REPUBLIC OF THE PHILIPPINES
COURT OF TAX APPEALS
QUEZON CITY

PHILACOR CREDIT CORPORATION,
Petitioner,

- versus -

C.T.A. CASE NO. 5674

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Promulgated:
AUG 14 2003

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DECISION

This Petition for Review seeks for the cancellation and withdrawal of the deficiency assessments issued by the respondent against herein petitioner in the total amount of P17,442,231.61, consisting of alleged deficiency (a) income tax – P12,888,085.09; (b) percentage tax – P1,185,977.07; and (c) documentary stamp tax – P3,368,169.45, all for the fiscal year ended July 31, 1993.

The antecedent facts are as follows:

Petitioner is a domestic corporation duly organized and existing under the laws of the Republic of the Philippines and is engaged in the business of retail financing, particularly to buyers of its parent company Philippine Appliance Corporation's household products *(Stipulated Fact, par. 1, CTA records, p. 231)*.

For the fiscal year ended July 31, 1993, petitioner filed its Corporation Annual Income Tax Return *(Exhibit A)* and Quarterly Percentage Tax Returns *(Exhibits B, C, D & E)*. Pursuant to Letter of Authority No. 17107 dated July 6, 1994 *(Exhibit 1, BIR*

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records, p. 6) issued to petitioner, Revenue Officer Celestino Mejia examined petitioner's books of accounts and other accounting records for all internal revenue taxes for the fiscal year August 1, 1992 to July 31, 1993. After the examination of petitioner's books of accounts, petitioner received tentative computations of deficiency taxes for its fiscal year ended July 31, 1993 *(Stipulated Facts, pars. 4 and 5, CTA records, p. 232)*. Through a letter dated April 17, 1995 *(Exhibit 4, BIR records, p. 253)*, petitioner's Finance Manager, Ms. Leticia Pangan, contested the tentative computations of the alleged deficiency taxes totaling P20,037,013.83 and requested for a conference to discuss the details of her opposition as contained in her letter.

On May 16, 1995, Mr. Mejia sent a letter *(Exhibit 5, BIR records, pp. 254- 256)* to petitioner, revising the preliminary assessments as follows:

Deficiency Income Tax	P 9,832,098.22
Deficiency Percentage Tax	866,287.60
Deficiency Documentary Stamp Tax	3,368,169.45
Total	P14,066,555.27

In his letter, the said revenue examiner urged petitioner to submit its comment thereto within five days from receipt thereof.

Petitioner then received Pre-Assessment Notices (PANs), all dated July 18, 1996, *(Exhibits 6, 7, & 8, BIR records, pp. 278 & 279)* covering the alleged deficiency income, percentage and documentary stamp taxes, including increments. *(Stipulated Fact, par. 8, (CTA records, p. 232)*.

Petitioner, through Mr. C.P. Noel of SGV & Co., filed its comments to the PANs in a letter dated August 28, 1996 *(Exhibit 9, BIR records, pp. 280-281)* relative to the proposed assessments indicated in the PANs as aforementioned.

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On September 4, 1996, petitioner executed a Waiver of the Statute of Limitations Under the National Internal Revenue Code extending respondent's right to assess and collect not later than January 1, 1997. On December 11, 1996, another waiver was executed by petitioner, extending respondent's right to assess and collect not later than July 31, 1997. Finally, on July 11, 1997, a third waiver was executed by petitioner, extending respondent's right to assess and collect until January 31, 1998.

Thus, on February 3, 1998, petitioner received letters of demand *(Exhibits N & O)* and the corresponding assessment notices, all dated January 28, 1998 *(Exhibits L, L-1 and M)*. The assessments, inclusive of increments, cover the following:

Deficiency Income Tax	-	P12,888,085.09
Deficiency Percentage Tax	-	1,185,977.07
Deficiency DST	-	3,368,169.45
Total	-	P17,442,231.61

On March 4, 1998, petitioner through SGV & Co., protested the aforesaid deficiency assessments *(BIR records, pp. 294-295)* with a request for reconsideration and/or reinvestigation, on the following grounds:

> ***Income Tax*** – The bulk of understated revenues were picked up by Respondent's examiner by totaling Interest, Discount and Finance Fees, as well as the Service charges and Fees amounting to P77,443,293.00 and P5,573,050.00, respectively, without considering the reversing entries in contra accounts and other income adjustments such as repossession, write-off and legal accounts, entries which would have reduced the gross revenues under said items to P63,475,734.00 and P4,786,007.00, respectively, as correctly stated in the petitioner's Financial Statements. Said disallowances alone account for a reduction of P14,944,601.00 in the gross revenues per examination.
>
> ***Percentage Tax*** – The total revenue reported per income statement varies with the total reported percentage tax return for the reason that the amount that appears in the income statement was purely based from monthly set-up or amortization of income while the total

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> reported gross receipts per return was based on actual receipts of payment from the customers. In arriving at actual receipts, the reversing entries of Repossessions, Legal accounts, and Write-offs are taken into consideration in the recognition of gross revenues.
>
> ***Documentary Stamp Tax*** – The liability for Documentary Stamp Taxes on the purchase of notes under Sections 174 and 198 appears to be based on Respondent's examiner's observation that the petitioner's records do not show the DST payments as part of its expenses. The absence of records showing payment of the DST on the promissory notes is due to the fact that the accredited dealers of our client are required to affix the documentary stamps on all notes purchased. This is evidenced by the fact of affixture itself of the DST on all the notes purchased during the year in question until this was stopped upon the effectivity of Republic Act No. 7660, otherwise known as "An Act Rationalizing Further the Structure and Administration of the Documentary Stamp Tax" which took effect on January 15, 1994.

A day after, petitioner through its present counsel, Tan & Venturanza Law Offices, filed a supplemental protest *(BIR records, pp. 296-298)* which considered the assessments as null and void for failure to state the law and the facts on which they were based.

