REPUBLIC OF THE PHILIPPINES
COURT OF TAX APPEALS
QUEZON CITY

SECOND DIVISION

MCDONALD'S PHILIPPINES REALTY CORPORATION, Petitioner,	**CTA Case No. 8506**
	Members:
-versus-	**CASTAÑEDA, JR.,** *Chairperson* **CASANOVA,** and **COTANGCO-MANALASTAS,** *JJ.*
COMMISSIONER OF INTERNAL REVENUE, Respondent.	Promulgated: OCT 29 2014 10:10 a.m.

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DECISION

CASTAÑEDA, JR., ***J.*:**

THE CASE

This is a Petition for Review under Section 9 of Republic Act No. 9282[1] assailing the Commissioner of Internal Revenue's final decision on disputed assessment of alleged deficiency value added tax of P10,194,107.65, inclusive of interest and surcharge for the calendar year ended December 31, 2008 against Mcdonald's Philippines Realty Corporation.

[1] AN ACT EXPANDING THE JURISDICTION OF THE COURT OF TAX APPEALS (CTA), ELEVATING ITS RANK TO THE LEVEL OF A COLLEGIATE COURT WITH SPECIAL JURISDICTION AND ENLARGING ITS MEMBERSHIP, AMENDING FOR THE PURPOSE CERTAIN SECTIONS OF REPUBLIC ACT NO. 1125, AS AMENDED, OTHERWISE KNOWN AS THE LAW CREATING THE COURT OF TAX APPEALS, AND FOR OTHER PURPOSES.

THE FACTS

Mcdonald's Philippines Realty Corporation ("petitioner") is a foreign corporation organized and existing under the Laws of Delaware, United States of America with license to do business through its Philippine branch located at 17th Floor Citibank Center Building, Paseo de Roxas, Salcedo Village, Makati City. It is a registered taxpayer of the Bureau of Internal Revenue ("BIR"), Large Taxpayers District Office as shown by its Certificate of Registration dated January 1, 1997 with Taxpayer's Identification Number ("TIN") 000-130-921-000.[2]

On the other hand, the Commissioner of Internal Revenue ("respondent") as a public official is tasked to decide disputed assessments, collection, refund of erroneously or excessively paid internal revenue taxes, fees or other charges, penalties, or other matters under the 1997 National Internal Revenue Code ("NIRC"), as amended, or other laws administered by the BIR.[3]

Petitioner established its Philippine branch office for the purpose of acquiring and leasing back two (2) existing Mcdonald's restaurants to Golden Arches Development Corporation ("GADC"), and developing new Mcdonald's restaurant sites which will then be leased to McGeorge Foods, Inc.[4]

On October 18, 2011, respondent through OIC-Assistant Commissioner Alfredo V. Misajon sent petitioner a preliminary assessment notice ("PAN") of its alleged 2008 value added tax ("VAT") deficiency of P7,422,438.30.[5]

Respondent issued a formal assessment notice ("FAN") which was received by petitioner on November 22, 2011. In the FAN, respondent informed petitioner of its alleged 2008 VAT deficiency of P7,438,096.98 inclusive of interest, detailed as follows:

Rentals and Interest Receivable, beg. (P38,866,011.00 ÷ 1.12)	34,701,795.50

[2] Joint Stipulation of Facts and Issues, Rollo, pp.173-174
[3] Joint Stipulation of Facts and Issues, Rollo, p. 174.
[4] Joint Stipulation of Facts and Issues, Rollo, p. 174.
[5] Exhibit "A". See Joint Stipulation of Facts and Issues, Rollo, p. 174

Add: Income during the year		
1. Rentals	38,776,417.00	
2. Interest	25,755,318.00	64,531,735.00
Total amount available for collection		99,233,530.50
Less: Rentals & Interest, Receivable, end.		
(P26,005,282.00 ÷ 1.12)		23,219,001.78
Gross Receipts for the year 2008		76,014,528.72
Output VAT due		9,121,743.14
Less: creditable input tax		(31,134.00)
VAT payable per audit		9,090,609.14
Less: VAT payment		(4,392,863.68)
Basic deficiency VAT due		4,697,745.46
Add: 20% interest		2,740,351.52
Total		7,438,096.98[6]

On December 22, 2011, petitioner protested the FAN.[7]

On May 22, 2012, petitioner received a copy of the final decision on disputed assessment ("FDDA") dated April 25, 2012 reiterating respondent's demand for payment of its alleged 2008 VAT deficiency and interest in the increased amount of P10,194,107.65 computed as follows:

Rentals and Interest Receivable, beg.		
(P38,866,011.00 ÷ 1.12)		34,701,795.50
Add: Income during the year		
1.Rentals	38,776,417.00	
2.Interest	25,755,318.00	64,531,735.00
Total amount available for collection		99,233,530.50
Less: Rentals & Interest, Receivable,		
end.(P26,005,282.00 ÷12)		(23,219,001.78)
Gross Receipts for the year 2008		76,014,528.72
Output VAT due		9,121,743.14
Less: creditable input tax		(31,134.00)
VAT payable per audit		9,090,609.14
Less: VAT payments		(4,392,863.68)
Basic deficiency VAT due		4,697,745.46
Add: 50% surcharge based on Section 248[B]		2,348,872.73
20% interest from January 26,2009 to May 31		3,147,489.46

[6] Exhibit "B". See Joint Stipulation of Facts and Issues, Rollo, p. 174.
[7] See Joint Stipulation of Facts and Issues, Rollo, p. 175.

2012	
Total	**10,194,107.65.**[8]

The FDDA is premised on the following grounds:

(a) The FAN was issued in accordance with existing law and regulations;
(b) There is substantial underdeclaration of gross receipts for taxable year 2008 which would warrant the extension of the prescriptive period up to ten (10) years;
(c) There is underpayment of VAT on rental income because petitioner's method of declaration of revenue per 2008 VAT returns is not on accrual basis;
(d) Petitioner's interest income is subject to VAT; and
(e) The computation of petitioner's gross receipts subject to VAT was based on Revenue Administrative Memorandum Order No. 1-90.[9]

Dissatisfied, petitioner filed before the Court of Tax Appeals Second Division ("Court in Division") a petition for review on June 21, 2012. Petitioner seeks for the cancellation and withdrawal of respondent's assessment for deficiency VAT of P10,194,107.65, inclusive of interest and surcharge for calendar year ("CY") ended December 31, 2008.[10]

In response to the petition for review, respondent in her answer countered that petitioner failed to substantiate or controvert by substantial evidence the BIR factual findings as shown under the Details of Discrepancies attached to the PAN, FAN and FDDA; that petitioner failed to subject to VAT its gross receipts relating to rental/interest income of P39,147,881.33; that petitioner is a lender investor for the past several years as reflected in its prior years' income tax returns and clearly earning yearly profits of P25,755,318.00 for the year 2008 which is 70% of the main income; that she complied with the due process requirement by stating the factual and legal bases in the issuance of the PAN, FAN and FDDA; that petitioner substantially underdeclared its gross receipts by more

[8] Exhibit "C". See Joint Stipulation of Facts and Issues, Rollo, pp.175-176.
[9] Joint Stipulation of Facts and Issues, Rollo, pp. 175-176.
[10] Rollo, pp. 6 &30.

than 30% as declared in its VAT returns for year 2008; that assessment period is within ten (10) years from discovery of falsity or fraud when a taxpayer files "false or fraudulent returns"; that all presumptions are in favor of the correctness of the assessment and failure to present proof of error in the assessment will justify judicial affirmation of the assessment.[11]

During trial, both parties proffered their testimonial and documentary evidence.

