REPUBLIC OF THE PHILIPPINES
Court of Tax Appeals
QUEZON CITY

SECOND DIVISION

LG ELECTRONICS PHILIPPINES, INC. (formerly LG COLLINS ELECTRONICS MANILA, INCORPORATED),
Petitioner,

C.T.A. CASE NO. 5994

Members:

- versus -

CASTAÑEDA, JR., *Chairperson*
UY, *and*
PALANCA-ENRIQUEZ, *JJ.*

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Promulgated:

APR 0 4 2007

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DECISION

UY, J.:

Before Us is a Petition for Review seeking the cancellation of the assessment issued by the respondent against the petitioner for deficiency income taxes covering the taxable year 1995 in the total amount of P21,748,895.63, inclusive of interest.

THE FACTS

The facts are undisputed.

LG Collins Electronics Manila, Incorporated ("petitioner") is a corporation duly organized and existing under and by virtue of the laws of the Republic of the Philippines, with principal office at No. 15 Francisco Legaspi Street, Barrio Maybunga, Pasig City. On the other hand, the Commissioner of Internal Revenue ("respondent") is the chief official of the Bureau of Internal Revenue ("BIR") vested by law to decide disputed assessments and to enforce the provisions of the National Internal Revenue Code ("NIRC") and other tax laws.

On March 19, 1999, petitioner received a Formal Assessment Notice[1] ("FAN") and Demand Letter,[2] both dated March 10, 1999, from the BIR, for deficiency income tax in the amount of P21,748,895.63 for taxable year 1995.

On April 16, 1999, petitioner, through its external auditor, Sycip Gorres Velayo and Company ("SGV"), filed with the BIR an administrative protest against the FAN. On June 15, 1999, petitioner, through SGV, filed with the BIR a supplemental protest reiterating its disagreement against the subject income tax assessment and transmitted to the BIR all the relevant supporting documents to support its position against the merit of the assessment.[3]

The subject income tax assessment arose from the disallowance of the following:

a) Inventory Write-Offs in the amount of P8,923,473.00;

b) Raw Materials Inventory in the amount of P376,259.49 which represents the discrepancy between the Raw Materials Ending Inventory per petitioner's Audited Financial Statements for calendar year 1995 and the Raw Materials Inventory per the

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[1] Assessment Notice No. 000103 dated March 10, 1999, Exhibit "DD".
[2] Demand Letter dated March 10, 1999, Exhibit "EE".
[3] Joint Stipulation of Facts and Issues, paragraphs 4 and 5, Records, pp. 46-49.

Inventory Listings submitted by petitioner for said year pursuant to Revenue Regulations (RR) V-1;

c) Salaries and other related expenses in the amount of P25,256,623.75, which represents the discrepancy of the sums of said expenses in petitioner's Audited Financial Statements for calendar year 1995 on one hand and the salaries reported in the Alpha List submitted by petitioner for withholding tax purposes on the other hand;

d) Interest Expense in the amount of P1,443,260.00, which represents the discrepancy between the interest expense reported per petitioner's Income Statement for calendar year 1995 and the interest expense appearing in petitioner's Cash Flow Statement for said year;

e) Adjustment to Retained Earnings in the amount of P2,240,089.00; and

f) Allowable Creditable Tax Withheld for calendar year 1995 in the amount of P381,228.08.[4]

Due to respondent's inaction on the administrative protest filed by petitioner within one hundred eighty (180) days from submission of all relevant supporting documents, petitioner filed the instant petition pursuant to Section 228 of the NIRC.

Respondent, in his Answer, raised the following Special and Affirmative Defenses:

> "4) Petitioner failed to submit all relevant documents in support of its protest. For instance, it did not submit the corresponding documents to justify the alleged inventory write-offs. For its failure to submit all relevant supporting documents, the assessment has become final. (Section 22, 1997 National Internal Revenue Code)
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> 5) The noted discrepancy in the Alpha Listing and the Audited Financial Statement of the Petitioner, particularly in the Salary and Other Related Account, should be disallowed as an item of deduction since the Petitioner failed to give a credible explanation to substantiate such discrepancy. Petitioner allegedly employed contractual employees for a period of less

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[4] Ibid, par. 7, Records, p. 47.

