REPUBLIC OF THE PHILIPPINES
Court of Tax Appeals
QUEZON CITY

SECOND DIVISION

MILWAUKEE INDUSTRIES CORPORATION,
Petitioner,

- versus -

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

C.T.A. CASE NO. 6202

Members:

CASTAÑEDA, JR., *Chairperson*
UY, *and*
PALANCA-ENRIQUEZ, *JJ.*

Promulgated:

JAN 1 6 2008
4:00 p.m.

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DECISION

UY, J.:

This is a Petition for Review praying for the cancellation and/or withdrawal of assessments imposing deficiency income, expanded withholding, and value-added taxes in the aggregate amount of P173,063,711.58, inclusive of increments, for taxable year ended December 31, 1997.

THE FACTS

Milwaukee Industries Corporation (Petitioner) is a domestic corporation duly organized and existing under the laws of the Republic of the Philippines.[1]

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[1] Par. 1, Summary of Stipulated Facts, Joint Stipulation of Facts and Issues; Docket, p. 62.

On the other hand, the Commissioner of Internal Revenue (Respondent) is the public officer authorized under the National Internal Revenue Code of 1997 (Tax Code) to examine and to assess any taxpayer the correct amount of internal revenue tax.[2]

In July 1998, respondent served Letter of Authority No. 000018418 on petitioner to examine the latter's books of accounts and other accounting records for "all internal revenue taxes" for "1997 & unverified prior years."[3] In the course of the examination, petitioner submitted the documents requested by respondent and became part of the BIR records.[4]

On January 21, 2000, petitioner received three (3) undated assessment notices with an accompanying demand letter and details of discrepancies.[5] The deficiency income, expanded withholding, and value-added taxes in the aggregate amount of P173,063,711.58, inclusive of increments, were computed as follows:[6]

	Basic Tax	Interest	Compromise Penalty	Total
Deficiency Income Tax ST-Income-97-0093-2000	P 43,114,980.66	P20,264,040.91	25,000.00	**P63,404,021.57**
Deficiency Expanded Withholding Tax ST-EWT-97-0092-2000	19,438.95	9,284.23	1,000.00	**29,723.18**
Deficiency Value-Added Tax ST-VAT-97-0091-2000	72,108,530.81	37,496,436.02	25,000.00	**109,629,966.83**
TOTALS	**P115,242,950.42**	**P57,769,761.16**	**P51,000.00**	**P173,063,711.58**

[2] Par. 2, Summary of Stipulated Facts; *ibid.*
[3] Par. 3, Summary of Stipulated Facts: *ibid.*, p. 63.
[4] Par. 4, Summary of Stipulated Facts; *ibid.*
[5] BIR Records, pp. 1721-1731.
[6] Par. 5, Summary of Stipulated Facts; *ibid.*

On February 21, 2000, petitioner through counsel protested the assessment by requesting reconsideration thereof.[7]

On April 24, 2000, petitioner submitted all relevant documents in support of the protest and manifested that its protest dated February 21, 2000 and the documents previously submitted to the BIR examiners which formed part of the BIR records, constituted as relevant supporting documents of the protest in compliance with Section 228 of the Tax Code.[8]

To date, no decision has been made by respondent on the protest, notwithstanding that one hundred eighty (180) days had passed since the submission of the documents on April 24, 2000. Consequently, in order to comply with the thirty (30)-day period for filing an appeal with the Court of Tax Appeals counted from the 180-day period given to respondent to decide the protest, the Petition for Review was filed on November 20, 2000 for the purpose of having the assessment cancelled and/or withdrawn.[9]

On January 16, 2001, respondent through counsel filed an Answer and asserted the following Special and Affirmative Defenses:

> "5. Investigation conducted revealed that petitioner realized a gross profit in the amount of P90,713,406.43 as a result of a consummated sale between Petitioner and Littlegiant Steel Pipe Corporation, an affiliate, but was not recorded in petitioner's books as purchases in 1997 although payments thereof in domestic Letters of Credit have been recorded in the books as loans.
>
> 6. Verification disclosed that the claim that the merchandise were forthwith returned and Littlegiant issued checks to reimburse Petitioner for drawings against LCs and subsequently deposited with RCBC is negated by the following:

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[7] Par. 6, Summary of Stipulated Facts; *ibid.,* p. 64.; Annex "H," Petition for Review.
[8] Par. 7, Summary of Stipulated Facts; *ibid.*
[9] Par. 8, Summary of Stipulated Facts; *ibid.*

6.1. The dates of the checks issued by Littlegiant per Certification under oath of Mr. Benson Hari-Ong, Vice-President, RCBC are the dates when the LCS were opened/granted. Hence, when the same were deposited with RCBC, Milwaukee's liability under the LCS was extinguished. However, the Debit Advices issued by RCBC to Milwaukee for drawings of Littlegiant on the LCs spanned a period from September 26, 1997 to January 26, 1998 with corresponding bank charges and interest of P10,025,576.94, per available documents, which were in turn claimed by Milwaukee as deduction in its 1997 Income Tax Returns. However, Milwaukee failed to record in its books of accounts its liability to RCBC.

