REPUBLIC OF THE PHILIPPINES
# *Court of Tax Appeals*
QUEZON CITY

## *Third Division*

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| **LUDO & LUYM CORPORATION,** *Petitioner,* | **CTA CASE NO. 8613** |
| | Members: **BAUTISTA,** *Chairperson,* **FABON-VICTORINO,** *and* **RINGPIS-LIBAN,** *JJ.* |
| *- versus -* | |
| **COMMISSIONER OF INTERNAL REVENUE,** *Respondent.* | Promulgated: AUG 08 2016 10:20 a.m. |

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# *DECISION*

***BAUTISTA, J:***

## *The Case*

This case involves a Petition for Review filed on February 27, 2013[1] pursuant to *Rule 8, Section 4(a)*[2] *of the Revised Rules of the Court of Tax Appeals ("RRCTA")*, which seeks to annul the deficiency income tax and value-added tax ("VAT") assessments issued by respondent for calendar year ("CY") 2007 in the aggregate amount of Php57,863,909.86, inclusive of interest and surcharge.

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[1] *Records, CTA Case No. 8613, Vol. 1, Petition for Review ("PFR")*, pp. 6-184, with annexes.

[2] A.M. No. 05-11-07-CTA (2005). The relevant provision states:

> **Sec. 4.** ***Where to appeal; mode of appeal.*** – (a) An appeal from a decision or ruling or the inaction of the Commissioner of Internal Revenue on disputed assessments or claim for refund of internal revenue taxes erroneously or illegally collected, the decision or ruling of the of Commissioner of Customs, the Secretary of Finance, the Secretary of Trade & Industry, the Secretary of Agriculture, and the Regional Trial Court in the exercise of their original jurisdiction, shall be taken to the Court by filing before it a petition for review as provided in Rule 42 of the Rules of Court. The Court in Division shall act on the appeal.

## *The Parties*

Petitioner is a corporation engaged in the business of processing and selling coconut oil and other products, and with principal office at Tupas St. Cebu City.[3]

Respondent is the duly appointed Commissioner of the Bureau of Internal Revenue ("BIR"), with principal office address at the 5th Floor, BIR National Office Building, Diliman, Quezon City, and vested with the power to decide tax cases, including disputed assessments pursuant to *Section 4 of the 1997 National Internal Revenue Code, as amended ("NIRC")*[4].

## *The Facts*

On July 1, 2008, the Large Taxpayers District Office - Cebu ("LTDO"), Cebu Office of the BIR issued Letter of Authority No. 00007074 for the examination of petitioner's books of accounts for CY 2007 covering all internal revenue taxes, which petitioner received on July 16, 2008.[5]

On September 23, 2010, petitioner received a letter from the Large Taxpayer Service ("LTS") dated September 22, 2010, informing the former of the results of the investigation, and inviting petitioner to an informal conference on September 29, 2010.[6]

On March 16, 2011, the LTS issued a Preliminary Assessment Notice ("PAN") informing petitioner of its assessment for deficiency income tax, VAT, and expanded withholding tax ("EWT") for CY

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[3] *Records, Vol. 1, Pre-Trial Order ("PTO")*, p. 344.

[4] *Republic Act No. 8424*, as amended (1997). The relevant provision states:

> **Sec. 4.** ***Power of the Commissioner to Interpret Tax Laws and to Decide Tax Cases.*** - The power to interpret the provisions of this Code and other tax laws shall be under the exclusive and original jurisdiction of the Commissioner, subject to review by the Secretary of Finance.
>
> The power to decide disputed assessments, refunds of internal revenue taxes, fees or other charges, penalties imposed in relation thereto, or other matters arising under this Code or other laws or portions thereof administered by the Bureau of Internal Revenue is vested in the Commissioner, subject to the exclusive appellate jurisdiction of the Court of Tax Appeals.

[5] *Records, Vol. 1, Joint Stipulation of Facts and Issues ("JSFI")*, p. 312; *BIR Records, Exhibit* "R-1," *Letter of Authority ("LOA")*, p. 1.

[6] *Records, Vol. 1, JSFI*, p. 312; *BIR Records, Exhibit* "R-2," *Notice of Informal Conference*, p. 389.

2007 in the aggregate amount of Php194,543,838.71.[7] Under the PAN, petitioner was given a period of fifteen (15) days within which to reply.[8] Petitioner received the PAN on March 17, 2011.[9]

On April 11, 2011, the LTS issued a Final Assessment Notice ("FAN") informing petitioner of its assessment for deficiency income tax, VAT, and EWT for CY 2007 in the aggregate amount of Php195,542,828.83, which petitioner received on even date.[10] Under the FAN, respondent found the following discrepancies:

Income Tax

a) Additional Gross Income [Php]22,333.52 for purchases from POM's Ventures
b) Alleged fictitious expenses arising from alleged bank overdrafts or negative balance in the amount of [Php]154,964,207.83 which it added to the taxable income of petitioner for CY 2007
c) Disallowance of Interest Expense in the amount of [Php]223,794,203.46
d) Disallowed Bad Debts in the amount of [Php]2,665,255.75[11]
e) Disallowed Miscellaneous Expense in the amount of [Php]2,104,216.74
f) Disallowed Other Expenses not subject to Expanded Withholding Tax in the amount of [Php]167,609,715.92
g) CWT Disallowance in the amount of [Php]762.64[12]
h) Compromise Penalty for failure to submit audited financial statement