On September 30, 1998, petitioner filed the instant petition for review for the purpose of having all the January 28, 1998 assessments declared null and void.

Respondent, for his part, posted an Answer on November 17, 1998, specifically denying some material allegations in the petition and raised therein the following Special and Affirmative Defenses:

> 1. The assessments in question were made and issued in accordance with existing laws, rules and regulations;
>
> 2. All presumptions are in favor of the correctness of the tax assessment *(Interprovincial Autobus, Inc. vs. Collector of Internal Revenue, 98 Phil. 290).*

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The issues to be resolved in the case at bar, as jointly stipulated by the parties, are as follows:

> 1. Whether or not the assessments dated January 28, 1998 are null and void for having been issued without stating the facts and the law on which the assessments are based as required by Section 228 of the Tax Code;
>
> 2. Whether or not the disallowance of reversing entries in contra accounts and other income adjustments such as repossessions, write-offs, and legal accounts, which are entries that could have reduced the gross revenues under the income items Interests, Discounts, and Financing Fees as well as Service Charges and Fees, was proper.
>
> 3. Whether or not the deficiency percentage tax assessed on the alleged discrepancy between the revenues reported in the financial statement and the gross receipts reported in the percentage tax returns was proper.
>
> 4. Whether or not the petitioner was liable to pay Documentary Stamp Taxes on the accredited dealers' assignment of Promissory Notes to it.

Section 228 of the 1997 Tax Code, which was already in force at the time the subject assessments were issued on January 28, 1998, provides in part:

> ***"Section 228. Protesting of Assessment.*** - When the Commissioner or his duly authorized representative finds that proper taxes should be assessed, he shall first notify the taxpayer of his findings: *Provided, however*, That a pre-assessment notice shall not be required in the following cases:
>
> xxx xxx xxx
>
> <u>The taxpayers shall be informed in writing of the law and the facts on which the assessment is made; otherwise the assessment shall be void."</u> *(underscoring supplied)*

Relying on the clear import of the aforesaid provision, petitioner now questions the validity of the deficiency assessments issued against it, citing particularly the failure of the respondent to state the law and the facts on which the assessments were based.

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Judging from the circumstances surrounding the instant case, we believe that there was sufficient compliance with Section 228 of the Tax Code. While it is true that the Formal Assessment Notices dated January 28, 1998 *(Exhibits L, L-1 and M)* merely contain the assessed amounts, devoid of any bases in fact and in law, a judicious look at the supporting records would reveal the obvious attempt of the respondent to explain one by one the details of the assessments. As a matter of fact, the demand letters accompanying the assessment notices showed how the assessed amounts were arrived at *(Exhibits N & O)*. Likewise worthy to note is the May 16, 1995 letter *(Exhibit 5)* of the respondent as well as the attached computation sheet, which showed notable discrepancies on petitioner's computations of income and percentage taxes as well as the necessary adjustments made, that brought forth the deficiency assessments, as well as the specific law which supports the DST assessment.

Needless to say, the exchange of correspondence between petitioner and respondent belies petitioner's assertion that it was not informed of the facts and the laws on which the assessments were based. In fact, the tenor of the various letters sent by petitioner would indicate that petitioner clearly understood the nature and the bases of the assessment notices issued against him. Had it not been aware of the bases thereof, petitioner could not have intelligently protested the assessments issued against it. As ruled by this court:

> "Since we rule that by petitioner's actual knowledge of the bases of the assessments, the requirement under Section 228 of the Tax Code that "the taxpayer be informed of the law and the facts on which the assessment is made" is deemed to have been complied, it follows then that the assessments x x x are not null and void, even if the same failed to state the law and the facts on which they were based" ***(Belle***

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Corporation vs Commissioner of Internal Revenue, CTA Case No. 5930, April 4, 2002).

It is likewise significant to note that the purpose of Section 228 is to give the taxpayer the opportunity to refute the findings of the examiner and give a more accurate and detailed explanation regarding the proposed assessment. We believe that all the notices received by petitioner *(ie. Revised PANs dated May 16, 1995, the preliminary assessments dated July 18, 1996 and the various demand letters and Formal Assessment Notices dated January 28, 1998),* have verily met the purpose of apprising the petitioner of the factual as well as the legal bases of the assessments.

DEFICIENCY INCOME TAX

We now proceed to resolve the second issue of whether or not the disallowance of reversing entries in contra accounts and other income adjustments such as repossessions, write-offs, and legal accounts, which are entries that could have reduced the gross revenues under the income items Interests, Discounts, and Financing Fees as well as Service Charges and Fees, was proper.

Respondent contends that petitioner underdeclared its income in the amount of P15,965,971.41 representing the discrepancy between the gross income declared in the income tax return in the amount of P72,947,225.00 and gross revenue per investigation in the amount of P88,913,196.41. The underdeclared income of P15,965,971.41 corresponds to the following items of adjustments: (a) Interests, Discounts & Financing Fees; (b) Service & Handling Fees; and (c) Other Income. Respondent believes that the amount of P88,913,196.41, is the correct income; hence, deficiency income tax in the sum of

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P12,888,085.09, inclusive of increments, was assessed against petitioner, detailed as follows: *(Exhibit N)*