6.2. The checks mentioned above allegedly issued by Littlegiant were not recorded in its books of accounts.

7. Petitioner did not intend to report the sale by Littlegiant in its 1997 Income Tax Return as shown by the following facts:

7.1. Only Pro-Forma Invoices were issued to cover the same instead of regular sales invoices;

7.2. Delivery receipts issued do not belong to the series used during 1997;

7.2. The sales, whether aborted or consummated, were not recorded in the books of accounts of Littlegiant for 1997.

8. Interest and Bank charges amounting to P18,128,498.26 were disallowed for the following reasons:

8.1 Only the interest expenses on the Prime Currency (US Dollar) loan from PBC and the interests and bank charges on the repurchase of the assigned Prime Currency (US Dollar) with PBC Capital and Investment Corporation (PBCCAP) were recorded in petitioner's 1997 books of accounts and not the liability. Said interests and bank charges were subsequently claimed as deduction in Petitioner's 1997 Income Tax return.

8.2 Petitioner did not receive the proceeds of, neither did it benefit from, the Prime Currency loan and its reassignment with PBCCAP because the bank accounts used (Milwaukee's Account No. 1041-01768-6 and Prime Currency Savings Account No. 2-534-00391-1, both with PBC) are not recorded in the Petitioner's books of accounts.

9. The purchases of scrap materials from junk shops in the amount of P9,040,701.37 in 1997 are not properly documented. Said purchases are too substantial to be considered as 'marginal economic activity' on the part of junk shops so as to exempt them from the requirement of issuing official receipts in their sale or transfer of merchandise.

10. Miscellaneous expenses consisting of petty cash charged to expense and foreign exchange losses (P4,429,982.42) were not properly documented.

11. Unrecorded sales amounting to P283,745,406.43 traceable to unaccounted purchases of raw materials (21,448.0 metric tons of hot rolled steel) from Littlegiant Steel Pipe Corporation resulted to a deficiency value-added tax.

12. Petitioner failed to subject to expanded withholding tax some of its income payments representing freight and delivery as well as professional fees, hence, the deficiency EWT.

13. The assessments were issued in accordance with law and regulations;

14. All presumptions are in favor of the correctness of tax assessments."[10]

Trial proceeded and both parties presented their respective testimonial and documentary evidence. The case was submitted for decision on January 18, 2007 after considering petitioner's Memorandum sans respondent's Memorandum.[11]

[10] Docket, pp. 40-42.
[11] Docket, p. 1747.

THE ISSUES

The parties stipulated the following issues[12] for the Court's resolution:

"1. Whether the assessment for deficiency income tax in the amount of ₱63,404,021.57 inclusive of increments, has basis in fact and in law. Such assessment is broken down as follows:

> 1.1. Whether there are alleged unrecorded sales of ₱90,713,406.43 from Littlegiant Steel Pipes Corporation.
>
> 1.2. Whether the interest and bank charges amounting to ₱18,128,498.26 are proper deductions.
>
> 1.3. Whether purchases of scrap materials from junk shops in the amount of ₱9,040,701.37 are proper deductions.
>
> 1.4. Whether miscellaneous expenses consisting of petty cash charged to expense (₱1,214,393.18) and foreign exchange losses (₱4,429,982.42) are allowable as deductions.
>
> 1.5. Whether the 13th month pay and cost of subsistence of Petitioner's employees should be allowed as proper deductions.

2. Whether the assessment for deficiency value-added tax in the amount of ₱109,629,966.83, inclusive of increments, has basis in fact and in law. Such assessment is broken down, as follows:

> 2.1. Whether there are alleged unrecorded purchases from Littlegiant Steel Pipes Corp. amounting to ₱283,749,406.43 which should be subject to VAT.
>
> 2.2. Whether sales discounts by the Petitioner are allowable deductions from the gross selling price.
>
> 2.3. Whether the sales to Ciriaco Corporation, being a domestic corporation enjoying tax exemption privileges are subject to VAT.

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[12] Statement of the Issues; *ibid.*, pp. 64-66.

2.4. Whether the input VAT by the petitioner should be allowed as deductions from the gross VATable sales.

3. Whether the assessment for deficiency expanded withholding tax in the amount of ₱29,723.18 is valid."

THE COURT'S RULING

The Court will resolve the issues in *seriatim*.

DEFICIENCY INCOME TAX – P63,404,021.57

The deficiency income tax of P63,404,021.57, inclusive of interest and penalty, was computed by respondent's examiner as follows:[13]

Taxable net income per return		P 873,070.55
Add: Adjustments to taxable net income		
Interest Expense	P 18,128,498.26	
Gross Profit of unrecorded purchase from an affiliate	90,713,406.43	
Unsupported purchases	9,040,701.37	
Miscellaneous expense, unsupported	4,429,982.42	122,312,588.48
Total taxable net income per investigation		P 123,185,659.03
Income tax due thereon		P 43,114,980.66
Less: Income tax paid per return	P -	
Creditable withholding tax-unsupported		
Total		-
Deficiency income tax due before penalties		P 43,114,980.66
Add: 47% interest	P20,264,040.91	
Compromise	25,000.00	20,289,040.91
Total deficiency income tax due and collectible		**P 63,404,021.57**

The resolution of whether the 1997 deficiency income tax assessment of P63,404,021.57 is correct basically hinges on the propriety or impropriety of

[13] Exhibit "1." BIR Records, pp. 1684-1685.

the income imputed, the expense deductions, and the tax credits disallowed by respondent, namely:

1.1	Interest Expense	P 18,128,498.26
1.2	Gross Profit of unrecorded purchase from an affiliate	90,713,406.43
1.3	Unsupported purchases	9,040,701.37
1.4	Miscellaneous expense, unsupported	4,429,982.42
1.5	Creditable withholding tax-unsupported	1,532,443.97[14]

Interest Expense –P18,128,498.26

Respondent disallowed the interest and bank charges amounting to P18,128,498.26 claimed by petitioner as deduction from its gross income for taxable year 1997 for the following reasons:

1. Only the interest expenses on the Prime Currency (US Dollar) loan from PBC and the interests and bank charges on the repurchase of the assigned Prime Currency (US Dollar) with PBC Capital and Investment Corporation (PBCCAP) were recorded in its 1997 books of accounts and not the liability. Said interests and bank charges were subsequently claimed as deduction in Milwaukee Industries Corporation's (Milwaukee) 1997 Income Tax Return.

2. Milwaukee did not receive the proceeds of, neither did it benefit from, the Prime Currency (US Dollar) loan and its reassignment with PBCCAP because the bank accounts used (Milwaukee's Account No. 1041-01768-6 and Prime Currency Savings Account No. 2-534-00391-1, both with PBC) <u>are not recorded in Milwaukee's books of accounts</u>. Apparently, said accounts with PBC are under the control and disposition of the top officials of Milwaukee.[15]

Petitioner counters that such interest and bank charges should be allowed as deductible expenses for income tax purposes because the same were incurred and paid in 1997, as shown by the Certification dated April 22, 1999 of Philbank's Account Officer Celene G. Choa, which states:

[14] Petitioner's 1997 Income Tax Return; BIR Records, p. 1626.
[15] Exhibit "SSSS-3."

> "This is to certify that MILWAUKEE INDUSTRIES CORPORATION has paid total interest amounting to Pesos: EIGHTEEN MILLION ONE HUNDRED TWENTY EIGHT THOUSAND FOUR HUNDRED NINETY EIGHT AND 26/100 (P18,128,498.26) for the year ending 1997.
>
> xxx xxx xxx"[16]

Petitioner further averred that the liability from which the interest charges arose was recorded when the loan was obtained in 1996. The amount of the loan remained outstanding in the books of petitioner as of the end of 1996 and was thus carried over to the following year. To support its claim, petitioner presented its Audited Financial Statements for the year 1997 that indicated its Notes Payable in the amount of P528,016,909.00 and its Books of Accounts for the year 1996 that indicated its Notes Payable.

The Court finds the disallowance proper.

The applicable provision is Section 29(b) of the National Internal Revenue Code of 1977, as amended, which provides as follows:

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

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

1. there must be an indebtedness;
2. the indebtedness must be that of the taxpayer;
3. the indebtedness must be connected with the business, trade or profession of the taxpayer;

[16] Exhibit "LLLL."

4. the interest must have been paid or accrued during the taxable year; and
5. the interest must have been stipulated in writing.[17]

There is no question as to petitioner's compliance with the first, second, fourth and fifth requisites. Respondent does not dispute that petitioner paid interests and bank charges in the amount of P18,128,498.26 in 1997 on loans obtained from Philippine Banking Corporation (PBC) and on repurchase of assigned accounts with PBC Capital and Investment Corporation; and that said loans from PBC were covered by promissory notes, which indicated the stipulated interest rates.[18]

The issue now is the presence of the third requisite, and that is whether petitioner's loans were used in connection with its business.

In the Report dated May 23, 2003, made by the Court-commissioned Independent CPA (ICPA) Edgardo S. Licuanan, Jr., the following findings regarding petitioner's claimed interest expense of P18,128,498.26[19] are stated:

> "Interest and bank charges originated from loans from Philbank and PBC Capital and recorded in 1997. The liabilities were obtained prior to 1997 and were still outstanding as reflected in the 1997 books of accounts and financial statements. The proceeds of the loans were received by Milwaukee and credited to Milwaukee's Philbank Account No. 1041-01768-6 and Savings Account No. 2-534-00391-1 and then recorded in the books. The interest and bank charges are necessary business expenses and should be allowed as deductions. Furthermore, Philbank issued a certification that Milwaukee paid a total of P18,128,498.26 in interest and bank charges for the calendar year 1997."

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[17] *Delfin Ma. V. Cruz, Jr., vs. The Court of Tax Appeals and The Commissioner of Internal Revenue*, CA-G.R. SP No. 25308, April 7, 1992.
[18] Exhibit "1." See also BIR Records, pp. 1686-1689.
[19] Exhibit "A-28."

While the above report stated that petitioner's claimed interest and bank charges of P18,128,498.26 were necessary business expenses, nowhere can it be found from the records that indeed the proceeds of the subject loans were used by petitioner in connection with the carrying on of its business. Thus, for petitioner's failure to show proof of the actual utilization of the proceeds of the subject loans, the interest paid by petitioner thereon in the amount of P18,128,498.26 cannot qualify for deduction against its 1997 taxable income.

