January 14, 2021

BIR RULING NO. OT-005-21

Section 32 (B) (6), NIRC of 1997, as amended; RMC No. 39-2012; RR No. 2-98, as amended; BIR Ruling No. 224-2019; BIR Ruling No. 003-2004

National Power Corporation
BIR Road cor. Quezon Avenue, Diliman
Quezon City

Attention: *AAA*

Gentlemen :

This refers to your letter dated December 10, 2020 requesting for a legal opinion on the applicable tax rates on the backwages awarded to the National Power Corporation (NPC)'s former employees and on the ten percent (10%) attorney's lien that were awarded in the case of *NPC Drivers and Mechanics Association (NPC-DAMA), et al. v. NPC, et al.* [1] which was subsequently validated by the Commission on Audit (COA).

It is represented that on September 26, 2006, the Supreme Court declared null and without effect National Power Board (NPB) Resolution Nos. 2002-124 and 2002-125, thereby giving NPC employees, who were illegally terminated on January 31, 2003, the right to (i) reinstatement, or (ii) separation pay in lieu of reinstatement (pursuant to a validly approved separation program); plus backwages, wage adjustments, and other benefits accruing from January 31, 2003 to the date of reinstatement (less amount of separation benefits previously received under the null NPB Resolutions). However, due to reorganization of NPC in 2003, reinstatement was not possible.

Also, by virtue of the September 26, 2006 decision, 10% Attorney's lien on the amounts recoverable by the illegally terminated employees was also ordered to be entered in the records of the case.

Hence, this request for opinion on the applicable tax rates.

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In reply, please be informed that backwages and the amount representing unpaid salaries are remuneration for services which are subject to income tax, and, consequently, to the withholding tax on wages. The employer is required to withhold the income tax corresponding to the income to be received as backwages by an employee found to be illegally dismissed. However, the illegally dismissed employee is accorded special treatment, *i.e.*, he is allowed to allocate or spread his backwages, allowances and benefits through the years he was dismissed from service, having been denied payment of his wages when they were due because of circumstances not of his own making and, therefore, beyond his control. [2]

Section 2.57 (B) of Revenue Regulations (RR) No. 2-98, as amended by RR No. 11-2018, provides as follows:

> *"Section 2.57. Withholding of Tax at Source. —*
>
> xxx xxx xxx
>
> *(B) Creditable Withholding Tax. — Under the creditable withholding tax system, taxes withheld on certain income payments are intended to equal or at least approximate the tax due of the payee on said income. The income recipient is still required to file an income tax return, as prescribed in Sections 51 and 52 of the NIRC, as amended, to report the income and/or pay the difference between the tax withheld and the tax due on the income. Taxes withheld on income payments covered by the expanded withholding tax (referred to in Sec. 2.57.2 of these regulations) and* ***compensation income (referred to in Sec. 2.78 also of these regulations)*** *are creditable in nature."* (emphasis supplied)

Whether an employee found to be illegally dismissed is reinstated or opts for separation, he is required to report such income (backwages) for the years he was dismissed from service, as he files and pays his corresponding income tax thereon by allocating or spreading his backwages, allowances and benefits through the years from the time of his dismissal to actual reinstatement or actual separation (if he opts for separation instead of reinstatement), as the case may be, crediting in the process the corresponding income tax withheld from said wage payments. [3]

Thus, in computing the NPC former employees' net income tax, the amount deducted and withheld for the taxable years they were illegally dismissed from service by NPC shall be allowed as a credit against the tax imposed under Section 24 (A) of the National Internal Revenue Code of 1997, as amended pursuant to Section 79 (C) (2) of the same Code. Moreover, they are allowed to deduct personal and additional exemptions during the years they were illegally dismissed in accordance with Section 35 (A) and (B) also of the same Code.

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Such being the case, said backwages and amount representing their unpaid salaries are subject to income tax and consequently, to withholding tax on wages pursuant to Section 79, Chapter XII, Title II of the NIRC of 1997, as amended and as implemented by Revenue Regulations (RR) No. 2-98, as amended by RR No. 11-2018. NPC shall apply the withholding tax rate as provided thereunder for the years 2003-2007.

On the other hand, the amount representing the 13th month pay of the NPC former employees received from the years 2003-2007 is exempt from income tax, the same being treated as an exclusion from the gross income under Section 32 (B) (7) (e) of the NIRC of 1997, as amended.

As regards the attorney's lien, which is the 10% charging lien on the amount recoverable by the NPC's former employees from NPC, the same shall also be subject to income tax, and consequently to the applicable creditable withholding tax, based on the prevailing rates at the time when such lien was paid to them.

This ruling is being issued on the basis of the foregoing facts as represented. However, if upon investigation, it will be ascertained that the facts are different, then this ruling shall be considered null and void.

Very truly yours,

(SGD.) CAESAR R. DULAY
Commissioner of Internal Revenue

Footnotes

1. G.R. No. 156208 dated September 17, 2008.
2. BIR Ruling No. 224-2019, April 3, 2019.
3. BIR Ruling No. 003-2004, January 19, 2004.

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