In compliance with the Order dated October 29, 2013[12], petitioner filed its memorandum sans respondent's memorandum. Thereafter, the case was submitted for Decision.

THE ISSUES

The parties jointly stipulated the following issues:

1. Whether or not petitioner's administrative and judicial protests against the deficiency VAT assessment for calendar year 2008 were filed within the periods prescribed under Section 228, Tax Code.

2. Whether or not the PAN, FAN and FDDA were issued in violation of the due process requirement under Section 228, Tax Code and Revenue Regulations No. 12-99.

3. Whether or not respondent's right to assess petitioner's deficiency VAT liability for the first, second and third quarters of calendar year 2008 had already prescribed.

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[11] Rollo,pp.131-134.
[12] Rollo, p. 409.

4. Whether or not petitioner failed to controvert by substantial evidence the BIR's factual findings, as shown in the Details of Discrepancies attached to the PAN, FAN/Formal Letter of Demand, and FDDA.

5. Whether or not petitioner underdeclared its rental income in its quarterly VAT returns for calendar year 2008.

6. Whether or not petitioner's interest income for calendar year 2008 is subject to VAT.

7. Whether or not petitioner substantially underdeclared its gross receipts by more than 30% as declared in its VAT returns for taxable year 2008 and, thus, rendered the subject VAT returns of petitioner for taxable year 2008 as "false or fraudulent returns" within the contemplation of Section 222 of the Tax Code.

8. Whether or not the imposition of a 50% surcharge on petitioner's alleged deficiency VAT for calendar year 2008 is valid.[13]

THE COURT'S RULING

The petition is partly meritorious.

PETITIONER PROTESTED THE FAN AND APPEALED BEFORE THE CTA WITHIN THE PERIODS MANDATED BY LAW.

Petitioner alleges that its protests undertaken before the administrative and judicial levels were within the statutory periods.

[13] Joint Stipulation of Facts and Issues, Rollo, p.183.

We concur.

A taxpayer aggrieved by the BIR assessment on internal revenue taxes may avail of the remedies under Section 228 of the 1997 NIRC, as amended, as follows:

> 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:
>
> xxx xxx xxx
>
> 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.
>
> Within a period to be prescribed by implementing rules and regulations, the taxpayer shall be required to respond to said notice. If the taxpayer fails to respond, the Commissioner or his duly authorized representative shall issue an assessment based on his findings.
>
> **Such assessment may be protested administratively by filing a request for reconsideration or reinvestigation within thirty (30) days from receipt of the assessment in such form and manner as may be prescribed by implementing rules and regulations. Within sixty (60) days from filing of the protest, all relevant supporting documents shall have been submitted; otherwise, the assessment shall become final.**
>
> **If the protest is denied in whole or in part, or is not acted upon within one hundred eighty (180) days from submission of documents, the taxpayer adversely affected by the decision or inaction may appeal to the Court of Tax Appeals within thirty (30) days from receipt of the said decision, or from**

> **the lapse of the one hundred eighty (180)-day period; otherwise, the decision shall become final, executory and demandable.** (Emphasis supplied.)

In the event there is a finding by the respondent or any of her authorized representatives of any deficiency or delinquent internal revenue taxes due against the taxpayer, a PAN shall be issued. Should the taxpayer fail to respond to the PAN, a FAN shall be issued and the aggrieved taxpayer is given thirty (30) days from receipt of the assessment notice to file a protest. Within sixty (60) days from filing of the protest, all relevant supporting documents should be submitted. The denial of the protest or the inaction on the protest within 180 days from submission of documents allows the taxpayer thirty (30) days from receipt of the adverse ruling or upon the lapse of the 180-day period within which to appeal to the Court of Tax Appeals.

Here, upon receipt of the FAN on November 22, 2011, petitioner contested the same within the thirty-day period or until December 22, 2011 and duly appealed to this Court against respondent's adverse ruling on June 21, 2012 which is also within the thirty (30)-day period reckoned from its receipt of the FDDA on May 22, 2012.[14] Thus, the protest on the assessment and appeal before the CTA were undertaken within the periods prescribed by law.

PAN, FAN AND FDDA ARE SUPPORTED BY FACTUAL AND LEGAL BASES.

Petitioner questions the validity of the PAN, FAN and FDDA covering calendar year 2008 for having been issued in violation of the tenets of due process under Section 228 of the 1997 NIRC and Revenue Regulations ("RR") No. 12-99.

These notices and the FDDA are devoid of factual and legal bases.

Petitioner further argues that respondent failed to inform petitioner of the computation of the "interest/rental income" in the

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[14] Rollo, p. 6 and Joint Stipulation of Facts and Issues, Rollo, pp. 174-175.

amount of P39,147,881.33 and the alleged deficiency VAT of P4,697,745.76. Respondent did not state specific taxable quarters when the interest and rental income were received.

Respondent maintains that she fully complied with the due process requirement pursuant to 1997 NIRC, as amended, implementing RR No. 12-99 in the issuance of the PAN, notice of informal conference, FAN, FDDA and other BIR correspondences to petitioner.

The Court agrees with respondent's contention.

In interpreting Section 228 of the 1997 NIRC as implemented by RR 12-99, the Supreme Court emphasized that the letter of demand and FAN should be anchored by factual and legal bases as shown in the case of *Commissioner of Internal Revenue v. Enron Subic Power Corporation*[15] where it was ruled that:

> A notice of assessment is:
>
> [A] declaration of deficiency taxes issued to a [t]axpayer who fails to respond to a Pre-Assessment Notice (PAN) within the prescribed period of time, or whose reply to the PAN was found to be without merit. The Notice of Assessment shall inform the [t]axpayer of this fact, and that the report of investigation submitted by the Revenue Officer conducting the audit shall be given due course.
>
> **The formal letter of demand calling for payment of the taxpayer's deficiency tax or taxes shall state the fact, the law, rules and regulations or jurisprudence on which the assessment is based, otherwise the formal letter of demand and the notice of assessment shall be void.**
>
> Section 228 of the NIRC provides that the **taxpayer shall be informed in writing of the law and the facts on which the assessment is made. Otherwise, the assessment is void.** To implement the

[15] G.R. No. 166387, Resolution dated January 19, 2009, 576 SCRA 212.

provisions of Section 228 of the NIRC, RR No. 12-99 was enacted. Section 3.1.4 of the revenue regulation 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**. The same shall be sent to the taxpayer only by registered mail or by personal delivery. xxx xxx xxx

It is clear from the foregoing that a taxpayer must be informed in writing of the legal and factual bases of the tax assessment made against him. The use of the word "shall" in these legal provisions indicates the mandatory nature of the requirements laid down therein. We note the CTA's findings:

> In [this] case, [the CIR] merely issued a formal assessment and indicated therein the supposed tax, surcharge, interest and compromise penalty due thereon. The Revenue Officers of [the CIR] in the issuance of the Final Assessment Notice did not provide Enron with the written bases of the law and facts on which the subject assessment is based. [The CIR] did not bother to explain how it arrived at such an assessment. Moreso, he failed to mention the specific provision of the Tax Code or rules and regulations which were not complied with by Enron. (Emphasis supplied.)

The Supreme Court earlier made similar pronouncements in *Commissioner of Internal Revenue v. Azucena T. Reyes and Azucena T. Reyes v. Commissioner of Internal Revenue*[16] as follows:

[16] G.R. Nos. 159694 & 163581, January 27, 2006, 480 SCRA 382.

> Under the present provisions of the Tax Code and pursuant to elementary due process, **taxpayers must be informed in writing of the law and the facts upon which a tax assessment is based; otherwise the assessment is void**. (Emphasis supplied.)

