REPUBLIC OF THE PHILIPPINES
COURT OF TAX APPEALS
QUEZON CITY

FIRST DIVISION

MARIONNAUD PHILIPPINES, INC.,
Petitioner,

-*versus*-

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

CTA Case No. 9615

Members:

DEL ROSARIO, *P.J., Chairperson,*
FABON-VICTORINO, *and*
MANAHAN, *JJ.*

Promulgated:
MAY 29 2020 ; 1:40 P.M

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D E C I S I O N

MANAHAN, *J.:*

The instant Petition for Review filed on June 14, 2017 prays that the Amended Final Decision on Disputed Assessment (Amended FDDA) issued against petitioner for deficiency income tax and compromise penalty in the aggregate amount of Php99,528,707.37 for calendar year 2011, be declared null and void.[1]

FACTS

Petitioner Marionnaud Philippines, Inc. is registered as a domestic corporation with the Bureau of Internal Revenue (BIR) under Tax Identification Number (TIN) 006-329-939-00000.[2]

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[1] Docket, Vol. II, Pre-Trial Order (PTO), Summary of the Case, p. 946.
[2] Docket, Vol. III, Exhibit "P-2", p. 1201.

On the other hand, respondent is the duly appointed Commissioner of Internal Revenue who holds office at the BIR National Office Building, Agham Road, Diliman, Quezon City.[3]

On June 13, 2013, Letter of Authority (LOA) No. LOA-116-2013-00000142 (SN: eLA201100007148) was issued by Mr. Alfredo Misajon, OIC-Assistant Commissioner (ACIR), Large Taxpayers Service of the BIR,[4] authorizing Revenue Officers (ROs) Jennifer Almedilla, Vivien Guillermo, Ferly Ann Paez, Susan Salcedo, and Group Supervisor (GS) Marivic Bautista, to examine petitioner's books of accounts and other accounting records for income taxes for the period from January 1, 2011 to December 31, 2011.

Subsequently, petitioner received the BIR's Preliminary Assessment Notice (PAN) dated September 22, 2014, with Details of Discrepancies on September 24, 2014,[5] finding deficiency income tax in the amount of Php248,694,571.86, inclusive of interest and compromise penalty, for the taxable year ending December 31, 2011. In the same PAN, it was stated that petitioner was given the opportunity to present in writing its side, and if it is amenable, may pay the said amount using BIR Payment Form (BIR Form 0605) thru EFPS; and, that if the BIR fails to hear from petitioner, the latter shall be considered in default, in which case, a formal letter of demand and assessment notice shall be issued calling for payment of the aforesaid deficiency tax, inclusive of penalty and interest.

On October 9, 2014, petitioner filed a letter[6] with the BIR, protesting the PAN.

On February 25, 2015, petitioner received the Formal Letter of Demand (FLD)[7] dated February 24, 2015, with Details of Discrepancies[8] and corresponding Audit Result/Assessment Notice (FAN),[9] informing petitioner that it has been found liable for deficiency income tax in the amount of Php130,164,294.17, inclusive of interest and compromise penalty, for the taxable year ending December 31, 2011. In the same FLD, the BIR reiterated what it has stated in the PAN: (1) that petitioner was given the opportunity to present in writing its side, and if it is

[3] Docket, Vol. II, Joint Stipulation of Facts and Issues (JSFI), p. 931.
[4] BIR Records, Exhibit "P-3"/"R-1", p. 288.
[5] BIR Records, Exhibit "P-4"/"R-6", pp. 438-442.
[6] BIR Records, Exhibit "P-5", pp. 513-522.
[7] BIR Records, Exhibit "P-6"/"R-9", pp. 545-546.
[8] BIR Records, Exhibit "P-6-1"/"R-10", pp. 534-544
[9] BIR Records, Exhibit "P-6-2"/"R-11", p. 533.

amenable, may pay the said amount using BIR Payment Form (BIR Form 0605) thru EFPS; and, (2) that if the BIR fails to hear from petitioner, the latter shall be considered in default, in which case, a formal letter of demand and assessment notice shall be issued calling for payment of the aforesaid deficiency tax, inclusive of penalty and interest.

Petitioner then filed the letter[10] dated March 30, 2015 with respondent on even date, protesting the assessment made in the said FLD/FAN.

Thereafter, OIC-ACIR Nestor S. Valeroso issued the Final Decision on Disputed Assessment (FDDA)[11] dated February 29, 2016 with Details of Discrepancies[12] and the corresponding FAN,[13] requesting petitioner to pay deficiency income tax in the amount of Php133,246,226.90, deficiency expanded withholding tax in the amount of Php2,801,855.62, inclusive of interest and compromise penalty, for the taxable year ending December 31, 2011. The said FDDA was received by petitioner on March 4, 2016.[14]

Petitioner then filed the letter[15] dated April 4, 2016 with respondent requesting reconsideration of the FDDA dated February 29, 2016.

Respondent issued the Amended FDDA[16] dated May 9, 2017, with Details of Discrepancies[17] and the corresponding FAN,[18] requesting petitioner to pay deficiency income tax in the reduced amount of Php99,528,707.37 inclusive of interest and compromise penalty, for taxable year ending December 31, 2011. The said Amended FDDA was received by petitioner on May 15, 2017.[19]

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[10] BIR Records, Exhibit "P-7", pp. 547-566.
[11] BIR Records, Exhibit "P-8"/"R-14", pp. 596-597.
[12] BIR Records, Exhibit "P-8-1", pp. 587-595.
[13] BIR Records, Exhibits "P-8-2"/"R-15" and "P-8-3"/"R-15-A", pp. 585-586.
[14] BIR Records, Exhibit "P-8"/"R-14", pp. 596-597.
[15] BIR Records, Exhibit "P-9", pp. 600-613.
[16] BIR Records, Exhibit "P-10"/"R-18", pp. 646-647.
[17] BIR Records, Exhibit "P-10-1", pp. 638-645.
[18] BIR Records, Exhibit "P-10-2"/"R-19", p. 637.
[19] BIR Records, Exhibit "P-10"/"R-18", pp. 646-647.

