**Republic of the Philippines**
**COURT OF TAX APPEALS**
**Quezon City**

***SECOND DIVISION***

**TELESAT, INC.,**
*Petitioner,*

- versus -

**COMMISSIONER OF INTERNAL REVENUE,**
*Respondent.*

**C.T.A. CASE NO. 6812**

Members:

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

Promulgated:

JAN 02 2006

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# DECISION

## CASTAÑEDA, JR., J.:

The case involves an appeal for the cancellation of the assessment issued by respondent against petitioner covering alleged deficiency income tax in the amount of P42,184,277.44 for taxable year 1997.

Petitioner is a domestic corporation duly organized and existing under the laws of the Philippines, with office address at Unit 210 Amberland Plaza, Julia Vargas Ave., Ortigas, Pasig City. It is engaged in the business of providing management services (*par. 1.01, Joint Stipulation of Facts*).

On July 13, 1999, respondent, through Revenue District Office No. 43, issued Letter of Authority No. 00011290 which was received by petitioner on August 11, 1999, authorizing the examination of the latter's books of accounts and other accounting records for all internal revenue tax liabilities covering the period January 1, 1997 to December 31, 1997 and unverified prior years *(page 88, BIR Records)*.

As a result of the investigation, the Revenue District Office (RDO) No.43, Pasig City, issued a Pre-Assessment Notice (1st PAN) dated December 6, 2000 disclosing an alleged deficiency income tax in the amount of P22,560,990.55 and deficiency VAT in the amount of P2,129,402.25 totaling P24,690,382.80 for taxable year 1997, the detailed computations of which are as follows:

| | | | |
|---|---|---|---|
| ***DEFICIENCY INCOME TAX*** | | | |
| Basic Tax Due | | P 12,019,194.96 | |
| Add: | 25% Surcharge | 3,004,798.74 | |
| | 20% Interest | 7,511,996.85 | |
| | Compromise | 25,000.00 | |
| Total Deficiency Income Tax | | | P 22,560,990.55 |
| ***DEFICIENCY VAT*** | | | |
| Basic Tax Due | | P 1,052,201.13 | |
| Add: | 25% Surcharge | 263,050.28 | |
| | 20% Interest | 789,150.84 | |
| | Compromise | 25,000.00 | |
| Total Deficiency VAT | | | 2,129,402.25 |
| Grand Total | | | P 24,690,392.80 |

*(par. 1.04, Joint Stipulation of Facts; pages 112 & 113, BIR Records)*

On December 15, 2000, petitioner filed a letter dated December 14, 2000 protesting the 1st PAN (*Exhibit C*).

On January 5, 2001, petitioner filed a supplemental protest to the 1st PAN arguing that the proposed assessments have no legal and factual bases and requesting for the cancellation thereof *(Exhibit D)*.

On May 22, 2001, or almost five (5) months after the submission of the aforesaid supplemental protest letter, a follow-up letter was filed by petitioner since no reply/action on the part of respondent was made on the protest, requesting for the termination of the case as the right to assess has already prescribed (*par. 1.22, Joint Stipulation of Facts*).

On September 23, 2002, petitioner received from the RDO No. 43, Pasig City, a Post Reporting Notice dated September 11, 2002 (*pages 159 – 160, BIR Records*), recommending no amount of deficiency VAT but an increased deficiency income tax of P39,732,638.74 which included a 50% surcharge, computed as follows:

| | | |
|---|---|---|
| ***DEFICIENCY INCOME TAX*** | | |
| Basic Tax Due | | P 17,275,060.32 |
| Add: | 50% Surcharge | 8,637,530.16 |
| | 20% Interest (4/16/98 to 4/16/02) | 13,820,048.26 |
| Total Amount Due | | P 39,732,638.74 |

In a letter dated November 6, 2002 and which was received by the RDO No. 43, Pasig City on November 22, 2002, petitioner again protested the assessment attached to the Post-Reporting Notice dated September 11, 2002, reiterating that the assessment was erroneous and that the right of the government to assess has already prescribed (*pages 174 – 175, BIR Records*).

On December 9, 2002, petitioner received a second Pre-Assessment Notice (2nd PAN) dated November 22, 2002, this time from Revenue Region No. 7, reaffirming the deficiency income tax in the amount of P39,732,638.74 as well as enumerating the details of assessments/discrepancies. This latter Pre-Assessment Notice provided for a 50% surcharge on the assessment (*par. 1.24, Joint Stipulation of Facts; pages 176 – 178, BIR Records*).