Value-Added Tax

i) Additional Taxable Sales in the amount of [Php]1,540,088[.00]
j) Disallowance on Input - expenses with no corresponding documents ([Php]18,848,210.95)

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[7] *Records, Vol. 1, JSFI,* p. 313; *Records, Vol. 1, Exhibit* "P-1," *Preliminary Assessment Notice ("PAN")*, pp. 475-478.
[8] *Records, Vol. 1, JSFI,* p. 313; *Records, Vol. 1, Exhibit* "P-1," *PAN,* p. 478; *BIR Records, Exhibit* "R-3," *PAN,* pp. 482-483.
[9] *Records, Vol. 1, JSFI,* p. 313; *BIR Records, Exhibit* "R-3," *PAN,* pp. 478-485.
[10] *Records, Vol. 1, JSFI,* p. 313; *Records, Vol. 1, Exhibit* "P-2," *Final Assessment Notice ("FAN")*, pp. 468-474, with annexes; *BIR Records, Exhibit* "R-4," *FAN,* pp. 489-495, with annexes.
[11] PTO provides the amount of Php2,665.76 but FAN provides the amount of Php2,665,255.75; *see Records, Vol. 1, Exhibit* "P-2," *FAN,* p. 468; *BIR Records, Exhibit* "R-4," *FAN,* p. 495.
[12] PTO provides the amount of Php764.63 but FAN provides the amount of Php762.64; *see Records, Vol. 1, Exhibit* "P-2," *FAN,* p. 468; *BIR Records, Exhibit* "R-4," *FAN,* p. 495.

Withholding Tax - Expanded

k) Deficiency Expanded Withholding Tax [Php]5,290,293.41.[13]

On May 10, 2011, petitioner filed its protest against the FAN.[14]

On December 21, 2011, LTS issued a Final Decision on Disputed Assessment ("FDDA") stating that it has reconsidered the assessment against petitioner.[15] Petitioner received the FDDA on January 3, 2012.[16] The FDDA stated:

Income Tax

a) Additional Gross Income [Php]22,333.52 for purchases from POM's Ventures
b) Alleged fictitious expenses arising from alleged bank overdrafts in the amount of [Php]80,425,042.37 which it added to the taxable income of petitioner for 2007
c) Disallowance of Interest Expense in the amount of [Php]223,794,203.46
d) Disallowed Bad Debts in the amount of [Php]2,665,255.76
e) Disallowed Miscellaneous Expense in the amount of [Php]982,771.79
f) Additional Gross Income on Unrecorded Purchases in the amount of [Php]180,250.45
g) CWT Disallowance in the amount of [Php]762.64[17]
h) Compromise Penalty for failure to submit audited financial statement

Value-Added Tax

i) Additional Taxable Sales in the amount of [Php]1,540,088[.00]
j) Disallowance on Input Tax allegedly claimed on fictitious expenses ([Php]154,964,207.83) and Miscellaneous Expenses ([Php]2,104,216.74).[18]

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[13] *Records, Vol. 1, JSFI,* p. 313.
[14] *Records, Vol. 1, JSFI,* p. 313; *Records, Vol. 1, Exhibit* "P-3," *Protest to the FAN,* pp. 479-497; *BIR Records, Protest to the FAN,* pp. 878-911, with annexes.
[15] *Records, Vol. 1, JSFI,* p. 314; *Records, Vol. 2, Exhibit* "P-4," *Final Decision on Disputed Assessment ("FDDA"),* pp. 498-503; *BIR Records, Exhibit* "R-6," *FDDA,* pp. 867-872.
[16] *Records, Vol. 1, JSFI,* p. 314; *Records, Vol. 2, Exhibit* "P-4," *FDDA,* p. 503; *BIR Records, Exhibit* "R-6," *FDDA,* p. 867.
[17] PTO provides the amount of Php764.63 but FDDA provides the amount of Php762.64; *see Records, Vol. 2, Exhibit* "P-4," *FDDA,* p. 503; *BIR Records, Exhibit* "R-6," *FDDA,* p. 868.
[18] *Records, Vol. 1, JSFI,* p. 314.

On January 30, 2012, petitioner filed with the Commissioner of Internal Revenue ("CIR") a motion for reconsideration against the FDDA.[19]

On February 1, 2012 and February 23, 2012, petitioner filed a Supplement to the Motion for Reconsideration[20] and a Second Supplement to the Motion for Reconsideration[21], respectively.

On January 29, 2013, petitioner received the letter issued by the CIR (the "CIR's Decision") with attached Audit Result/Assessment Notice under Assessment Nos. IT-123-LA 7074-07-13-06 and VT-123-LA 7074-07-13-07.[22] The CIR's Decision denied petitioner's motion for reconsideration.[23] The CIR found that the tax liability of petitioner is, as follows:[24]

| Tax Type | | Basic Tax | | Increment | | Total |
|---|---|---|---|---|---|---|
| I. Income Tax | Php | 12,134,027.21 | Php | 17,702,382.17 | Php | 29,836,409.38 |
| II. VAT | | 11,196,276.32 | | 16,831,224.16 | | 28,027,500.48 |
| **Total** | **Php** | **23,330,303.53** | **Php** | **34,533,606.33** | **Php** | **57,863,909.86** |

Within thirty (30) days from receipt of the CIR's Decision, or on February 27, 2013, petitioner filed the instant Petition for Review.[25]

On June 11, 2013, respondent filed his Answer[26] interposing his Special and Affirmative Defenses.