Respondent's findings in the PAN should also be based on factual and legal grounds as pointed in the case of *Commissioner of Internal Revenue v. Metro Star Superama,* Inc. [17] where the Supreme Court explained that:

> Indeed, **Section 228 of the Tax Code clearly requires that the taxpayer must first be informed that he is liable for deficiency taxes through the sending of a PAN. He must be informed of the facts and the law upon which the assessment is made. 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. (Emphasis supplied.)

The FDDA is covered by Section 3.1.6 of RR 12-99 requiring the BIR to buttress its findings on factual and legal grounds as follows:

> 3.1.6. *Administrative Decision on a Disputed Assessment.* – The decision of the Commissioner or his duly authorized representative shall (a) state the facts, the applicable law, rules and regulations, or jurisprudence on which such decision is based, otherwise, the decision shall be void.[18]

Contrary to petitioner's assertion, the PAN, FAN with attached details of discrepancies and FDDA are supported by factual and legal bases. The figures on the notices and details of discrepancies and FDDA pertaining to income arising from rentals and interest received by petitioner for the year 2008 can be reconciled with its financial

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[17] G.R. No. 185371, December 8, 2010, 637 SCRA 633.
[18] See *Commissioner of Internal Revenue v. Liquigaz Philippines Corporation* and *Liquigaz Philippines Corporation v. Commissioner of Internal Revenue, CTA EB Case Nos.* 989 & 990, May 22, 2014; *City of Makati v. Commissioner of Internal Revenue,* CTA EB Case No. 641, September 16, 2011.

statements, VAT returns and other documents.[19] Respondent also cited Section 105 of the 1997 NIRC, as amended, and the *CS Garments Inc. v. Commissioner of Internal Revenue*[20] case to justify why petitioner is liable for the 2008 deficiency VAT assessment. Clearly, the PAN, FAN with attached details of discrepancies and FDDA duly explain petitioner's 2008 VAT deficiency, and are therefore valid.

PETITIONER DULY REPORTED ITS 2008 RENTAL INCOME.

PETITIONER UNDERDECLARED SUBSTANTIAL RECEIPTS FROM INTEREST INCOME ON LOANS.

FALSE RETURNS ARE ASSESSED WITHIN TEN (10) YEARS FROM DISCOVERY OF THE FALSITY.

The assessment period of internal revenue taxes is specified in Section 203 of the 1997 NIRC as follows:

> "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 the 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 of thereof shall be considered filed on such last day." (Emphasis supplied.) ge

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[19] Exhibit "T" Note 9 of 2008 FS.
[20] CTA EB Case No. 287, January 14, 2008.

The assessment of internal revenue taxes is made within three years from the time prescribed by law for filing the return or the actual date of the filing of the return, whichever is later.[21]

VAT returns are filed every quarter, specifically within twenty five (25) days following the close of each taxable quarter under Section 114 of the 1997 NIRC, as amended, reading:

> "SEC. 114. *Return and Payment of Value-Added Tax.* –
>
> "(A) *In General.* - Every person liable to pay the value-added tax imposed under this Title shall file a quarterly return of the amount of his gross sales or receipts within twenty-five (25) days following the close of each taxable quarter prescribed for each taxpayer: *Provided, however,* That VAT-registered persons shall pay the value-added tax on a monthly basis.
>
> Any person, whose registration has been cancelled in accordance with Section 236, shall file a return and pay the tax due thereon within twenty-five (25) days from the date of cancellation of registration: *Provided,* That only one consolidated return shall be filed by the taxpayer for his principal place of business or head office and all branches."

Applying Section 114(A) in relation to Section 203 of the 1997 NIRC, as amended, respondent had until the following dates within which to assess petitioner of deficiency VAT for the four (4) quarters of calendar year 2008:

CY 2008	Exhibit	Filing Ref. No.	Date Filed	Last Day to File Return	Last Day to Assess
1st Quarter	"BBB"	100800002176386	04/11/2008	04/25/2008	04/25/2011
2nd Quarter	"CCC"	100800002362837	07/21/2008	07/25/2008	07/25/2011
3rd Quarter	"DDD"	100800002530631	10/20/2008	10/27/2008[22]	10/27/2011
4th Quarter	"LLL"	100900002714201	01/21/2009	01/26/2009[23]	01/26/2012

[21] *Commissioner of Internal Revenue v. Next Mobile, Inc. (Formerly Nextel Communications Philippines, Inc., CTA EB Case No. 1001, May 28, 2014;* and *Commissioner of Internal Revenue v. First Sumiden Realty, Inc.*, CTA EB Case No. 975, January 7, 2014.
[22] October 25, 2008 fell on a Saturday.
[23] January 25, 2009 fell on a Sunday.

According to petitioner, considering that the FAN[24] was only issued on November 10, 2011 and received on November 22, 2011, it is clear that the assessments for petitioner's alleged deficiency VAT for the first, second, and third quarters of CY 2008 were issued beyond the 3-year prescriptive period provided under Section 203 of the 1997 NIRC, as amended.[25]

However, respondent alleges in her Final Decision on Disputed Assessment (FDDA)[26], the substantial underdeclaration of petitioner's gross receipts for CY 2008 warrants extension of the prescriptive period to ten (10) years. The percentage of petitioner's undeclared receipts to the total declared VAT receipts corresponds to more than 30% as shown in the following:

$$\frac{₱25,755,318.00}{₱36,866,647.35} = 69.86\%$$

Invoking Section 248(B) of the NIRC of 1997, as amended, respondent avers that such under declaration rendered petitioner's VAT returns for the CY 2008 as false or fraudulent.

Under extraordinary cases of filing false, fraudulent returns or failure to file returns, the prescriptive period is within ten (10) years from discovery of the falsity, fraud or omission in accordance with Section 222(a) of the 1997 NIRC, as amended, which provides:

> "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: *Provided*, That in a fraud assessment which has become final and executory, the fact of fraud shall be judicially taken cognizance of in the civil or criminal action for the collection thereof. *ju*

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[24] Exhibit "B"; *Reference supplied.*
[25] Petition for Review, par. 29, Docket, p. 18.
[26] Exhibit "C".

The three-year assessment period does not apply in three instances, namely: (1) filing a false return, (2) filing a fraudulent return with intent to evade tax, and (3) failure to file a return. In all these instances, the period within which to assess deficiency taxes is ten (10) years from discovery of the fraud, falsification or omission.[27]

In resolving the issue on the timeliness of the issuance of assessment, it is necessary to determine whether or not petitioner's VAT returns for the CY 2008 are false or fraudulent.

Respondent computed the deficiency VAT assessment by imposing 12% VAT on petitioner's gross receipts on rental and interest income for CY 2008, as shown below[28]:

Rentals and Interest Receivable (beg.) (₱38,866,011.00 ÷ 1.12)		₱ 34,701,795.50
Add: Income during the year		
1. Rentals	₱38,776,417.00	
2. Interest	25,755,318.00	64,531,735.00
Total Amount Available for Collection		₱ 99,233,530.50
Less: Rentals & Interest Receivable (end) (₱26,005,282.00 ÷ 1.12)		23,219,001.78
Gross Receipts for the year 2008		₱ 76,014,528.72

Output VAT Due	₱ 9,121,743.14
Less: Creditable Input Tax	(31,134.00)
VAT Payable per Audit	₱ 9,090,609.14
Less: VAT Payments	(4,392,863.68)
Basic Deficiency VAT Due	₱ 4,697,745.46
Add: 50% Surcharge based on Section 248 (B)	2,348,872.73
20% Interest from January 26, 2009 to May 31, 2012	3,147,489.46
TOTAL AMOUNT DUE	**₱ 10,194,107.65**

RENTAL INCOME *jc*

[27] *Commissioner of Internal Revenue v. Arturo Tulio*, G.R. No. 139858, October 25, 2005, 474 SCRA 147.
[28] Exhibit "C".

