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LA VERDAD, INC.,
Petitioner,

- versus - C.T.A. CASE NO. 257

April 15, 1958

COLLECTOR OF INTERNAL REVENUE,
Respondent.

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D E C I S I O N

This is an appeal from the decision of respondent Collector of Internal Revenue assessing against and demanding from petitioner, La Verdad, Inc., specific taxes on alcohol for which no tax had been previously paid for the years 1953 and 1954 in the total sum of ₱47,149.20, plus ₱10,000.00 as administrative penalty for alleged violation of the book-keeping regulations and deficiency income tax in the amount of ₱19,318.50, plus surcharge, for the year 1952.

Petitioner is a corporation duly organized under the laws of the Philippines, with principal place of business at 520 Sto. Cristo, Manila (par. 1, Petition for Review, admitted). It is engaged in the business of compounding distilled spirits and the manufacture of wines and other liquors from alcohol purchased from duly licensed distillers (par. 2, Petition for Review, admitted; pp. 65, 71, t.s.n.). It is also engaged in the sale of wines and liquors, foreign and local, which it purchases locally (pp. 169-170, t.s.n.).

On March 31, 1955, the Chief of the Specific Tax Division instructed BIR Agents Mariano P. Uy and Venancio V. Ona to investigate the business transactions of petitioner for the five-year period comprising January 1, 1950 to December 31, 1954 and submit a report on their investigation (p. 31, BIR rec.). Acting upon this instruction, a team of BIR agents composed of Messrs. Arsenio F. Santos, Jesus N. Flandes and Tirso S. Viray, who were under the direct guidance and supervision of Agents Mariano P. Uy and Venancio V. Ona, investigated the business transactions of petitioner and submitted a report of their findings on August 11, 1955 (Exh. 2, p. 30, BIR rec.).

The report states that petitioner presumably used, in the production and manufacture of liquor for the years 1953 and 1954, the respective amounts of 52,647 and 14,709 proof liters of alcohol for which no tax thereon had been previously paid. On the basis of this finding, the BIR agents recommended to respondent Collector of Internal Revenue the assessment for specific taxes for those years in the sums of ₱36,852.90 and ₱10,296.30 or a total of ₱47,149.20 against petitioner.

Accordingly on August 16, 1955, respondent assessed against and demanded from petitioner the amount of ₱47,149.20 as previously recommended to cover specific taxes due for the years 1953 and 1954 on alcohol used in the compounding of liquors, plus the sum of ₱10,000.00 as penalty for the alleged violation of section 133 (a) of the National Internal Revenue Code in relation to section 174 of the same Code, and an additional sum of ₱300.00 as penalty for petitioner's violation of the bookkeeping regulations (Exh. 3, pp. 39-40, BIR rec.).

On October 5, 1955, petitioner requested for the reconsideration of the decision of the Collector of Internal Revenue for the reason that there was, contrary to the latter's finding, no increase of proof-liters in the tax paid alcohol used in the compounding of liquors, and if there was any increase, the increase was in the volume of liters (Exh. 4, pp. 45-50, BIR rec.). However, on March 13, 1956, respondent denied this request, hence, on April 2, 1956, petitioner filed its petition for review with this Court.

The parties entered into a partial stipulation of facts, which we reproduce hereunder:

> "1. That upon subsequent verification conducted by the petitioner and the respondent, it was ascertained that the petitioner did not incur any income tax liability for the year 1952;
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> "2. That it was ascertained also that the specific tax involved in this case for the year 1953 has been reduced from ₱36,852.90 to ₱25,180.40, which reduced amount was arrived at as follows:

Inventory of finished liquors as of Jan. 1, 1953	29,571 p.l.
Add: Liquors transferred for sales	358,000 p.l.
Total available for sale	387,571 p.l.
Less: Inventory of finished liquors as of Dec. 31, 1953	17,194 p.l.
Quantity of tax-paid alcohol used in compounding and sold ...	370,377 p.l.
Total sales	₱904,102.24
Less: Sales of purchased liquors	286,858.63
Sales of own compounded liquors	₱617,243.61
Divided by average selling price per proof liter	₱ 1.519
Quantity of own compounded liquors actually sold	₱406,349 p.l.
Quantity of tax-paid alcohol used in compounding and sold ...	370,377 p.l.
Difference	35,972 p.l.
Specific tax due thereon at ₱0.70 per proof liter	₱ 25,180.40

"3. That the specific tax involved in this case for the year 1954 has been reduced from ₱10,296.30 to ₱5,521.60, which reduced amount has been arrived at as follows:

Inventory of finished liquors as of Jan. 1, 1954	17,194.p.l.
Add: Liquors transferred for sales	453,106 p.l.
Total available for sale	470,300 p.l.
Less: Inventory of finished liquors as of Dec. 31, 1954	27,223 p.l.
Quantity of tax-paid alcohol used in compounding and sold ...	443,077 p.l.
Total sales	₱913,905.07
Less: Sales of purchased liquors	228,888.65

Sales of own compounded liquors	₱685,016.42
Divided by average selling price per proof liter	₱ 1.519
Quantity of own compounded liquors actually sold	450,965 p.l.
Quantity of tax-paid alcohol used in compounding and sold ...	443,077 p.l.
Difference	7,888 p.l.
Specific tax due thereon at ₱0.70 per proof liter	₱ 5,521.60

"4. That the parties herein hereby reserve their right to present additional evidence in support of their respective contentions."

