REPUBLIC OF THE PHILIPPINES
COURT OF TAX APPEALS
QUEZON CITY

FIRST DIVISION

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AAPI REALTY CORPORATION,
Petitioner,

C.T.A. CASE NO. 6344

Members:

\- versus -

ACOSTA, *Chairman*
BAUTISTA, and
CASANOVA, *JJ.*

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Promulgated:
JUN 23 2005

x - x

DECISION

***ACOSTA, E., PJ.*:**

The instant Petition for Review is an appeal for the cancellation and withdrawal of the deficiency income and value-added tax assessments issued by respondent against petitioner for the taxable year 1997 in the aggregate amount of P27,099,584.72.

Petitioner is a corporation duly organized and existing under the laws of the Philippines with business address at NSC Compound, Km. 22, East Service Road, South Superhighway, Muntinlupa (*par. 1, Stipulation of Facts*). It is principally engaged in the lease of real property (*page 7, TSN, June 3, 2002*).

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Through Letter of Authority No. 00005997 dated December 3, 1998 issued by the Revenue District Office (RDO) No. 53, Las Piñas, Muntinlupa City, respondent caused the examination of petitioner's books of accounts/accounting records for the latter's all internal revenue tax liabilities for the period January 1, 1997 to December 31, 1997 (*Exhibit 1, page 23, BIR Records*).

As a result of the investigation, respondent issued two Pre-Assessment Notices dated March 22, 2000 together with the "Details of Discrepancies" informing petitioner about the proposed deficiency income tax and value-added tax (VAT) assessments for taxable year 1997 in the amounts of P6,307,315.20 and P13,356,270.12, respectively, inclusive of increments (*Exhibits 4 to 4-d*).

On May 4, 2000, petitioner filed a protest letter against the proposed deficiency income tax and VAT assessments for lack of legal and factual bases and requested for a reinvestigation and/or reconsideration thereof (*pages 191-198, BIR Records*).

In view of its request for reinvestigation/reconsideration, petitioner, on June 30, 2000, executed a waiver, which was accepted and agreed to by Revenue District Officer Rosalie U. Sarthou of RDO No. 53, Las Piñas, Muntinlupa City, extending respondent's period to assess until December 31, 2000 (*page 202, BIR Records*).

In a letter dated September 26, 2000, respondent denied petitioner's request for reinvestigation/reconsideration and reiterated the proposed 1997 deficiency income tax and VAT assessments (*page 203, BIR Records*).

On December 29, 2000, petitioner received from respondent two Formal Assessment Notices, both numbered 000025-97-00-658 and dated December 22, 2000, with accompanying Formal Letter of Demand and Details of Discrepancies covering petitioner's alleged deficiency income tax and deficiency VAT for taxable year 1997 in the respective amounts of P8,719,275.53 and P18,380,309.19 (inclusive of increments) totalling P27,099,584.72 (*Exhibits A-B;9-9b; par. 4, Stipulation of Facts*)

On January 25, 2001, petitioner filed a protest against the Formal Assessment Notices (*Exhibit C; par. 6, Stipulation of Facts*). Subsequently, on March 26, 2001, petitioner submitted a supplemental protest reiterating its disagreements with the subject deficiency income and VAT assessments and submitting therewith all the relevant documents to support its position (*par. 7, Stipulation of Facts*).

In view of respondent's failure to act on petitioner's protest letters within the period allowed by law, petitioner filed the instant Petition for Review on October 22, 2001 in compliance with Section 228 of the National Internal Revenue Code (NIRC) of 1997.

As jointly stipulated by the parties, the issues to be resolved by this Court are as follows:

1. Whether or not petitioner has undeclared interest income in the amount of P300,011.52 for taxable year 1997;

2. Whether or not petitioner's claimed interest expense amounting to P30,244,025.00 and taxes and licenses amounting to P261,440.00 for taxable year 1997 should be disallowed as deductions from petitioner's gross income for 1997;

3. Whether or not petitioner's claimed interest expense, taxes and licenses for taxable year 1997 are duly substantiated;

4. Whether or not petitioner is liable for deficiency VAT in the amount of P18,380,309.19 inclusive of increments for taxable year 1997 due; and

5. Whether or not petitioner is liable for deficiency income tax and VAT assessments in the aggregate amount of P27,099,584.72, inclusive of surcharges, interest, and compromise penalties for

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taxable year 1997, covered under Final Assessment Notices No. 000025-97-00-658, dated December 22, 2000.