Net income disclosed by the return as audited		P 38,600,392.00
Add: Discrepancies		
Interest, Discounts & Financing Fees (a)	P 77,443,293.00	
Service & Handling Fees (b)	5,573,050.00	
Other Financing Income (c)	3,437,105.32	
Interest on other Loans Rec'ble (c)	1,119,012.26	
Interest on deposits with banks	784,361.89	
Income from assets acquired (c)	114,573.00	
Profit from asset sold/exchanged (c)	385,255.80	
Dividend Income	1,697.12	
Miscellaneous Income (c)	840,907.02	
Total	P 89,699,255.41	
Less: Interest Income subjected to F/T	(784,362.00)	
Dividend Income	(1,697.00)	
Gross Revenue	P 88,913,196.41	
Less: Gross Revenues reported per ITR	72,947,225.00	
Total Adjustments		15,965,971.41
Net income per investigation		P 54,566,363.41
Income Tax Due (35%)		P 19,098,227.19
Less: Amount already assessed		13,510,137.00
B A L A N C E		P 5,588,090.19
25% Surcharge		1,397,022.54
20% Interest (11-15-93 to 01-31-98)		5,877,972.36
Compromise Penalty		25,000.00
Deficiency Income Tax		P 12,888,085.09

On the other hand, petitioner avers that it is not liable to the said deficiency income tax. Petitioner explains that out of the three items considered by the respondent, the Interest, Discounts & Financing Fees and Service & Handling Fees are not income components but are correcting entries manually recorded to reflect its true income. *(TSN dated March 19, 2002)*. Petitioner further avers that it cannot explain the Other Financing Income because the examiner failed to explain the basis thereof.

Before we delve on the issue, it is necessary to consider first the nature of petitioner's business and how its transactions are being recorded.

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Petitioner is engaged in the business of retail financing which extends credit (loan) to customers who are interested in buying home appliances on installment basis. Once petitioner approves the application, the appliance dealer will require the customer to execute a Promissory Note *(Exhibits F and F-1)* and a Sale with Reservation of Title *(Exhibits G and G-1)*. The appliance will then be delivered to the customer. On the other hand, the dealer, in exchange for the consideration (cash price of the appliance) received from petitioner, assigns both the Promissory Note and the Sale with Reservation of Title in favor of petitioner *(Exhibits F-1-1 and G-1-1)*. This financing transaction is initially recorded by debiting the total amount of the Promissory Note (i.e., the total obligation that the customer promises to pay over a certain period) to the account title "Finance Receivable" and crediting the amount payable to the appliance dealer (i.e., the cash price of the appliance) to the account title "Due to Dealer".

The amount debited to "Finance Receivable" is greater than the amount credited to "Due to Dealer," with the difference representing the finance and add-on charges of petitioner. These finance and add-on charges are accounted for by three (3) credit components – the "Unearned Discount & Interest" account, the "Unearned Service & Handling Fees" account, and the "Prompt Payment Discount" account. The pro-forma entry to record the financing of an appliance is as follows:

	DR	CR
Finance Receivable	xxx	
Unearned Discount and Interest		xxx
Unearned Service and Handling Fees		xxx
Prompt Payment Discount		xxx
Due to Dealer		xxx

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For the fiscal year ended July 31, 1993, petitioner had a total of 19,205 financing transactions. This translates to an average of 52.62 transactions per day. To handle the voluminous transactions, petitioner uses a computerized accounting system. In 1993, petitioner recorded the transactions by batches, such that all transactions on a given day were summarized into a single accounting entry, following the aforementioned pro-forma accounting entry and is recorded in the Dealers Note Purchase Invoice Register *(Exhibit H)*.

The "Unearned Discount and Interest" account and the "Unearned Service and Handling Fees" account are deferred income accounts which are amortized over the financing term or period of repayment chosen by the customer, which is usually expressed in months. For purposes of recording the monthly amortization, transactions done on the same day are classified according to their financing or repayment term (i.e., 6, 9, 12, 18 or 24 months). Then all transactions with the same financing or repayment term are added together and the total unearned income for each financing or repayment term is divided by the applicable financing or repayment term to get the monthly amortization. This is then fed to the computer for automatic amortization regardless of whether the customer pays or not. The computer will then automatically record the amortization of unearned income on a monthly basis for each term since petitioner adopts the accrual method of accounting *(TSN, January 9, 2002, pp. 9-11 and March 6, 2000, pp. 22-24)*. The following is the pro-forma entry of the amortization of unearned income:

	DR	CR
Unearned Discount and Interest	xxx	
Unearned Service and Handling Fees	xxx	
Interest, Discount and Finance Fees		xxx
Service Charges and Fees		xxx

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The above accounting entry is recorded in the Journal Voucher Register *(Exhibit I)*.

The "Prompt Payment Discount" is a suspense account because it is determined by a future event which is the actual date the customer pays an installment. The initial amount credited to "Prompt Payment Discount" is divided by the financing term or period of repayment chosen by the customer, which is usually expressed in months. Thus, in a given month, if the customer pays late, then there is a debit to "Prompt Payment Discount" and a credit to the income account "Other Financing Income". If the customer pays on or before due date, then there is no income recognition, instead there is a debit to "Prompt Payment Discount" and a credit to the asset account "Finance Receivable", which decreases the asset account. Finally, if the customer does not pay then there is no accounting entry *(TSN, March 6, 2000, pp. 24-26)*. Accordingly, the accounting entries to record actual payment or non-payment of installment due are as follows:

1. If late:

	DR	CR
Prompt Payment Discount	xxx	
Other Financing Income		xxx

2. If on time:

	DR	CR
Prompt Payment Discount	xxx	
Finance Receivable		xxx

3. If no payment — No Entry

The above accounting entries are recorded in the Official Receipts Register *(Exhibits J and K)*.

The foregoing entries to record the amortization of unearned income continue until the end of the term of the loan. In the case of Prompt Payment Discount, the foregoing entries continue until the loan is fully paid. However, not all accounts are paid in full or reach their respective maturity date. Some accounts are cancelled due to repossession, considered not feasible for litigation or written off; conversely, a handful of accounts are paid earlier than the financing term agreed upon.