On June 14, 2017, petitioner filed the instant Petition for Review.[20] The case was initially raffled to this Court's Second Division.

Respondent filed his Answer[21] on August 29, 2017 and the pre-trial conference[22] was held on September 28, 2017.

Respondent's Pre-Trial Brief[23] was filed on September 18, 2017; while the Pre-Trial Brief for the Petitioner[24] was submitted on September 25, 2017. The BIR Records were transmitted on September 25, 2017.[25]

The parties submitted their Joint Stipulation of Facts and Issues (JSFI)[26] on October 12, 2017. In the Pre-Trial Order (PTO)[27] dated October 26, 2017, the said JSFI was approved and adopted by this Court, and the pre-trial was deemed terminated.

During trial, petitioner presented documentary and testimonial evidence through its witnesses: (1) Mr. Raymundo R. Bukid,[28] Accounting Manager of Watsons Personal Care Stores (Philippines), Inc. (Watsons); (2) Ms. Shirley U. Rubia,[29] Senior Operations Manager of Watsons; (3) Mr. Christian Aldrin F. Bibat,[30] Audit Supervisor of Watsons; and (4) Ms. Madonna Mia S. Dayego,[31] the Court-commissioned Independent Certified Public Accountant (ICPA).[32]

The ICPA Report[33] was posted on January 26, 2018 and received by the Court on February 1, 2018.

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[20] Docket, Vol. I, pp. 10-32.
[21] Docket, Vol. II, pp. 793-797.
[22] Docket, Vol. II, Minutes of Hearing and Order dated September 28, 2017, pp. 917 and 918.
[23] Docket, Vol. II, pp. 817-820.
[24] Docket, Vol. II, pp. 850-860.
[25] Docket, Vol. II, pp. 822-823.
[26] Docket, Vol. II, pp. 931-939.
[27] Docket, Vol. II, pp. 946-953.
[28] Docket, Vol. III, Exhibit "P-58", pp. 1008-1049; Minutes of Hearing and Order dated November 22, 2017, pp. 1050 and 1052.
[29] Docket, Vol. III, Exhibit "P-59", pp. 957-965; Minutes of Hearing and Order dated December 11, 2017, pp. 1056 and 1057.
[30] Docket, Vol. II, Exhibit "P-61", pp. 828-836; Minutes of Hearing and Order dated December 11, 2017, pp. 1056 and 1057.
[31] Docket, Vol. III, Exhibit "P-62", pp. 1089-1153; Minutes of Hearing and Order dated February 26, 2018, pp. 1155 and 1156.
[32] Docket, Vol. III, Oath of Commission, p. 1051.
[33] Docket, Vol. III, pp. 1069-1084.

On March 5, 2018, petitioner filed a *Motion for Remarking of Exhibit P-42-4 Erroneously Marked as P-43-4 and Formal Offer of Evidence for the Petitioner.*[34] Respondent filed his *Comment (on Petitioner's Formal Offer of Evidence)*[35] on March 15, 2018.

In the Resolution dated May 15, 2018,[36] the Court resolved petitioner's FOE, thereby admitting and denying some of petitioner's exhibits. Upon reconsideration, the Court admitted petitioner's exhibits which were previously denied, except for the exhibits which petitioner failed to identify during trial.[37]

Respondent presented his lone witness Ms. Ivy Jennifer Almedilla Potot,[38] Revenue Officer III of the BIR.

On September 7, 2018, respondent filed his *Formal Offer of Evidence,*[39] while petitioner filed its *Comment (On the Respondent's Formal Offer of Evidence)*[40] on September 17, 2018.

In the Order dated September 24, 2018,[41] the instant case was transferred to this Court's First Division.

In the Resolution dated December 18, 2018,[42] the Court admitted respondent's exhibits and gave the parties a period of thirty (30) days from notice to file their respective memorandum.

Respondent filed his *Memorandum*[43] on March 6, 2019, while the *Memorandum for the Petitioner*[44] was submitted on March 8, 2019.

The instant case was submitted for decision on March 14, 2019.[45]

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[34] Docket, Vol. III, pp. 1157-1200.
[35] Docket, Vol. III, pp. 1352-1353.
[36] Docket, Vol. III, pp. 1357-1360.
[37] Docket, Vol. III, Resolution dated July 30, 2018, pp. 1380-1382.
[38] Docket, Vol. II, Exhibit "R-21", pp. 805-815; Minutes of Hearing and Order dated August 29, 2018, pp. 1386 and 1384-1385.
[39] Docket, Vol. III, pp. 1391-1398.
[40] Docket, Vol. III, pp. 1400-1408.
[41] Docket, Vol. III, p. 1409.
[42] Docket, Vol. III, pp. 1414-1416.
[43] Docket, Vol. III, pp. 1426-1435.
[44] Docket, Vol. III, pp. 1437-1486.
[45] Docket, Vol. III, p. 1488.

ISSUES[46]

The parties submitted the following issues in their JSFI:

Principal issue:

Whether the assessment for Income Tax Deficiency, plus Compromise Penalty and interest, in the total amount of Php99,528,707.37 has factual and legal bases.

Sub-issues:

a. Whether the assessment of Unaccounted Income Payments – Goods amounting to Php149,757,722.69 is tenable.

b. Whether the Disallowance of Bad Debts in the amount of Php1,248,666.00 is tenable.

c. Whether the Disallowed Shrinkages & Losses of Inventories in the amount of Php18,669,457.62 is tenable.

d. Whether the assessment on the alleged Unrecorded Sales (SLP Masterlife vs. EWT Masterfile vs. SAWT-TP) – Php519,928.24 is valid.

e. Whether the assessment on the alleged Unrecorded Purchases (SAWT Masterfile vs. EWT-TP) at grossed-up amount – Php6,597,136.59 is valid.

f. Whether the imposition of Compromise Penalty of Php50,000.00 is meritorious.

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[46] Docket, Vol. II, JSFI, pp. 931-932.

