REPUBLIC OF THE PHILIPPINES
Court of Tax Appeals
QUEZON CITY

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COMMISSIONER OF INTERNAL REVENUE, *Petitioner,*	**C.T.A. EB NO. 352 (C.T.A. CASE NO. 6753)**
	Present:
-versus-	ACOSTA, Presiding Justice, CASTAÑEDA, JR., BAUTISTA, UY, CASANOVA, and PALANCA-ENRIQUEZ, JJ.
LANCASTER PHILIPPINES, INC., *Respondent.*	**Promulgated:** APR 3 0 2008 1:35 p.m.

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DECISION

PALANCA-ENRIQUEZ, J.:

THE CASE

This is a Petition for Review filed by the Commissioner of Internal Revenue (hereafter "petitioner") under *Section 11 of RA 9282 (An Act Expanding the Jurisdiction of the Court of Tax Appeals)*, in relation to *Rule 43 of the 1997 Rules of Civil Procedure*, as amended, which seeks to reverse and set aside the Decision dated September 12, 2007 granting the

Petition for Review rendered by the First Division of this Court in C.T.A. Case No. 6753, the dispositive portion of which reads as follows:

> "**IN VIEW OF THE FOREGOING,** the subject Petition for Review is hereby **GRANTED**. Accordingly, respondent is **ORDERED** to **CANCEL** and **WITHDRAW** the deficiency income tax assessment issued against petitioner under Formal Letter of Demand and Audit Result/ Assessment Notice No. LTAID II IT-98-00007 dated October 11, 2002, in the amount of P6,466,065.50, covering the fiscal year from April 1, 1998 to March 31, 1999.
>
> **SO ORDERED.**"

The Commissioner of Internal Revenue's Motion for Reconsideration was denied by the First Division in its Resolution dated December 12, 2007, the dispositive portion of which reads as follows:

> "**WHEREFORE**, finding no compelling reasons to justifiably amend or overturn this Court's Decision of September 12, 2007, respondent's "Motion for Reconsideration" is hereby **DENIED** for lack of merit.
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> **SO ORDERED.**"

THE FACTS

The facts are not in dispute:

Petitioner is the duly appointed Commissioner of Internal Revenue mandated by law and vested with the authority to administer, enforce and

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implement national internal revenue laws, as well as related statutes and their implementing rules and regulations.

Respondent Lancaster Philippines, Inc., on the other hand, is a corporation duly organized and existing under the laws of the Republic of the Philippines engaged in the production, processing and marketing of tobacco since 1963. It is a subsidiary of Lancaster Leaf Tobacco Company of Lancaster, Pennsylvania, U.S.A.

On September 19, 2002, petitioner sent a Preliminary Assessment Notice (PAN) dated September 16, 2002 to respondent, demanding payment of its deficiency income taxes in the amount of P6,466,065.50.

On October 3, 2002, respondent filed its reply to the PAN, contending, among others, that for the past decades, it had utilized an entire tobacco-cropping season in determining its total purchases which covers a one (1) year period from October up to September of the following year. Respondent further alleged that it has adopted the 6-month timing difference to conform to the matching concept and the said method has been installed as part of its system and it has been consistently applying the same in its accounting books.

On November 6, 2002, respondent received a Formal Letter of Demand and Audit Result/Assessment Notice LTAID II IT-98-00007, both dated October 11, 2002, reiterating respondent's income tax liability of P6,466,065.50 and demanding from respondent to pay the same.

On December 2, 2002, respondent filed a formal protest, contesting the deficiency tax assessment made by the petitioner. Thereafter, on January 27, 2003, respondent filed with the petitioner its "Supplemental Protest" together with the documents supporting its arguments.

Due to petitioner's inaction to respondent's protest, on August 21, 2003, respondent filed a "Petition for Review" with this Court, docketed as C.T.A. Case No. 6753.

In his Answer, the Commissioner of Internal Revenue interposed the following special and affirmative defenses:

> "4. In the examination of the books of accounts and pertinent documents of petitioner, overstated purchases were added back to taxable income for purposes of computing the income tax due for the year. Though it was being contested by petitioner, alleging that pertinent Purchase Invoice Vouchers of February and March 1998 should form part of its purchases, it was disallowed for being in violation of Section 43 of the Tax Code which requires that the taxable income should be computed upon the basis of the taxpayer's annual accounting period (fiscal or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer. Furthermore, it did not comply

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with the generally accepted accounting principle of proper matching of cost and revenue.