Gross Profit of unrecorded purchase from an affiliate - P90,713,406.43

Respondent alleges that petitioner's purchases of 21,448 metric tons of hot rolled steel coils valued at P193,032,000.00 from its affiliate Littlegiant Steel Pipe Corporation (Littlegiant) have not been taken up as purchases during 1997, although the payments therefor in domestic Letters of Credit (LCs) have been recorded in the books as loans and not purchases. Due to petitioner's failure to account for the substantial purchases of raw materials in its records, respondent concluded that these were processed and sold by petitioner in the ordinary course of the business. Hence, petitioner allegedly has untaxed gross profit due to undeclared purchases from Littlegiant, computed as follows:

Unrecorded purchases of hot rolled steel coils from Littlegiant	P 193,032,000.00
Divided by ratio of Cost of Sales to Net Sales per audited F/S	68.03%
Undeclared Sales traceable to unrecorded purchases from Littlegiant	P 283,745,406.43
Multiply by ratio of gross profit to net sales per audited F/S	31.97%
Gross Profit traceable to unrecorded purchases from Littlegiant	**P 90,713,406.43**

Petitioner does not dispute the receipt of hot rolled steel coils from Littlegiant and the drawing of Letters of Credit with RCBC for the payment of the goods. However, petitioner argues that there are no unrecorded purchases. The delivery and drawing of Littlegiant upon the LCs were erroneous. The purchases were not recorded because they were eventually cancelled. Petitioner returned the goods and Littlegiant paid the equivalent amount of the LCs drawn. And since the purchases were not recorded, petitioner also did not record the returned goods. Hence, it alleges that the unrecorded purchases were already offset against the unrecorded purchase returns.

The letter of petitioner to Littlegiant dated October 8, 1997, which petitioner presented, supports its contention that the parties agreed to cancel the sale/purchase transaction.[20] Likewise, to prove that Littlegiant returned the proceeds of the LCs in the sum of P193,032,000.00, four checks in favor of petitioner were offered as evidence, to wit:

Check No.	Date	Amount
651119[21]	09/26/97	P 52,020,000.00
651142[22]	09/30/97	54,000,000.00
651143[23]	10/02/97	47,007,000.00
651179[24]	10/06/97	40,005,000.00
		P 193,032,000.00

On the other hand, in compliance with the agreement, petitioner returned the hot rolled steel coils to Littlegiant, supported by the following documents:

[20] Exhibit "MMMM."
[21] Exhibit "NNN."
[22] Exhibit "OOO."
[23] Exhibit "PPP."
[24] Exhibit "QQQ."

Date of Return	Covered by DR No.	Weight in Metric Tons	Amount
10/13/1997	179652[25]	2,222.50	20,002,500.00
10/16/1997	179673[26]	2,222.50	20,002,500.00
10/20/1997	16872[27]	2,890.00	26,010,000.00
10/23/1997	17857[28]	2,890.00	26,010,000.00
10/27/1997	17952[29]	2,611.50	23,503,500.00
10/29/1997	179556[30]	2,611.50	23,503,500.00
11/2/1997	17918[31]	3,100.00	27,900,000.00
11/5/1997	17915[32]	2,900.00	26,100,000.00
Total		**21,448.00**	**193,032,000.00**

The four checks issued by Littlegiant in the aggregate amount of P193,032,000.00 correspond to the value of goods covered by the alleged sales.

This Court finds the above documentary evidence of petitioner sufficient to support its explanation that all the hot rolled steel coils were returned and that indeed the sales by Littlegiant were cancelled.

The Decision of this Court's First Division in another but related case entitled *Littlegiant Steel Pipe Corp. vs. Commissioner of Internal Revenue*[33] corroborates petitioner's above explanation. The pertinent portions are as follows:

> "We find the above documentary evidence of petitioner sufficient to support its explanation that indeed its sales to Milwaukee Industries Corporation of hot rolled steel coils were cancelled.
>
> We are also convinced that the unrecorded sales were cured by the unrecorded sales returns emanating from the cancelled sales. In fact, the examiners additionally noted that

[25] Exhibit "FFF."
[26] Exhibit "GGG."
[27] Exhibit "HHH."
[28] Exhibit "III."
[29] Exhibit "JJJ."
[30] Exhibit "KKK."
[31] Exhibit "LLL."
[32] Exhibit "MMM."
[33] CTA Case No. 6203, July 19, 2005.

the proceeds of sales were not recorded by petitioner. This means that while petitioner drew the LCs, it did not record the amount encashed, denoting petitioner's intention not to reflect the whole cancelled sale transaction.

Hence, there is no reason for the petitioner to be assessed for undeclared sales because the said sales were cancelled."

The disputed sales transactions in the *Littlegiant Steel Pipe Corporation case* are the very same transactions which petitioner disputes in this case. The Court concurred that there were no unrecorded sales based on its findings that the documentary evidence of Littlegiant was sufficient to support its explanation that indeed its sales to petitioner of hot rolled steel coils were cancelled. The said documentary evidence consisting of the letter dated October 8, 1997 of Mr. Philip Go to Mr. Nazarito Fua, the four checks issued by *Littlegiant Steel Pipe Corporation* in favor of petitioner, the LCs applied for by petitioner, and the return receipts of the hot rolled steel coils are the same pieces of evidence presented in this case for the Court's appreciation.

Consequently, respondent's allegation that petitioner had gross profit on sales traceable to unrecorded purchases from Littlegiant amounting to P90,713,406.43 is without basis.

Unsupported purchases –
P9,040,701.37

Respondent disallowed petitioner's scrap purchases from various junk shops in the amount of P9,040,701.37 for being unsupported. Respondent posits that the scrap vouchers covering the purchase of junk materials are self-serving for being issuances of petitioner and that the amount of

P9,040,701.37 is too substantial to be considered as "marginal economic activity" so as to exempt the said junk shops from the requirement of issuing official receipts in their sale or transfer of merchandise.