RULING OF THE COURT

The petition has merit.

Petitioner received the Amended FDDA on May 15, 2017, and timely filed its Petition for Review with the Court on June 14, 2017.

As to the assessments, the Amended FDDA[47] contained the following details:

Taxable Income (Loss) per Return		P 125,010,029.59
Add: Adjustments		
Unaccounted income payment-goods	P 149,757,722.69	
Disallowed bad debts	1,248,666.00	
Disallowed shrinkages & losses of inventories	18,669,457.62	
Unrecorded sales (SLP Masterfile vs EWT Masterfile vs SAWT-TP)	519,928.24	
Unrecorded purchases (SAWT Masterfile vs EWT-TP) at grossed-up amount (P5,287,604.98/80.15% = P6,597,136.59)	6,597,136.59	
	P 176,792,911.14	176,792,911.14
Total adjusted taxable income		P 301,802,940.73
Income tax		P 90,540,882.22
Less: Tax Credits/Payments per Return		
Prior year's excess credits other than MCIT	P 42,631,744.00	
Tax payments	-	
Creditable tax withheld	26,800,480.92	
Deficiency income tax	P 69,432,224.92	
Adjustments:		
Excess tax credits carried over succeeding year	(31,929,216.19)	37,503,008.73
Deficiency Income Tax		P 53,037,873.49
Add: Interest (04/16/2012 to 08/31/2016)	46,440,833.88	
Compromise penalty	50,000.00	46,490,833.88
TOTAL AMOUNT DUE		**P 99,528,707.37**

As can be gleaned from the Amended FDDA, the following items comprise the deficiency tax assessment against petitioner:

A	Unaccounted income payment-goods	149,757,722.69
B	Disallowed bad debts	1,248,666.00
C	Disallowed shrinkages & losses of inventories	18,669,457.62
D	Unrecorded sales (SLP Masterfile vs. EWT Masterfile vs. SAWT-TP)	519,928.24
E	Unrecorded purchases (SAWT Masterfile vs. EWT-TP) at grossed-up amount	6,597,136.59
F	Excess tax credits carried over succeeding year	(31,929,216.19)

[47] BIR Records, Exhibit "P-10"/"R-18", pp. 646-647.

A. Unaccounted income payment – Goods (Php149,757,722.69)

According to respondent, a discrepancy on petitioner's income payments on goods, as shown in Schedule 1 of the Details of Discrepancies, was noted after comparing the amount per Financial Statement (FS) as against per Alphalist-EWT. The discrepancy was considered as undeclared revenue pursuant to the doctrine that unreflected sources of funds not accounted for in the taxpayer's returns leads to the inference that part of his income has not been reported. Hence, the corresponding income tax due thereon was assessed pursuant to Section 31 in relation to Section 27 of the 1997 National Internal Revenue Code, as amended (NIRC).[48]

Petitioner argues that an examination of its records reveals that there were purchases that have been accrued in prior year/s. However, the related expanded withholding taxes (EWT) were only recognized and remitted in 2011 which resulted to a higher income payment reported in its annual alphalist of EWT in 2011 than the expense declared in its FS/ITR. A summary of these purchases are as follows:

Purchases in 2010, EWT remitted in 2011	
Consignor inventory	P 141,020,508.74
Other Liability (Purchase of Fixed Asset)	9,314,346.03
Total	**Php 150,334,854.77**

Petitioner explains that with respect to consigned inventory (Php141,020,508.74), the same pertains to accrual of purchases for the month of December 2010 made from its Major Consignors. However, the EWT for said purchases was only recognized and remitted in 2011, upon actual payment to suppliers.

With regard to the Other Liability Accounts subjected to 1% EWT (Php9,314,346.03), this pertains to the accrual of purchase of capital goods and non-capital goods from several suppliers in 2010 which was just subjected to EWT only in 2011.

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[48] BIR Records, Exhibit "P-10-1", pp. 643-645.

Petitioner claims that based on the foregoing, for both the Consignor Inventory Account and the Other Liability Accounts, it is clear that petitioner has no unaccounted income payments as the petitioner's reconciliation on the alleged unaccounted income payments-goods show a difference of Php577,132.08 where the expenses/purchases per FS are higher than the amount of income payments per Alphalist of EWT, details of which are as follows:

Per Analysis	P 1,793,444,951.17
Add: Reconciliation	
Purchases in 2010 & prior years, EWT remitted in 2011	150,334,854.77
Total	P 1,943,779,805.94
Per Alphalist of EWt	1,943,202,673.86
Difference	P 577,132.08

As to the above discrepancy of Php577,132.08, with a view to avoiding a potential concern under Section 34(K) of the NIRC, petitioner allegedly paid the corresponding EWT effect of the said discrepancy on April 15, 2016.

We find the assessment untenable.

The imputation of alleged undeclared revenue is based on a mere presumption that since there were alleged discrepancies on petitioner's income payments on goods per its FS *vis-à-vis* the Alphalist, there was likewise undeclared income which corresponds to it.

As held in the case of *Commissioner of Internal Revenue v. Agrinurture, Inc.*,[49] a finding of under-declaration of purchase or expense does not by itself result in the imposition of income tax.

The three (3) elements in the imposition of income tax are: (i) there must be gain or profit; (2) that the gain or profit is realized or received, actually or constructively; and (3) it is not exempted by law or treaty from income tax. Income tax is assessed on income received from any property, activity or service.[50]

In the instant case, said elements are not present. Respondent merely presumed that the alleged discrepancy

[49] CTA EB No. 1054, January 13, 2015.
[50] *Commissioner of Internal Revenue v. Court of Appeals, et al.*, G.R. No. 108576, January 20, 1999.

constitutes undeclared income. Hence, respondent's assessment was not based on undeclared income actually received by petitioner.

While axiomatic is the fact that all presumptions are in favor of the correctness of tax assessments, the assessment itself should not be based on presumptions no matter how logical the presumption might be. In order to stand the test of judicial scrutiny, the assessment must be based on actual facts. The presumption of correctness of assessment being a mere presumption cannot be made to rest on another presumption.[51]

For lack of factual basis, the deficiency income tax assessment corresponding to the alleged unaccounted income payments should be cancelled.