During repossession, the customer voluntarily surrenders the appliance subject of the financing. As a consequence, both the Promissory Note and the Sale with Reservation of Title are cancelled. Items for litigation occurs when the customer defaults for three months but still refuses to pay and to voluntarily surrender the appliance. In such a situation, the account of the customer is endorsed to a collection agency that will exert all efforts to be able to collect or repossess the appliance. Ultimately, the account is written-off because the cost of collecting is a lot more than the amount for collection considering that this is a home appliance financing. Write-offs are made after credit investigators from the city or municipality where the customer was last known to reside and provincial lawyers who act as skip tracers, report that the customer can no longer be found. Once they report that they can no longer find the customer, petitioner writes-off the account. On the other hand, accounts are also closed or zeroed-out when the customer pre-pays the Promissory Note. In the foregoing situations, the customers' account will be closed or cancelled out. The accounting entry is:

	DR	CR
Repossessed Inventory	xxx	
Unearned Discount and Interest	xxx	
Unearned Service and Handling Fees	xxx	
Interest, Discount and Finance Fees	xxx	

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Services Charges and Fees	xxx	
Prompt Payment Discount	xxx	
Finance Receivable		xxx

The above entry is recorded in the Journal Voucher Register *(Exhibit I)*.

Notwithstanding the fact that a customer's account has been cancelled or zeroed-out because of (1) repossession; (2) items not feasible for litigation; (3) write-offs; and (4) prepayment, the computerized accounting system adopted by petitioner continues to amortize the unearned income pertaining to such accounts. Thus, there is a need for correcting entries because the transactions in the above cases have in the meantime been cancelled. The correcting entries are simply reversing entries to correct the automatic amortization of unearned income *(TSN, January 9, 2002, pages 11-14, March 19, 2002, pages 7-15)* which are made at the end of the fiscal year July 31, 1993 and are recorded in the Journal Voucher Register *(Exhibit I)*.

It should be noted that in arriving at the deficiency income tax assessment, the examiner considered the following: (1) Interests, Discounts & Financing Fees; (2) Service & Handling Fees; and (3) Other Income. We shall tackle the first two items jointly based on the examiner's presentation and then we proceed to Other Income.

In arriving at the alleged correct amounts of Interests, Discounts & Financing Fees and Service & Handling Fees of P77,443,293.00 and P5,573,050.00, respectively, the revenue examiner analyzed the total debits to Unearned Discount & Interest and Unearned Service & Handling Fees and deducted therefrom all the charges not pertaining to income *(BIR records, pages 258-260)*, to wit:

	Unearned Discount & Interest	Unearned Service & Handling Fees
Total debits during the year	P 88,743,319.25	P 5,926,439.50

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Less: Items debited not pertaining to income		
Adjustments	4,593.00	605.00
Repossessions	5,548,163.00	335,881.00
Sales Return	22,893.00	1,567.00
Change of Terms	52,338.00	1,733.00
Cancellation	7,849.00	486.00
Legal Account	174,376.00	10,386.00
Write-Offs	34,749.00	1,820.00
Overpayments	233.25	19.50
Price Adjustment	1,030.00	
Acceleration	10,801.00	892.00
Change of Interest Rate	120,522.00	
Computer Error	5,322,479.00	
Total	P 11,300,026.25	P 353,389.50
Earned Discount & Interest and Earned Service & Handling Fees	P 77,443,293.00	P 5,573,050.00

To contest the above findings of the revenue examiner, petitioner reconciled the discrepancy between the amount claimed per its income tax return with that of the findings of the examiner regarding the Earned Discount & Interest account and Earned Service & Handling Fees account, thus:

Reconciliation of Interests, Discounts and Financing Fees
(Exhibit P)

	BIR	PHILACOR
Total	P 77,443,293.00	P 63,475,734.00
Difference accounted for in the:		
Official Receipts Register regarding entries to record rebates given to customers on account of paying the account earlier than the initial term agreed upon.	1,776,797.00	
Journal Voucher Register regarding entries to reverse income recorded on cancelled accounts	12,190,762.00	
Reconciled Total	P 63,475,734.00	P 63,475,734.00

Reconciliation of Service and Handling Fees
(Exhibit Q)

	BIR	PHILACOR
Total	P 5,573,050.00	P 4,786,007.00

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Difference is accounted for in the:		
Official Receipts Register regarding entries to record rebates given to customers on account of paying the account earlier than the initial term agreed upon.	128,168.00	
Journal Voucher Register regarding entries to reverse income recorded on cancelled accounts	658,875.00	
Reconciled Total	P 4,786,007.00	P 4,786,007.00

Petitioner claims that the above reconciling items pertain to adjusting entries which were manually recorded to correct the continuous and automatic amortization of unearned income which was done by the previously programmed amortization schedule in the computer *(TSN, March 19, 2002, pp. 15-16)*. Likewise, petitioner presented the Journal Voucher *(Exhibit I)*, Official Receipt Register *(Exhibits J & K)*, and Dealer's Note Purchase Invoice Register *(Exhibit H)* from which the reconciling items were based to support its stand.