The first three issues arose due to the adjustments made by the respondent in arriving at the 1997 deficiency income tax assessment of P8,719,275.53, which was computed as follows:

Net Income per return			P (17,984,425.00)
Add:	Adjustments		
	Undeclared interest income	P 300,011.52	
	Disallowed interest expense	30,244,025.00	
	Taxes and licenses		30,805,476.52
		261,440.00	
Net income per audit			P 12,821,051.52
Deficiency income tax			
			4,487,368.03
Add:	Surcharge		1,121,842.00
	Interest 04-15-98 to 01-15-2001		3,085,065.50
	Suggested compromise penalty		25,000.00
Total Amount Due			P 8,719,275.53

As can be gleaned from the above computation, respondent charged petitioner with an undeclared interest income in the amount of P300,011.52 and disallowed petitioner's claimed deductions for interest expense in the amount of P30,244,025.00 and for taxes and licenses in the amount of P261,440.00 for taxable year 1997.

On the first issue of whether or not petitioner has undeclared interest income in the amount of P300,011.52, respondent explains in the Details of Discrepancy that:

> Based on the lease contract which states that an interest charge will be imposed for every delay in the payment of rent, it was found out that there was undeclared interest income amounting to P300,011.52 in violation of Section 32(A) of the NIRC which provides:
>
> "Except when otherwise provided in this title, gross income derived from whatever source..".

Petitioner, however, in its supplemental protest letter dated March 26, 2001, argues that the assessment pertaining to the imputation of the interest income of P300,011.52 is void because of respondent's failure to state the factual basis thereof pursuant to Section 228 of the NIRC of 1997 as implemented by Section 3.1.4 of Revenue Regulations No. 12-99.

The Court agrees with petitioner.

Section 228 of the NIRC of 1997, provides, among others, that "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". This is in consonance with the due process requirement of the 1997 Philippine Constitution, which provides that "No person shall be deprived of his property without due process of law." The taxpayer has to be informed in writing of the nature of the examiner's findings in order to be able to properly contest the same and submit supporting documents. In the Details of Discrepancy attached to the assessment notices, it was not indicated how the respondent's examiner arrived at the alleged undeclared income of P300,011.52. As correctly pointed out by petitioner, the respondent did not state in detail: a) whether the tenant-lessees of petitioner were in fact delinquent in the payment of the monthly rentals to petitioner; b) the period for which the tenant-lessees were delinquent in the payment of the monthly rentals for purposes of computing the alleged undeclared interest income amounting to P300,011.52; and c) whether petitioner in fact enforced the late payment clause under the lease contract and collected from its tenant-lessees the amount of P300,011.52 representing the alleged penalty interest. Petitioner cannot be expected to be able to determine and thereafter refute the examiner's findings without the disclosure of the details of the

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assessment. Hence, the assessment corresponding to the alleged undeclared income of P300,011.52 is void.

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

On the disallowed interest expense of P30,244,025.00, respondent alleges that the same was unsupported in violation of Section 29 of the NIRC.

Petitioner, on the other hand, avers that the interest expense of P30,244,025.00 represents legitimate business expense incurred in connection with its trade or business and duly substantiated in its books and accounting records, thus, deductible from gross income pursuant to Section 29(b)(1) of the NIRC of 1977, as amended.

Petitioner alleges that the said interest expense arose from the foreign currency loans obtained by Amkor Anam Pilipinas, Inc. ("AAPI"), an affiliate, from Equitable-PCI Bank for and on behalf of petitioner; that it used the proceeds of the loan for the purchase of real property in Laguna Technopark and used such property in its business; and that the amount of interest charged by PCI Bank to AAPI on account of the loan obtained by AAPI for petitioner's purposes was the same amount that was charged or passed on by AAPI to petitioner.