Petitioner, on the other hand, alleges that the vouchers were duly acknowledged and signed by representatives of the junk shop dealers. Thus, respondent's allegation that the purchases were unsupported is erroneous.

This Court agrees with respondent.

The contention of petitioner that BIR Ruling No. 085-94 dated April 6, 1994, exempts junk shops from the requirement of issuing official receipts in their sale or transfer of merchandise has no legal basis. Pursuant to this Ruling, only those raw materials bought from small-time or "backyard" scraps or junk vendors, who trade their junks by means of push-carts and who are in the same category as the "magdidiyaryo-bote" can be considered as people conducting "marginal economic activity." Considering the amount involved for each voucher, it can hardly be considered as purchase from small-time vendors who can not issue the required invoice and/or receipt in their sales or transfers of merchandise.

Section 238 of the 1977 Tax Code provides:

> "Section 238. *Issuance of receipts or sales or commercial invoices.* – All persons subject to an internal revenue tax shall for each sale or transfer of merchandise or for services rendered valued at P25 or more, issue receipts or sales or commercial invoices, prepared at least in duplicate, showing the date of transaction, quantity, unit cost and description of merchandise or nature of service: *Provided*, That in case of sales, receipts or transfers in the amount of P100 or more, or regardless of amount, where the sale or transfer is made by persons subject to value-added tax to other persons also subject to value-added tax; or, where the receipt is issued to cover payment made as rentals, commissions, compensations or fees, receipts or invoices shall be issued

> which shall show the name, business style, if any, and address of the purchaser, customer, or client. The original of each receipt or invoice shall be issued to the purchaser, customer, or client at the time the transaction is effected, who, if engaged in business or in the exercise of profession, shall keep and preserve the same in his place of business for a period of 3 years from the close of the taxable year in which such invoice or receipt was issued, while the duplicate shall be kept and preserved by the issuer, also in his place of business, for a like period.
>
> The Commissioner may, in meritorious cases, exempt any person subject to an internal revenue tax, from compliance with the provisions of this section."

Under Chapter IV of Revenue Regulations No. V-1, as amended, the Commissioner of Internal Revenue may exempt certain groups of persons from the requirement of issuing official receipts on their sale of merchandise, but none of those includes junk shops, to wit:

> "The Commissioner of Internal Revenue may, in meritorious cases, exempt any person subject to an internal revenue tax from compliance with the provisions of this section. In any event, public market vendors selling exclusively domestic meat, fruits, vegetables, games, poultry, fish and other food products are hereby exempted from the provisions of this section."

Thus, respondent is correct in disallowing the scrap materials purchased by petitioner from various junk shops as unsupported purchases.

Unsupported Miscellaneous Expenses – P4,429,982.42

In disallowing petitioner's claimed foreign exchange losses in the amount of P4,429,982.42 classified under miscellaneous expenses, respondent stated in his Final Decision[34]:

> "2. Foreign Exchange Losses Classified as Miscellaneous Expense.

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[34] BIR Records, p. 1721-1726.

> This account will only be deducted upon actual incurrence such as payment of the loan (Section 29, NIRC). The taxpayer alleged that bank debit advice/memo were presented to the examiners which only reflect payment of interest expense and partial settlement of the principal amount of the loan. However, to be able to ascertain actual or transactional loss realized, taxpayer must show proof of the historical cost of the liability at the time of availment as compared to the actual or prevailing exchange rate at the time of termination of debt, which the taxpayer did not comply up to this date."[35]

Petitioner, on the other hand, maintains that the foreign exchange losses of P4,429,982.42 satisfy the requisites of deductibility of losses under the law, to wit: (1) the loss is that of the taxpayer; (2) the loss must have been sustained during the taxable year; (3) the loss must be evidenced by a closed and completed transaction; and (4) the loss must not have been compensated by insurance or other form of indemnity.

Petitioner avers that respondent takes no issue with the first and last requisites. As to the second and third requisites, petitioner allegedly complied with the same as shown in the partial and supplemental Reports submitted by the ICPA.[36] Based on the said Reports, petitioner had a trust receipts payable balance at the beginning of the year 1997 in the amount of P34,710,392.33 and had to pay P39,140,375.25 in satisfaction of the principal amount of its loans resulting in foreign exchange losses in the amount of P4,429,982.42 because of fluctuation in foreign exchange rates during the year 1997.

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[35] BIR Records, p. 1722.
[36] Exhibits "A-3," "A-4" and "YYYY."

Petitioner argues that upon conversion of the dollar-denominated loans to peso obligations, it had incurred losses as it could already ascertain the additional amount that it would have to pay in order to settle its debts. Since the foreign exchange loss of P4,429,982.42 was actually sustained in 1997, the same must be recognized as such during the same year. Likewise, petitioner's payment of dollar obligations in 1997 allegedly rendered said foreign exchange losses fixed, determined and irrevocable; thus, a closed and completed transaction which must be claimed within the year.

The Court finds the disallowance in order.