Respondent and petitioner filed their Pre-Trial Briefs on January 13, 2014[27] and February 14, 2014[28], respectively. On March 17, 2014, the parties filed their Joint Stipulation of Facts and Issues

[19] *Records, Vol. 1, JSFI*, p. 314; *Records, Vol. 2, Exhibit "P-5," Motion for Reconsideration ("MR") re: FDDA*, pp. 504-525; *BIR Records, MR re: FDDA*, pp. 981-1011.
[20] *BIR Records, Supplement to the MR re: FDDA*, pp. 920-945, with annexes.
[21] *Id., Second Supplement to the MR re: FDDA*, pp. 939-940, with annexes.
[22] *Records, Vol. 1, JSFI*, p. 314; *Records, Vol. 2, Exhibit "P-6," Commissioner of Internal Revenue ("CIR")'s Decision*, pp. 526-533, with annexes; *BIR Records, Exhibit "R-8," CIR's Decision* pp. 989-994.
[23] *Records, Vol. 1, JSFI*, p. 314; *Records, Vol. 2, Exhibit "P-6," CIR's Decision*, pp. 526-533, with annexes; *BIR Records, Exhibit "R-8," CIR's Decision*, pp. 989-994.
[24] *Records, Vol. 1, JSFI*, p. 314; *Records, Vol. 2, Exhibit "P-6," CIR's Decision*, p. 532; *BIR Records, Exhibit "R-8," CIR's Decision*, p. 1107.
[25] *Records, Vol. 1, PFR*, pp. 6-184, with annexes.
[26] *Id., Answer*, pp. 213-226. Respondent failed to timely file his Answer, but filed a Motion to Admit Attached Answer on June 11, 2013, which the Court granted in a Resolution promulgated on August 14, 2013.
[27] *Id., Respondent's Pre-Trial Brief*, pp. 262-269.
[28] *Id., Petitioner's Pre-Trial Brief*, pp. 272-280.

("JSFI").[29] Accordingly, a Pre-Trial Order was issued by this Court on March 24, 2014.[30]

On June 26, 2014, petitioner filed its Formal Offer of Evidence ("FOE")[31] offering *Exhibits* "P-1" to "P-18," with sub-markings. In a Resolution[32] promulgated by this Court on August 11, 2014, the Court denied *Exhibits* "P-7-a," "P-8-c," "P-8-d," "P-11-b," "P-11-KK," and "P-13," noted that *Exhibit* "P-9-d" was not offered as evidence, and admitted all other exhibits of petitioner.

On April 6, 2015, respondent filed his FOE[33] offering *Exhibits* "R-1" to "R-9" and "R-9-a." In a Resolution[34] promulgated on June 30, 2015, the Court admitted all respondent's exhibits.

In compliance with this Court's Resolution[35] dated June 30, 2015, which ordered the parties to file their respective memoranda within thirty (30) days from receipt thereof, petitioner filed its Memorandum[36] on September 3, 2015. Respondent, on the other hand, filed a Manifestation[37] on September 10, 2015 stating that he will be adopting his arguments raised in his Answer dated June 11, 2013 as his memorandum.

On September 15, 2015, this Court promulgated a Resolution[38] submitting the case for decision; hence, this Decision.

## *The Issues*

The issues for consideration of the Court are:

1. WHETHER THE ASSESSMENTS AGAINST PETITIONER FOR DEFICIENCY INCOME TAX AND VAT FOR CY 2007 ARE BARRED BY PRESCRIPTION; AND

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[29] *Records, Vol. 1, JSFI,* pp. 312-320.
[30] *Id., PTO,* pp. 344-351.
[31] *Id., Vol. 2, Petitioner's Formal Offer of Evidence ("FOE"),* pp. 812-821-A.
[32] *Id.* at 872-874.
[33] *Id., Respondent's FOE,* pp. 923-929.
[34] *Id.* at 933-934.
[35] *Records, Vol. 2, Respondent's FOE,* pp. 933-934.
[36] *Id., Petitioner's Memorandum,* pp. 941-973.
[37] *Id.* at 974-976.
[38] *Id.* at 978.

2. WHETHER PETITIONER IS LIABLE FOR DEFICIENCY INCOME TAX AND VAT FOR CY 2007 IN THE TOTAL AMOUNT OF PHP57,863,909.86, INCLUSIVE OF SURCHARGE AND DEFICIENCY AND DELINQUENCY INTEREST.[39]

### *The Ruling of the Court*

The Petition for Review is meritorious.

**The assessment against petitioner for deficiency income tax for CY 2007 was timely made; however, the assessment for deficiency VAT for CY 2007 has already prescribed.**

*Section 203 of the 1997 Tax Code* states that, as a rule, internal revenue taxes shall be assessed within three (3) years from the last day prescribed by law for the filing of the return or from the day the return was filed, whichever is later, thus:

> **Sec. 203.** ***Period of Limitation Upon Assessment and Collection.*** - Except as provided in Section 222, internal revenue taxes shall be assessed within three (3) years after the last day prescribed by law for the filing of the return, and no proceeding in court without assessment for the collection of such taxes shall be begun after the expiration of such period; *Provided*, That in a case where a return is filed beyond the period prescribed by law, the three (3)-year period shall be counted from the day the return was filed. For purposes of this Section, a return filed before the last day prescribed by law for the filing thereof shall be considered as filed on such last day.[40]

Considering the instant case involves deficiency income tax and VAT, the prescribed due dates for filing of the respective returns, which shall be used as bases for the counting of the three (3)-year prescriptive period, varies.