B. Disallowed Bad Debts (Php1,248,666.00)

Respondent's verification disclosed that there were bad debts claimed as deduction per Income Tax Return (ITR). Petitioner submitted sample screenshots of entries on the write-off of accounts to prove that it is connected with the trade and business of petitioner and the same has been actually charged off the books of accounts as of the end of the period.

Respondent maintains that, in the case of *Western Pacific Corporation v. Collector of Internal Revenue*[52], the Court held that the taxpayer must take reasonable steps to collect the debt. He does not have to go to court if it can be shown that a judgment once obtained would be worthless because the debtor is insolvent or 'judgment proof'.

Moreover, respondent disallowed petitioner's bad debts expense pursuant to Revenue Regulations (RR) No. 25-2002, quoted as follows:

> Sec. 3. *Requisites for valid deduction of bad debts from gross income.* – The requisites for deductibility of bad debts are:

[51] *Collector of Internal Revenue v. Benipayo*, G.R. No. L-13656, January 31, 1962.
[52] CTA Case No. 720 dated May 22, 1961.

> (1) There must be an existing indebtedness due to the taxpayer which must be valid and legally demandable;
>
> (2) The same must be connected with the taxpayer's trade, business or practice of profession;
>
> (3) The same must not be sustained in a transaction entered into between related parties enumerated under Sec. 36(B) of the Tax Code of 1997;
>
> (4) The same must be actually charged off the books of accounts of the taxpayer as of the end of the taxable year; and
>
> (5) The same must be actually ascertained to be worthless and uncollectible as of the end of the taxable year.
>
> Before a taxpayer may charge off and deduct a debt, he must ascertain and be able to demonstrate with a reasonable degree of certainty the uncollectibility of the debt. The Commissioner of Internal Revenue will consider pertinent evidence, including the value of the collateral, if any, securing the debt and the financial condition of the debtor in determining whether a debt is worthless, or the assigning of the case for collection to an independent collection laywer who is not under the employ of the taxpayer and who shall report on the legal obstacle and the virtual impossibility of collecting the same from the debtor and who shall issue a statement under oath showing the propriety of the deductions thereon made for alleged bad debts. Thus, where the surrounding circumstances indicate that a debt is worthless and uncollectible and that legal action to enforce payment would in all probability not result in the satisfaction of execution on a judgment, a showing of those facts will be sufficient evidence of the worthlessness of the debt for the purpose of deduction.

Petitioner submits that the above assessment lacks factual and legal bases.

In his Amended Judicial Affidavit,[53] Mr. Raymundo R. Bukid, petitioner's witness, explained that the amount pertains to excess or overestimated rebates, discounts and other vendor support, which should have been offset against petitioner's payable to suppliers. However, there are cases wherein the suppliers from whom the vendor support should have been collected became inactive suppliers of petitioner. In such

[53] Docket, Vol. III, Exhibit "P-58", Q&A 75 to 77, p. 1028.

situation, the estimated vendor support, which was already recognized as income in petitioner's books should have been reversed.

He added that the subject amount is not in the nature of "bad debts" but are estimated rebates and discounts, and they are not the ordinary trade receivables, which are ordinarily valid, due and demandable that are properly the subject of the revenue regulations cited by respondent in the Amended FDDA.

Further, the said amount was recorded as bad debt expense instead of reducing its income. However, despite the accounting treatment adopted, the recording of such expense instead of a reduction of income will produce the same effect in computing for its taxable income. And since this amount is not bad debts expense in nature, the strict rules on deductibility of bad debts expense should not be applied in this case.

Petitioner's arguments lack support.

Petitioner classified these expenses amounting to Php1,248,666.00 as reversal of the income that has already been recorded in anticipation of rebates and discounts from its suppliers. Due to sudden inactivity of the related suppliers, petitioner then had to write-off the expected income.

However, as per ICPA testimony,[54] there was no way that she can verify this contention made by petitioner, to wit:

> Q74. What did you do to ascertain the correctness of such disallowance of bad debts?
>
> A: We were not able to ascertain the nature of the bad debts claimed as deduction by the Petitioner in its Annual Income Tax Return ("AITR") for the CY 2011 due to the absence of documents showing the breakdown of the outstanding AR-Others-Suppliers as rebates, discounts and other vendor support.
>
> In addition, we were also not able to validate whether such amount was already recorded as part of the Petitioner's income in the previous years which should have been reversed instead of recording it as a bad debts expense.

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[54] Docket, Vol. III, Exhibit "P-62", Q&A No. 74-76, p. 1134.

Q75. Why do you have to make such verification?

A: Because petitioner alleged that the amount of bad debts expense charged in its AITR in CY 2011 actually represents excess or over-estimated rebates, discounts and other vendor support, which should have been offset against the Petitioner's payables to supplier/s.

It was further alleged however that the supplier from whom the vendor support should have been collected became an inactive supplier. The estimated vendor support, which was already recognized by the petitioner as income in petitioner's books should have been reversed. Despite the accounting treatment, the Petitioner explained that the recording of an expense rather than reduction to income have the same effects in its taxable income because gross revenue in CY 2011 is understated while expense is overstated of the same amount.

The Petitioner emphasized that the amount claimed as deduction in its books are not in the nature of "bad debts" but are over-estimated rebates, discounts, and other vendor support, and these are not the ordinary trade receivables, which are ordinarily valid, due and demandable that are subject or *(sic)* RR cited by the BIR in the Amended FDDA.

Q76. What is your recommendation for this issue?

A: Since we have no means of ascertaining the truth behind Petitioner's allegations, it is our recommendation that the disallowance of bad debts be retained.

Considering that petitioner did not submit to the Court any supporting documents to prove its claim, the Court is constrained to sustain the deficiency assessment on the subject amount of Php1,248,666.00.