A loss which is the result of a foreign exchange fluctuation ascertained and realized during the taxable period and not compensated by insurance or otherwise, except those provided in Sec. 29(d) of the 1977 Tax Code is deductible from gross income of the said taxable period, albeit it may relate to transaction of prior years.[37]

However, as correctly pointed out by respondent, in order for this Court to ascertain actual or transactional loss realized, petitioner must show proof of the historical cost of the liability at the time of availment as compared to the actual or prevailing exchange rate at the time of termination of debt. In the case at bar, petitioner allegedly had to pay a higher amount of P39,140,375.25 due to foreign exchange rates fluctuations in 1997 to settle its trust receipts payable balance at the beginning of the said year in the amount of P34,710,392.33, thereby resulting in a foreign exchange loss in the amount of P4,429,982.42. The documents submitted by petitioner such as bank debit

[37] *The Coca-Cola Export Corporation vs. Commissioner of Internal Revenue,* C.T.A. Case No. 5238, December 19, 1997.

advices and cash vouchers[38] in support of the Reports of the ICPA[39] merely established petitioner's actual payment of the amount of P39,140,375.25. Petitioner did not submit the loan documents establishing its trust receipts payable balance of P34,710,392.33. Thus, for lack of material evidence proving the trust receipts payable amount of P34,710,392.33, petitioner's claimed foreign exchange loss in the amount of P4,429,982.42 cannot be allowed as deduction from its 1997 taxable gross income.

Unsupported Creditable Withholding Taxes - P1,532,443.97

Respondent denied petitioner's claimed creditable withholding taxes in the amount of P1,532,443.97 for being unsupported. For petitioner's failure to refute respondent's finding, the disallowance of the amount of P1,532,443.97 shall be upheld.

In sum, petitioner is still liable for 1997 deficiency income tax in the amount of P16,706,973.96, computed as follows:

Taxable net income per return		P 873,070.55
Add: Adjustments to taxable net income		
Interest Expense	P 18,128,498.26	
Unsupported Purchases	9,040,701.37	
Unsupported Miscellaneous Expense	4,429,982.42	31,599,182.05
Total taxable net income per investigation		P 32,472,252.60
Income tax due thereon		P 11,365,288.41
Less: Income tax paid per return	P -	
Unsupported Creditable Withholding Taxes	-	
Total		-

nb

[38] Exhibits "N" to "CC," inclusive of submarkings.
[39] Exhibits "A-3," "A-4" & "YYYY."

Deficiency income tax due	P 11,365,288.41
Add: Interest	5,341,685.55
Total deficiency income tax payable	**P16,706,973.96**

The compromise penalty of P25,000.00 will not be imposed as compromise implies mutual agreement, which is absent in the case under consideration. The imposition of the same without the conformity of the taxpayer is illegal and unauthorized.[40]

VALUE-ADDED TAX – P109,629,966.83

The deficiency value-added tax in the amount of P109,629,966.83, inclusive of increments was computed as follows:[41]

Sales declared per VAT returns		P 519,323,448.20
Add: Adjustments to vatable sales per investigation:		
a) Unrecorded sales traceable to unrecorded purchases from an affiliate		283,745,406.43
b) Sales per ITR/FS	P 519,489,563.80	
Less: Sales per VAT returns	(519,334,400.24)	
Variance		155,163.56
Total Sales subject to 10% VAT		P 803,224,018.19
VAT due thereon		P 80,322,401.82
Less: VAT paid per return	P 905,112.00	
Allowable input tax	7,308,759.01	
Total		(8,213,871.01)
Deficiency VAT due before penalties		72,108,530.81
Add: 52% interest	P 37,496,436.02	
Compromised penalty	25,000.00	37,521,436.02
Total deficiency VAT due and collectible		**P 109,629,966.83**

Based on the above computation, respondent included as part of petitioner's taxable sales: (a) the alleged unreported sales of P283,745,406.43 traceable to unrecorded purchases from petitioner's affiliate Littlegiant Steel Pipe Corporation; and (b) the discrepancy of P155,163.56

[40] *Commissioner of Internal Revenue vs. Lianga Bay Logging Co., Inc. and the Court of Tax Appeals,* G.R. No.35266, January 21, 1991.
[41] BIR Records, p. 1684.

between the net sales amounts appearing in the income tax return/financial statements vis-à-vis the VAT returns of petitioner. Also, respondent allowed only the amount of P7,308,759.01 out of petitioner's total declared input VAT of P51,027,232.82.

Unreported Sales Traceable to Unrecorded Purchases from Littlegiant Steel Pipe Corporation - P283,745,406.43

As earlier discussed, the undeclared sales traceable to unrecorded purchases from Littlegiant in the amount of P283,745,406.43 were cancelled. Thus, there is no taxable transaction.

Discrepancy in Net Sales - P155,163.56

Petitioner alleges that the amount of P155,163.56 represents the sales made to Ciriaco Corporation, a duly registered Clark Special Economic Zone (CSEZ) enterprise, and is exempt from local and national taxes including but not limited to the withholding income taxes and value-added taxes. [42] Because of the VAT exemption of Ciriaco Corporation, petitioner's sales thereto are allegedly not subject to VAT.

Respondent, on the other hand, contends that the tax exemption granted to Ciriaco Corporation pertains only to its direct tax liabilities and does not extend to its indirect tax liabilities such as the VAT passed on by its local suppliers such as petitioner.

[42] Evidenced by the Certificate of Tax Exemption No. 97-25 issued by CSEZ in favor of Ciriaco Corporation, Exhibit "XXXX."