With the foregoing conflicting positions of the parties, the court deemed it proper to make its own examination of the documents submitted and based on the available data, the following are the proper charges *(not pertaining to income)* against the Unearned Interest, Discount & Financing Fees and Unearned Service & Handling Fees:

Per Official Receipt Register
(Exhibits J & K)

Particulars	Unearned Discount & Interest	Unearned Service & Handling Fees	Total
August	P 132,360.00	P 11,360.00	P 143,720.00
September	82,656.00	6,320.00	88,976.00
October	96,070.00	8,490.00	104,560.00
November	104,080.00	8,622.00	112,702.00
December	204,234.00	16,173.00	220,407.00
January	127,216.00	9,708.00	136,924.00

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February	142,649.00	10,310.00	152,959.00
March	178,841.00	10,658.00	189,499.00
April	159,200.00	11,711.00	170,911.00
May	129,845.00	9,521.00	139,366.00
June	186,130.00	13,085.00	199,215.00
July	224,685.00	11,620.00	236,305.00
Total	P 1,767,966.00	P 127,578.00	P 1,895,544.00

Journal Voucher Register
(Exhibit I)

Particulars	Unearned Discount & Interest	Unearned Service & Handling Fees	Total
Adjustments	P 8,199,928.00	P 400,579.00	P 8,600,507.00
Repossessions	5,548,163.00	335,881.00	5,884,044.00
Sales Return	22,893.00	1,567.00	24,460.00
Change of Terms	41,919.00	1,466.00	43,385.00
Cancellation	10,849.00	486.00	11,335.00
Legal Account	174,376.00	10,386.00	184,762.00
Write-Offs	34,749.00	1,820.00	36,569.00
Overpayments	32,735.25	538.50	33,273.75
Price Adjustment	1,030.00		1,030.00
Acceleration	10,801.00	892.00	11,693.00
Change of Interest Rate	120,522.00		120,522.00
Computer Error	5,322,479.00		5,322,479.00
Total	P 19,520,444.25	P 753,615.50	P 20,274,059.75

Furthermore, the court noted that the correct total debit amount of Unearned Interest, Discount & Financing Fees and Unearned Service & Handling Fees are P86,814,203.25 and P5,797,705.50, respectively, based on Journal Voucher Register *(Exhibit I)*, detailed as follows:

Schedule of Total Debit to Unearned Discount & Interest
and Unearned Service & Handling Fees per Court's Verification

Particulars	Unearned Discount & Interest	Unearned Service & Handling Fees
August	P 4,961,909.00	P 449,929.00
September	4,763,091.00	442,793.00
October	5,527,100.00	486,731.00
November	5,436,915.00	485,677.00
December	6,335,498.25	494,108.50
January	6,948,041.00	501,355.00
February	11,292,689.00	508,178.00
March	7,428,515.00	528,821.00

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April	6,893,746.00	530,012.00
May	7,316,791.00	304,230.00
June	7,148,574.00	523,179.00
July	12,761,334.00	542,692.00
Total	P 86,814,203.25	P 5,797,705.50

Therefore, the court came up with following underdeclared income of petitioner with respect to Earned Discount & Interest and Earned Service & Handling Fees, to wit:

	Unearned Discount & Interest	Unearned Service & Handling Fees	Total
Total debits during the year	P 86,814,203.25	P 5,797,705.50	P 92,611,908.75
Less items debited not pertaining to income:			
Per Official Receipt Register	1,767,966.00	127,578.00	1,895,544.00
Per Journal Voucher Register	19,520,444.25	753,615.50	20,274,059.75
Total	P 21,288,410.25	P 881,193.50	P 22,169,603.75
Earned Income	**P 65,525,793.00**	**P 4,916,512.00**	**P 70,442,305.00**
Less amount declared in the income tax return	63,475,734.00	4,786,007.00	68,261,741.00
Under declared Income	**P 2,050,059.00**	**P 130,505.00**	**P 2,180,564.00**

As regards the Other Income, the court verified the amounts considered by the examiner against the Other Income declared in petitioner's 1993 income tax return. As a result, the following discrepancies were noted: *(Exhibit R)*

OTHER INCOME	Per BIR	Per Petitioner's ITR	Variance
Other Financing Income	P 3,437,105.32	P 3,432,378.32	P 4,727.00
Interest on Other Loans Receivable	1,119,012.26	1,117,399.26	1,613.00
Interest on Deposits with Banks	784,361.89	784,361.89	-
Income from assets Acquired	114,573.00	114,573.41	(0.41)
Profit from Assets Sold/Exchange	385,255.80	(631,204.82)	1,016,460.62
Dividend Income	1,697.12	1,697.12	-
Miscellaneous Income	840,907.02	652,337.75	188,569.27
Total	P 6,682,912.41	P 5,471,542.93	P 1,211,369.48

Petitioner posits in its memorandum that it cannot account for the above discrepancies because the respondent failed to explain the same.

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Hence, the court re-examined the BIR records and was able to ascertain that the amounts considered by the respondent were taken from the General Ledger Trial Balance *(BIR records, p. 243)*.

After a meticulous scrutiny of the said document, we found that the respondent erred in its analysis of the entries in the Profit from Assets Sold/Exchange. The general ledger trial balance shows that the Profit from Assets Sold/Exchange has a debit balance (i.e, the total amount on the debit side exceeds that of the total amount on the credit side) which means that petitioner incurred losses from its sales of assets in the total amount of P901,941.72. This is contrary to respondent's position that petitioner incurred profit from its disposal of assets in the sum of P385,255.80 *(Exhibit 3)*. Prescinding from the above analysis, we are convinced that petitioner did not underdeclare its Other Income account as presented below:

OTHER INCOME	Per Petitioner's ITR	Per Court's Verification
Other Financing Income	P 3,432,378.32	P 3,437,105.32
Interest on Other Loans Receivable	1,117,399.26	1,119,012.26
Interest on Deposits with Banks	784,361.89	784,361.89
Income from assets Acquired	114,573.41	114,573.41
Profit/(Loss) from Assets Sold/Exchange	(631,204.82)	(901,941.72)
Dividend Income	1,697.12	1,697.12
Miscellaneous Income	652,337.75	840,907.02
Total	P 5,471,542.93	P 5,395,715.30

Therefore, petitioner is only liable to a reduced deficiency income tax in the amount of P1,757,968.17, computed as follows:

Net income per ITR		P 38,600,392.00
Add: Under declared income		
a. Interest, Discount & Financing Fees	P 2,050,059.00	
b. Service & Handling Fees	130,505.00	2,180,564.00
Total Taxable Income		P 40,780,956.00
Income Tax Due (35%)		P 14,273,334.60
Less: Payments made		13,510,137.00