than 6 months whose wages do not exceed PHP60,000 per employee. But it is noteworthy to stress that the names of the alleged employees were not listed in the Alpha Listing. Hence, the said expense was not substantiated by evidence;

6) Interest expense should likewise be disallowed as an item of deduction. For an expense to be deductible, the following requisites must be satisfied: (1) it must be ordinary and necessary expense; (2) it must be paid or incurred during the taxable year in carrying on the trade or business; (3) the amount must be reasonable; (4) it must be substantiated by adequate proof; (5) it must not be against the law or public policy. The corporation must not only meet the business test (Numbers 1 and 2). It must substantially prove by evidence or records, the deductions claimed under the law; otherwise, the same will be disallowed. The mere allegation of the taxpayer that an item of expense is ordinary and necessary does not justify its deduction. (Esso Standard Eastern, Inc. vs. Commissioner of Internal Revenue, 175 SCRA 149, July 07, 1989) It is but logical that for an expense to be deductible, the taxpayer should prove by substantial evidence the amounts being claimed as deduction;

7) The assessment was issued in accordance with law and regulations; and

8) All presumptions are in favor of the correctness of the assessment (Commissioner of Internal Revenue vs. Avelino, 8 SCRA 572)."[5]

During trial, petitioner submitted testimonial and documentary evidence in support of its position while respondent was declared by this Court to have waived his right to present evidence due to the repeated absence of respondent's counsel despite due notice; after which, both parties' counsels were directed to file their respective Memorandum during the hearing held on May 23, 2005.[6] Only petitioner submitted its Memorandum on September 21, 2005.[7]

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[5] Answer, Records, pp. 23-25.
[6] Resolution dated May 27, 2005, Records, p. 285.
[7] Memorandum for Petitioner, Records, pp. 302-329.

It appearing however that the BIR Records of this case have not been forwarded to this Court, respondent's counsel, Atty. Philip A. Mayo, was directed to do so in the Resolution dated November 21, 2005,[8] within ten (10) days from receipt thereof pursuant to Section 2, Rule 7 of the CTA Rules and Summons dated January 13, 2002.[9] In compliance thereto, respondent's counsel filed a "Compliance/ Manifestation with Motion for Issuance of Subpoena Duces Tecum" on December 5, 2005, alleging, among others, that he did not receive the summons dated January 13, 2002; that he already requested the BIR Records of petitioner for taxable year 1995 through a letter-request addressed to the Revenue District Officer of Revenue District Office No. 43, Pasig City, the office having jurisdiction over the business of herein petitioner; and that there has been no reply thereto and the BIR Records have not been forwarded to him thereby constraining him to request for the issuance of a subpoena duces tecum to compel the District Office to submit the BIR Records of there herein petitioner to this Honorable Court.[10]

In the meantime, the Court noticed a change in petitioner's name as reflected in the caption of its Memorandum filed on September 21, 2005[11] causing it to issue its Resolution dated March 31, 2006[12] directing petitioner to submit proof of its change of name from "LG Collins Electronics Manila, Inc." into "LG Electronics Philippines, Inc" within ten (10) days from receipt thereof. In compliance thereto, petitioner's counsel submitted a Manifestation on May

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[8] Resolution dated November 21, 2005, Records, p. 332.

[9] Summons is actually dated January 12, 2000, not January 13, 2002, duly received by respondent on January 13, 2000, Records, p. 21.

[10] Compliance/Manifestation with Motion for Issuance of Subpoena Duces Tecum, Records, pp. 334-336.

[11] Petitioner's Memorandum, p. 1, Records, p. 302.

[12] Resolution dated March 31, 2006, Records, p. 350.