As illustrated in the table below, petitioner insists it has duly paid VAT on all of its gross receipts for CY 2008. Hence, it should not be held liable for deficiency VAT on its rental income for CY 2008.

	Rental Income	**Output VAT**	**Exhibit**
1st Qtr.	₱ 8,825,064.83	₱ 1,059,007.78	"BBB"
2nd Qtr.	4,573,560.83	548,827.30	"CCC"
3rd Qtr.	6,692,022.25	803,042.67	"DDD"
4th Qtr.	16,775,999.44	2,013,119.93	"LLL"
Total	**₱36,866,647.35**	**₱4,423,997.68**	

Moreover, petitioner argues that respondent's computation of the alleged discrepancies in petitioner's gross receipts for CY 2008 is erroneous. First, respondent computed the beginning and ending inventories of petitioner's receivables by dividing the amount of receivables by 1.12, instead of 1.07 (*i.e.*, net of the 5% expanded withholding tax component). Second, respondent failed to take into account the amount of ₱1,680,056.96 advance VAT paid by petitioner when it filed its amended Quarterly VAT Return for the fourth quarter of CY 2007 on March 26, 2008.

However, in her FDDA, respondent alleges that the underpayment of VAT on rental income stems from the protest letter stating that the rental income per 2008 income tax return is ₱38,766,417.00 and the declared rental income per VAT return is only ₱36,866,647.35, with a discrepancy of ₱1,899,769.65. The method of declaration of revenue per petitioner's 2008 VAT return is not on accrual basis. Respondent recomputed petitioner's VAT liability on rental income under Section 108 of the Tax Code, based on gross receipts method together with the interest income.

Further, respondent claims that her computation of gross receipts is correct based on Revenue Memorandum Order ("RAMO") No. 1-90 which provides that beginning and ending receivables should be net of VAT. In this instant case, the beginning and ending receivables were divided by the divisor 1.12 only. Petitioner's advanced VAT payments in its 2007 VAT returns cannot be considered as VAT payments for the year 2008 which require further documentation.[29]

[29] Exhibit "C", par. 3(c) under the caption "Our Final Decision".

There is no dispute that the 12% VAT imposed on the use or lease of properties is based on gross receipts from lease/rental payments as provided for under Section 108(A) of the NIRC of 1997, as amended, which states:

> "SEC. 108. *Value-added Tax on Sale of Services and Use or Lease of Properties.-*
>
> "(A) *Rate and Base of Tax.* - There shall be levied, assessed and collected, a value-added tax equivalent to ten percent (10%)[30] of the gross receipts, derived from the sale or exchange of services, including the use or lease of properties.
>
> xxx xxx xxx
>
> The term **'gross receipts'** means the **total amount of money or its equivalent representing** the contract price, compensation, service fee, **rental** or royalty, including the amount charged for materials supplied with the services and deposits and advanced payments **actually or constructively received during the taxable quarter for the services performed or to be performed for another person, excluding value-added tax**." (*Emphasis supplied*)

The issue however is whether or not respondent correctly computed petitioner's vatable gross receipts for CY 2008.

In her computation of vatable gross receipts for CY 2008, respondent divided petitioner's rental and interest receivables as of December 31, 2007 and December 31, 2008 with the respective amounts of ₱38,866,011.00 and ₱26,005,282.00 by 1.12 before adding and deducting the same from the total rental and interest income during the year 2008.

Petitioner, on the other hand, argues that respondent should have divided the Rental Receivables by 1.07 [*i.e.* net of the 5% expanded withholding tax component (EWT)] instead of 1.12. gr

[30] Effective February 1, 2006 the VAT rate was increased from 10% to 12% (Revenue Memorandum Circular No. 7-06).

We subscribe with petitioner's posture.

As illustrated by the Court-commissioned Independent Certified Public Accountant (ICPA)[31], petitioner's entries for the rent accrual are as follows[32]:

Account Code	Particulars	Debit	Credit
214.010	Income Tax Payable (5% Expanded Withholding Tax)	xxx	
233.010004	Other Amounts Due from GADC (Receivables)	xxx	
411.030001	Minimum Rent to MPRC (Sales)		xxx
411.030002	% Rent in Excess of Minimum (Sales)		xxx
213.020001	Deferred Output VAT (Liability)		xxx

By way of an example, the ICPA used the journal entry for rent accrual in January 2008, to wit[33]:

Account Code	Particulars	Debit	Credit
214.010	Income Tax Payable (5% EWT)	₱ 111,068.07	
233.010004	Other amounts due from GADC (Receivables)	2,376,856.61	
411.030001	Minimum Rent to MPRC (Sales)		833,333.33
411.030002	% Rent in Exc of Min (Sales)		166,752.19
411.030002	% Rent in Exc of Min (Sales)		82,914.78
411.030002	% Rent in Exc of Min (Sales)		571,701.06
411.030002	% Rent in Exc of Min (Sales)		449,186.95
411.030002	% Rent in Exc of Min (Sales)		117,473.01
213.020001	Deferred Output VAT (Liability)		266,563.36

Total sales amounted to ₱2,221,361.32 (consolidated totals of Account Codes 411.030001 – Minimum Rent to MPRC and Account Code 411.030002 - % Rent in Exc of Minimum).

Deferred VAT payable amounted to ₱266,563.36 (₱2,221,361.32 x 12%) and EWT amounted to ₱111,068.07 (₱2,221,361.32 x 5%). Note that the 5% EWT is required to be

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[31] Constantino Guadalquiver & Co., through its Partner, Ms. Katherine O. Constantino.
[32] Exhibit "AAA", p. 13.
[33] Exhibit "JJJ-1".

withheld on rentals pursuant to Section 2.57.2 in relation to Section 2.57.4 of Revenue Regulations (RR) No. 2-98, as amended by RR Nos. 12-01 and 17-03.

Receivables booked under Account Code 233.010004 – Other Amounts Due from GADC amounting to ₱2,376,856.61 already included the VAT portion less the five percent (5%) expanded withholding tax (₱2,221,361.32 + ₱266,563.36 - ₱111,068.07).

Total Sales	₱2,221,361.32
Add: Deferred Output VAT	266,563.36
Less: Expanded Withholding Tax	(111,068.07)
Other Amounts Due from GADC (Receivables)	₱2,376,856.61

For the collection of rental income, petitioner's entry includes[34]:

Cash	xxx	
Deferred Output VAT	xxx	
Other Amounts Due from GADC (Receivables)		xxx
Output VAT		xxx

The above ICPA findings coincide with the details found in the official receipts (ORs)[35]. For comparison, the February 2008 official receipt is made reference pertaining to the January 2008 rental.

Exhibit	O.R. No.	Date	Amount Received
"KKK-3"	0099	29-Feb-08	2,376,856.61

Additionally, as can be seen in most O.R.s (*e.g.* Nos. 0098[36], 0100[37], 0103[38], etc.), the breakdown of the amount received reflects the following details: "P" – gross rental income; "V" – 12% VAT; and "T" – 5% EWT. As such, it can be deduced that the amount written in the "sum of Pesos" pertains to the net receivable amount, that is, rental plus 12% VAT and less 5% EWT.

In fine, petitioner's Rental Receivables as of December 31, 2007 and December 31, 2008 should have been divided by 1.07

[34] Exhibit "AAA", p. 14.
[35] Exhibits "KKK-1" to "KKK-16".
[36] Exhibit "KKK-2".
[37] Exhibit "KKK-4".
[38] Exhibit "KKK-7".

instead of 1.12 in order to arrive at the amount of rental income, net of VAT.