To prove that it is entitled to the claimed deduction of P30,244,025.00, petitioner submitted in evidence various documents, to wit:

a) the promissory notes issued by AAPI as borrower, in favor of PCI Bank, as lender; (*Exhibits J & K*);
b) Debit/Credit Advices issued by AAPI to petitioner (*Exhibits L to O*);
c) Schedule of Accounts Receivable of AAPI (*Exhibits P to S*);
d) Schedule of the Summary of Interest Charges of petitioner for the year 1997 in the account of AAPI (*Exhibit T*);
e) Schedule of Computation of Interest Expense of petitioner for the year 1997 (*Exhibit U*);

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f) Certification of Loan/Interest Payments debited from Amkor Technology Philippines (P1/P2), Inc.'s FCDU SA passbook formerly under FCDU SA number 5745-00529-6 from PCI Bank (*Exhibit V*);
g) Certificate of filing of Amended Articles of Incorporation of Amkor Technology Philippines (P1/P2) [formerly AAPI] (*Exhibit W*);
h) Certificate of Amendment of the Articles of Incorporation of Amkor Technology Philippines (P1/P2) (*Exhibit X*); and
i) Schedule of Summary of Interest Payments of AAPI (*Exhibit Y*).

Based on the evidence presented, the Court finds the disallowance proper and in order.

Section 29(b) of the NIRC of 1977, as amended, provides:

> Sec. 29. Deductions from gross income. – x x x
>
> xxx xxx xxx
>
> (b) **Interest.** – (1) **In general.** – The amount of interest paid or accrued within a taxable year on indebtedness in connection with the taxpayer's profession, trade or business, except on indebtedness incurred or continued to purchase or carry obligation the interest upon which is exempt from taxation as income under this Title.

Pursuant to the aforecited provisions, the following requisites must concur to validly claim deductibility of interest expense, to wit:

1. There must be an indebtedness;
2. The indebtedness must be that of the taxpayer;
3. The indebtedness must be connected with the business, trade or profession of the taxpayer;
4. The interest must have been paid or accrued during the taxable year; and
5. The interest must have been stipulated in writing (***DELFIN MA. V. CRUZ, JR., vs. THE COURT OF TAX APPEALS AND THE COMMISSIONER OF INTERNAL REVENUE, .CA-G.R. SP No. 25308. April 7, 1992***).

From the foregoing, it may be clearly inferred that for interest payment to be deductible, the same must be supported by a written agreement of the indebtedness the term of which stipulates for the payment of an interest. This is in consonance with Article 1956 of the Civil Code, providing that:

> "Article 1956. No interest shall be due unless it has been expressly stipulated in writing."

In other words, the written agreement of the indebtedness is an indispensable requirement to support a claim of deductibility of interest payment. For how could a claimant prove concurrence of all the said requisites without showing the written agreement of the indebtedness (***DELFIN MA. V. CRUZ, JR., vs. THE COURT OF TAX APPEALS AND THE COMMISSIONER OF INTERNAL REVENUE, supra***).

Petitioner failed to comply with the said requisite. A thorough examination of the records in this case failed to disclose that there was a written loan agreement between petitioner and its affiliated company, AAPI. The various Debit/Credit Advices issued by AAPI to petitioner merely establish that certain amounts are being charged by AAPI against petitioner. These documents cannot be made as substitutes for a written contract stipulating on the payment of interest payable by petitioner to AAPI on the loan so granted.

Likewise, other than a bare statement that the proceeds of the loan were used by petitioner in connection of its business, petitioner was not able to show by documentary evidence that indeed the proceeds of the loan were used in acquiring the properties used its leasing business. More particularly, petitioner failed to prove that the proceeds on the loan were used in the purchase of real property in the Laguna Technopark as well as in the reconstruction of improvements thereon.

In addition, Section 29(b)(2)(ii) in relation to Section 30(b)(3) provides exception to the rule of deductibility of interest expense as follows:

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SECTION 29. Deductions from gross income. – x x x

xxx xxx xxx

(b) **Interest.** – xxx

(2) No deduction shall be allowed in respect of interest under the succeeding paragraphs:

xxx xxx xxx

(ii) If both the taxpayer and the person to whom the payment has been made or is made are persons specified under Section 30(b).