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2, 2006, attaching thereto a Certificate of Filing of Amended Articles of Incorporation to evidence the change of petitioner's corporate name as aforementioned.[13]

Thereafter, pursuant to the Subpoena Duces Tecum issued on May 23, 2006 addressed to Raul Vicente Recto, District Officer, RDO 43, Pasig City, a Manifestation was filed by respondent's counsel on July 4, 2006,[14] alleging among others, that despite diligent efforts to locate the BIR records of this case, Revenue District Officer ("RDO") Raul Vicente Recto could not produce or submit the documents requested because their Revenue District Office does not have any available records of the case and he assumed his position as RDO only on June 2, 2003. A duly notarized Certification[15] issued by RDO Raul Vicente Recto to that effect was attached thereto, as well as a Sworn Statement[16] executed by Jane C. Denosta, Revenue Officer IV at the BIR, alleging that she and a certain Ro Erna Estevez (now deceased) were assigned to conduct a reinvestigation of the subject tax case of petitioner for the taxable year 1995, and further attested that she referred the tax docket of petitioner to her examiner, Ro Erna Estevez, during her lifetime, and the latter had custody and possession of said tax docket until her death on December 21, 2003.

Realizing the futility of awaiting for the submission of the required BIR Records, this case was considered submitted for decision in the Resolution

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[13] Manifestation filed on May 2, 2006, Records, pp. 353-359.
[14] Manifestation filed on July 4, 2006, Records, pp. 363-365.
[15] Certification dated June 29, 2006, Records, p. 366.
[16] Sworn Statement, Records, p. 370.

dated July 19, 2006 without submission of the corresponding BIR Records and any memorandum filed by the respondent.[17] Hence, this Decision.

THE ISSUES

The stipulated issues are the following:

1. Whether or not the income tax assessment issued by respondent against petitioner for taxable year 1995 in the total amount of P21,748,895.63 is void for having been issued in violation of the procedure prescribed under Revenue Regulations No. 12-85;

2. Whether or not the income tax assessment issued by respondent against petitioner for taxable year 1995 in the total amount of P21,748,895.63 is void for failure to state the law and the facts on which the assessment was made;

3. Whether or not the disallowed inventory write-offs of petitioner for taxable year 1995 in the total amount of P8,923,473.00 is duly supported by documentary evidence showing that the destruction of the inventory items was made with the permission and clearance of the officials of BIR Revenue District Office No. 43;

4. Whether or not the disallowed Raw Materials Inventory for taxable year 1995 in the amount of P376,259.49 represents receivables from petitioner's employees for Class B inventory items, which were erroneously included in the Raw Materials Inventory per the Inventory Listings submitted by petitioner pursuant to Revenue Regulations No. V-1;

5. Whether or not the disallowed salaries and other related expenses of petitioner for taxable year 1995 in the total amount of P25,256,623.75 represents compensation and other expenses, which are not subject to withholding tax on compensation;

6. Whether or not the disallowed interest expense of petitioner for taxable year 1995 in the amount of P1,443,260.00 represents unsupported interest expense;

7. Whether or not the disallowed Adjustments to Retained Earnings of petitioner for taxable year 1995 in the amount of

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[17] Resolution dated July 19, 2006, Records, p. 375.

P2,240,089.00 represents the cumulative effect of the change of petitioner's accounting practice in compliance with Statement of Financial Accounting Standards No. 23; and

8. Whether or not the creditable income tax withheld reported in petitioner's Annual Corporate Income Tax Return for calendar year 1995 in the total amount of P5,491,641.00 is duly supported by Certificates of Creditable Income Tax Withheld.

THE COURT'S RULING

The petition is meritorious.

Before We consider the issues pertaining to petitioner's alleged liability to pay deficiency income taxes, it is crucial that We first determine whether respondent properly complied with the procedural requirements in the tax assessment process because a negative determination thereof will correspondingly result in the nullification of the assailed assessment.

Petitioner argues that the FAN it received is void because it was not given the opportunity to contest the issues raised in the FAN and Demand Letter, in clear violation of Revenue Regulations No. 12-85 and of its right to due process of law. Moreover, petitioner contends that the FAN was issued without stating the factual and legal bases on which the assessments were based.

We agree.

Revenue Regulations No. 12-99 which became effective on January 1, 1998[18] applies in the present case, considering that the subject FAN and Demand Letter were issued on March 10, 1999. Section 3 of Revenue

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[18] Section 8.1, Revenue Regulations No. 12-99 and ruled by the Supreme Court in Commissioner of Internal Revenue vs. Azucena T. Reyes, G.R. Nos. 159694 & 163581, January 27, 2006.