The Court finds that petitioner's sales to Ciriaco Corporation in the amount of P155,163.56 maybe classified as effectively zero-rated sales.

As can be seen in the Certificate of Tax Exemption No. 97-25 issued by CSEZ in favor of Ciriaco Corporation, the latter is exempt from VAT pursuant to Section 15 of Republic Act No. 7227/Executive Order No. 62, Section 5 of Executive Order No. 80/Proclamation No. 163, BIR Revenue Regulation No. 1-95 and further confirmed by BIR Ruling No. 946-95 dated March 3, 1995. By virtue of the VAT exemption of Ciriaco Corporation, petitioner's sales thereto are effectively zero-rated for VAT purposes pursuant to Section 100(a)(2)(C) of the 1977 Tax Code, as amended, and Section 4.100-2(c) of Revenue Regulations No. 7-95, to quote:

> "Sec. 100. *Value-added tax on sale of goods or properties*.-(a) *Rate and base of tax*.- xxx
>
> xxx xxx xxx
>
> (2) The following sales by VAT-registered persons shall be subject to 0%:
>
> xxx xxx xxx
>
> (C) Sales to persons or entities whose exemption under special laws or international agreements to which the Philippines is a signatory effectively subjects such sales to zero-rate."
>
> "SECTION 4.100-2. Zero-rated sales. — A zero-rated sales by a VAT-registered person, which is a taxable transaction for VAT purposes, shall not result in any output tax. However, the input tax on his purchases of goods, properties or services related to such zero-rated sale shall be available as tax credit or refund in accordance with these regulations.
>
> The following sales by VAT-registered persons shall be subject to 0%:
>
> xxx xxx xxx
>
> (c) Sales to persons or entities whose exemption under special laws, e.g. R.A. No. 7227 duly registered and accredited

enterprises with Subic Bay Metropolitan Authority (SBMA) and Clark Development Authority (CDA), R.A. No. 7916, Philippine Economic Zone Authority (PEZA), or international agreements, e.g. Asian Development Bank (ADB), International Rice Research Institute (IRRI), etc. to which the Philippines is signatory effectively subject such sales to zero-rate."

However, petitioner must substantiate its effectively zero-rated sales to Ciriaco Corporation in the amount of P155,163.56 by proper VAT invoices in accordance with Section 108(a) of the 1977 Tax Code, which states that:

"**SEC. 108.** ***Invoicing and accounting requirements for VAT-registered persons. – (a) Invoicing requirements.*** — A VAT-registered person shall, for every sale, issue an invoice or receipt. In addition to the information required under Section 238, the following information shall be indicated in the invoice or receipt:

(1) A statement that the seller is a VAT-registered person, followed by his taxpayer's identification number (TIN); and

(2) The total amount which the purchaser pays or is obligated to pay to the seller with the indication that such amount includes the value-added tax."

Corollary thereto, Section 4.108-1 of Revenue Regulations No. 7-95, reads as follows:

"**SEC. 4.108-1. Invoicing Requirements**. — All VAT-registered persons shall, for every sale or lease of goods or properties or services, **issue duly registered** receipts or **sales or commercial invoices** which must show:

1. the name, TIN, and address of seller;
2. date of transaction;
3. quantity, unit cost and description of merchandise or nature of service;
4. the name, TIN, business style, if any, and address of the VAT-registered purchaser, customer or client;
5. **the word 'zero-rated' imprinted on the invoice covering zero-rated sales; and**
6. the invoice value or consideration.

xxx xxx xxx

> **Only VAT-registered persons are required to print their TIN followed by the word 'VAT' in their invoices or receipts and this shall be considered as a 'VAT Invoice'.** All purchases covered by invoices other than 'VAT Invoice' shall not give rise to any input tax.
>
> xxx xxx xxx." (*Emphasis supplied*)

While the invoice[43] covering the sales amount of P155,163.56 bears the TIN-VAT number of petitioner, and the BIR authority to print or BIR permit number; however, the same failed to reflect that the sales amount of P155,163.56 is VAT zero-rated for the word "zero-rated" is not imprinted thereon. Consequently, the sales to Ciriaco Corporation shall be taxable and petitioner shall be liable to pay VAT on the amount of P155,163.56.

Disallowance of Input VAT by the BIR

Out of the P51,027,232.82 input VAT claimed by petitioner, it is the position of respondent that the allowable input VAT of petitioner shall only be the following amounts:

Imported Purchases of spare parts, supplies, etc.	P 5,805,978.79
Local Purchases	1,502,780.22
	P 7,308,759.01

Petitioner, on the other hand, submitted various suppliers' invoices and receipts to support its claimed input VAT[44]. Upon examination of said documents, the ICPA summarized his findings as follows:[45]

[43] Exhibit "XXX-1306."
[44] Exhibits "AAAA-1 to AAAA-3322."
[45] Exhibit "A-35."