[39] *Records, Vol. 1, PTO,* p. 347.
[40] Underscoring ours.

With regard to the income tax assessment, *Section 77(B) of the 1997 NIRC* provides that the filing of the Income Tax Return ("ITR") shall be on or before the fifteenth (15th) day of April, or the fifteenth (15th) day of the fourth (4th) month following the close of the fiscal year, as the case may be, to wit:

> **Sec. 77.** ***Place and Time of Filing and Payment of Quarterly Corporate Income Tax. -***
>
> xxx xxx xxx
>
> (B) **Time of Filing the Income Tax Return.** - The corporate quarterly declaration shall be filed within sixty (60) days following the close of each of the first three (3) quarters of the taxable year. <u>The final adjustment return shall be filed on or before the fifteenth (15th) day of April, or on or before the fifteenth (15th) day of the fourth (4th) month following the close of the fiscal year, as the case may be</u>.[41]

On the other hand, with regard to the VAT assessment, *Section 114(A) of the 1997 NIRC* provides that the filing of the Quarterly VAT Returns must be made within twenty-five (25) days after the close of each taxable quarter, as follows:

> **Sec. 114.** ***Return and Payment of Value-added Tax. -***
>
> (A) **In General.** - <u>Every person liable to pay the value-added tax</u> imposed under this Title <u>shall file a quarterly return of the amount of his gross sales or receipts within twenty-five (25) days following the close of each taxable quarter prescribed for each taxpayer</u>: *Provided, however,* That VAT-registered persons shall pay the value-added tax on a monthly basis.[42]

Based on the foregoing, the relevant dates for the determination of the timeliness of the income tax and VAT assessments against petitioner for CY 2007 are summarized, as follows:

[41] Underscoring ours.
[42] Underscoring ours.

| Tax Return | Exhibit | Date of Actual Filing | Last Day to File Return | Last Day to Assess |
|---|---|---|---|---|
| Income Tax - Annual filing | | | | |
| Annual Income Tax Return ("ITR") | -[43] | April 15, 2008 | April 15, 2008 | April 15, 2011 |
| VAT - Quarterly filing | | | | |
| 1st Quarter | P-15[44] | April 25, 2007 | April 25, 2007 | April 25, 2010 |
| 2nd Quarter | P-15-B[45] | July 24, 2007 | July 25, 2007 | July 25, 2010 |
| 3rd Quarter | P-15-C[46] | October 30, 2007 | October 25, 2007 | October 30, 2010 |
| 4th Quarter | P-15-D[47] | January 30, 2008 | January 25, 2008 | January 30, 2011 |

Considering that the FAN was issued and received by petitioner on April 11, 2011, it is clear that the assessment for income tax for CY 2007 was timely made while the assessment for VAT for CY 2007 has already prescribed.

Having ruled on the timely issuance of the assessment for income tax for CY 2007, the Court will now proceed with the determination of the validity of the same.

**Petitioner is not liable for deficiency income tax for CY 2007.**

In the CIR's Decision[48], respondent recomputed the deficiency income tax assessment in the amount of Php29,836,409.38, inclusive of increments, as follows:

| | | MCIT | | Normal |
|---|---|---|---|---|
| Taxable income *per* return | Php | 28,503,578.44 | Php | (273,171,636.55) |
| Adjustments: | | | | |
| Disallowed Expenses | | | | |
| (1) Fictitious Expenses-arising from bank overdrafts | | | | 80,425,042.37 |
| (2) Interest Expense | | | | 223,794,203.46 |
| (3) Bad Debts | | | | 2,665,255.75 |
| (4) Miscellaneous | | | | 982,771.79 |
| (5) Additional Gross Income on Unrecorded Purchases | | | | 180,250.45 |
| Taxable income *per* investigation | Php | 28,503,578.44 | Php | 34,875,887.27 |
| Income Tax Due | Php | 570,071.57 | Php | 12,206,560.54 |
| Tax Due | | | Php | 12,206,560.54 |
| Less: Payments/Credits | | | | |
| Prior year excess credit | Php | 10,493,516.00 | | |
| [(6)] Credit carried-over to the following year | | (11,852,215.56) | | |

[43] BIR Records, pp. 16-17.
[44] *Records, Vol. 2, Exhibit* "P-15," pp. 684-685; *BIR Records*, pp. 95-96.
[45] *Records, Vol. 2, Exhibit* "P-15-B," pp. 708-709; *BIR Records*, pp. 89-90.
[46] *Records, Vol. 2, Exhibit* "P-15-C," pp. 737-738; *BIR Records*, pp. 83-84.
[47] *Records, Vol. 2, Exhibit* "P-15-D," pp. 764-765; *BIR Records*, pp. 77-78.
[48] *Records, Vol. 1, JSFI*, p. 314; *Records, Vol. 2, Exhibit* "P-6," *CIR's Decision*, pp. 526-533, with annexes; *BIR Records, Exhibit* "R-8," *CIR's Decision*, pp. 989-994.