Regulations No. 12-99 provides, in pertinent part thereof, the procedure in issuing a deficiency tax assessment, to wit:

REVENUE REGULATIONS NO. 12-99

SUBJECT: *Implementing the Provisions of the National Internal Revenue Code of 1997 Governing the Rules on Assessment of National Internal Revenue Taxes, Civil Penalties and Interest and the Extra-judicial Settlement of a Taxpayer's Criminal Violation of the Code Through Payment of a Suggested Compromise Penalty.*

To : *All Internal Revenue Officers and Others Concerned.*

x x x x x x

"SECTION 3. Due Process Requirement in the Issuance of a Deficiency Tax Assessment. —

"(3.1) Mode of procedures in the issuance of a deficiency tax assessment:

(3.1.1) Notice for informal conference. — The Revenue Officer who audited the taxpayer's records shall, among others, state in his report whether or not the taxpayer agrees with his findings that the taxpayer is liable for deficiency tax or taxes. If the taxpayer is not amenable, based on the said Officer's submitted report of investigation, the taxpayer shall be informed, in writing, by the Revenue District Office or by the Special Investigation Division, as the case may be (in the case Revenue Regional Offices) or by the Chief of Division concerned (in the case of the BIR National Office) of the discrepancy or discrepancies in the taxpayer's payment of his internal revenue taxes, for the purpose of "Informal Conference," in order to afford the taxpayer with an opportunity to present his side of the case. If the taxpayer fails to respond within fifteen (15) days from date of receipt of the notice for informal conference, he shall be considered in default, in which case, the Revenue District Officer or the Chief of the Special Investigation Division of the Revenue Regional Office, or the Chief of Division in the National Office, as the case may be, shall endorse the case with the least possible delay to the Assessment Division of the Revenue Regional Office or to the Commissioner or his duly authorized representative, as the case may be, for appropriate review and issuance of a deficiency tax assessment, if warranted.

(3.1.2) Preliminary Assessment Notice (PAN). — If after review and evaluation by the Assessment Division or by the Commissioner or his duly authorized representative, as the case may be, it is determined that there exists sufficient basis to assess the taxpayer for any deficiency tax or taxes, the said Office shall issue to the taxpayer, at least by registered mail, a Preliminary Assessment Notice (PAN) for the proposed assessment, showing in detail, the facts and the law, rules and regulations, or jurisprudence on which the proposed assessment is based x x x. If the taxpayer fails to respond within fifteen (15) days from date of receipt of the PAN, he shall be considered in default, in which case, a formal letter of demand and assessment notice shall be caused to be issued by the said Office, calling for payment of the taxpayer's deficiency tax liability, inclusive of the applicable penalties.

x x x x x x x x x x

(3.1.4)Formal Letter of Demand and Assessment Notice. — The formal letter of demand and assessment notice shall be issued by the Commissioner or his duly authorized representative. The letter of demand calling for payment of the taxpayer's deficiency tax or taxes shall state the facts, the law, rules and regulations, or jurisprudence on which the assessment is based, otherwise, the formal letter of demand and assessment notice shall be void x x x. The same shall be sent to the taxpayer only by registered mail or by personal delivery. If sent by personal delivery, the taxpayer or his duly authorized representative shall acknowledge receipt thereof in the duplicate copy of the letter of demand, showing the following: (a) His name; (b) signature; (c) designation and authority to act for and in behalf of the taxpayer, if acknowledged received by a person other than the taxpayer himself; and (d) date of receipt thereof."

As outlined in the aforequoted pertinent provisions of Section 3 of Revenue Regulation No. 12-99, due process requires that prior to the issuance of the subject deficiency tax assessment against petitioner, the Revenue Officer who audited petitioner's tax records should state in his report whether or not petitioner agrees or disagrees with his findings of liability for deficiency tax or taxes, in order to afford herein petitioner-taxpayer the opportunity to present his side of the case during an "Informal Conference" duly set for that purpose. It is only in case of petitioner's failure to respond within fifteen (15) days from receipt of the Notice of Informal Conference should its case be endorsed to the Assessment Division of the Revenue Regional Office to which it belongs, for appropriate review and issuance of a deficiency tax assessment, if warranted.