C. Disallowance of Shrinkages & Losses of Inventories (Php18,669,457.62)

In the Details of Discrepancies attached to the Amended FDDA, respondent noted that there was no notice/application for inventory destruction for the damaged goods whereby the BIR should have been afforded the chance to witness/inspect whether the said goods are indeed damaged/expired and to evaluate whether the valuation thereof is acceptable/accurate. Likewise, it is a current industry practice that damaged/expired goods are returned to the principal/supplier which is the party who absorbs the losses.

Details of the disallowance per amended FDDA are as follows:

	Account Title	**Per FS/TB**
5501100	COS – Outright VAT	P 1,169,865,355.19
5501199	COS – Outright BST VAT	19,573,370.97
5501500	COS – Outright Cost Variance	(1,987,019.26)
5502100	COS – Consignor VAT	911,090,471.76
5210100	Purchase Discount – Outright VAT	(18,408,558.88)
		P 2,080,133,619.78
	Cost of Sales claimed per ITR	P 2,098,803,077.40
	Disallowed shrinkages & losses on inventories claimed per ITR	**P 18,669,457.62**

The same is broken down as follows:

Inventory Losses and shrinkages			
5610000	Loss, Damages and Shrinkage – Actual	16,489,527.96	
5620000	Loss, Damages and Shrinkage – Pr	(3,667,802.55)	
5620703	Watsons Provision for Slow-moving	(8,344,976.47)	
		4,476,748.94	4,476,748.94
Provision for inventory reversal claimed per ITR (as part of COS)			14,192,708.67
Disallowed Shrinkages and losses of inventories claimed per ITR			**P 18,669,457.61**
5610000	Loss, Damage and Shrinkage - Ac		16,489,527.96
	Write-off on allowance for inventory losses & shrinkages (per FS)		2,179,929.00
Disallowed shrinkage & losses of inventories claimed per ITR			**P 18,669,456.96**

Petitioner claims that losses, breakages and spoilages are normal operating losses that petitioner incurs and suffers in carrying out its business as a retailer of fast-moving consumer goods. The above amount represents actual stock losses incurred by petitioner which have been determined through its regular stock-take process.

Petitioner argues that its claims for shrinkages and losses arose from a comparison of the actual inventory as against the perpetual inventory records at the end of the year; hence, if the recognition of losses is only after comparing inventory records, there is actually no inventory destruction to be witnessed by the BIR.

To further strengthen its claim, petitioner cites *Commissioner of Internal Revenue v. Nidec Copal Philippines Corporation, and Nidec Copal Philippines Corporation v. Commissioner of Internal Revenue,*[55] where it was ruled that:

> The respondent's examiner disallowed petitioner's claimed inventories written-off in the amount of P5,530,136.33 for being unsubstantiated, there being no prior BIR approval nor the presence of a representative from the BIR. While a certification from the BIR of the actual destruction of the claimed obsolete inventories is not necessary in order that the cost thereof may be written-off and claimed as deduction, petitioner should have presented competent documentary evidence to establish that the amount of P5,530,136.33 actually pertained to destroyed obsolete inventories. For failure of the petitioner to substantiate the inventory written-off amounting to P5,530,136.33, this Court sustains the disallowance of the same.

Petitioner contends that it can be deduced from the foregoing that a certificate from the BIR that there were actual losses in the inventory is not a condition *sine qua non* before a taxpayer may be entitled to a deduction. All that is required is a competent documentary evidence to establish the amount of loss.

In this regard, petitioner argues that entries with the attached physical count sheets are considered competent documentary evidence to establish such loss. These are considered to be official entries in the course of business. As such, the law considers them reliable and dependable.

We partially uphold the assessment.

The disallowed shrinkages and losses on inventories of Php18,669,457.62[56] may be broken down as follows:

[55] CTA EB Case Nos. 250 and 255, October 1, 2007.
[56] With Php0.01 difference.

Loss, Damage and Shrinkage - Actual		
Adjustments for physical count/stock-take result	P 15,990,229.00	
Adjustments for damaged products received upon delivery	287,032.69	
Adjustments for near-expiry products	212,266.27	P 16,489,527.96
Write-off on allowance for inventory losses & shrinkages (per FS)		2,179,929.65
Disallowed shrinkages & losses of inventories claimed per ITR		**P18,669,457.61**

As to the adjustments for damaged products received upon delivery (Php287,032.69) and for near-expiry products (Php212,266.27), as well as the write-off on allowance for inventory losses & shrinkages (Php2,179,929.65), as ascertained by the ICPA, petitioner failed to present the related supporting documents. As such, the same shall be disallowed.

As to the adjustment amounting to Php15,990,229.00,[57] the same represents results of regular physical count or stock-take process conducted by petitioner's Store Operations (SO) on a weekly basis and Internal Audit (IA) Team on a semi-annual basis as mandated by its stock-take policy.

First, "stock-take" or the actual physical count is an activity initiated by petitioner's SO and IA to account for all inventories found within a specified location. Petitioner employs this stock-take policy in order to help achieve an accurate stock-take result and ensure the reliability of Stock on Hand (SOH) which is critical to petitioner's daily store operations and replenishment process.

Second, petitioner makes some adjustments in its **Oracle GL** based on the results of the stock-take (actual physical count). There are adjustments based on the physical count conducted by the SO Team on a weekly basis in order to determine whether there are variances between actual physical counts against inventory balances per petitioner's books. Other than the regular physical count, the procedure includes review of out-of-stock items, including **Stock Keeping Units (SKUs)** with system quantity for product replenishment.

Third, the count results will be compared against inventory balance per petitioner's books and will be summarized

[57] Consists of Php10,778,873.47 and Php5,211,355.53, which shall be discussed separately.

through the **Retail Store Inventory Management - Stock Adjustment Report (RSIM-SAR)**. SKUs with noted variances must be investigated and appropriate reason codes shall be assigned thereto. Some of the standard reason codes for transaction adjustment include: warehouse delivery shortages or overages, erroneous POS processing, return to vendors, stock conversion, pest control charges, customer refund, and others.

