REPUBLIC OF THE PHILIPPINES
DEPARTMENT OF FINANCE
BUREAU OF INTERNAL REVNEUE
Quezon City

January 22, 2007

REVENUE MEMORANDUM CIRCULAR NO. 39 - 2007

SUBJECT	:	**Clarifying the Income Tax and VAT Treatment of Agency Fees/Gross Receipts of Security Agencies Including the Withholding of Taxes Due thereon.**
TO	:	All Security Agencies, their Clients, Internal Revenue Officers and Others Concerned.

I. BACKGROUND

For income tax purposes, all sellers of services, as well as sellers of goods or properties, may adopt either the cash basis or accrual basis as their accounting method for reporting income. This means that the timing of the imposition of the tax depends on the accounting method employed by the taxpayer. However, for VAT purposes, sellers of services, including Security Agencies, have to be taxed solely on the cash basis – that is upon actual or constructive receipt of the income because the VAT on sale of services is specifically imposed by law on the taxpayer's gross receipts. **But in order that an amount received will form part of gross receipts, the same must constitute the gross income of the taxpayer when received or earned.** Hence, if something is received by a taxpayer but the amount received does not or will not form part of its gross income (i.e., receipt of money constituting a loan or liability), the same cannot be part of its gross receipts subject to VAT.

The issue that comes into fore is whether or not the security guard's salaries, which form part of the Contract Price of the security services rendered by the Security Agency, can be treated as gross income of the Security Agency, which will constitute as part of the taxable gross receipts subject to VAT, whether actually or constructively received.

In several rulings issued by the Bureau, it has been consistently maintained that salaries of the security guards form part of the taxable gross receipts of a security agency. As cited in BIR Ruling Nos. 69-02, 049-85 and 271-81, the reason for this is *"that the salaries of the security guards are actually the liability of the agency and that the guards are considered their employees; hence, for percentage tax purposes, the salaries of the security guards are includible in its gross receipts."*

However, technically speaking, the salaries of the security guards are being paid for by the principals or clients of the Security Agency. Under Section 6 of Republic Act No. 6727 (The Wage Rationalization Act) amending Presidential Decree No. 442, as amended, otherwise known as "The Labor Code of the Philippines", the liability of the security agencies for the prescribed increases in the wage rates of workers are explicitly required to be borne by the principals or clients of the service contractors (*e.g. Security Agency)*, with the latter being made jointly and severally liable for the same, but only in the event that the principal or client fails to pay the prescribed wage rates, *to wit*:

> "Sec. 6. In the case of contractors for construction projects and for security, janitorial, and similar services, the prescribed increase in the wage rates of the workers shall be borne by the principals or clients of the construction/service contractors and the contract shall be deemed amended accordingly. In the event, however, that the principal or client fails to pay the prescribed wage rates, the construction/service contractor shall be jointly and severally liable with its principal or client"

Furthermore, under Section 1, Rule XIV of the 1994 Revised Rules and Regulations implementing Republic Act No. 5487, as amended, which governs the *"Organization and Operation of Private Security Agencies and Company Security Forces throughout the Philippines,"* it is so provided that:

> "Section 1. Compensation. – No watchman, security guard or private detective shall be paid a salary or compensation less than prescribed by existing laws, rules and regulations including those that may be promulgated relative thereto. The amount prescribed therein shall be ***earmarked and set aside*** for the purpose aforestated; thus the same shall thereafter be ***segregated from the monies received by the agency from its clients as an amount reserved for the remuneration of the guard or detective***." (Emphasis supplied).