The original specific tax deficiency assessment for the years 1953 and 1954, as well as the amended assessment stated in the above partial stipulation of facts of the parties, was arrived at by respondent by employing the gross profit method and the average method. These methods were resorted to by respondent allegedly because not all the sales invoices for the said years were presented by petitioner to the investigators for verification such that the total amount of daily sales based on the sales invoices available did not tally with the corresponding total amount of sales as recorded in petitioner's journal (Exh. 2, p. 29, BIR rec.).

By the gross profit method, the gross profit of petitioner's business for the years 1953 and 1954 was first obtained by securing the total sales and subtracting therefrom the cost of sales, i.e., purchases plus the inventory at the beginning less the inventory at the end of the accounting period of these years, all disclosed from petitioner's profit and loss statement. The gross profit percentage was then arrived at by dividing the gross profit by the cost of sales. Since petitioner sold both local and foreign-made liquors which were previously purchased from the local market, the revenue agents accordingly eliminated the corresponding sales of such liquors purchased. The sales of the locally purchased liquor was obtained by adding the cost of sales thereof to the gross profit element.

The average method was used in order to arrive at the quantity of petitioner's manufactured liquors actaally sold in terms of proof liters. By this method, the revenue agents divided the sales of petitioner's manufactured wines and liquors by the average selling price per proof liter of compounded liquor sold during the year. The average selling price per proof liter was based upon "the total selling prices of the various brands of liquors compounded by the corporation" during the years 1953 and 1954 secured from available records divided by the total number of proof liters contained therein. By this computation, the revenue agents determined the amount of proof liters alleged to have been actually used and sold by petitioner. Comparing this figure with that amount of proof liters of alcohol which was deemed removed and sold—tax-paid, as computed from the Official Register Book, Exhibit 1—the agents arrived at the excess of actual sales over the quantity deemed removed and sold tax paid (see Exh. 2, pp. 25-30 BIR rec.). This excess was considered as the amount of alcohol for which no tax had been previously paid and was then assessed at the rate of ₱0.70 per proof liter, pursuant to section 133 (a) of the National Internal Revenue Code and the subject of the present appeal.

From the afore-stated partial stipulation of facts, it appears that petitioner did not incur any income tax liability for the year 1952. Hence, we accordingly find that there is no deficiency income tax with respect to said year. The remaining questions therefore to be resolved in this appeal relate to the specific tax assessed and demanded from said petitioner in the sums of ₱25,180.40 and ₱5,521.60 for the years 1953 and 1954 respectively. Thus, the issues now before us may be summarized as follows:

1. Whether or not the methods employed by respondent in the assessment of specific tax against petitioner are justified;

2. Whether or not there was really an excess of alcohol, used by petitioners in the production of wines and liquors over the amount of tax-paid alcohol;

3. Whether or not the excess of alcohol, if any, is tax unpaid; and

4. Whether or not petitioner is liable for administrative penalty or compromise.

We will take up these issues <u>in seriatim</u>.

Respondent contends that the "gross-profit method" and "average method" were resorted to in pursuance of section 15 of the Tax Code which authorizes the assessment of the tax on the basis of the "best evidence available". On the other hand, petitioner contends that the methods employed in arriving at the assessment are not justified. It is argued that under said section 15, these methods of assessment may be used only in cases where a report required by law as a basis for the assessment has not been submitted to the Collector of Internal Revenue or that any such report is false, incomplete or erroneous. It is maintained that since there was nothing wrong, anomalous or irregular in the keeping by petitioner of the Official Register Book, the sales journal, the profit and loss statements, inventories and other pertinent records, the Collector of Internal Revenue could not assess the tax on the basis of the "gross profit method" and "average method" which were substitute methods.

We find petitioner's contention meritorious. It has submitted the transcripts of the Official Register Book which show that the same were properly kept by it as required of distillers, rectifiers and compounders. Respondent's own witnesses, Agents Leopoldo Camacho, Delfin Empalmado and Arsenio F. Santos, the latter a certified public accountant, who were among the members of the BIR team that investigated this case, admitted that they did not find these records to be false, incomplete or erroneous.