Fourth, in accordance with the stock-take policy of petitioner, adjustments should be posted in petitioner's Oracle GL within three (3) days from the detection of the variance subject to final review and approval of the Area and Regional Store Managers.

On the other hand, there are adjustments which are results of the physical count headed by petitioner's IA Team in the stores and warehouses, with the participation of the SO Team, at least twice a year with intervals not exceeding six (6) months, with the exception of the newly opened and low and high shrinkage level stores.

Fifth, once the SO and IA team have separately performed their stock counts and recounts (if necessary when major discrepancies are found in the initial counts), and have confirmed the count results in accordance with petitioner's stock-take policy, the results will be compared against the inventory balance per petitioner's books through the **Physical Count Variance Summary (PCVS)**. This report shows the resulting shrinkage or overage based on the stock-take including variance per SKUs, amounts in Suggested Retail Price (SRP), final shrinkage ratio of the store and other ratios such as SKU integrity, inventory accuracy, not on shelves and damages. The IA team finalizes the PCVS within seven (7) days after the actual count and discusses the result to the Store Manager for sign-off. In addition, an **Inventory Department Final Variance Report (FVR)** is prepared to show the reconciliation of SRP per PCVS and equivalent cost which will be the basis for recording in the Oracle GL.

For adjustments made by the SO team, actual copies[58] of RSIM-SAR was obtained by the ICPA and summarized the same under Summary of the Retail Store Inventory Management-Stock Adjustment.[59] These adjustments were traced to Oracle

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[58] Exhibit "P-109-1" to "P-109-9".
[59] Exhibit "P-109".

Journal Entry (JE) screenshots[60] to validate if these were actually posted in petitioner's books under the account 5610000: Loss, Damages and Shrinkage-Actual[61] for CY 2011.

The results of such tracing is as follows:

Summary of Comparison of Summary of SAR with Oracle JE and Oracle GL – 5610000: Loss, Damages and Shrinkage – Actual				
Exhibit No.	**Particulars**	**Amounts**		
	Per BIR's assessment	P 10,778,873.47		
P-110-11	Per Oracle GL	10,778,873.47	P 10,778,873.47	P 10,778,873.47
	Supported by:			
P-110-1 to P-110-11	Per Oracle JE	-	10,116,612.86	-
P-109	Per RSIM-SAR	-	-	10,116,635.32
	Difference	-	**P 662,260.61**	**P 662,238.15**

For the physical count adjustments made by the IA team, actual copies of the PCVS[62] were obtained and the ICPA summarized them under Summary of Physical Count Variance for CY 2011.[63] The ICPA also obtained the CY-Batch extract,[64] Summary of Pcount Sheets[65] and Variance per SKU[66] per all existing stores/branches of petitioner, and compared the details against the actual PCVS, to validate whether or not inventory shrinkages were properly supported.

The results are as follows:

Summary of Comparison of the Summary of PCVS with MMS CY-Batch Extract and Summary of Pcount Sheets			
Exhibit No.	**Particular**	**Amounts in SRP[67]**	**Quantity**
P-95	Per CY Batch Extract	P 744,156,171.33	6,947,700
P-96	Per Summary PCount Sheets	736,404,939.63	6,841,137
P-94	Per PCVS – Variance per SKU	7,751,231.70	106,563
P-93	Per Variance per SKU-Overage/(Shrinkage)	7,751,231.70	106,563
	Difference	P -	-

Then, the ICPA obtained and reviewed the FVRs[68] to reconcile the SRP of the Net Variance per SKU to the equivalent cost recorded in the Oracle JE screenshots and Oracle GL – 5610000.

[60] Exhibit "P-110-1" to "P-110-10".
[61] Exhibit "P-110-11".
[62] Exhibit "P-94-1" to "P-94-71".
[63] Exhibit "P-94".
[64] Exhibit "P-95-1" to "P-95-71".
[65] Exhibit "P-96-1" to "P-96-71".
[66] Exhibit "P-94-1-a" to "P-94-70-a".
[67] Suggested Retail Price.
[68] Exhibit "P-97-12" to "P-97-46".

The ICPA also traced the Net Shrinkage per PCVS to FVR,[69] Oracle JE screenshots,[70] and Oracle GL – 5610000[71] to validate whether or not Net Shrinkage was actually posted in petitioner's books in CY 2011.

The results are summarized as follows:

Summary of Comparison of the Summary of PCVS versus FVR				
Exhibit No.	**Particulars**	**Amounts**		**Quantity**
		SRP	**Cost**	
P-94	Per PCVS – Variance per SKU	P 7,751,231.70	P -	106,563
P-97	Per FVR	5,065,222.40	3,832,965.39	53,777
	Unsupported by FVR	**P 2,686,009.30**		**52,786**

Summary of Net Shrinkage per PCVS to FVR and Oracle JE and Oracle GL 5610000: Loss, Damages and Shrinkages-Actual				
Exhibit No.	**Particulars**	**Amounts**		
	Per BIR's assessment	P 5,211,355.53		
P-110-11	Per Oracle GL	5,211,355.53	P 5,211,355.53	P 5,211,355.53
	Supported by:			
P-110-1 to P-110-11	Per Oracle JE	-	3,832,965.39	-
P-109	Per RSIM-SAR	-	-	3,832,965.05
	Difference	**P -**	**P 1,378,390.14**	**P 1,378,390.48**

Finally, the ICPA determined if the total amounts per Oracle GL – 5610000 tally with the amounts of Cost of Sales, reported in Petitioner's Audited Financial Statement for the year ended December 31, 2011.

The results are as follows:

Exhibit No.	**Particulars**	**Per Various Oracle GL vs. AFS**	**Per AFS vs. AITR**
P-88	Per Various Expenses' GLs	P 2,062,659,275.73	P -
P-80-1	Per AFS	2,062,659,276.00	2,062,659,276.00
P-111-1	Per AITR	-	2,098,803,077.40
		P (0.27)	P (36,143,801.40)
	Schedule 3: Reconciliation of Net Income per Books Against Taxable: Provision for Inventory Losses – Reversal Others	 -	 14,192,708.67 21,951,093.00
	Rounding-off Difference	**0.27**	**(0.27)**

[69] *Id.*
[70] Exhibit "P-97-1" to "P-97-11".
[71] Exhibit "P-110-1" to "P-110-11".