5. Purchases of leaf tobacco from traders were reflected in the Purchase Invoice Vouchers (PIV's). LFS accounts, on the other hand, are company-funded advances to various farmers for the planting and harvesting of tobacco leaf for the company. To finance said advances, the company has an existing inter-company foreign currency denominated loan. Since no breakdown of monthly Cost of Sales transactions were provided and only an incomplete Tally Sheets listing of the farmers were made available, the credits to LFS accounts were considered as the value of leaf tobacco purchased from various farmers. After evaluating the PIV schedules submitted and the credits to LFS accounts based on the General Ledger abstract, discrepancies were noted amounting to P11,496,770.18 representing purchases for the months of February & March 1998.

6. The assessments were issued in accordance with the law and regulations.

7. All presumptions are in favor of the correctness of tax assessments."

On October 24, 2003, Lancaster Philippines, Inc. filed its Reply, maintaining that the posting of its Purchase Invoice Vouchers (PIV) as part of its purchases for the taxable year 1998, is in accordance with *Section 43 of the Tax Code, as amended*, and with the generally accepted accounting principle of proper matching of cost and revenue.

On September 12, 2007, the First Division rendered judgment in the terms earlier set forth.

On October 2, 2007, the Commissioner of Internal Revenue petitioner filed a "Motion for Reconsideration."

On November 14, 2007, an "Opposition to the Motion for Reconsideration" was filed by Lancaster Philippines, Inc.

On November 22, 2007, the Commissioner of Internal Revenue filed a "Reply to the Petitioner's Opposition to Respondent's Motion for Reconsideration".

In a Resolution dated December 12, 2007, the First Division denied the Commissioner of Internal Revenue's "Motion for Reconsideration" for lack of merit.

Hence, this Petition For Review raising the sole:

ISSUE

WHETHER OR NOT RESPONDENT LANCASTER PHILIPPINES, INC. IS LIABLE FOR DEFICIENCY INCOME TAX ASSESSMENT IN THE AMOUNT OF P6,466,065.50 COVERING THE FISCAL YEAR FROM APRIL 1, 1998 TO MARCH 31, 1999.

On January 24, 2008, without necessarily giving due course to the petition, We required respondent to file its comment, not a motion to dismiss, within ten (10) days from notice.

On February 18, 2008, respondent filed its Comment.

Hence, the petition is now deemed submitted for decision.

THE COURT *EN BANC'S* RULING

The petition is devoid of merit.

Petitioner CIR'S
Arguments

Petitioner maintains that respondent is liable for deficiency income tax amounting to P6,466,065.50 for fiscal year April 1998 to March 1999; that respondent made an overstatement of purchases amounting to P11,496,770.18 for taxable year 1998, in violation of *Sections 43 and 45 of the NIRC of 1997, as amended,* in relation to *Revenue Regulations No. 2*; that respondent's application of the six-month timing difference to conform to the matching of cost and revenue, in relation to its accounting method to determine its income, is without petitioner's approval; and petitioner's examiners did not exceed their authority in investigating respondent's taxable period not covered by the Letter of Authority.

Respondent Lancaster Philippines, Inc.'s
Counter-Argument

Respondent counter-argues that despite respondent's consistent use of the timing difference, petitioner did not issue any assessment for the previous fiscal years, nor assessment for the fiscal year following the fiscal year in question.

Well settled is the rule that an audit process to which a particular taxpayer may be subjected begins when a Letter of Authority is issued by the Commissioner of Internal Revenue. The Letter of Authority is an official document that empowers a Revenue Officer to examine and scrutinize a taxpayer's books of accounts and other accounting records, in order to determine the taxpayer's correct internal revenue tax liabilities.

In this regard, Revenue Audit Memorandum Order (RAMO) No. 2-95 provides that a Letter of Authority authorizes or empowers a designated revenue officer to examine, verify and scrutinize a taxpayer's books and records, in relation to internal revenue tax liabilities for a particular period *(RAMO 2-95, VIII [C]) [b] [b.2]).*

In this case, the Letter of Authority No. 000012289, dated September 30, 1999, which was the basis of the BIR to examine respondent's books of account clearly stated that the examination covers only the taxable year 1998 *(Exhibit "A").* The Letter of Authority reads as follows:

"LETTER OF AUTHORITY

SEP 30 1999

LANCASTER PHILS. INC.
11th Flr. Metro Bank Plaza
Makati City

SIR/MADAM/GENTLEMEN:

The bearer(s) hereof RO's Irene Goze & Rosario Padilla to be supervised by GII Catalina Leny Barrion of the Special Team created pursuant to RSO 770-99 is/are authorized to examine your books of accounts and other accounting records for all internal revenue taxes for the period from taxable year, 1998 to ________, 19__. He is/ They are provided with the necessary identification card(s) which shall be presented to you upon request.