| | | | | |
|---|---|---|---|---|
| Creditable W/tax | | 1,431,232.89 | Php | 72,533.33 |
| Deficiency Income Tax Due | | | Php | 12,134,027.21 |
| Add: (7) 50% Surcharge for false return | Php | 6,067,013.61 | | |
| Interest 04/16/2008 to 01/30/2013 | | 11,635,368.56 | Php | 17,702,382.17 |
| Deficiency Income Tax Payable | | | **Php** | **29,836,409.38** |

Seven (7) items of the assessment are vital in the determination of whether or not petitioner is liable of any deficiency income tax for CY 2007, namely:

| | | | |
|---|---|---|---|
| (1) | Fictitious Expenses-arising from bank overdrafts | Php | 80,425,042.37 |
| (2) | Interest Expense | | 223,794,203.46 |
| (3) | Bad Debts | | 2,665,255.75 |
| (4) | Miscellaneous | | 982,771.79 |
| (5) | Additional Gross Income on Unrecorded Purchases | | 180,250.45 |
| (6) | Credit carried-over to the following year | | 11,852,215.56 |
| (7) | 50% Surcharge for false return | | 6,067,013.61 |

The Court shall discuss each item of assessment in *seriatim*.

1. *Fictitious expenses arising from bank overdrafts - Php80,425,042.37*

Respondent's verification of petitioner's cash account revealed that there were year-end negative balances or bank overdrafts in the total amount of Php80,425,042.37, which were added to taxable income *per* investigation as Fictitious Expenses pursuant to *Title IX(A)J of Revenue Audit Memorandum Order ("RAMO") No. 01-00*[49]. The bank accounts with net negative balances include the following:

| | | |
|---|---|---|
| CHINABANK | Php | (305,587.36) |
| EASTWEST | | (39,713,919.87) |
| IBANK | | (28,629,925.77) |
| LBP | | (11,775,609.37) |
| **Total** | **Php** | **(80,425,042.37)** |

Petitioner argues that the assessment on Fictitious Expenses is not based on actual facts but on mere analysis, allegations, and assumptions. It further explained that the negative balances resulted from non-posting or erroneous posting of deposits and fund transfers (from one bank to another) in its books.

[49] March 17, 2000.

*a.* *China Banking Corporation ("Chinabank")*

The negative amount of Php305,587.36 is net of the balances of petitioner's two (2) accounts with Chinabank in the amounts of (Php327,736.38) and Php22,149.02.

To reconcile the negative amount, petitioner submitted a bank reconciliation with supporting documents[50], which shows the 2005 transactions allegedly unrecorded in its books. Petitioner further alleged that the account was closed on January 5, 2006; however, it failed to give proof of the same. The Statement of Account from Chinabank dated January 13, 2006[51] presented by petitioner only shows that it had an ending balance of zero as of the statement date, but does not prove the closure of the said account. There may have been other transactions beyond the said date which may have changed its balance at year end.

Meanwhile, based on petitioner's trial balance[52], from which respondent based the amount of assessment, there were no transactions in either of the two Chinabank accounts of the petitioner for CY 2007, and the net negative amount of Php305,587.36 was the carried over balance from the end of CY 2006. Accordingly, there were no overdrafts in petitioner's Chinabank accounts in CY 2007 that may have resulted in the alleged fictitious expense.

*b.* *East West Banking Corporation ("EastWest")*

The negative balance of Php39,713,919.87 was sourced by respondent from petitioner's East West-FA/GA-FCDU account *per* trial balance[53].

As argued by petitioner, there was no overdraft on the said account, and that the negative amount was due to erroneous posting and unrecorded deposits and fund transfers. Moreover, relying on the ICPA's findings[54], its account with Eastwest Bank allegedly has a

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[50] *Records, Vol. 2, Exhibits* "P-8" to "P-8-B," "P-8-E" to "P-8-F," pp. 543-546, 551-552.
[51] *Id., Exhibit* "P-8-G," p. 554.
[52] *BIR Records*, p. 348.
[53] *Id.*
[54] *Records, Vol. 1, Exhibit* "P-18," p. 396.

positive balance of Php7,831,550.01 (US$144,524.25) as of December 31, 2007.

However, the Court notes that the documents[55] submitted by petitioner and used by the ICPA, to arrive at her findings were not pre-marked, not offered as evidence, and not admitted by the Court as forming part of the records of the case - which therefore cannot be used to support petitioner's position. Thus, having no other evidence presented to the Court for verification, petitioner failed to support its argument.

*c. International Exchange Bank ("iBank")*

Respondent computed its finding of negative balances on petitioner's iBank accounts, as follows:[56]

| | | |
|---|---|---|
| iBank -FA/GA | Php | 10,582,193.43 |
| iBank -FA/GA-FCDU | | (46,536,478.45) |
| iBank -Philcorn Mnl | | 11,546,795.10 |
| iBank -Philcorn Mnl-C/A#502-03-004441-6 | | 62,632.20 |
| iBank -F. Abella/G. Abella | | 1,182,997.70 |
| iBank -F. Abella/G. Abella-#11 | | (5,468,065.75) |
| **Net negative balance** | **Php** | **(28,629,925.77)** |

Petitioner avers that its iBank accounts were closed in 2006 and that its failure of posting fund transfer and other bank transaction shows that while the said accounts were closed in 2006, some accounts reflected a positive balance in 2007. In support thereof, petitioner submitted Bank Statements and Certifications issued by iBank (now, Union Bank of the Philippines) and copies of its passbook accounts.[57]

However, the Court finds that the documents submitted by petitioner do not prove that all the aforementioned accounts were closed in 2006. Further, it cannot be ascertained as to which of these accounts the Bank Statements, Passbook, and Certifications actually pertain to since petitioner did not provide the details of each account. Also, contrary to petitioner's averment that the accounts have been

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[55] Referred to as *Exhibits* "A-1-b.1" to "A-1-b.7-a-20" under the List of Exhibits (*Exhibit* "P-18-b") of the ICPA Report.
[56] *BIR Records*, p. 844.
[57] *Records, Vol. 2, Exhibits* "P-10" to "P-10-E," pp. 562-568.

closed, the two (2) accounts with negative balances of Php46,536,478.45 and Php5,468,065.75 have transactions in 2007 as appearing in the trial balance[58], which petitioner failed to account for. Thus, this assessment stands.