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Basic Deficiency Income Tax Due	P	763,197.60
Add: 25% surcharge		190,799.40
20% interest (11-15-93 to 1-31-98)		803,265.47
Deficiency Income Tax Due	P	1,757,262.47

DEFICIENCY PERCENTAGE TAX

Anent the third issue, the bone of contention of deficiency percentage tax is the respondent's alleged erroneous usage of the prompt payment discount factor as his basis for the assessment, computed as follows:

Total Credits to:	
Unearned Discount & Interest	P 95,824,181.00
Unearned Service & Handling Fees	6,708,137.00
Total	P102,532,318.00
Divided by Total Credits to Prompt Payment Discount (PPD is directly proportional to Unearned Discount & Interests and Service & Handling Fees)	P 7,248,598.00
Prompt Payment Discount Factor (PPD Factor)	14.1451

While petitioner does not dispute the computation of respondent in arriving at the prompt payment discount factor, it however questions the improper application of such factor in arriving at the alleged total debits to Unearned Discount & Interest and Unearned Service & Handling Fees.

Respondent claims that the total credit of Unearned Discount & Interest and Unearned Service & Handling Fees is directly proportional to the total credit of Prompt Payment Discount. Therefore, he concluded that the total debit to Prompt Payment Discount has also the same proportion (PPD factor) with that of the Earned Discount & Interest and Earned Service & Handling Fees. The deficiency percentage tax in the amount of P1,185,976.96 is computed as follows: *(BIR records, pp. 257-258)*

Total Debits to Prompt Payment Discount	P 6,082,074.27

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Multiply by PPD Factor		14.1451
Total Debits to Unearned Discounts & Interests/Service & Handling Fees directly related to PPD		P86,031,548.76
Less: Items debited not pertaining /classified as income		11,653,415.75
Gross Receipts on Earned Discounts & Interest and Service & Handling Fees		P 74,378,133.01
Add: Other Financing Income	P3,437,105.32	
Interest on Other Loans Receivable	1,119,012.26	
Interest on Deposits with Banks	784,361.89	
Income from Assets Acquired	114,573.00	
Profit from Asset Sold/Exchanged	385,255.80	
Dividend Income	1,697.12	
Miscellaneous Income	840,907.02	6,682,912.41
Total Gross Receipts for the Year		P 81,061,045.42
Less: Gross Receipts Reported Per Percentage Tax Return		71,211,824.87
Understated Gross Receipts Subject to Percentage Tax		P 9,849,220.55
Multiply by Percentage Tax Rate (Sec. 120)		5%
Deficiency Percentage Tax		P 492,461.03
Add: 25% Surcharge		123,115.26
Interest		545,400.68
Compromise Penalty		25,000.00
Total Deficiency Percentage Tax		**P 1,185,976.96**

Contrariwise, petitioner contends that there is no direct relationship between the two unearned income accounts and the Prompt Payment Discount account. Petitioner posed in its memorandum the following explanation:

> "This is patently erroneous because there is no direct relationship between unearned income and Prompt Payment Discount. Firstly, debits to "Unearned Discount and Interest" and "Unearned Service and Handling Fees" are always credited against their respective income accounts for purposes of amortizing unearned income, while debits to "Prompt Payment Discount" are not always credited against an income account because when the customer pays on or before due date, the credit is to the asset account "Finance Receivable" which effectively decreases such asset. Secondly, unearned income is debited to reflect its amortization, and because Philacor Credit follows the accrual basis of accounting, this is done regardless whether the customer pays or not. On the other hand, the debits to "Prompt Payment Discount" are only done if there is a payment because if there is no payment, no accounting entry is made. In short, it is dependent upon whether the customer pays or not, and if the customer pays, whether the customer pays on or before the due date *(TSN, 19 March 2002, pp. 28-34, also TSN, 7 March 2001, pp. 10-16)*."

We find the ratiocination of petitioner meritorious.

While it is true that when petitioner approves a financing transaction, the amount credited to Prompt Payment Discount account represents 14.1451 times of the total amount credited to Unearned Discount & Interest and Unearned Service & Handling Fees, it is, however, erroneous to assume that the similar factor can be applied to the total debit of Prompt Payment Discount in order to eventually arrive at the total Earned Discount & Interest and Earned Service & Handling Fees.

It is to be noted that a debit to Prompt Payment Discount is made on three occasions – (1) payment on time; (2) late payment; and (3) closing of accounts (due to repossession, etc.). These three situations have different effects on petitioner's business. Payment of client on time and closing of financing account do not result to recognition of income. It is only when a client pays late that petitioner can realize income from a particular transaction. It is also worth stressing that a debit entry to Prompt Payment Discount results to a credit to Miscellaneous Income or Finance Receivable and not to Earned Discount & Interest and Earned Service & Handling Fees. Therefore, it does not follow that the total amount reflected on the debit side of Prompt Payment Discount account is also 14.1451 times that of the total Earned Discount & Interest and Earned Service & Handling Fees and charges pertaining to income.

Corollary thereto, the court believes that the actual controversy lies on the correct tax base in computing the percentage tax liability of petitioner.