Clearly, the Security Agency has no control or dominion over that portion of the payment received from its Client which is intended or earmarked as salaries of the security guards. The Security Agency does not own the funds such that it cannot use it for any other purpose like payment of rentals, utilities, taxes and other expenses. **It is now well settled that only receipts which is subject to a taxpayer's unfettered command and which he is free to enjoy at his own option is taxed to him as his income whether he sees fit to enjoy it or not . *(Corliss v. Bowers, 281 U.S. 376).*** In view of the clear language of the law and its implementing regulations placing the primary obligation on the Client to pay the salaries of the security guards coupled with the requirement that the monies received by the Security Agency representing salaries shall be earmarked and segregated for the said guards, the amount paid by the Client representing the salaries of the security guards will not form part of the Security Agency's gross income, and neither will it form part of its taxable gross receipts when actually or constructively received. **This peculiarity obviously places the Security Agency on a tax situation <u>different from other service providers</u>.**

Hence, this Revenue Memorandum Circular is issued to clarify the tax treatment of the amount paid by the Client to a Security Agency which is comprised of the agency fee and the amount reserved for the salaries of the security guards.

II. INCOME TAX TREATMENT OF THE PAYMENTS MADE TO THE SECURITY AGENCY. --

1. On the Part of the Security Agency:

The Security Agency must record as part of its gross income the Agency Fee portion of the payment, net of the VAT thereon. Since the security guards' salaries are tacked in as part of the service fees, the Security Agency must always recognize that portion of the fees as a **LIABILITY**. For this purpose, the Contract for Security Services entered into by and between the Security Agency and its Client must provide for a breakdown of the amount of security services into two components: (1) the Agency Fee, and (2) the Security Guards' Salaries. **If the Contract does not provide for a breakdown of the amount payable to the Security Agency, the entire amount representing the Contract Price will be taxed as income to the Agency, which must form part of its gross receipts,** whether actually or constructively received.

For illustrative purposes, assume that Vigilant Security Agency, Inc. was contracted by Tanzo Jewelry Corp. to provide security services in the latter's store. The contract price on a monthly basis is Eighteen Thousand Pesos (18,000.00) broken down into: Security Guards' Salaries of P14,179.08 and Agency Fee of P3,820.92 (inclusive of the VAT). The entry to record the transaction should be as follows:

Debit:	Cash	P17,931.77	
	Prepaid Income Tax (2% EWT on agency fee)	68.23	
	Credit: Service Income (agency fee)		P 3,411.54
	Output Tax (on agency fee)		409.38
	Due to Security Guards		14,179.08

The Security Agency who is the trustee of the funds segregated and earmarked as salaries of the security guards is the withholding agent for purposes of the withholding tax on compensation income. Upon payment of the security guards salaries, the Security Agency shall record the same as follows:

Debit:	Due to Security Guards	P 14,179.08	
	Credit: Cash		P 12,637.11
	Withholding Tax Payable		1,541.97*

*Withholding tax on the security guard's salaries was computed based on the assumption that the security guard employed is single and included in his taxable income were the basic pay, overtime, holiday premiums, night differential and ECOLA.

2. On the Part of the Client or User of Security Services:

The Client who is engaged in business can claim as a deduction from gross income the total amount paid to the Security Agency, net of the VAT on the Agency Fee. It is allowed to recognize an input tax based on the Agency Fee if the transaction is covered by a VAT Official Receipt issued by the Security Agency. It is also required to withhold and remit the Expanded Withholding Tax (EWT) on the Agency Fee. The portion of the expense pertaining to the security guards Salaries will be covered by a Non-VAT acknowledgment Receipt issued by the Security Agency.

When the expense (Security Services) is paid, the Client must record the transaction as follows:

Debit: Security Services – Agency Fee	P 3,411.54	
Security Services – Security Guards Salaries	14,179.08	
Input Tax (only on Agency fee)	409.38	
Credit: Cash		P 17,931.77
Withholding Tax Payable (2% EWT on Agency Fee)		68.23

III. VAT TREATMENT OF THE PAYMENTS FOR SECURITY SERVICES. —

1. On the Part of the Security Agency:

For VAT purposes, the taxable gross receipts of the Security Agency pertains to the amount actually or constructively received by it constituting its gross income. Since only the amount covering the Agency Fee represents its gross income, then that portion alone of the Contract Price, when actually or constructively received, will constitute the Security Agency's taxable gross receipts. This means that the amount received by the Security Agency which is segregated, earmarked or set aside for the salaries of the security guards will not form part of its gross receipts but should be recognized as a LIABILITY. Accordingly, the twelve per cent (12%) output tax will only be computed on the Agency Fee which shall in turn be the input tax of its Client.