*d. Land Bank of the Philippines ("LBP")*

Allegedly, petitioner used this LBP bank account to cover its electronic payment of taxes, and that *per* bank records, there was no overdraft in the said account but simply a failure of recording in petitioner's books.

A perusal of the bank statement issued by LBP for the period November 30 to December 31, 2007[59] shows that petitioner's account has an ending balance of Php166,230.78. Hence, there was no overdraft in or fictitious expense related to petitioner's account.

In fine, for the assessment on fictitious expenses arising from bank overdrafts, the Court finds that only the disallowance of fictitious expenses pertaining to overdrafts in EastWest and iBank accounts, in the aggregate amount of Php68,343,845.64 (total of Php39,713,919.87 and Php28,629,925.77) are valid.

2. *Disallowed Interest Expense - Php223,794,203.46*

Based on the FDDA[60] and the CIR's Decision[61], the interest expense of Php223,794,203.46 was disallowed following *Section 4, BSP Circular No. 202, series of 1999*[62]. According to respondent, since banks are not allowed to recognize interest income on non-performing loans, petitioner should not be allowed to accrue interest expense and deduct the same from its taxable income.[63] In the PAN[64]

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[58] *BIR Records*, p. 348.
[59] *Records, Vol. 2, Exhibit* "P-9-A," p. 556.
[60] *Id., Exhibit* "P-4," pp. 498-503.
[61] *Id., Exhibit* "P-6," pp. 527-528.
[62] *Section 4, BSP Circular No. 202, series of 1999* provides:

> **Sec. 4. *Accrual of Interest Earned on Loans.*** No accrual of interest income is allowed if a loan has become non-performing as defined under this Circular. Interest on non-performing loans shall be taken up as income only when actual payments thereon are received.

[63] *Records, Vol. 2, Exhibit* "P-4," p. 499; *Records, Vol. 2, Exhibit* "P-6," pp. 527-528.
[64] *Id., Vol. 1, Exhibit* "P-1," pp. 475-478.

and the FAN[65], however, respondent initially explained the disallowance for interest expense as follows:

> **3) Disallowed Interest Expense (P[hp]223,794,203.46) -** *Per* verification, accrual method of accounting has been used in recording liabilities and in taking into account all interests [*sic*] expenses. In this case, the application of the accrual basis of accounting in recording its interest expenses presupposes it as incurred although actual payments have not yet been made. In reference to Revenue Regulations No. 6-85, the obligation to deduct and withhold the taxes due arises at the time when an income which is subject to withholding is payable or paid. No withholding has been made, thereby, disallowed pursuant to Section 2.58.5 of RR 2-98.[66]

Petitioner thus argues that the assessment item should be set aside as the change is null and void. Petitioner further argues that *BSP Circular No. 202, series of 1999* is applicable only to banks, and not to petitioner.

The Court holds that petitioner's right to due process was not impaired by the subsequent change in legal basis for the disallowed interest expense as petitioner was still accorded the opportunity to be heard and to dispute the subsequent basis for the disallowance when petitioner filed its January 30, 2012 letter and respondent issued the CIR's Decision.[67] Further, the item of assessment as well as the amount assessed remained the same.

Notwithstanding the foregoing, however, the Court holds that *BSP Circular No. 202, series of 1999* finds no application to petitioner. The BSP exercises supervisory and regulatory powers over banks and quasi-banks.[68] Petitioner, an entity engaged in the business of processing and selling coconut oil and other products, clearly does not fall within the jurisdiction of the BSP. Accordingly, *BSP Circular No. 202, series of 1999* cannot be applied to petitioner.

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[65] *Records, Vol. 1, Exhibit* "P-2," pp. 468-474.

[66] *Id., Exhibit* "P-1," p. 476; *Records, Vol. 1, Exhibit* "P-2," p. 470.

[67] *But cf. CIR v. BPI-Philam Life Assurance Corporation,* CTA *EB* No. 1240 (CTA Case No. 8240), August 24, 2015.

[68] *See Bank of Commerce v. Planters Development Bank,* G.R. Nos. 154470-71 & 154589-90, September 24, 2012, 681 SCRA 521.

Meanwhile, petitioner is legally bound to pay its loan obligations, including stipulated interests, by virtue of the loan agreements/promissory notes[69] it enters into. In fact, petitioner is already in default in the payments, and some of petitioner's loans are even the subject of litigation[70]. Thus, petitioner's loans and the interest thereon are due and demandable.