Respondent argues that the tax base consists of all income including but not limited to interest, dividends and other miscellaneous income whether or not subjected to the final tax *(Exhibit 5, BIR Records, page 255).*

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Records show that petitioner's business is embraced under Title V (Other Percentage Taxes) of the Tax Code. Specifically, petitioner is liable to percentage tax at the rate of 5% on its gross receipts pursuant to Section 120 of the Tax Code, to wit:

> "***Sec. 120. Tax on finance companies.*** *– There shall be collected a tax of five per centum on the gross receipts derived by all finance companies as well as other financial intermediaries not performing quasi-banking functions doing business in the Philippines from* <u>*interests, discounts, and all other items treated as gross income under this Code:*</u> **Provided**, *That, interests, commissions and discounts from lending activities, as well as income from financial leasing shall be taxed, on the basis of remaining maturities of the instruments from which such receipts are derived in accordance with the following schedule:*
>
> xxx xxx xxx
>
> (Underlining supplied)

Thus, the term "gross receipts" is not limited to interest and discounts but also includes all other items treated as gross income. Gross income is defined under Section 28 of the Tax Code as:

> "**Sec. 28. Gross Income.** – (a) **General definitions**. – *"Gross income" means all income from whatever source derived, including (but not limited to) the following items:*
>
> *(1) Compensation for services, including fees, commissions, and similar items;*
> *(2) Gross income derived from business;*
> *(3) Gains derived from dealings in property;*
> *(4) Interest;*
> *(5) Rents;*
> *(6) Royalties;*
> *(7) Dividends;*
> *(8) Annuities;*
> *(9) Prizes and winnings;*
> *(10) Pensions; and*
> *(11) Partner's distributive share of the gross income of general professional partnership.*

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Based on the quarterly percentage tax returns, petitioner derived the following gross receipts during the year fiscal year ended July 31, 1993, to wit:

QUARTER INVOLVED	EXHIBIT	GROSS RECEIPTS	TAX DUE
1st Quarter	B	P 15,945,484.72	P 797,274.00
		93,615.76	2,809.00
2nd Quarter	C	17,287,006.75	864,350.33
		48,771.00	1,463.13
3rd Quarter	D	18,492,840.24	934,642.00
		28,676.04	860.00
4th Quarter	E	19,285,351.82	964,268.00
		30,078.54	902.00
Total		P 71,211,824.87	P 3,566,568.46

Earlier, we have ruled that the total correct amounts of Earned Discount & Interest and Earned Handling & Service Fees are P65,525,793.00 and P4,916,512.00, respectively. These amounts together with the amounts declared by petitioner in its 1993 income tax return as Other Income should be the proper tax base in computing the percentage tax liability. To recapitulate, the gross receipts of petitioner based on our own finding should be P76,545,052.75, broken down as follows:

	Amount
Earned Discount & Interest	P 65,525,793.00
Earned Service & Handling Fees	4,916,512.00
Other Income:	
Other Financing Income	3,432,378.32
Interest on Other Loans Receivable	1,117,399.26
Interest on Deposits with Banks	784,361.89
Income from assets Acquired	114,573.41
Dividend Income	1,697.12
Miscellaneous Income	652,337.75
Total Gross Receipts	P 76,545,052.75

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Inasmuch as petitioner declared only the amount of P71,211,824.87 as its total gross receipts in its 1993 quarterly percentage tax returns, there is an evident deficiency percentage tax still due to petitioner in the amount of P614,234.43, computed as follows:

		Amount
Total Gross Receipts for the Year	P	76,545,052.75
Less Gross Receipts Reported in the Percentage Tax Returns		71,211,824.87
Under declared Gross Receipts	P	5,333,227.88
Multiply by GRT rate		5%
Basic Deficiency Gross Receipts Tax	P	266,661.39
Add: 25% surcharge		66,665.35
20% interest		280,661.12
Deficiency Gross Receipts Tax Due	P	613,987.86

DEFICIENCY DOCUMENTARY STAMP TAX

Lastly, the deficiency documentary stamp tax assessment is anchored on respondent's observation that the promissory notes (PNs) which petitioner claimed to have been subjected by the dealers to documentary stamp tax (DST) were not properly declared as part of its expenses. According to respondent, even assuming that the DST were passed on to dealers or customers, then these should have formed part of the taxpayer's gross receipt and/or revenues. However, based on the examination conducted, no income or receipt from these sources was reported. And since petitioner failed to establish that indeed said DST were paid, respondent assessed petitioner of a deficiency DST. In arriving at the total deficiency DST of P3,368,169.45, respondent used as legal bases Sections 174, 186 and 198 of the 1993 Tax Code *(Exhibit 3, BIR records, p. 257)*, detailed as follows:

We find the sections cited by respondent not applicable.

Section 198 actually speaks of:

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- assignment or transfer of mortgage, lease or policy of insurance
- renewal or continuance of any agreement, contract, charter or any evidence of obligation and indebtedness

True enough, the subject promissory notes do not fall under any of the documents as described above. It can never be said that it is a renewal of the evidence of indebtedness as nothing in the subject promissory notes would indicate that they are in fact renewed. Renewal, as commonly used with reference to notes and bonds, means to continue in force for a fresh period, importing a postponement of maturity of obligations dealt with *(Black's Law Dictionary, 6th Edition).*

Neither is Section 186 applicable as said provision deals mainly with DST on annuities and pre-need plans. Section 174 is likewise not applicable as what is taxed under said section are bonds, debentures and certificates of indebtedness issued by any association, company or corporations. Although it may appear that the subject promissory notes may fall under the term certificate of indebtedness, this is not so upon further scrutiny of the said term as used in Section 174. As defined, the term certificate of indebtedness refers to an instrument having the general character of investment securities issued by a corporation as distinguished from an instrument evidencing debts arising in ordinary transactions between individuals *(Section 9, Revenue Regulations No. 26, Revised Documentary Stamp Tax Regulations).* The subject promissory notes, being issued merely by individuals in a transaction involving loans on appliances cannot fall under the said section.