Review of the documents show that the ending balance of Oracle GL – 561000: Loss, Damages and Shrinkage amounting to Php16,489,527.96 (Exhibit "P-110-11" was indeed reported in the AITR as part of Cost of Sales amounting to Php2,098,803,077.40 (Exhibit "P-111-1"), reconciled as follows:

Cost of Sales Accounts per General Ledger reported in the Notes to Financial Statements		**Amounts**	
5210100	Purchase Discount – Outright Va	P (18,408,558.88)	
5210200	Purchase Discount – Outright Za	0.01	
5501100	COS – Outright Vat	1,169,865,355.19	
5501199	COS – Outright BST Vat	19,573,370.97	
5501500	COS – Outright Cost Variance	(1,987,019.26)	
5502100	COS – Consignor Vat	911,090,471.76	
5610000	**Loss, Damage and Shrinkage – Ac**	**16,489,527.96**	
5620000	Loss, Damage and Shrinkage – Pr	(3,667,802.55)	
5620703	Watsons Provision for Slow movi	(8,344,976.47)	
	TOTAL Cost of Sales per AFS		**P2,084,610,368.73**
Cost of Sales per Annual Income Tax Return CY 2011			2,098,803,077.40
Difference			**P 14,192,708.67**
Reconciliation: Provision for Inventory Losses Reversal –Reported in AITR CY 2011 Schedule 3 (FS to ITR recon)			(14,192,708.67)
Unaccounted difference			-

Based on the foregoing, out of the total claimed losses, damages and shrinkages of Php18,669,457.61, the Court finds that the total amount of Php13,949,577.91 are actual losses incurred in the normal course of petitioner's business operations which resulted from the comparison of inventory balance per petitioner's books and actual physical count conducted on a periodic basis during the taxable year 2011. To reiterate, the items were charged to shrinkages/losses account once approved by the store and area managers (SAR adjustments) and/or IA and store managers (IA adjustments) which are in the nature of <u>pilferage</u>, thus, did not necessitate the BIR personnel to witness the disposal process because there were no items to dispose of.

The summary of results is as follows:

Particulars	Per BIR's assessment	Properly supported	Not Supported
Disallowed shrinkages and losses of inventories	*P 18,669,457.62*		
Retail store inventory adjustment by SO	P 10,778,873.47	P10,116,612.86	P 662,260.61
Adjustments based on regular physical count by IA	5,211,355.53	3,832,965.05	1,378,390.48
Unverified adjustments for damaged products received upon delivery	287,032.69	-	287,032.69
Unverified adjustments for near-expiry products	212,266.27		212,266.27
Unverified write-off on allowance for inventory shrinkages and losses per AFS	2,179,929.65	-	2,179,929.65
Total	**P18,669,457.61**	**P13,949,577.91**	**P4,719,879.70**

Thus, the assessment on unsupported losses, damages and shrinkages in the amount of Php4,719,879.70 is sustained.

D. Unrecorded Sales - SLP Masterfile vs. EWT Masterfile vs. SAWT-TP (Php519,928.24)

According to respondent, the SLP and EWT Masterfiles from various suppliers/withholding agents/payors generated from CAATTS Laboratory were compared against the reported Summary List of Withholding Taxes (SAWT). The differences, as detailed below, were treated as unrecorded sales pursuant to Section 32(A) of the NIRC:

TIN	Customer's Name	Masterfile SLP/EWT - Third Parties	TP-SAWT	Unrecorded Sales
205172945	METRO MANILA SHOPPING MECCA CORP. (B)	P 179,278,807.97	P 179,005,719.00	P 273,088.97
708174	BDO UNIBANK, INC. (A)	34,792,228.00	34,698,138.00	94,090.00
283723	LOREAL PHILIPPINES, INC. (A)	50,000.00	0.00	50,000.00
406761	ABS-CBN CORPORATION (A)	49,009.02	0.00	49,009.02
498300	SB CARDS CORP. (A)	142,526.00	108,456.00	34,070.00
438366	BANK OF THE PHILIPPINES ISLANDS (A)	575,078.13	555,642.88	19,435.25
6329939	MARIONNAUD PHILIPPINES, Inc.	235.00	0.00	235.00
	TOTAL	**P 214,887,884.12**	**P 214,367,955.88**	**P 519,928.24**

Petitioner questions the legality and propriety of the above tax assessment. Petitioner points out that CAATTS Laboratory's extraction data are not evidence in themselves to support a tax assessment. The BIR has to comply with the procedures laid down in RMO No. 46-2004 before such third-party information can enjoy the presumption of correctness, that is, the BIR must secure the Sworn Declaration of the third-party, in this case, the specific clients/customers of the Company that such amounts were indeed sales by the Company to them. Otherwise, the BIR's data are mere hearsay evidence that will not stand the scrutiny of the Court.

Thus, the supposed third-party information compared to petitioner's SAWT or any other information are mere naked assessments absent the sworn statements/declarations. Since this item of the assessment is simply based on a mere assumption and not on facts, it must be cancelled and set aside.

We agree with the petitioner.

A perusal of the records reveals that respondent failed to verify the amounts per SLP and EWT Masterfiles with petitioner's various suppliers/withholding agents/payors. Without the confirmation from such third parties, the finding casts doubts as to the reliability and correctness of the assessment on the alleged unrecorded sales.