The justification of the exercise of the power of the Collector of Internal Revenue to assess the proper tax on the best evidence obtainable is predicated upon the instance where a (1) report required by law as a basis for the assessment shall not be forthcoming within the time allowed by law or regulation, or (2) when there is reason to believe that such report is false, incomplete, or erroneous (Sec. 15, Revenue Code). Unless it is shown that any of the two circumstances given above exists it follows that respondent cannot disregard the records maintained and reports submitted by the taxpayer and determine his tax liability through the "gross profit method" and "average method" employed in the instant case.

In the absence of a showing that the reports (transcripts of the official Register Book) were false, incomplete and erroneous, we could not see any plausible justification of use of substitute methods by respondent in order to support a finding that there is any excess alcohol over the tax-paid alcohol used in the compounding of petitioner's manufactured wines and liquors.

Moreover, the use of the inventory method in this case has not been shown to be proper considering that petitioner dealt with liquors of varying inventory classification, each with different margins of profit, for which no distinction was placed.

As admitted in the case at bar by Arsenio Santos, respondent's witness, in answer to a question on cross-examination, he testified that the gross profit rate for foreign and locally purchased wines and liquors are not the same as locally manufactured products of petitioner. Yet, the gross profit percentage rate arrived at by respondent as regards petitioner's business during the years 1953 and 1954, which percentage was taken from the total sales for those years, was applied indiscriminately to the cost of sales of the locally purchased liquors and wines, as well as that of foreign manufactured liquors. After arriving at the total sales for purchased liquors during these years, the amount obtained was subtracted from the total sales of all liquors and wines manufactured or purchased by petitioner without providing for any allowance for price or profit differences between the different products nor for the difference in quantities thereof. "Because <u>different types of goods have different gross profit margins, the use of one or a few very broad inventory classes is likely to result in significant error</u>." (Sec. 12, Accountants Handbook, Rufus Wixon 4th Ed., p. 56.)

The resultant total sales for manufactured products is therefore far from being real but a poor and inadequate approximation or calculation.

Going to the average method, respondent in arriving at the selling price per proof liter of wine or liquor proceeded upon the assumption that all sales were made proportionately from all acquisitions, which assumption is contrary to ordinary merchandising procedure. It need not be extensively discussed that the sales for all kinds of liquors could hardly be alike in price and in volume the fact being that the liquor may be sold at different or variable prices in different quantities. This circumstance would greatly affect the volume of sales derived, for where the volume of sales is greater on thoseproof liters of wines or liquors with a higher price per proof liter, the application of the average selling price on the total sales will tend to increase the number of proof liters sold. On the other hand, where the volume of sales is greater on those proof liters of wines or liquors with lower prices per proof liter, the tendency is to decrease the proof liters sold. No allowance for the price or volume variance having been provided by respondent, the ultimate result is, therefore, unreal. This average pricing being unreal, the same would substantially affect the amount of proof liters obtained by respondent as alleged to have been used in the compounding. Under the circumstances, we therefore find respondent's use of the "average method" in arriving at the selling price per proof liter to be not proper in the instant case.

We now proceed to the question raised as to whether or not there was an excess of alcohol used by petitioner. In the main, the testimonies and documentary evidences presented tend to prove that the alcoholic contents of the compounded wines and liquors produced by petitioner are generally lower than the alcoholic contents stated in the labels (Exhs. A to G, inclusive, pp. 69-75, CTA rec.). Petitioner's witnesses, Maria B. Gatmaitan and Manuela F. Buensuceso, both analysts of the Public Health Research Laboratory, testified that, having subjected the sample products of petitioner to chemical analysis for any violation of the Pure Food Law, they found that the actual alcoholic strength thereof was lower than those stated in their labels. Their respective testimony was strengthened by the corroborating statement of Luzonica M. Pesigan, Chief of the Food and Drug Section of the Public Health Research Laboratory of the Department of Health an ex-officio member of the Board of Food Inspection, who even went to the extent of saying that she has not come across a liquor which is above the strength stated in the label. Moreover, we take note of the testimony of Ramon Aguinaldo, Supervisor of Distilleries of the Bureau of Internal Revenue, who further corroborated the testimonies of the three previously named witnesses.

In addition, we have Rafael Juan, wine mixer of petitioner, who testified that the addition of water, clarifying agents and lodo de Europa to petitioner's products increased the volume of gauge liters of the compound without increasing the grade or strength. This testimony of Rafael Juan has been corroborated by Luzonica M. Pesigan. Hence, although there may have been an increase in the volume of gauge liters in petitioner's products by reason of the additives, there was no increase in the proof liters in taxable alcohol to justify respondent's assessment.