On December 23, 2002, petitioner filed a supplemental position paper addressed to the Regional Director of Revenue Region No. 7, protesting the above findings of alleged discrepancies subject to income tax for the year 1997 (*Exhibit I*).

On January 8, 2003, petitioner received a Final Assessment Notice (FAN) dated December 27, 2002 with accompanying Formal Letter of Demand and Details of Discrepancies from Revenue Region No. 7 (*par. 1.08, Joint Stipulation of Facts; Exhibit J*), assessing petitioner for deficiency income tax in the total amount of P42,184,277.44 inclusive of penalties for taxable year 1997, including surcharge at the rate of 50%, broken down as follows:

| ***DEFICIENCY INCOME TAX*** | |
|---|---|
| Basic Tax Due | 17,275,060.32 |
| Add: 50% Surchrage | 8,637,530.16 |
| 20% Interest (4/16/98 to 1/27/03) | 16,271,686.96 |
| Total Amount Due | 42,184,277.44 |

On February 7, 2003, petitioner filed a protest letter against the FAN *(Exhibit K)*.

On April 8, 2003, petitioner submitted a letter to Mr. Danilo A. Duncano, Regional Director, Revenue Region No. 7, attaching all relevant documents in support of its protest, namely: a) reconciliation of accrual and cash basis – declaration of income; b) general ledger of financing and service income; c) general ledger of accounts receivable – financing and service income; d) official receipts – collection of financing and service income; e) reconciliation of professional fees and compensation; f) check vouchers and official receipts of payees who are general professional partnerships; g) general ledger of legal audit and professional fees; and h) general ledger of de minimis benefits accounts (SSS & Pag-Ibig Contributions, medicines, medical and dental benefits).

On June 12, 2003, petitioner received Tax Verification Notice ("TVN") No. 2001-00122919 dated March 3, 2003 authorizing Revenue Officer Claro E. Bartolome to reinvestigate the case (*par. 1.10, Joint Stipulation of Facts*).

On July 10,2003, petitioner filed a letter-reply to the TVN dated July 1, 2003 emphasizing that its protest letter dated February 6, 2003 against the FAN dated January 8, 2003 was premised on the issue of prescription. Petitioner pointed out that since the 2nd PAN and FAN were issued beyond April 14, 2001, the expiry date of the three-year prescriptive period for the respondent to assess, there was no need of any reinvestigation as it would only result in the cancellation of the deficiency tax assessment (*Exhibit N*).

Alleging inaction on the part of the respondent on its protest, petitioner filed the instant appeal before Us on November 3, 2003.

Respondent, in his Answer filed on January 26, 2004, interposed the following Special and Affirmative Defenses:

> 10. The herein Petitioner failed to submit all relevant documents to contradict the assessment issued against it. Not all supporting documents were submitted to the Bureau of Internal Revenue. For its failure to submit all relevant documents, the assessment had become final (Section 222 of the National Internal Revenue Code of 1997);
>
> 11. The assessment notices issued to the herein Petitioner are valid because under Section 222 of the National Internal Revenue Code of 1997 there are certain exceptions to the general rule that final

assessment notices should be issued within three years from the date of filing of the Income Tax Return. In the case of the herein Petitioner, it was established that it filed a false or fraudulent return with intent to evade the tax. Hence, the right of the government to assess is extended to ten years after the discovery of the falsity, fraud or omission;

12. The undeclared income per Value-Added Tax Return in the amount of P34,340,557.00 was arrived at upon verification that the Petitioner failed to declare in its Income Tax Return for 1997 the whole income declared by the Petitioner in its Value-Added Tax Return for the said year. There was substantial understatement of the Petitioner's taxable income;

13. In the audit investigation conducted by the District Examiners it was disclosed that the Petitioner derived income from the services it rendered to Liberty Broadcasting Network, Inc. during the year 1997 and the same was neither recorded in its books of accounts nor declared in its Income Tax Return. There was likewise an understatement of the Petitioner's taxable income for 1997;

14. In addition, certain income payments were not subjected to withholding tax. Upon investigation it was disclosed that certain items of deduction from the Petitioner's gross income for 1997 were not subjected to expanded withholding tax in violation of Section 29(j) of the National Internal Revenue Code of 1997, hence, should be disallowed on audit; and

15. All presumptions are in favor of the correctness of the tax assessments. (Commissioner of Internal Revenue vs. Avelino; 8 SCRA 572).