Thereafter, in the event that, upon review and evaluation by the Assessment Division, it is determined that there exist sufficient basis to assess petitioner for any deficiency tax or taxes, the said Office should have issued to petitioner, at least by registered mail, a Preliminary Assessment Notice ("PAN") for the proposed tax assessment. In the instant case, respondent did not issue and/or send a Notice for Informal Conference and a PAN before it sent the disputed FAN and Demand Letter.

Its witness and Accounting Supervisor, Ms. Rose Jimena, testified to petitioner's receipt of only the FAN and Demand Letter as follows:

> "ATTY. CASTRO:
> Q: Prior to the company's receipt of such Formal Assessment Notice and Demand Letter did the company receive a Preliminary Assessment Notice in this from the BIR in respect to the results of your investigation for taxable year 1995, Ms. Witness?
>
> MS. JIMENA:
> A: No, we did not actually receive any Preliminary Assessment Letter from the BIR Examiner for the taxable year 1995, Sir.
>
> ATTY. CASTRO:
> Q: Did the company receive any letter of invitation for informal conference from the Bureau of Internal Revenue inviting any authorized officer of the company for the purpose of discussing the results of your investigation covering taxable year 1995, Ms. Witness?

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MS. JIMENA:
A: No, there was no actual letter or invitation received by the company from the examiner regarding the informal discussion of the results of their investigation for the said taxable year 1995, Sir."[19]

A careful verification of the records confirms that respondent did not attempt to invite petitioner for an informal conference to at least discuss with the latter the bases for the assessment nor did he sent petitioner any PAN or other notices. Although in the protest filed by the petitioner, it was able to present its arguments against the assessments made by respondent, thereby giving rise to the impression that it was sufficiently informed of the legal and factual bases thereof, petitioner was able to do so only after receipt of the FAN and Demand Letter, while the period of thirty (30) days within which to file an administrative protest was running[20], and this protest was made possible only because it asked its external auditor, SGV, to discuss this matter with the BIR.[21]

Clearly therefore, the failure of respondent to observe the procedures mandated in the pertinent provisions of Section 3 of Revenue Regulations No. 12-99 is a violation of petitioner's right to due process.

We likewise agree with petitioner's contention that the subject deficiency assessment is void for failing to state in writing the law and facts on which the assessment was based pursuant to the provisions of the second paragraph of Section 228 of the NIRC of 1997, which provides as follows:

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[19] TSN, August 14, 2001, pp. 7-8.
[20] Section 3.1.5, Revenue Regulations No. 12-99.
3.1.5 Disputed Assessment. — The taxpayer or his duly authorized representative may protest administratively against the aforesaid formal letter of demand and assessment notice within thirty (30) days from date of receipt thereof. x x x
[21] As testified by petitioner's witness, Rose Jimena, TSN, June 13, 2001, p. 8.

> "**SEC. 228. Protesting of Assessment. —** When the Commissioner of 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:*
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> x x x x x x x x x x
>
> "**<u>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</u>**." *(Underscoring and emphasis ours)*

Furthermore, Section 3.1.4 of Revenue Regulations No. 12-99, in implementing the provision above-quoted reads:

> "**3.1.4 Formal Letter of Demand and Assessment Notice. —** The formal letter of demand and assessment notice shall be issued by the Commissioner or his duly authorized representative. The letter of demand calling for payment of the taxpayer's deficiency tax or taxes shall state the facts, the law, rules and regulations, or jurisprudence on which the assessment is based, otherwise, the formal letter of demand and assessment notice shall be void x x x."

In the present case, petitioner was definitely not informed in writing of the law and facts on which the assessment was made. A careful consideration of the Demand Letter dated March 10, 1999, discloses that the alleged assessment made by the BIR is replete of any legal or factual support. In fact, the Demand Letter merely showed the following computation without explaining how the net business income and discrepancies, the tax base of the alleged assessment, were obtained:

Net Business Income		P 11,904,490.00
Add: Discrepancies		38,239,705.23
Taxable Income		P 50,144,195.23
Tax Due		P 17,550,468.33
Less: Tax Withheld/Allowable Tax Credits	P 5,110,412.92	
Tax Paid Per Return	191,270.59	
Tax Paid Total	P 5,301,683.51	
Less: TCC applied to subsequent taxable year	1,516,339.00	3,785,344.51

Ny

Deficiency Income Tax	P 13,765,123.82
Interest (4-16-96 to 3-10-99)	7,983,771.81
Total Amount Due and Collectible	**P 21,748,895.63**

Similarly, the FAN contains only the amount of tax due and its interest without, again, explaining how these were arrived at. In fine, the FAN and Demand Letter did not have any details of discrepancy attached to it as testified to by Ms. Rose Jimeno, to wit:

"ATTY. CASTRO:
Q: Ms. Witness, aside from the Assessment Notice and the Demand Letter, did you receive any other documents from the BIR?