However, the subject promissory notes are not entirely exempt from DST. Since the issue stipulated upon by the parties involves the question of whether the promissory note is subject to DST, this court, on this aspect resolves the issue in the affirmative. Thus, the more applicable provision of law with regard to the matter is Section 180, in relation to Section 173 of the 1993 Tax Code, to wit:

> "***Section 180. Stamp tax on promissory notes, bills of exchange, drafts, certificates of deposit bearing interest and others not payable on sight or demand.*** – On all bills of exchange (between points within the Philippines), drafts or certificates of deposits drawing interest, or orders for the payment of any sum of money otherwise than at sight or on demand, or on all promissory notes, whether negotiable or non-negotiable, except bank notes issued for circulation, and on such renewal of any such note, there shall be collected a documentary stamp tax of twenty centavos on each two hundred pesos, or fractional part thereof, of the face value of any such bill of exchange, draft, certificate of deposit, or note. *(underlining ours).*"
>
> ***Section 173. Stamp taxes upon documents, instruments, and papers.*** - Upon documents, instruments, and papers and upon acceptances, assignments, sales and transfers of the obligation, right, or property incident thereto, there shall be levied, collected and paid for, and in respect of the transaction so had or accomplished, the corresponding documentary stamp taxes prescribed in the following sections of this Title, by the person making, signing, issuing, accepting or transferring the same, and at the same time such act is done or transaction had: Provided, That whenever one party to the taxable document enjoys exemption from the tax herein imposed, the other party thereto who is not exempt shall be the one directly liable for the tax.

It is clear from the foregoing provisions that a documentary stamp tax is a tax on documents, instruments and papers evidencing the acceptance, assignment, sale or transfer of an obligation, right or property incident thereto whereby both the person issuing and the person to whom the document is issued as well as the subsequent transferee thereof may be held liable for the tax. It is an excise tax because it is imposed on the privilege to enter into a transaction.

The subject documents involved here are promissory notes issued by the buyers of appliances in favor of the dealers as payee and then assigned to petitioner. The question would be: Is the assignment of said notes to petitioner subject to DST?

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As can be inferred from afore-quoted provisions, a promissory note, whether accepted, assigned or transferred shall be subject to a corresponding DST, which is paid for by anyone who signed, issued, accepted or transferred the said instrument. In other words, the subsequent transfer of said promissory note is subject to DST at the same rate prescribed in the aforesaid Section 180 of the Tax Code. Thus, the party liable for the payment thereof may be the party transferring the note or the one using it. Section 42 of Regulations No. 26, otherwise known as the Revised Documentary Stamp Tax Regulations, provides:

> ***"Section 42. Responsibility for payment of tax on promissory notes. -*** The person who signs or issues a promissory note **and** any person transferring or using a promissory note can be held responsible for the payment of the documentary stamp tax *(emphasis ours).*"

Readily, the legal conclusion is that petitioner, having accepted the promissory notes (being the user/transferee thereof), is liable to pay for the deficiency DST absent any proof of previous payment of the corresponding DST on the subject notes. Thus, the deficiency documentary stamp tax is computed as follows:

Total Notes purchased during the taxable year	P 269,453,556.94
Divided by rate under Section 180	200.00
Basis of DST	P 1,347,267.78
Multiply by DST rate (Sec. 180, 1993 Tax Code)	.20
DST on notes purchased	P 269,453.55
Add: Total DST on Notes assigned (Section 180)	269,453.55
Deficiency Documentary Stamp Tax	P 538,907.10
Add: 25% surcharge	134,726.78
Total Deficiency Documentary Stamp Tax	P 673,633.88

It must be pointed out that since DST is intended to be a tax on the privilege to enter into a transaction, then it must attach on the first issue as well as its subsequent negotiation. Thus, under normal circumstances, the party who originally issued the note

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and the party who transferred the note must pay the DST attached to negotiated promissory notes. Since it was not shown that the subject notes were previously subjected to DST, then petitioner, as the subsequent transferee who accepted the note, could be held liable to pay the unpaid DST on the document pursuant to Section 173 of the Tax Code.

It likewise bears stressing that RA 7660, otherwise known as "An Act Rationalizing Further the Structure and Administration of the Documentary Stamp Tax", cannot find application in the case at bar. Apparently, the said law which exempts promissory notes the aggregate amount of which does not exceed P250,000.00 executed by an individual for his purchase on installment for his personal use or that of his family applies only to those transactions entered into beginning January of 1994. Obviously, the promissory notes in this case executed on fiscal year ended July 31, 1993 do not fall within the coverage of the said law.

WHEREFORE, the petition for review is ***PARTIALLY GRANTED.*** Accordingly, petitioner is hereby **ORDERED to PAY** the respondent the reduced amount of P3,044,884.21 representing deficiency income, percentage and documentary stamp tax for the fiscal year ended July 31, 1993, computed as follows:

DEFICIENCY INCOME TAX

Basic Deficiency Income Tax Due	P 763,197.60	
Add: 25% Surcharge	190,799.40	
20% interest (11-15-93 to 1-31-98)	803,265.47	
Total Deficiency Income Tax Due		P 1,757,262.47

DEFICIENCY PERCENTAGE TAX

Basic Deficiency Gross Receipts Tax	P 266,661.39	
Add: 25% surcharge	66,665.35	
20% interest	280,661.12	
Total Deficiency Gross Receipts Tax Due		613,987.86

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DEFICIENCY DOCUMENTARY STAMP TAX

Basic Documentary Stamp Tax Due	P 538,907.10	
Add: 25% Surcharge	134,726.78	
Total Documentary Stamp Tax Due		673,633.88
GRAND TOTAL		P 3,044,884.21

plus 20% delinquency interest computed from March 2, 1998 until the amount is fully paid pursuant to Section 249(c) of the Tax Code.

SO ORDERED.

ERNESTO D. ACOSTA
Presiding Judge

WE CONCUR:

JUANITO C. CASTAÑEDA, JR.
Associate Judge

LOVELL R. BAUTISTA
Associate Judge

CERTIFICATION

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

ERNESTO D. ACOSTA
Presiding Judge

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