While it is true that tax assessments have the presumption of correctness and regularity in its favor, it is also equally true that assessments should not be based on mere presumptions no matter how reasonable or logical the presumption might be.[72] This was highlighted in the case of *Commissioner of Internal Revenue v. Hantex Trading Co., Inc.*,[73] the pertinent portions of which are quoted as follows:

> We agree with the contention of the petitioner that, as a general rule, tax assessments by tax examiners are presumed correct and made in good faith. All presumptions are in favour of the correctness of a tax assessment. It is to be presumed, however, that such assessment was based on sufficient evidence. Upon the introduction of the assessment in evidence, a prima facie case of liability on the part of the taxpayer is made. If a taxpayer files a petition for review in the CTA and assails the assessment, the prima facie presumption is that the assessment made by the BIR is correct, and that in preparing the same, the BIR personnel regularly performed their duties. This rule for tax initiated suits is

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[72] *Commissioner of Internal Revenue v. Fax N Parcel, Incorporated*, CTA EB No. 883, February 14, 2013.
[73] G.R. No. 136975, March 31, 2005.

premised on several factors other than the normal evidentiary rule imposing proof obligation on the petitioner-taxpayer: the presumption of administrative regularity; the likelihood that the taxpayer will have access to the relevant information; and the desirability of bolstering the record-keeping requirements of the NIRC.

However, the prima facie correctness of a tax assessment does not apply upon proof that an assessment is utterly without foundation, meaning it is arbitrary and capricious. Where the BIR has come out with a "naked assessment," i.e. without any foundation character, the determination of the tax due is without rational basis. In such a situation, the U.S. Court of Appeals ruled that the determination of the Commissioner contained in a deficiency notice disappears. Hence, the determination by CTA must rest on all the evidence introduced and its ultimate determination must find support in credible evidence."

As such, the finding that petitioner had unrecorded sales cannot be enforced against petitioner; otherwise, the Court stands to tax petitioner arbitrarily. Accordingly, the deficiency income tax assessment on the alleged unrecorded sales in the amount of Php519,928.24 is cancelled and withdrawn.

E. Unrecorded Purchases (SAWT Masterfile vs. EWT – TP) (Php6,597,136.59)

Respondent compared the SAWT-Masterfile from various suppliers generated from CAATTS Laboratory as against the reported Expanded Withholding Tax (EWT). The discrepancy amounting to Php5,287,604.98) was grossed up using a 15% cost ratio, and was considered as undeclared revenue, pursuant to the doctrine that unreflected sources of funds not accounted for in the taxpayer's returns leads to the inference that part of his income has not been reported. The corresponding income tax due thereon was assessed pursuant to Section 32(A) of the NIRC.

The discrepancy is composed of the following:

Customer's Name	SAWT - Masterfile	Annual Alphalist of MPI	Unrecorded Purchases

Zuellig Pharma Corp.	P 26,710,298.00	P 24,706,185.00	P 2,004,113.00
Cosmos Bazar Inc.	9,854,047.00	8,206,091.63	1,647,955.37
PhilUSA Corp.	6,718,518.00	5,235,668.00	1,482,850.00
Vibelle Manufacturing Corp.	10,250,135.00	10,180,046.88	70,088.12
Green Cross Inc.	2,553,752.00	2,515,338.52	38,413.48
Globe Telecom Inc.	69,158.50	35,329.50	33,829.00
Ace Hardware Phils. Inc.	4,576.00	(5,780.00)	10,356.00
Total Unrecorded Purchases	**P 56,160,484.50**	**P 50,872,879.53**	**P 5,287,604.97**

Petitioner maintains that due to respondent's failure to secure the necessary certifications from the third parties, the revenue officers can only speculate by way of extrapolation as to the alleged undeclared revenue of petitioner. Since this item of assessment is based on a mere assumption and not on facts, it must be cancelled and set aside.

The Court agrees with petitioner.

Considering that the basis of the subject assessments are the discrepancies found by comparing the SAWT-Masterfile from various suppliers generated from CAATTS Laboratory as against the reported EWT, which were not verified with the relevant suppliers, the assessment is utterly without foundation, meaning it is arbitrary and capricious.

Moreover, it is worthy to note that respondent's imputation of alleged undeclared income is based on a mere presumption that since there were alleged undeclared purchases, there was likewise undeclared income which corresponds to it. We hold that even if these alleged undeclared expenses are to be considered as income, the same will be offset by recording the equivalent payments as expenses. Hence, no taxable income will result from the said transactions.

For lack of factual basis, the deficiency income tax assessment corresponding to the alleged undeclared income from unrecorded purchases amounting to Php6,597,136.59 is cancelled.

F. Disallowed excess tax credits carried over to the succeeding year (Php31,929,216.19)

In the amended FDDA, respondent deducted the amount of Php31,929,216.19 from the available tax credits of petitioner.

However, respondent failed to provide the legal and factual bases for the above disallowance. This renders the disallowance null and void for not being compliant with Section 228 of the NIRC, which requires that the taxpayer shall be informed of the law and the facts on which the assessment is made. Consequently, the deficiency income tax assessment thereon is cancelled.

Based on the foregoing findings, petitioner does not have any deficiency income tax, as computed below:

Taxable Income(Loss) per Return		P 125,010,029.59
Add: Adjustments		
Disallowed bad debts	P 1,248,666.00	
Disallowed shrinkages & losses of inventories	4,719,879.70	5,968,545.70
Total adjusted taxable income		P 130,978,575.29
Income Tax Due		P 39,293,572.59
Less: Tax Credits/Payments per Return		
Prior years' excess credits other than MCIT	P42,631,744.00	
Creditable tax withheld	26,800,480.92	69,432,224.92
Excess Tax Credits/Overpayments		**(P30,138,652.33)**

The compromise penalty of Php50,000.00 is likewise cancelled.

WHEREFORE, the instant Petition for Review is **GRANTED**. Accordingly, the subject tax assessment and the Amended FDDA dated May 9, 2017, holding petitioner liable for deficiency income tax and compromise penalty in the aggregate amount of Php99,528,707.37, for calendar year 2011, are **CANCELLED AND SET ASIDE**.

SO ORDERED.

Catherine T. Manahan

CATHERINE T. MANAHAN
Associate Justice

WE CONCUR:

ROMAN G. DEL ROSARIO
Presiding Justice

ESPERANZA R. FABON-VICTORINO
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's Division.

ROMAN G. DEL ROSARIO
Presiding Justice