Petitioner uses the accrual method of accounting, *i.e.*, it accrues interest expense as incurred, although not yet paid. The accrual of income and expense is permitted when the all-events test, which requires that the right to income or liability be fixed and that the amount of such income or liability be determined with reasonable accuracy, has been met.[71]

The accrual method relies upon the taxpayer's right to receive amounts or its obligation to pay them, in opposition to actual receipt or payment, which characterizes the cash method of accounting. Amounts of income accrue where the right to receive them become fixed, where there is created an enforceable liability. Similarly, liabilities are accrued when fixed and determinable in amount, without regard to indeterminacy merely of time of payment.[72]

Accordingly, petitioner's liability for interest on loans was stipulated on the loan documents and can be determined with reasonable accuracy. Nonetheless, except in questioning the deductibility of interest expense, respondent did not attempt to dispute the amount or computation of such expense by petitioner for CY 2007. Thus, the disallowance of interest expense in the amount of Php223,794,203.46 is cancelled.

*3. Disallowed Bad Debts - Php2,665,255.75*

According to respondent, petitioner did not submit a valid document to support its claim for bad debts in the amount of Php2,665,255.75. Under *RR No. 25-02*[73], a taxpayer must ascertain and be able to demonstrate with reasonable degree of certainty the worthlessness and uncollectibility of the debt before such taxpayer

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[69] *Records, Vol. 2, Exhibits* "P-11-A," "P-11-C" to "P-11-JJ" & "P-11-LL," pp. 570-573, 575-608 & 612.
[70] *Id., Exhibits* "P-12," "P-12-A" & "P-12-B," pp. 617-624, 625-645 & 646-666.
[71] *CIR v. Isabela Cultural Corporation*, G.R. No. 172231, February 12, 2007, 515 SCRA 556.
[72] *Id.* citing *Mertens Law of Federal Income Taxation, Vol.2 (1996), Cash and Accrual Methods, Chapter 12A, §12A:51*, p. 12A-77.
[73] November 19, 2002.

can write-off an accounts receivable and claim the corresponding loss as a deductible expense.

Petitioner, on the other hand, argued that said debts have been ascertained as worthless as petitioner has already submitted a Sworn Statement and its list of outstanding customer accounts. In the Sworn Statement, petitioner's lawyer and legal counsel attested that the outstanding accounts receivable has already been long overdue for more than two (2) to twelve (12) years, that said accounts were from customers who are either financially incapable or could no longer be found, and that petitioner has already spent so much time to locate and collect from these customers but all efforts, including through legal demands, were in vain - making collection a virtual impossibility.

Respondent denied petitioner's protest, and argued that the worthlessness of the accounts could not be ascertained by a sworn statement. No letters of demand nor civil suits for collection were presented and there was no way of ascertaining the truth of the contents of the sworn statement.

The Court finds for respondent.

*Section 34(E)(1) of the 1997 NIRC*[74], as implemented by *RR No. 05-99*[75], provides that in order that a bad debt deduction may be validly claimed, it is essential that: (a) there is a valid and subsisting debt due to the taxpayer which must be valid and legally demandable; (b) the same must be connected with the taxpayer's trade, business, or practice of profession; (c) the same must not be

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[74] *Section 34(E)(1) of the 1997 NIRC* provides:

> **Sec. 34.** ***Deductions from Gross Income.*** - Except for taxpayers earning compensation income arising from personal services rendered under an employer-employee relationship where no deductions shall be allowed under this Section other than under Subsection (M) hereof, in computing taxable income subject to income tax under Subsections 24(A); 25(A); 26; 27(A), (B) and (C); and 28(A)(1), there shall be allowed the following deductions from gross income:
>
> xxx xxx xxx
>
> (E) **Bad Debts.**
>
> (1) *In General.* - Debts due to the taxpayer actually ascertained to be worthless and charged off within the taxable year except those not connected with profession, trade or business and those sustained in a transaction entered into between parties mentioned under Section 36(B) of this Code; *Provided*, That recovery of bad debts previously allowed as deduction in the preceding years shall be included as part of the gross income in the year of recovery to the extent of the income tax benefit of said deduction.

[75] March 10, 1999.

sustained in a transaction entered into between related parties enumerated under *Section 36(B) of the 1997 NIRC*[76]; (d) the same must be actually charged off the books of the taxpayer as of the end of the taxable year; and (e) the same must be actually ascertained to be worthless and uncollectible as of the end of the taxable year. Furthermore, the following steps must be undertaken by the taxpayer to prove that he exerted diligent efforts to collect the debts, as follows: (a) sending statements of accounts; (b) sending collection letters; (c) giving the account to a lawyer for collection; and (d) filing a collection case in court.[77]

Petitioner failed to satisfy the foregoing requisites to validly deduct its claim for bad debts and lacked documentary evidence to justify the same. It did not present any other supporting document to validate its bad debts accounts aside from the Summary of Bad Debts[78], which does not even tally with the amount of bad debts claimed as expense and which was not admitted by the Court. Moreover, petitioner failed to prove the existence of the accounts due for collection, or submit documentation to show that certain customers are indeed bound to pay any obligation, which eventually became uncollectible.