SECTION 30. Items not deductible. –

xxx xxx xxx

(b) **Losses from sales or exchanges of property.** – In computing net income, no deduction shall in any case be allowed in respect of losses from sales or exchanges of property directly or indirectly –

xxx xxx xxx

(3) Except in the case of distributions in liquidation, <u>between two corporations more than fifty per centum in value of the outstanding stock of each of which is owned, directly or indirectly by or for the same individual, if either one of such corporations, with respect to the taxable year of the corporations preceding the date of the sale or exchange was, under the law applicable to such taxable year, a personal holding company or a foreign personal holding company</u>. *(Underlining supplied)*

Petitioner failed to show proof that the alleged interest payment of P30,244,025.00 does not fall under the above exception. No documentary evidence was presented establishing that petitioner and AAPI are not related taxpayers or that either one of them is not a personal holding company of the other as contemplated under Section 30.

Considering that the claimed interest expense of P30,244,025.00 was not properly substantiated, the same cannot be allowed as deduction from petitioner's gross income for taxable year 1997.

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On the disallowed taxes and licenses in the amount of P261,440.00, respondent claims that the same was unsupported in clear violation of Section 29 of the NIRC.

Petitioner, on the other hand, disagrees contending that the amount of P261,440.00 represents documentary stamp taxes due on the renewal of the foreign currency loan obtained by AAPI on behalf of petitioner on October 10, 1997, which AAPI paid initially and petitioner later reimbursed. Since the proceeds of the loan were allegedly used to acquire real property in Laguna Technopark for its real estate business, petitioner claims that the documentary stamp taxes it paid to AAPI, are legitimate business expenses deductible from its gross income pursuant to Section 29(c) [now 34(C)] of the NIRC of 1977, as amended, which states:

> **Sec. 29. Deductions from gross income.** – x x x
>
> xxx xxx xxx
>
> (c) **Taxes. –** (1) **In general. –** Taxes paid or accrued within the taxable year in connection with the taxpayer's profession, trade or business, xxx.

The Court disagrees with the petitioner.

As earlier stated, petitioner failed to establish that it incurred indebtedness and that such indebtedness was incurred in connection with its leasing business. Accordingly, the alleged documentary stamp taxes of P261,440.00 paid by AAPI to PCI Bank but later on charged by AAPI to petitioner cannot be allowed as deduction from petitioner's 1997 gross income.

In fine, We find petitioner liable for deficiency income tax for taxable year 1997 in the amount of P8,497,583.89, computed as follows:

Net Loss per return			P (17,984,425.00)
Add:	Disallowed Interest Expense	P 30,244,025.00	
	Taxes and licenses	261,440.00	30,505,465.00

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Net income per audit	P 12,521,040.00
Deficiency income tax	P 4,382,364.00
Add: Surcharge	1,095,591.00
Interest 04-15-98 to 01-15-2001	3,019,628.89
Total Amount Due	P 8,497,583.89

There being no compromise agreement between the parties, this Court cancels the compromise penalty of P25,000.00 originally imposed by the respondent *(Collector of Internal Revenue vs. UST, 104 Phil. 1062; Philippine International Fair, Inc. vs. The Collector of Internal Revenue, 4 SCRA 781).*

With reference to the fourth issue, the deficiency VAT assessment of P18,380,309.19 resulted from the respondent's disallowance of the current input VAT on domestic purchases of goods and services reflected by petitioner in its 1997 quarterly VAT returns amounting to P9,213,677.71 on the ground that the same did not correspond to purchases made in 1997 but to purchases made during the taxable year 1996. Respondent computed the alleged 1997 deficiency VAT of P18,380,309.19 as follows:

Taxable Income	P 27,273,775.00
Output Tax Due	P 2,727,377.50
Less: Creditable Input Tax	3,281,713.34
Value-Added Tax Due (Overpayment)	P (554,335.84)
Less: Carried-Over per Return	9,768,013.55
Deficiency Value-Added Tax	P 9,213,677.71
Add: Surcharge	2,303,419.40
Interest up to 01-15-2001	6,838,212.08
Compromise	25,000.00
Total Amount Payable	P 18,380,309.19

Petitioner, on the other hand, contends that the deficiency VAT assessment was arbitrary and without legal basis.