The parties mutually posed the following issues for this Court's resolution:

1. Whether or not the right of the government to assess has already prescribed;

2. Whether or not there is evidence of fraud to warrant extension of prescriptive period and imposition of 50% surcharge;

3. Whether or not the assessment has legal and factual basis; and

4. Whether or not the assessment has become final on the ground that the petitioner failed to submit all documents in support of its protest.

As the first and second issues are interrelated, the same shall be discussed jointly.

Respondent claims that petitioner's failure to report the alleged discrepancy in income rendered petitioner's income tax return for taxable year 1997 false and fraudulent, thus, the extension of the prescriptive period to assess is ten (10) years and the imposition of 50% surcharge is proper (Jose B. Aznar vs. Court of Tax Appeals and CIR, GR No. L-20569 dated August 23, 1974 and Section 248(B) of the National Internal Revenue Code (NIRC), as amended by R.A. No. 8424).

Upon the other hand, petitioner maintains that the right of the respondent to assess had already prescribed pursuant to Section 203 of the Tax Code. Petitioner argues that since its income tax return for the year 1997 was filed on April 15, 1998 (*Exhibit O*), the right of the Bureau of Internal Revenue to assess it for any deficiency income tax expired on April 13, 2001 (the year 2000 being a leap year). The 2nd Pre-Assessment Notice (2nd PAN) and the Final Assessment Notice (FAN) which petitioner received on December 9, 2002 and January 8, 2003, respectively, were beyond the prescriptive period considering that around one (1) year and nine months had already lapsed after April 13, 2001 and that petitioner had not filed any waiver of the defense of prescription under the statute of limitations.

Petitioner asseverates that while Section 222 of the Tax Code provides for certain exceptions as to the period of limitation, *i.e.,* in case of fraud or fraudulent return with intent to evade tax or failure to file a return, such is not attendant in this case to warrant extension of the prescriptive period to ten (10) years and the imposition of the 50% surcharge. Respondent's alleged findings of fraud and imposition of a 50% surcharge was a mere afterthought and a ruse in order to avail of the longer period of prescription.

We agree with the petitioner.

It must be noted that respondent does not dispute the allegation that the assessment was issued beyond the three-year prescriptive period and has, thus, prescribed pursuant to Section 203 of the NIRC of 1977, as amended. In fact, respondent posits that the applicable prescriptive period for the subject assessment is ten (10) years as provided under Section 223 of the same Code, which states:

> "**SEC. 223.** ***Exceptions as to period of limitation of assessment and collection of taxes***.- (a) xxx
>
> "(b) If before the expiration of the time prescribed in the preceding section for the assessment of the tax, both the Commissioner and the taxpayer have agreed in writing to its assessment after such time, the tax may be assessed within the period agreed upon. The period so agreed upon may be extended by subsequent written agreement made before the expiration of the period previously agreed upon."

The application of Section 223 by the respondent is based on the theory that petitioner's income tax return for taxable year 1997 was false and fraudulent because there was substantial under-declaration of its income for the said year in the amounts of P34,340,557.00 and P13,333,498.18.

By comparing petitioner's declared gross receipts/collection per VAT returns filed for the year 1997 in the amount of P84,581,606.00 as against the reported gross revenue per petitioner's 1997 income tax return in the amount of P50,241,049.00, respondent presumed that petitioner under-declared its income in the amount of P34,340,557.00.

Likewise, in charging against petitioner an undeclared service income of P13,333,498.18 , respondent merely compared the income payment of P31,159,791.00 as appearing in the Certificate of Creditable Tax Withheld at Source issued by Liberty Broadcasting Network, Inc. ("LBNI") *vis-a-vis* the reported service income of P16,492,942.84 per petitioner's 1997 income tax return and deduced therefrom that petitioner had undeclared service income in the amount of P13,333,498.18.

Apparently, respondent's assessment is based on mere inferences and assumptions and it is unsupported by any clear and convincing proof. Considering so, the fraudulent intent being imputed against petitioner is without factual basis and the ten-year prescriptive period to assess cannot be made to apply in the instant case.