Input VAT with available supporting papers	**P**	**28,662,239.99**
Input VAT with supporting papers not available	**P**	**1,550,495.91**
Input VAT carry over from the previous year	**P**	**21,560,097.46**

Based on the above findings, the input VAT with no supporting papers available in the amount of P1,550,495.91 shall be denied outright. The same holds true with the input VAT carry-over from the previous year in the amount of P21,560,097.46 for petitioner's failure to prove its existence via VAT invoices, receipts, and quarterly VAT returns of the previous year. As to the input VAT of P28,662,239.99, a part thereof in the amount of P5,061,208.22 was found to be without supporting documents; thus, shall be disallowed. Out of the P23,601,031.77 remaining input VAT with supporting documents, the amount of P5,118,015.35 shall be disallowed for it was not properly substantiated with VAT invoices/receipts and only the amount of P18,483,016.42[46] represents petitioner's valid input VAT pursuant to the invoicing requirements under Section 108(a) in relation to Section 104(a)(2) of the 1977 Tax Code and Section 4.104-5 of Revenue Regulations No. 7-95. Consequently, instead of the P7,308,759.01 input VAT allowed by respondent, the input VAT amount of P18,483,016.42 shall be applied against petitioner's output tax in computing the amount of VAT still due and payable.

In sum, petitioner is liable for 1997 deficiency value-added tax in the reduced amount of P49,490,793.79, computed as follows:

Sales declared per VAT returns	P 519,323,448.20
Add: Adjustments to vatable sales per investigation:	
Sales to Ciriaco Company	155,163.56
Total Sales subject to 10% VAT	P 519,478,611.76

[46] See details per attached Annex "A."

VAT due thereon		P 51,947,861.18
Less: VAT paid per return	P 905,112.00	
Allowable input tax (*See details per Annex A*)	18,483,016.42	
Total		19,388,128.42
Deficiency VAT due		P 32,559,732.76
Add: Interest		16,931,061.03
Total deficiency VAT payable		**P 49,490,793.79**

The compromise penalty of P25,000.00 should not be imposed in the absence of mutual agreement between the parties.[47]

EXPANDED WITHHOLDING TAX
– P29,723.18

Petitioner contends that pursuant to Section 228 of the Tax Code, the assessment for expanded withholding tax in the amount of P29,723.18 should be considered void for there was no written statement of the law and the facts upon which the assessment was based, or at the very least, a computation behind the stated figures.

The Court agrees with petitioner.

As the assessment notices were issued on January 21, 2000, the 1997 Tax Code applies. Section 228 thereof provides, among others, that "the taxpayer shall be informed in writing of the law and the facts on which the assessment is made; otherwise, the assessment shall be void."

The Revenue Officer's Audit Report on Expanded Withholding Taxes dated September 30, 1999 shows that the deficiency expanded withholding tax assessment of P29,723.18 was based on the finding that petitioner failed

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[47] *Dr. Felisa L. Vda. De San Agustin, in substitution of Jose Y. Feria, in his capacity as Executor of the Estate of Jose San Agustin vs. Commissioner of Internal Revenue*, G.R. No.138485, September 10, 2001.

to withhold tax on the following expenses amounting to P1,307,048.31, pursuant to Section 57(B) of the CTRP:[48]

Brokerage, Freight and Delivery Charges not subjected to tax	P	1,236,287.61	
Professional Fees not subjected to tax		22,000.00	
Professional Fees booked under misc. account not subjected to tax		48,760.70	P 1,307,048.31

Respondent, however, failed to convey in writing such information to petitioner. In the demand letter and assessment notices for taxable year 1997 sent by respondent to petitioner and particularly in the attached "Final Decision on Disputed Assessment,"[49] there was no indication whatsoever as to how respondent's examiner arrived at the alleged deficiency expanded withholding tax of P29,723.18 and the legal basis for such assessment. Petitioner cannot be expected to be able to determine and thereafter refute the examiner's findings without the disclosure of the details of the assessment. Accordingly, the Court finds the deficiency expanded withholding tax assessment of P29,723.18 invalid for respondent's failure to inform petitioner in writing of the facts and the law on which the said assessment is based.

WHEREFORE, the instant Petition for Review is hereby **PARTIALLY GRANTED**. The deficiency expanded withholding tax assessment in the amount of P29,723.18 is hereby **CANCELLED** and **WITHDRAWN**. However, the deficiency income tax and value-added tax assessments are hereby **AFFIRMED but in the reduced amounts of P16,706,973.96 and P49,490,793.79, respectively, or in the total amount of P66,197,767.75.**

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[48] BIR Records, p. 1674.
[49] BIR Records, pp. 1721-1731.

Accordingly, petitioner is hereby **ORDERED to PAY** the following deficiency assessments:

	Basic	Interest	Total
Deficiency Income Tax	P11,365,288.41	P 5,341,685.55	P16,706,973.96
Deficiency Value-Added Tax	32,559,732.75	16,931,061.03	49,490,793.79
Totals	**P43,925,021.16**	**P22,272,746.58**	**P66,197,767.75**

In addition, petitioner is **ORDERED TO PAY** 20% delinquency interest per annum on the total amount of P66,197,767.75 computed from January 21, 2000 until full payment thereof, pursuant to Section 249(C) of the 1997 Tax Code.

SO ORDERED.

ERLINDA P. UY
Associate Justice

WE CONCUR:

JUANITO C. CASTAÑEDA, JR.
Associate Justice

OLGA PALANCA-ENRIQUEZ
Associate Justice

ATTESTATION

I attest 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.

JUANITO C. CASTAÑEDA, JR.
Associate Justice
Chairperson

CERTIFICATION

Pursuant to Article VIII, Section 13 of the Constitution, and the Division Chairperson's Attestation, 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.

ERNESTO D. ACOSTA
Presiding Justice