The Court-commissioned ICPA provided a breakdown of the Rental and Interest Receivables as of December 31, 2007 and 2008 shown in Note 9 of petitioner's Audited Financial Statements for the year 2008 in the respective amounts of ₱38,866,011.00 and ₱26,005,282.00 as follows[39]:

	Rental Receivable (a)	**Interest Receivable (b)**	**Total (a + b)**	**Per Note 9 of the audited financial statements for the year 2008 (Exhibit EEE)**	**Difference**
December 31, 2007	₱19,727,415.57	19,129,671.34	₱38,857,086.91	38,866,011.00	₱ (8,924.09)
December 31, 2008	₱ 6,806,177.62	20,209,572.14	₱27,015,749.76	26,005,282.00	₱1,010,467.76

According to the ICPA, as represented by petitioner, the difference amounting to ₱8,924.09 pertains to other expenses paid by petitioner in behalf of GADC. The difference amounting to ₱1,010,467.76 comprises various expenses (such as real property tax) paid by GADC in petitioner's behalf[40].

As of December 31, 2007 and 2008, the aforesaid Rental Receivables in the amounts of ₱19,727,415.57 and ₱ 6,806,177.62, respectively, shall be divided by 1.07, thus, resulting to the amounts of ₱18,436,836.98 and ₱6,360,913.66 Rental Receivables as of December 31, 2007 and 2008, net of VAT, respectively.

Petitioner, in its protest, likewise argues that respondent failed to take into account the amount of ₱1,680,056.96 advance VAT paid when it filed the amended Quarterly VAT Return for the fourth quarter of CY 2007 on March 26, 2008.

The Court finds petitioner's stance correct. *Je*

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[39] Exhibit "AAA", p. 10.
[40] Exhibit "AAA", p. 10.

The ICPA identified the collections, net of VAT, received by petitioner for CY 2008 based on the quarter on which it should be reported (*i.e.,* based on dates of official receipts). The collections were then compared with the amounts reported in petitioner's Quarterly VAT Returns per "Line 15 VATable Sales/Receipts – Private", as summarized below[41]:

	1st Quarter (January to March 2008)	**2nd Quarter (April to June 2008)**	**3rd Quarter (July to Sept. 2008)**	**4th Quarter (Oct. to Dec. 2008)**	**Total**
Per Quarterly collections per books*(Exhibit "AAA", Annex 3)*	₱8,825,064.79	₱4,573,560.71	₱19,705,976.91	₱16,761,218.02	₱49,865,820.43
Per "Line 15 VATable Sales/Receipts – Private" 2008 Quarterly VAT Returns	8,825,064.83	4,573,560.83	6,692,022.25	16,775,999.44	36,866,647.35
Difference	₱(0.04)	₱(0.12)	₱13,013,954.66	₱(14,781.42)	₱12,999,173.08

As found by the ICPA, the difference for the fourth quarter of 2008 amounting to ₱14,781.42 pertains to the sale of aircon evidenced by general journal number 02832.[42]

The difference for the third quarter of CY 2008 in the amount of ₱13,013,954.66 excluding VAT and withholding tax pertains to the actual cash collection received on July 25, 2008 as supported by OR No. 0106[43] for the rent rebuild stores for 2006 and 2007. Accrual of rent rebuild was recorded in the books on February 27, 2008 with General Journal 02629[44] for posting in the accounting period of 2007 as follows[45]:

Income tax payable	700,023.73	
Other amounts due from GADC (Receivables)	14,980,507.86	
% Rent in Exc of Minimum (Sales)		14,000,474.63
Deferred Output VAT		1,680,056.96

The ₱986,520.01 represents the amount advanced by GADC in behalf of petitioner.[46]

[41]Exhibit "AAA", p. 19.
[42]Exhibit "CCCC".
[43]Exhibit "KKK-10".
[44]Exhibit "WWW".
[45]Exhibit "AAA", p. 19.
[46] *Ibid.*

The output VAT of ₱1,680,056.96 on the collected rent rebuild was remitted to the BIR per petitioner's amended Quarterly VAT Return for the fourth quarter of 2007, as shown below:

	Original 4th Quarter 2007 VAT Return (Exhibit "UUU")	**Amended 4th Quarter VAT Return (Exhibit "VVV")**	**Difference**
Sales	₱ 4,398,294.00	₱ 22,835,131.00	₱ (18,436,837.00)
VAT Output	527,795.28	2,740,215.72	(2,212,420.44)
Net VAT Payable	₱ 527,795.28	₱ 2,740,215.72	₱(2,212,420.44)
Less:			
Monthly VAT payments-previous two months	₱ 527,795.28	₱ 527,795.28	₱ -
Others - VAT for November and December 2007 rent collected in January 2008		532,363.48	(532,363.48)
Total Tax Credits	₱ 527,795.28	₱ 1,060,158.76	₱ (532,363.48)
Total Amount Payable (Overpayment)	**₱ -**	**₱ 1,680,056.96**	**₱(1,680,056.96)**

As accounted for by the ICPA, the difference comprises the following[47]:

i. Sales

Particulars	**Journal Listing No.**	**Exhibit Reference**	**Rent Income**
Rent rebuild for 2006 and 2007 for the period of December 2007	2629	WWW	₱14,000,474.67
Rent for November 2007 received on January 2008	2580	GGGG-1	2,089,223.59
Rent for December 2007 received on January 2008	2596	GGGG-2	2,347,138.73
Total			₱18,436,836.99

ii. VAT Output/Net VAT Payable

Particulars	**Rent Income**	**VAT Output (Rent Income x 12%)**
Rent rebuild for 2006 and 2007 for the period of December 2007	₱14,000,474.63	₱ 1,680,056.96
Rent for November 2007 booked in January 2008	2,089,223.59	250,706.83
Rent for December 2007 booked in January 2008	2,347,138.73	281,656.65
Total	₱18,436,836.95	₱ 2,212,420.44

jc

[47]Exhibit "AAA", pp. 21-22.

iii. Others

Others pertain to VAT payments on January 2008 VAT return filed on February 20, 2008 with filing reference number 090800002081752 and paid on February 20, 2008 with payment confirmation of 80446930 amounting to ₱532,363.48. This pertains to the following rent income:

Particulars	Journal Listing No.	Exhibit Reference	Rent Income
Rent for November 2007 received in January 2008 supported by OR No. 0097 (Exhibit "JJJ-1")	2580	GGGG-1	₱ 2,089,223.59
Rent for December 2007 received in January 2008 supported by OR No. 0098 (Exhibit "JJJ-2")	2596	GGGG-2	2,347,138.73
Total			₱ 4,436,362.32

iv. Total Amount Payable

This amount pertains to VAT output pertaining to the rent rebuild in 2006 and 2007 for the account period 2007 recorded on February 27, 2008 with General Journal 02629[48] for the account period 2007.

Particulars	Rent Income	VAT Output (Rent income x 12%)
Rent rebuild for 2006 and 2007 for the period of December 2007	₱14,000,474.67	₱1,680,056.96

The VAT payable amounting to ₱1,680,056.96 was paid through EFPS on March 26, 2008 with payment transaction number 80501312 for Filing Reference No. 100800002143254[49]

In sum, petitioner has sufficiently proven that the ₱1,680,056.96 output VAT due on the ₱13,013,954.66 collection it received on July 25, 2008 for the rent rebuild stores for 2006 and 2007, was paid in advance on March 26, 2008 through the filing of its

[48]Exhibit "WWW".
[49]Exhibit "VVV-2".

amended Quarterly VAT Return for the fourth quarter of 2007. Consequently, the amount of ₱1,680,056.95 was credited against the output tax liability of petitioner for CY 2008.

