemptions, such grant is not all-encompassing but is limited only to those taxes for which a SBFZ-registered business may be directly liable. Hence, SBFZ locators are not relieved from the indirect taxes that may be shifted to them by a VAT-registered seller.

At this juncture, it must be stressed that the VAT is an indirect tax. As such, the amount of tax paid on the goods, properties or services bought, transferred, or leased may be shifted or passed on by the seller, transferor, or lessor to the buyer, transferee or lessee.[17] Unlike a direct tax, such as the income tax, which primarily taxes an individual's ability to pay based on his income or net wealth, an indirect tax, such as the VAT, is a tax on consumption of goods, services, or certain transactions involving the same. The VAT, thus, forms a substantial portion of consumer expenditures.

Further, in indirect taxation, there is a need to distinguish between the liability for the tax and the burden of the tax. As earlier pointed out, the amount of tax paid may be shifted or passed on by the seller to the buyer. What is transferred in such instances is not the liability for the tax, but the tax burden. In adding or including the VAT due to the selling price, the seller remains the person primarily and legally liable for the payment of the tax. What is shifted only to the intermediate buyer and ultimately to the final purchaser is the burden of the tax.[18] Stated differently, a seller who is directly and legally liable for payment of an indirect tax, such as the VAT on goods or services is not necessarily the person who ultimately bears the burden of the same tax. It is the final purchaser or consumer of such goods or services who, although not directly and legally liable for the payment thereof, ultimately bears the burden of the tax.[19]

Exemptions from VAT are granted by express provision of the Tax Code or special laws. Under VAT, the transaction can have preferential treatment in the following ways:

> (a) VAT Exemption. An exemption means that the sale of goods or properties and/or services and the use or lease of properties is not subject to VAT (output tax) and the seller is not allowed any tax credit on VAT (input tax) previously paid.[20] This is a case wherein the VAT is removed at the exempt stage (i.e., at the point of the sale, barter or exchange of the goods or properties).
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> The person making the exempt sale of goods, properties or services shall not bill any output tax to his customers because the said transaction is not subject to VAT. On the other hand, a VAT-registered purchaser of VAT-exempt goods/properties or services which are exempt from VAT is

not entitled to any input tax on such purchase despite the issuance of a VAT invoice or receipt.[21]

(b) Zero-rated Sales. These are sales by VAT-registered persons which are subject to 0% rate, meaning the tax burden is not passed on to the purchaser. A zero-rated sale by a VAT-registered person, which is a taxable transaction for VAT purposes, shall not result in any output tax. However, the input tax on his purchases of goods, properties or services related to such zero-rated sale shall be available as tax credit or refund in accordance with these regulations.[22]

Under Zero-rating, all VAT is removed from the zero-rated goods, activity or firm. In contrast, exemption only removes the VAT at the exempt stage, and it will actually increase, rather than reduce the total taxes paid by the exempt firm's business or non-retail customers. It is for this reason that a sharp distinction must be made between zero-rating and exemption in designating a value-added tax.[23]

Apropos, the petitioner's claim to VAT exemption in the instant case for its purchases of supplies and raw materials is founded mainly on Section 12 (b) and (c) of Rep. Act No. 7227, which basically exempts them from all national and local internal revenue taxes, including VAT and Section 4 (A)(a) of BIR Revenue Regulations No. 1-95.[24]

On this point, petitioner rightly claims that it is indeed VAT-Exempt and this fact is not controverted by the respondent. In fact, petitioner is registered as a NON-VAT taxpayer per Certificate of Registration[25] issued by the BIR. As such, it is exempt from VAT on all its sales and importations of goods and services.

Petitioner's claim, however, for exemption from VAT for its purchases of supplies and raw materials is incongruous with its claim that it is VAT-Exempt, for only VAT-Registered entities can claim Input VAT Credit/Refund.

The point of contention here is whether or not the petitioner may claim a refund on the Input VAT erroneously passed on to it by its suppliers.

While it is true that the petitioner should not have been liable for the VAT inadvertently passed on to it by its supplier since such is a zero-rated sale on the part of the supplier, the petitioner is not the proper party to claim such VAT refund.

Section 4.100-2 of BIR's Revenue Regulations 7-95, as amended, or the "*Consolidated Value-Added Tax Regulations*" provide:

Sec. 4.100-2. Zero-rated Sales. A zero-rated sale by a VAT-registered person, which is a taxable transaction for VAT purposes, shall not result in any output tax. However, the input tax on his purchases of goods, properties or services related to such zero-rated sale shall be available as tax credit or refund in accordance with these regulations.

The following sales by VAT-registered persons shall be subject to 0%:

(a) Export Sales