Respondent, however, argues that there is no evidence adduced to show that the samples of the compounded liquors analyzed by the witnesses of petitioner were secured and collected from the latter. We find this claim not well founded, for on the contrary, the requests for analysis of the samples of products (Exhs. A to G, inclusive) refer to samples of products of petitioner and these were identified by Misses M. B. Gatmaitan and M. V. Buensuceso, in their testimonies. We find that respondent adduced no evidence to contradict the positive statements of these witnesses and the same therefore stand unassailed.

To bolster his view, respondent expressed the fear that petitioner's theory that the addition of water to alcohol merely increases the volume of gauge liters but not its proof liters may be availed of by compounders to the prejudice of the Government in the form of a loss in specific tax revenues. It may be stated, however, that this could be assuaged by the knowledge that the Government has all the means and facilities at its command, and all the potential capabilities, to detect the presence of or existence of used alcohol that are not tax-paid in the compounding of liquors and wines. This concern for the protection of government revenues is a matter of administrative supervision of the establishments of distillers, compounders and the like, but cannot by itself be a basis for the assessment of specific tax where the circumstances do not support the same. In the instant case, we find that the prima facie presumption of the correctness of respondent's assessment has been impeached and impaired by competent evidence, and consequently, the burden shifts on the Government to show, clearly and unmistakebly, that there was in fact an increase in proof liters of alcohol used and not in gauge liters. Both parties having been given the equal opportunity to sustain their respective allegation and it appearing that the government has failed to sustain its assessment where the same was impeached and impaired by adequate evidence, we could not see our way clear in finding the merit of respondent's fear that the state would be thus prejudiced.

Although the bhird issue is now rendered academic, we believe that a discussion thereof would in fact further stress our finding stated above. Respondent maintains that in the manufacture of its products, petitioner used alcohol for which no specific tax had previously been paid. Under the procedure of securing alcohol, any such alcohol must have been obtained from a distiller, and if there be any merit to the charge, the securing of such alcohol without prepayment of specific tax could only be done where there is connivance between the distillers and respondent's agents. We believe, however, that this allegation is without reasonable basis. Petitioner's establishment is situated in a commercial district and as such, it would be a dangerous risk for anyone to unload near or within its compound alcohol for which no tax had been previously paid. It may be added further that petitioner's establishment has a limited space and has only one door opening leading into the compound. Alcohol containers on which tax has been paid are sealed with the corresponding revenue stamps upon payment of the tax due thereon. Petitioner's witness, Rafael Juan, stated that the alcohol which petitioner uses in the compounding of its products is bought from licensed distilleries in which the tax has been previously paid. This fact has been corroborated by Roman Aguinaldo, Supervising Agent-at-Large of Distilleries, and Leopoldo Camacho and Delfin Empalmado, both storekeepers, and all of whom are government officers or employees charged with the duty of assessing petitioner's establishment as distiller and compounder. In regard to such any alcohol obtained from other distillers, the disposition thereof is controlled whenever compounding is to be made. As a matter of fact it was shown that the compound consisting of alcohol and water is placed in tanks, a separate tank being provided for each brand of compounded liquor, and each tank is covered by a separate account record. The storekeepers check the composition and contents of these tanks against the gauger's book. The entries of the gauger's book are also correspondingly recorded in the Official Register Book (Exhibit 1) which respondent's agent admit to have been found to be regularly kept without any information other than that the alcohol recorded therein were tax paid.

These circumstances all point out that there could not have been any alcohol used by the petitioner in the compounding of its products for which the specific tax had not been previously paid thereon.

In sum, we find that (1) the two methods (gross profit and average methods) were not properly employed and utilized by respondent in the making of the disputed assessment in accordance with the requirement of Section 15 of the National Internal Revenue Code; are arbitrary in nature; and (2) there was no adequate evidence to support respondent's determination that there was an under-declaration by petitioner of the alcohol contents of its products and that there is no excess in alcohol used on which no specific tax had been previously paid.

Having reached these conclusions, we find and so hold that petitioner is not liable for the amount of ₱25,180.40 and ₱5,521.60 as specific tax for the years 1953 and 1954 respectively. With this finding, there is no necessity for discussing the fourth issue raised regarding the amount of ₱10,000.00 as extra-judicial penalty or compromise penalty for alleged violation of Section 133 (a), in relation to section 174, of the National Internal Revenue Code. Be that as it may, we have repeatedly held that this Court has no jurisdiction to compel the taxpayer to pay the suggested compromise penalty, there being no showing that the taxpayer agreed thereto (see Bislig Bay Lumber Co., Inc. vs. Collector of Internal Revenue, C.T.A. Case No. 155, October 9, 1957).

WHEREFORE, the decision of respondent Collector of Internal Revenue should be, as it is hereby reversed, without pronouncement as to costs.

SO ORDERED.

Manila, April 15, 1958.

MARIANO NABLE
Presiding Judge

WE CONCUR:

AUGUSTO M. LUCIANO
Associate Judge

ROMAN M. UMALI
Associate Judge

Not appealed.