After taking into account all of the foregoing adjustments, **petitioner has established that it paid the VAT on all of its gross receipts on rental income** and sale of aircon for the CY 2008 as shown below:

Rental Receivables, Beginning	₱19,727,415.57	÷ 1.07	₱ 18,436,836.98
Add: Rental Income During the Year			38,776,417.00
Total Amount Available for Collection			₱ 57,213,253.98
Less: Rental Receivables, Ending	₱ 6,806,177.62	÷ 1.07	6,360,913.66
Gross Receipts on Rental Income			₱ 50,852,340.32
Gross Receipts on Sale of Aircon			14,781.42
Total Gross Receipts on Rental Income and Sale of Aircon for CY 2008			₱ 50,867,121.74
Output VAT Due			₱ 6,104,054.61
Less: Tax Credits/Payments			
Creditable Input Tax			₱ 31,134.00
VAT Payments			4,392,863.68
Advance VAT Payment			1,680,056.96
Total Tax Credits/Payments			₱ 6,104,054.64
VAT Payable/(Overpayment)			**₱ (0.03)**

INTEREST INCOME ON LOANS

According to petitioner, its interest bearing loans are not subject to VAT because these were not incurred in the ordinary course of trade of business. Petitioner is engaged in the business of leasing real properties, not lending money for profit.

Petitioner's interest income from loans for CY 2008 may not be considered incidental to its primary business activity which is leasing of real properties.

Citing BIR Ruling [DA-118-08] dated March 4, 2008, petitioner alleges that it cannot be considered a "lending investor" subject to VAT by virtue of its loan advances to GADC. *yr*

Respondent submits that petitioner was a lender of GADC for the past several years as reflected in its prior years' income tax returns and clearly earning yearly profits with a whopping amount of P25,755,318 for the year 2008 which is 70% of its main income, hence, petitioner can be categorized as lending investor under Section 108 of the 1997 NIRC, as amended. Moreover, since the rental and interest income were earned from one client, GADC, it follows that the interest from loans considered as incidental income, are also subject to VAT.

Petitioner's assertions deserve scant consideration.

Persons or entities liable to VAT are specified in Sections 105 & 108 of the 1997 NIRC, as amended, which provide:

> "SEC. 105. Persons Liable. — Any person who, in the course of trade or business, sells, barters, exchanges, leases goods or properties, renders services, and any person who imports goods shall be subject to the value-added tax (VAT) imposed in Sections 106 to 108 of this Code.
>
> The value-added tax is an indirect tax and the amount of tax may be shifted or passed on to the buyer, transferee or lessee of the goods, properties or services. This rule shall likewise apply to existing contracts of sale or lease of goods, properties or services at the time of the effectivity of Republic Act No. 7716.
>
> The phrase **"in the course of trade or business" means the regular conduct or pursuit of a commercial or an economic activity, including transactions incidental thereto, by any person** regardless of whether or not the person engaged therein is a nonstock, nonprofit private organization (irrespective of the disposition of its net income and whether or not it sells exclusively to members or their guests), or government entity.

The rule of regularity, to the contrary notwithstanding, services as defined in this Code rendered in the Philippines by nonresident foreign persons shall be considered as being rendered in the course of trade or business. (Emphasis supplied)

xxx xxx xxx

"SECTION 108. Value-added Tax on Sale of Services and Use or Lease of Properties. —

"(A) Rate and Base of Tax. — There shall be levied, assessed and collected, a value-added tax equivalent to ten percent (10%) of gross receipts derived from the sale or exchange of services, including the use or lease of properties.

"The phrase 'sale or exchange of services' means the performance of all kinds of services in the Philippines for others for a fee, remuneration or consideration, including those performed or rendered by construction and service contractors; stock, real estate, commercial, customs and immigration brokers; lessors of property, whether personal or real; warehousing services; lessors or distributors of cinematographic films; persons engaged in milling, processing, manufacturing or repacking goods for others; proprietors, operators or keepers of hotels, motels, resthouses, pension houses, inns, resorts; proprietors or operators of restaurants, refreshment parlors, cafes and other eating places, including clubs and caterers; dealers in securities; lending investors; transportation contractors on their transport of goods or cargoes, including persons who transport goods or cargoes for hire and other domestic common carriers by land relative to their transport of goods or cargoes; common carriers by air and sea relative to their transport of passengers, goods or cargoes from one place in the Philippines to another place in the Philippines, sales of electricity by generation companies, transmission, and distribution companies, services of franchise grantees of electric utilities, telephone and telegraph, radio and television broadcasting and all franchise grantees except those under Section 119 of this Code and nonlife

> insurance companies (except their crop insurances), including surety, fidelity, indemnity and bonding companies; **and similar services regardless of whether or not the performance thereof calls for the exercise or use of the physical or mental faculties.** xxx" (Emphasis supplied.)

Under the law, persons liable to VAT are those who in the course of trade or business, sell, barter, exchange, lease goods or properties, render services, and those who import goods. In the course of trade or business refers to regular conduct or pursuit of a commercial or an economic activity, including transactions incidental thereto.[50] Thus, transactions that are undertaken incidental to the pursuit of a commercial or economic activity are considered as entered into in the course of trade or business.[51] 'Incidental' means depending upon or appertaining to something else as primary; something necessary, appertaining to, or depending upon another, which is termed the principal; something incidental to the main purpose.[52]

In the case of *CS Garments, Inc. vs. Commissioner of Internal Revenue*[53], this Court held that although the primary business of CS Garments is the manufacturing of garments for sale abroad, the sale of motor vehicle to its general manager is considered an incidental transaction subject to VAT as it was purchased and used in carrying out petitioner's business in this manner:

> Here, petitioner's primary business is the manufacturing of garments for sale abroad. In carrying-out its business, petitioner acquired and eventually sold a Mercedes Benz to its General Manager Mr. Sudhoff. Prior to the sale, the motor vehicle formed part of petitioner's capital assets, specifically under the account, "Property, Plant and Equipment". The Rules on International Accounting Standards (IAS)16 defines Property, Plant and Equipment as follows:

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[50] *Commissioner of Internal Revenue v. Court of Appeals and Commonwealth Management and Services Corporation*, G.R. No. 125355, March 30, 2000, 329 SCRA 237
[51] Victor A. Deoferio, Jr. and Victorino Mamalateo, The Value Added Tax in the Philippines, 2000 Edition, p. 82.
[52] Black's Law Dictionary, 6th ed., p. 762.
[53] CTA EB Case No. 287, January 14, 2008.

"6. Definitions

Property, plant and equipment are tangible assets that:

(a) are held by an enterprise **for use in the production or supply of goods or services**, for rental to others, or **for administrative purposes**; and

(b) are expected to be used during more than one period."

Therefore, the sale of the motor vehicle is an incidental transaction because the said vehicle was purchased and used in furtherance of petitioner's business.

Once an activity has been identified as a business, any supply[sale] made while carrying it on is likely to be made in the course or furtherance of business. No distinction is made between capital and revenue items. Thus, a supply[sale] in the course or furtherance of business includes: (1) *the disposition of the assets and liabilities of a business*, (2) the disposition of a business as going concern; and (3) anything done in connection with the termination or intended termination of a business. (*Emphasis supplied*)

Similarly, in the case of *Lapanday Foods Corporation v. Commissioner of Internal Revenue*[54], this Court ruled that if the income from the main business activity is subject to VAT, the incidental income shall also be subject to VAT, provided that there is no particular provision applicable to the specific transaction.

Here, the financial statements for the years ended December 31, 2008 and 2007 disclose that the subject interest income arose from the following two (2) loan/debt agreements with its lone client, GADC, to be allocated for the acquisition of real properties and unpaid rentals.