False or fraudulent return as an exception to the period of limitation and to collect taxes provided in Section 223 of the NIRC of 1977, as amended, must be actual not constructive. It must be intentional, consisting of deception willfully and deliberately done or resorted to. Fraud must be proven by clear and convincing evidence amounting to more than mere preponderance. It cannot be justified by mere speculation. This is because fraud is never lightly to be presumed (***Yutivo Sons Hardware Company vs. Court of Tax Appeals and Collector of Internal Revenue, 1 SCRA 160***). In order to render a return made by a taxpayer a "false return" within the meaning of Section 223 of the NIRC, there must appear a design to mislead or deceive on the part of the taxpayer, or at least culpable negligence. A mistake, not culpable in respect of its value would not constitute a false return (***Commissioner of Internal Revenue vs. Ayala Hotels, Inc., CA-G.R. SP No. 70025, April 19, 2004***). In fact, the Supreme Court held that "mere falsity of a return does not merit the application of the ten-year prescriptive period. The element of fraud as in the case of taxpayer's intent to evade the payment of the correct amount of tax, must be clearly established". (***Commissioner of Internal Revenue vs. BF Goodrich Phils., Inc., 303 SCRA 546***)

Respondent miserably failed to substantiate its claim that there was willful intent on the part of petitioner to evade payment of income tax. Petitioner, on the other hand, has satisfactorily shown that the alleged undeclared income amounts found by the respondent are not actual income for the taxable year 1997. As clearly explained by Ms. Ofelia C. Mercado, petitioner's Accounting Manager, during the hearing conducted on July 4, 2004, the discrepancy of P34,340,557.00 between the amounts of gross receipts/collection as reported per petitioner's 1997 VAT returns and the gross revenues reflected per petitioner's 1997 income tax return, was brought about by the different accounting methods used by petitioner for income tax and VAT purposes. For income tax purposes, petitioner reports its income on an accrual basis while for VAT purposes, petitioner reports its income under cash method of accounting *(TSN July 14, 2004, pp. 8-10)*. The accrual method of reporting income for income tax purposes is allowed under Section 167 of Revenue Regulations No. 2, in relation to Section 37 of the NIRC of 1977, as amended. On the other hand, the VAT on services is based on gross receipts/collections, as mandated under Section 102 of the NIRC of 1977, as amended. Petitioner's adoption of the accrual method of accounting for income tax purposes (*i.e*, the income is reported in the period it is earned regardless of whether it has been received or not) and the cash method of accounting (*i.e.*, the income is reported based on gross receipts/collection) for VAT purposes, results to a timing difference in the recognition of its income.

Similarly, through the reconciliation schedule it submitted, petitioner was able to explain that the alleged undeclared service income of P13,333,498.18 was actually reported in its 1996 and 1998 income tax returns (*page 214, BIR Records*).

That petitioner had filed false and fraudulent income tax return in 1997 was merely alleged by the respondent to rationalize the applicability of the ten-year prescriptive period. In fact, as correctly observed by petitioner, the imposition of 50% surcharge appeared for the first time only in the Post Reporting Notice dated September 11, 2002. The 1$^{st}$ PAN which was received by petitioner on December 7, 2000, prior to the lapse of the prescriptive period, imposed only a 25% surcharge, indicating that there was really no factual finding of fraud. It was only when prescription had already set in that respondent imposed a 50% surcharge.

This Court holds that the respondent's right to assess petitioner of any deficiency income tax for taxable year 1997 had already prescribed and the Final Assessment Notice dated December 27, 2002 issued by the respondent against petitioner is void.

In view thereof, We do not find any reason to delve into the other issues raised in this case.

**WHEREFORE,** the instant petition is hereby **GRANTED** and the Final Assessment Notice/Demand No. 43506 dated December 27, 2002 is accordingly **CANCELLED** and **SET ASIDE.**

**SO ORDERED.**

**JUANITO C. CASTAÑEDA, JR.**
Associate Justice

*WE CONCUR:*

**ERLINDA P. UY**
Associate Justice

**OLGA PALANCA-ENRIQUEZ**
Associate Justice

## ATTESTATION

I attest 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's Division.

**JUANITO C. CASTAÑEDA, JR.**
Associate Justice
Chairperson

## CERTIFICATION

Pursuant to Article VIII, Section 13 of the Constitution, and the Division Chairman's Attestation, 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's Division.

**ERNESTO D. ACOSTA**
Presiding Justice