It is requested that all facilities be extended to the Revenue Officer(s) in order to expedite the examination.

You will be duly informed of the results of the examination upon approval of the report submitted by the aforementioned Revenue Officer(s).

Very truly yours,

(SGD.) BEETHOVEN L. RUALO"

In the Preliminary Assessment Notice issued by the Bureau of Internal Revenue on September 16, 2002, it is also clearly stated that the investigation is for the year 1998. Pertinent portion of the Preliminary Assessment Notice reads as follows:

"September 16, 2002

The President
LANCASTER PHILS., INC.
24/F Discovery Centre, 23 ADB Ave.,
Ortigas Center, Pasig City

Sir:

Please be informed that after investigation of your income tax liabilities for year 1998 pursuant to Letter of Authority No. 12289 dated September 30, 1999, there has been found due from you, deficiency taxes as shown hereunder.

Assessment No. LTAID II IT-98-00007

INCOME TAX:	
Taxable Income per ITR	-o-
Add: Adjustments -Disallowed purchases	11,496,770.18
Adjusted Taxable Income per investigation	P11,496,770.18
INCOME TAX DUE-Basic	
April 1-December 31, 1998	
(9/12 x P11,496,770.18 x 34%)	P2, 913, 676.40
January 1-March 31, 1999	
(3/12 x P11,496,770.18 x 33%)	948,483.54
Income tax still due per investigation	P 3,880,159.94
Interest (6/15/99 to 10/15/02) .66	2,560,905.56
Compromise Penalty	25,000.00
TOTAL DEFICIENCY INCOME TAX	P 6,466,065.50

DETAILS OF DISCREPANCIES
Assessment No. LTAID II IT-98-00007

A. **INCOME TAX (P3,880,159.94)**- Taxpayer's fiscal year covers April 1998 to March 1999. Verification of the books of accounts and pertinent documents disclosed that there was an overstatement of the purchases for the year. Purchase Invoice Vouchers (PIVs) for February and March 1998 purchases amounting to P11,496,770.18 were included as part of purchases for taxable year 1998 in violation of Sec. 45 of the National Internal Revenue Code in relation Sec. 43 of the same and Revenue Regulations No.2 which states that the Crop-Basis method of reporting income may be used by a **farmer** engaged in producing crops which take more than one (1) year from the time of planting to the time of gathering and disposing of

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> crop, in such a case, the entire cost of producing the crop must be taken as deduction in the year in which the gross income from the crop is realized and that the taxable income should be computed upon the basis of taxpayer's annual accounting period, (fiscal or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping with the books of taxpayer. Furthermore, it did not comply with the generally accepted accounting principle of proper matching of cost and revenue."
>
> xxx xxx."

It is clear from the aforequoted assessment notice, that the income tax due was computed on the basis of respondent's transactions/purchases made during the fiscal year April 1, 1998 to March 31, 1999, which is beyond the 1998 taxable year indicated in the Letter of Authority.

Thus, the First Division aptly ruled:

> "Records reveal that respondent's alleged authority to examine petitioner's books of accounts which eventually led to his issuance of an assessment of deficiency income taxes against petitioner was pursuant to the Letter of Authority (LOA) No.00012289 dated September 30, 1999. The said LOA was issued giving the revenue examiners of the Bureau of Internal Revenue the authority to examine the books of accounts of petitioner for the taxable year 1998. In this case, given that petitioner adopts a fiscal year which starts from April 1 and end March 31 the following year, it follows then that the taxable year 1998 referred to in LOA is the fiscal year covering the period from April 1, 1997 to March 31, 1998. To rule otherwise would effectively allow respondent to examine petitioner's books of accounts not only those covered for the year 1998, but extends to those made during the year 1999. Hence, per LOA No.00012289, the revenue examiner's authority to investigate petitioner's books was limited only to its transactions covering the fiscal period from April 1, 1997 to March 31, 1998."

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Upon a careful review of the evidence on record, We concur with the above findings of the First Division that the subject deficiency income tax assessment of P6,466,065.50 against herein respondent should be considered without force and effect due to the fact that said deficiency assessment issued by petitioner covered not only the taxable year 1998, but extended to taxable year 1999 which is beyond the period covered in the Letter of Authority.

Petitioner's contention that respondent violated *Sections 43 and 45 of the NIRC of 1997, as amended,* and *Revenue Regulations No. 2*, when respondent made an overstatement of its purchases for the fiscal year covered from April 1, 1998 to March 31, 1999, by including purchases made for the months of February and March 1998 in the amount of P11,496,770.18, is likewise devoid of merit.