[54] CTA EB Case No. 367, January 29, 2009.

1. **Related Party Transactions**

   a. xxx xxx xxx

   b. On March 17, 2005, the Branch entered into a loan agreement with GADC covering interest-bearing, long term advances granted to GADC in prior years **<u>for land and equipment purchased for various restaurants and warehouse</u>** amounting to ₱57,431,435. The loan is payable in full on March 17, 2009. Interest on the loan shall accrue at 8.4375% from March 1, 2005 to March 17, 2006; thereafter, interest shall accrue at six-month PHIBOR rate plus 2%, which the Branch will reset on March 18 of each year.*(Emphasis supplied)*

   On the same date, the Branch and GADC signed an Acknowledgment of Debt Agreement, whereby GADC acknowledged that it has **<u>unpaid rentals</u>** and interest due to the Branch amounting to ₱366,712,722 ("receivable"). In accordance with the terms of the said agreement, GADC executed a Promissory Note in favor of the Branch for ₱366,712,722, which is payable in full on March 17, 2009. Interest on the receivable shall accrue at 8.4375% from March 1, 2005 to March 17, 2006; thereafter, the interest shall accrue at six-month PHIBOR rate plus 2%, which the Branch will reset on March 18 of each year."*(Emphasis supplied)*[55]

Relative to the loan amount of ₱57,431,435.38, the utilization of the proceeds thereof was clearly set forth in the Loan Agreement entered into by petitioner with GADC on March 17, 2005, thus[56]:

> WHEREAS, **MPRC loaned GADC an amount of money for the period 16 July 1985 to 14 June 1991 to assist GADC in its purchase of real properties in the Philippines**;
>
> WHEREAS, GADC acknowledges the existence of the loan and receipt thereof from MPRC and the use of

[55]Exhibit "T", Notes to Financial Statements, Note 9, p. 13.
[56]Exhibit "V", pp. 1-2.

> the proceeds thereof to purchase real properties located in the Philippines and more specifically described in Annex "A" of this Agreement;
>
> WHEREAS, **GADC has since developed some of the real properties as sites for McDonald's Restaurants, while one property was used to establish a distribution and supply warehouse**; and
>
> WHEREAS, while the real properties described in Annex "A" were sold by GADC in 2002 to another corporation, Golden Arches Realty Corporation, **the McDonald's Restaurants, as well as the distribution and supply warehouse located therein, remain the properties of GADC**. (*Emphasis Supplied*)

Considering that petitioner established its branch office in the Philippines for the purpose of purchasing and leasing back two (2) existing McDonald's Restaurants to GADC and developing new McDonald's Restaurant sites which will then be leased to McGeorge Foods, Inc. as stated in its License to Transact Business in the Philippines issued by the SEC on November 12, 1984[57], it can be safely concluded that the loan it granted to GADC in the amount of ₱57,431,435.38 was in the pursuit of its leasing business with GADC. Consequently, the interest income it derived from the said loan, being incidental to its leasing business, is deemed a transaction "in the course of trade and business" which is subject to VAT pursuant to Section 105 in relation to Section 108(A) of the NIRC of 1997, as amended.

The same holds true with regard to GADC's debt to petitioner in the amount of ₱366,712,722. The Acknowledgement of Debt executed by petitioner and GADC on March 17, 2005 states that[58]:

> WHEREAS, MPRC owns the leasehold improvements and the equipment, seating, signage and design of McDonald's Restaurants owned and operated by GADC which restaurants are listed in Annex "A" attached thereto; *gr*

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[57]Exhibit "X".
[58]Exhibit "W", pp. 1-2.

WHEREAS, MPRC also owns the leasehold improvements and equipment in the distribution and supply warehouse located at Marikina City, Philippines;

WHEREAS, MPRC leased the above leasehold improvements and the equipment seating, signage and design to GADC in return for payment of lease/rental fees; and

WHEREAS, to date, GADC has unpaid rentals due MPRC.

Article I – Amount of the Receivables

Upon and subject to the terms and conditions of this Agreement, GADC hereby acknowledges that it has unpaid rentals and unpaid interest due to MPRC in the amount of THREE HUNDRED SIXTY-SIX MILLION SEVEN HUNDRED TWELVE THOUSAND SEVEN HUNDRED TWENTY-ONE PHILIPPINE PESOS AND SEVENTY-NINE PHILIPPINE CENTAVOS (Php366,712,721.79), xxx

Evidently, from the foregoing, the interest income derived by petitioner from GADC's unpaid rentals, is considered a transaction made in the course of petitioner's lease business, and is subject to VAT pursuant to Section 105 in relation to Section 108(A) of the NIRC of 1997, as amended.

However, in computing petitioner's VATable gross receipts from interest income for CY 2008, respondent erroneously divided petitioner's Interest Receivables as of December 31, 2007 and 2008 by 1.12.

Records show that petitioner subjected its interest income to 2% EWT upon recording of the interest accrual as follows[59]:

Other amounts due from GADC (Receivables)	xxx	
Interest Inc-Debt Acknowledg		xxx
Interest on Loan		xxx
Income tax payable (2% EWT)	xxx	

[59]Exhibit "AAA", pp. 26-27.

Other amounts due from GADC (Receivables)		xxx

Petitioner's entry for the collection of interest income:

Cash	xxx	
Other amounts due from GADC		xxx

Thus, respondent should have divided the Interest Receivables as of December 31, 2007 and 2008 in the respective amounts of ₱19,129,671.34 and ₱20,209,572.14 by .98 (*i.e.* net of the 2% EWT) instead of 1.12 in order to arrive at the interest income, net of EWT.

As computed below, petitioner's undeclared gross receipts on interest income for CY 2008 amounted to ₱24,653,378.41 and petitioner shall be held liable to pay the corresponding deficiency VAT in the amount of ₱2,958,405.41, computed as follows:

Interest Receivables, beginnning	₱ 19,129,671.34	÷ 0.98	₱ 19,520,072.80
Add: Interest Income During the Year			25,755,318.00
Total Amount Available for Collection			₱ 45,275,390.80
Less: Interest Receivables, ending	₱ 20,209,572.14	÷ 0.98	20,622,012.39
Gross Receipts on Interest Income			₱ 24,653,378.41
Multiply by VAT Rate			x 12%
Basic Deficiency VAT			**₱ 2,958,405.41**

As stated earlier, under Section 222(a) of the NIRC of 1997, as amended, there are three exceptions to the three year prescriptive period for the assessment of internal revenue taxes, namely; (1) filing of false return, (2) filing of fraudulent return with intent to evade tax, and (3) failure to file a return. The tax may be assessed or a proceeding in court for the collection of such tax may be begun without assessment at any time within ten years after the discovery of the falsity, fraud or omission.

In the case of *Aznar vs. Court of Tax Appeals*[60], the Supreme Court distinguished between "false" and "fraudulent" returns as follows:

[60] G.R. No. L-20569, August 23, 1974, 58 SCRA 519.

> xxx xxx We believe that the proper and reasonable interpretation of said provision should be that in the three different cases of (1) false return, (2) fraudulent return with intent to evade tax, (3) failure to file a return, the tax may be assessed, or a proceeding in court for the collection of such tax may be begun without assessment, at any time within ten years after the discovery of the (1) falsity, (2) fraud, (3) omission. Our stand that the law should be interpreted to mean a separation of the three different situations of false return, fraudulent return with intent to evade tax, and failure to file a return is strengthened immeasurably by the last portion of the provision which segregates the situations into three different classes, namely 'falsity', 'fraud' and 'omission'. **That there is a difference between 'false return' and 'fraudulent return' cannot be denied. While the first merely implies deviation from the truth, whether intentional or not, the second implies intentional or deceitful entry with intent to evade the taxes due.**

Following the doctrine in the aforequoted *Aznar* case, it is evident that **petitioner committed falsity in its 2008 Quarterly VAT Returns as it did not declare substantial receipts from its interest income in the amount of ₱24,653,378.41**. Since there is a deviation from the truth, the ten (10)-year assessment period applies.