MS. JIMENO:
A: No, sir.

ATTY. CASTRO:
Q: To be more specific, did you receive a Details or *(sic)* Discrepancy from the BIR?

MS. JIMENO:
A: No, sir. We were not actually given any details or other documents aside from the Assessment and the letter of demand.

ATTY. CASTRO:
Q: Ms. Witness, when you received the Assessment Notice and the Demand Letter, were you able to understand the deficiency assessment?

MS. JIMENO:
A: No."[22]

In **Commissioner of Internal Revenue vs. Azucena T. Reyes,**[23] the High Tribunal discussed the rationale and importance of stating in writing the legal and factual bases of the assessment; thus:

"x x x [P]etitioner violated the cardinal rule in administrative law that the taxpayer be accorded due process.

[22] TSN, June 13, 2001, pp. 7-8.
[23] G.R. Nos. 159694 & 163581, January 27, 2006.

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> Not only was the law here disregarded, but also no valid notice was sent, either. A void assessment bears no valid fruit.
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> The law imposes a substantive, not merely a formal, requirement. To proceed heedlessly with tax collection without first establishing a valid assessment is evidently violative of the cardinal principle in administrative investigations: that taxpayers should be able to present their case and adduce supporting evidence. In the instant case, respondent has not been informed of the basis of the estate tax liability. Without complying with the unequivocal mandate of first informing the taxpayer of the government's claim, there can be no deprivation of property, because no effective protest can be made. The haphazard shot at slapping an assessment, supposedly based on estate taxation's general provisions that are expected to be known to the taxpayer, is utter chicanery.
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> Even a cursory review of the preliminary assessment notice, as well as the demand letter sent, reveals the lack of basis for – not to mention the insufficiency of – the gross figures and details of the itemized deductions indicated in the notice and the letter. This Court cannot countenance an assessment based on estimates that appear to have been arbitrarily or capriciously arrived at. Although taxes are the lifeblood of the government, their assessment and collection 'should be made in accordance with law as any arbitrariness will negate the very reason for government itself'."

In the light of the foregoing jurisprudential pronouncement, the subject assessment notice is declared void for failure of respondent, through its authorized revenue officers and examiners, to observe procedural due process set forth in Section 228 of the NIRC of 1997, as well as the procedural guidelines embodied in the pertinent provisions of Revenue Regulations No. 12-99. Moreover, it must be noted that no controverting evidence was presented by respondent to refute petitioner's claim that no Notice of Informal Conference and PAN were issued by respondent. Neither were the BIR records submitted by respondent despite having been directed by the Court in the Summons dated January 21, 2000, and in the Resolutions dated November 21, 2005 and May 12, 2006. This being the case, the Court finds it unnecessary to delve or pass upon the remaining issues raised in this petition.

WHEREFORE, premises considered, the instant petition is hereby **GRANTED**. Accordingly, the assessment for deficiency income tax, inclusive of interest, against petitioner for taxable year 1995 in the total amount of P21,748,895.63 is hereby **CANCELLED** and **SET ASIDE.**

SO ORDERED.

ERLINDA P. UY
Associate Justice

WE CONCUR:

JUANITO C. CASTAÑEDA, JR.
Associate Justice

OLGA PALANCA-ENRIQUEZ
Associate Justice

CERTIFICATION

Pursuant to Article VIII, Section 13 of the Constitution, it is hereby certified that the conclusions in the above Decision were reached in consultation before the case was assigned to the writer of the opinion of the Court.

JUANITO C. CASTAÑEDA, JR.
Acting Presiding Justice
Chairperson, Second Division