2. On the Part of the Client:

Only the portion of the payment representing the Agency Fee, if covered by a VAT Official Receipt, will entitle the VAT-registered Client to a claim of input tax credit. This means that the amount of output tax paid by the Security Agency is the amount of input tax available to the Client. The Client cannot claim an input tax on the salary portion of the expense (Security Services) because it pertains to services exempt from VAT. Section 109(I) of the National Internal Revenue Code, as amended, specifically exempts from VAT services rendered by individuals pursuant to an employer-employee relationship. The services of the security guards squarely fall under this category of exempt transaction. The services of the security guards squarely fall under this category of exempt transaction. This is because in substance, the Client has the principal obligation to bear the prescribed wage rates for the security guards as discussed

above, and the Security agency will be jointly and severally liable therefore only in the event of the Client's failure to pay.

IV. MANNER OF ISSUING RECEIPT FOR THE ENTIRE CONTRACT PRICE. –

Consonant with the provisions of Section 113 of the National Internal Revenue Code, as amended, and as implemented by Section 4.113-1 of Revenue Regulations No. 16-2005, the Security Agency shall issue a VAT Official Receipt for every sale, barter or exchange of services. The VAT Official Receipt shall cover the entire amount which the Client pays to the Security Agency representing the compensation of its services (Agency Fee) with the indication that such amount received includes the VAT. The VAT on the Agency Fee must always be shown as a separate item in the VAT Official Receipt. The VAT shown on the VAT Official Receipt will constitute the output tax of the Security Agency and in turn, the input tax of its Client.

With respect to the security guards' salaries which are mandated by law to be paid by the Client through the Security Agency, the amount so paid representing salaries must be covered by a Non-VAT Acknowledgement Receipt. This document, coupled with the notarized certification of the expanded withholding taxes prescribed in Paragraph V hereunder, shall be a sufficient substantiation for the expense that will be claimed as a deduction from gross income by the Client.

V. WITHHOLDING TAX COMPLIANCE. –

As a general rule, "all income payments which are required to be subjected to withholding of income tax shall be subject to the corresponding withholding tax rate to be withheld by the person having control over the payment and who, at the same time, claims the expenses." *(Revenue Regulations No. 2-98, as amended by Revenue Regulations No. 30-03).*

Insofar as the Agency Fee is concerned, the Client is constituted as the withholding agent of the EWT following the rule above-mentioned. However, with respect to the portion of the Contract Price representing the amount segregated and earmarked as salaries of the security guards, the Security Agency shall be the one responsible for the withholding of the tax on compensation income. This is so because while it is the Client who claims the payment as an expense, it is the Security Agency who physically controls the payment to the salaries of the Security Guards. However, in order to comply with the requirement for deductibility under Section 34(K), in relation to Section 58 and 81, all of the National Internal Revenue Code, as amended, the Security Agency must furnish its Client, on or before January 31 of the year following the year of withholding, a **Notarized Certification** (see Annex "A") indicating the names of the guards employed by the Client, their respective TINs, the amount of their salaries and the amount of tax withheld from each. This certification together with the covering Non-VAT Acknowledgment Receipt must be kept on file by the Client as substantiation for the claim of the expense.

The above requirement is without prejudice to the provisions of Revenue Regulations No. 2-2006 mandatorily requiring the filing and submission of the Monthly Alphalist of Payees (MAP) and Summary Alphalist of Withholding Agents (SAWT).

All concerned are hereby enjoined to be guided accordingly and to give this Circular as wide a publicity as possible.

(Original Signed)
JOSE MARIO C. BUÑAG
Commissioner of Internal Revenue