50% SURCHARGE IS INVALID.
25% SURCHARGE SHOULD BE IMPOSED.

In the *Aznar* case, the Supreme Court ruled that where there is a deviation from the truth, whether intentional or not, the ten-year prescriptive period to assess should be applied. At the same time, the High Court ruled that there is no basis for the imposition of the fifty percent (50%) fraud penalty in the absence of a willful fraudulent act on the part of the taxpayer, thus:

> The second issue which appears to be of vital importance in this case centers on the lower court's imposition of the fraud penalty (surcharge of 50% authorized in Section 72 of the Tax Code).

xxx xxx xxx

From the above exposition of facts, we cannot but emphatically reiterate the well established doctrine that fraud cannot be presumed but must be proven. As a corollary thereto, we can also state that fraudulent intent could not be deduced from mistakes however frequent they may be, especially if such mistakes emanate from erroneous entries or erroneous classification of items in accounting methods utilized for determination of tax liabilities. **The predecessor of the petitioner undoubtedly filed his income tax returns for "the years 1946 to 1951 and those tax returns were prepared for him by his accountant and employees. It also appears that petitioner in his lifetime and during the investigation of his tax liabilities cooperated readily with the B.I.R. and there is no indication in the record of any act of bad faith committed by him.**

The lower court's conclusion regarding the existence of fraudulent intent to evade payment of taxes was based merely on a presumption and not on evidence establishing a willful filing of false and fraudulent returns so as to warrant the imposition of the fraud penalty. The fraud contemplated by law is actual and not constructive. It must be intentional fraud, consisting of deception willfully and deliberately done or resorted to in order to induce another to give up some legal right. Negligence, whether slight or gross, is not equivalent to the fraud with intent to evade the tax contemplated by the law. It must amount to intentional wrong-doing with the sole object of avoiding the tax. It necessarily follows that a mere mistake cannot be considered as fraudulent intent, and if both petitioner and respondent Commissioner of Internal Revenue committed mistakes in making entries in the returns and in the assessment, respectively, under the inventory method of determining tax liability, it would be unfair to treat the mistakes of the petitioner as tainted with fraud and those of the respondent as made in good faith.

We conclude that the 50% surcharge as fraud penalty authorized under Section 72 of the Tax

> **Code should not be imposed, but eliminated from the income tax deficiency for each year from 1946 to 1951, inclusive.**[61]
> (Emphasis supplied.)

The 50% surcharge cited in the *Aznar* case is lifted from Section 72 of the then Tax Code, which reads as follows:

> SEC. 72. *Surcharges for failure to render returns and for rendering false and fraudulent returns.* - In case of willful neglect to file the return or list required under this Title within the time prescribed by law, or **in the case a false or fraudulent return or list is willfully made,** the Commissioner of Internal Revenue shall add to the tax or to the deficiency tax, **in case any payment has been made on the basis of such return before the discovery of the falsity or fraud, a surcharge of fifty per centum of the amount of such tax or deficiency tax**.xxx

In the present case, Section 248(B) of the NIRC of 1997, as amended applies, and mirrors a portion of the provision in Section 72 of the former Tax Code on the imposition of 50% surcharge as follows:

> "SEC. 248. *Civil Penalties.* —
>
> "(B) **In case of willful neglect to file the return within the period prescribed by this Code or by rules and regulations, or in case a false or fraudulent return is willfully made, the penalty to be imposed shall be fifty percent (50%) of the tax or of the deficiency tax, in case any payment has been made on the basis of such return before the discovery of the falsity or fraud**: Provided, That a substantial underdeclaration of taxable sales, receipts or income, or a substantial overstatement of deductions, as determined by the Commissioner pursuant to the rules and regulations to be promulgated by the Secretary of

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[61] See *Commissioner of Internal Revenue v. Japan Air Lines, Inc.*, G.R. No. 60714, October 4, 1991, 202 SCRA 450; *Commissioner of Internal Revenue v. Air India*, G.R No. L-72443, January 29, 1988, 157 SCRA 648; and *Next Mobile, Inc. v. Commissioner of Internal Revenue*, CTA Case No. 7970, Resolution dated August 12, 2013.

> Finance, shall constitute **prima facie** evidence of a false or fraudulent return: Provided, further, That failure to report sales, receipts or income in an amount exceeding thirty percent (30%) of that declared per return, and a claim of deductions in an amount exceeding thirty percent (30%) of actual deductions, shall render the taxpayer liable for substantial underdeclaration of sales, receipts or income or for overstatement of deductions, as mentioned herein. (*Emphasis supplied*)

Applying the rationale laid down by the Supreme Court in the *Aznar* case, the 50% surcharge imposed by the respondent in the present case is improper and, thus, must be cancelled and withdrawn. However, the Court imposes surcharge of 25% pursuant to Section 248 (A)(3) of the 1997 NIRC, as amended, for "failure to pay the deficiency tax within the time prescribed for its payment in the notice of assessment".

The underdeclaration in petitioner's gross receipts on interest income for the CY 2008 did not arise from a deliberate attempt on its part to evade tax but on the honest belief that it is not subject to VAT. This is supported by the fact that the interest income amounting to ₱25,755,318.00, as well as the rental and interest receivables as of December 31, 2007 and 2008 in the respective amounts of ₱38,866,011.00 and ₱26,005,282.00 used by the respondent in computing the deficiency VAT assessment are **disclosed in petitioner's Audited Financial Statements**[62] **for the years ended December 31, 2008 and 2007 and 2008 Annual Income Tax Return.**[63] Thus, respondent was not prevented from assessing the VAT on petitioner's gross receipts from interest income for the CY 2008.

WHEREFORE, premises considered, Petition for Review is **PARTIALLY GRANTED**. The Final Decision on Disputed Assessment issued by respondent against petitioner covering deficiency value-added tax for CY 2008 is partly upheld. Accordingly, petitioner should be ordered to pay respondent the amount of ₱3,698,006.76 representing the sum of the basic deficiency VAT for taxable year 2008 in the amount of ₱2,958,405.41 and the 25%

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[62] Exhibit "T", Notes to Financial Statements, under Note 9, par. b.
[63] Exhibit "S", Line 20B.

surcharge imposed under Section 248(A)(3) of the NIRC of 1997, in the amount of ₱739,601.35, as shown below:

Basic Deficiency VAT	₱ 2,958,405.41
Add: 25% Surcharge	739,601.35
Total	**₱ 3,698,006.76**

In addition, petitioner is liable to pay:

a) Deficiency interest at the rate of twenty percent (20%) per annum on the basic deficiency VAT of ₱2,958,405.41 computed from January 25, 2009, until full payment thereof pursuant to Section 249(B) of the 1997 NIRC, as amended; and

b) Delinquency interest at the rate of twenty percent (20%) per annum on the 20% deficiency interest which have accrued as aforestated in (a) and on the total amount of ₱3,698,006.76, computed from May 22, 2012 until full payment thereof pursuant to Section 249(C) of the 1997 NIRC, as amended.

SO ORDERED.

Juanito C. Castañeda, Jr.
JUANITO C. CASTAÑEDA, JR.
Associate Justice

WE CONCUR:

CAESAR A. CASANOVA
Associate Justice

(On Leave)
AMELIA R. COTANGCO-MANALASTAS
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.
JUANITO C. CASTAÑEDA, JR.
Acting Presiding Justice