Sections 43 and 45 of the NIRC of 1997, as amended, provide as follows:

> "SEC. 43. General Rule-The taxable income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; xxx"

"SEC. 45. Period for which Deductions and Credits Taken- The deductions provided for in this Title shall be taken for the taxable year in which 'paid or accrued' or 'paid or incurred,' dependent upon the method of accounting upon the basis of which the net income is computed, unless in order to clearly reflect the income, the deductions should be taken as of different period. xxx"

A careful examination of the evidence on records clearly shows that there is no violation made by the respondent.

First, the respondent did not deviate from its original accounting period it employed in keeping its books, which in this case, is covered by the fiscal year.

Second, respondent's usage of the crop year basis as its accounting method is in accordance with the law, as provided in *Section 45 of Revenue Regulations No. 2*, which provides as follows:

"SEC. 45. Gross Income of Farmers-

xxx If a farmer is engaged in producing crops which take more than a year from the time of planting to the time of gathering and disposing, the income therefrom may be computed upon the crop basis; but in any such cases the entire cost of producing the crop must be taken as a deduction in the year in which the gross income from the crop is realized."

Corollary thereto, *Revenue Audit Memorandum 2-95* defines the crop year basis accounting method as follows:

"II. Accounting Methods

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> F. Crop Year Basis is a method applicable only for farmers engaged in the production of crops which take more than a year from the time of planting to the process of gathering and disposal. Expenses paid or incurred are deductible in the year the gross incomes from the sale of the crops are realized."

Considering that respondent is engaged in the production of tobacco, it applied the crop year basis in determining its total purchases for each fiscal year. Thus, respondent's total cost for the production of its crops, which includes its purchases, must be taken as a deduction in the year in which the gross income is realized. Thus, We agree with the following ratiocination of the First Division:

> "Evident from the foregoing, the crop year basis is one unusual method of accounting wherein the entire cost of producing the crops (including purchases) must be taken as a deduction in the year in which the gross income from the crop is realized. Since the petitioner's crop year starts in October and ends in September of the following year, the same does not coincide with petitioner's fiscal year which starts in April and ends in March of the following year. However, the law and regulations consider this peculiar situation and allows the costs to be taken up at the time the gross income from the crop is realized, as in the instant case."

Respondent's fiscal period is from April 1, 1998 to March 31, 1999. On the other hand, its crop year is from October 1, 1997 to September 1, 1998. Accordingly, in applying the crop year method, all the purchases made by the respondent for October 1, 1997 to September

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1, 1998 should be deducted from the fiscal year ending March 31, 1999, since it is the time when the gross income from the crops is realized.

As further explained by the First Division:

> "Clearly, for the fiscal period April 1, 1998 to March 31, 1999, petitioner's corresponding crop year was from October1, 1997 to September 1, 1998. In this regard, all purchases made by the petitioner for the period cover from October 1, 1997 to September 1, 1998 related to the said crop year are then deductible in its fiscal year ending March 31, 1999. While the purchases in question were made during the months of February and March of 1998, the same is still considered deductible costs for the fiscal year ending March 31, 1999, in order to conform to the generally accepted accounting principles of matching of cost and revenue."

For all the foregoing, We therefore conclude that the assessment in question is invalid. The Letter of Authority No. 000012289 which granted the revenue officer the right to audit the books of herein respondent, which resulted to the subject assessment, only authorized the revenue officer to investigate respondent's tax liabilities for the year 1998. The overstated purchases made by respondent in the amount of P11,496,770.18, which resulted to the alleged tax deficiency of P6,466,065.50, should be deducted for the fiscal year ending March 31, 1999. Clearly, therefore, the subject assessment amounting to

P6,466,065.50 is clearly without factual and legal basis, for having been issued beyond the period covered in the Letter of Authority.

Finding no reversible error, We affirm the assailed Decision dated September 12, 2007 and Resolution dated December 12, 2007 of the First Division.

WHEREFORE, premises considered, the present Petition for Review is hereby **DENIED DUE COURSE**, and, accordingly **DISMISSED** for lack of merit.

SO ORDERED.

OLGA PALANCA-ENRIQUEZ
Associate Justice

WE CONCUR:

ERNESTO D. ACOSTA
Presiding Justice

JUANITO C. CASTANEDA, JR.
Associate Justice

LOVELL R. BAUTISTA
Associate Justice

(On Official Business)
ERLINDA P. UY
Associate Justice

CAESAR A. CASANOVA
Associate Justice

CERTIFICATION

Pursuant to Section 13, Article VIII of the Constitution, it is hereby certified that the above Decision has been reached in consultation with the members of the Court *En Banc* before the case was assigned to the writer of the opinion of the Court.

ERNESTO D. ACOSTA
Presiding Justice