We concur with the petitioner.

Even without passing on the issue of whether petitioner may validly claim the input VAT of P9,213,677.71 as tax credits for the year 1997, the Court finds the assessment glaringly erroneous. In computing the alleged deficiency VAT of

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P18,380,309.19, respondent disallowed the reported current input VAT of P9,213,677.71 but deducted the input VAT carried-over from 1996 amounting to P3,281,713.34 from the output VAT due for 1997 in the amount of P2,727,377.50 leaving an excess input VAT carried-over from 1996 amounting to P554,335.84. Clearly, the prior period input tax credit of P3,281,713.34 allowed by the respondent was more than enough to pay for the 1997 output VAT liability of P2,727,377.50. It was illogical on the part of the respondent to assess petitioner for deficiency output VAT equivalent to the disallowed input VAT of P9,213,677.71. A disallowance of any improperly claimed input tax credit would result to an output VAT deficiency only if the said tax credit was utilized to pay for the output VAT due for the same year. Considering that no amount of the disallowed input VAT of P9,213,677.71 was credited/applied against the output VAT liability of P2,727,377.50, petitioner cannot be assessed of any deficiency output VAT for 1997.

However, for purposes of academic discussion, We shall rule on whether or not it was proper for the respondent to disallow the input VAT of P9,213,677.71 on the sole ground that the same corresponds to purchases made in 1996 and not in 1997.

Section 104(b) of the NIRC of 1977, as amended, provides thus:

> **Sec. 104. Tax Credits**. – x x x
>
> (b) **Excess output tax or input tax**. – If at the end of any taxable quarter the output tax exceeds the input tax, the excess shall be paid by the VAT-registered person. **If the input tax exceeds the output tax, the excess shall be carried over to the succeeding quarters**. x x x (Emphasis supplied)

Pursuant to the aforequoted provision, the excess of the input tax over the output tax in a given taxable quarter may be carried-over and applied against the output VAT of the succeeding quarters. Thus, even if the input VAT of P9,213,677.71 disallowed by the respondent actually pertains to purchases made in 1996 and should have been reported by petitioner in its 1996 VAT returns, the law allows the carrying-over of the said input VAT to the succeeding quarters. In which case, the input VAT of P9,213,677.71 would have formed part of the excess input tax carried-over from 1996 reflected in petitioner's 1997 first quarterly VAT return in the amount of P3,281,713.45 (*Exhibit AA*) which was allowed by the respondent as tax credit in 1997. Evidently, therefore, respondent's disallowance of the input VAT of P9,213,677.71 is erroneous and without legal basis and the 1997 deficiency VAT assessment of P18,380,309.19 should be cancelled and withdrawn.

WHEREFORE, premises considered, the Petition for Review is hereby **PARTIALLY GRANTED**. The deficiency VAT assessment of P18,380,309.19 for taxable year 1997 is hereby **CANCELLED and WITHDRAWN**. However, the assessment for deficiency income tax is hereby **UPHELD** in a reduced amount of P8,497,583.89. Accordingly, petitioner is **ORDERED TO PAY** the respondent the sum of P8,497,583.89 (inclusive of surcharge and deficiency interest) representing deficiency income tax for taxable year 1997, plus 20% delinquency interest computed from January 24, 2001 until fully paid pursuant to Section 249 of the 1977 NIRC, as amended.

SO ORDERED.

ERNESTO D. ACOSTA
Presiding Justice

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WE CONCUR:

LOVELL R. BAUTISTA
Associate Justice

CAESAR A. CASANOVA
Associate Justice

CERTIFICATION

I hereby certify that the above decision was reached after due consultation with the members of the Division of the Court of Tax Appeals in accordance with Section 13, Article VIII of the Constitution.

ERNESTO D. ACOSTA
Chairman, First Division
Presiding Justice

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