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[76] *Section 36(B) of the 1997 NIRC* provides:

**Sec. 36** ***Items not Deductible.*** -

xxx xxx xxx

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

(1) Between members of a family. For purposes of this paragraph, the family of an individual shall include only his brothers and sisters (whether by the whole or half-blood), spouse, ancestors, and lineal descendants; or

(2) Except in the case of distributions in liquidation, between an individual and a corporation more than fifty percent (50%) in value of the outstanding stock of which is owned, directly or indirectly, by or for such individual; or

(3) Except in the case of distributions in liquidation, between two corporations more than fifty percent (50%) in value of the outstanding stock of each of which is owned, directly, or indirectly, by or for the same individual, if either one of such corporations, with respect to the taxable year of the corporation preceding the date of the sale or exchange was, under the law applicable to such taxable year, a personal holding company or a foreign personal holding company;

(4) Between the grantor and a fiduciary of any trust; or

(5) Between the fiduciary of a trust and the fiduciary of another trust if the same person is a grantor with respect to each trust; or

(6) Between a fiduciary of a trust and a beneficiary of such trust.

[77] *Philippine Refining Company (now known as "Unilever Philippines [PRC], Inc.") v. Court of Appeals*, G.R. No. 118794, May 8, 1996, 256 SCRA 667.

[78] *Records, Vol. 2*, p. 667.

It appears that the only evidentiary support given by petitioner for its claimed deduction was the testimony of its legal counsel through the latter's Sworn Statement[79] and several demand letters[80] to some of its customers with alleged delinquent accounts. However, the demand letters will not suffice to ascertain the worthlessness of the accounts. Further, the Sworn Statement of the legal counsel alone, without corroborating evidence, does not prove that the customers are financially incapable to pay or are nowhere to be found. Nor does such Sworn Statement prove that the debts, if existent, were indeed worthless and can be considered as bad debts as to make them deductible.

Thus, the bad debts disallowance of Php2,665,255.75 is sustained.

4. *Disallowed Miscellaneous Expense - Php982,771.79*

*Per* respondent's verification, there were items lodged in the account which were not considered as valid company expenses and there were expenses not fully accounted, hence, disallowed pursuant to *Section 34(b) of the 1997 NIRC*, as follows:

| | | |
|---|---|---|
| Interest on personal loans | Php | 535,327.01 |
| Unaccounted | | 447,444.78 |
| **Total Disallowance** | **Php** | **982,771.79** |

In its Motion for Reconsideration on the FDDA, petitioner asserted that the amount of Php535,327.01 represents interests paid for loans extended to it by an individual, Amanda Luym. The term "personal" referred to the fact that the person concerned in the loan is an individual but did not necessarily mean that the loan was obtained for personal purposes. The alleged unaccounted amount of Php447,444.78, on the other hand, were expenses incurred and paid to laborers for the cleaning of an empty lot in preparation for its planting.

Considering that petitioner did not offer proof to support its allegations and convince the Court that respondent's finding is

[79] *Records, Vol. 2, Exhibit* "P-14," p. 683.
[80] *Id., Exhibits* "P-14-A" to "P-14-K," pp. 669-682.

flawed, the disallowance of miscellaneous expenses in the amount of Php982,771.79 remains.

5. *Additional Gross Income on Unrecorded Purchases - Php180,250.45*

Respondent's reconciliation showed a discrepancy on the income payments after comparing the amount *per* Financial Statements ("FS") *vis-à-vis* the Alphalist. This discrepancy was considered Unrecorded Income pursuant to the doctrine held in the *Perez v. CTA*[81], which stated that unreflected sources of funds not accounted for in the taxpayer's returns leads to the inference that part of his income has not been reported. The difference was grossed up and multiplied by the gross profit rate in accordance with *Revenue Memorandum Order ("RMO") No. 17-09*[82] to arrive at the additional taxable sales and gross income to be subjected to income tax. Respondent computed the assessment, as follows:

| | | |
|---|---|---|
| Difference noted | Php | 12,249,565.10 |
| Divide by: Cost of Sales Ratio | | 98.55% |
| Additional Taxable Sales | Php | 12,429,815.55 |
| Multiply by: GP Rate | | 1.45% |
| **Additional Gross Income** | **Php** | **180,250.45** |

The Court finds the assessment unmeritorious.

Respondent's allegation that petitioner had unrecorded income arising from alleged unrecorded income payments is without factual basis. It is noteworthy that the imputation of the alleged undeclared income was relied on by respondent on a mere presumption that since there were sources of funds not accounted for in petitioner's ITR/FS, it has earned income which it failed to declare, without obtaining evidence corroborating such findings. However, the Court holds that an assessment should be based on facts and not on presumptions or inferences.

Thus, for lack of factual basis, the assessment pertaining to the alleged additional gross income on unrecorded purchases of Php180,250.45 shall not prosper.

[81] G.R. L-10507, May 30, 1958, 103 Phil. 1167.
[82] April 23, 2009.

*6. Credit carried-over to the following year - Php11,852,215.56*

Based on the computation of deficiency tax assessment in the CIR's Decision[83], respondent disallowed the excess tax credits of Php11,852,215.56 reflected in petitioner's 2007 Annual ITR and carried-over to the succeeding year.

Petitioner opted to carry over the excess tax credits in the amount of Php11,852,215.60 by marking the box "To be carried over as tax credit next year/quarter"[84], computed as follows:

| | | | | |
|---|---|---|---|---|
| Income Tax Due | | | Php | 72,533.33 |
| Prior Year's Excess Credits | Php | 10,493,516.04 | | |
| Creditable Tax Withheld for the First Three Quarters | | 1,030,788.20 | | |
| Creditable Tax Withheld for the 4th Quarter | | 400,444.69 | | 11,924,748.93 |
| **Tax Payable (Overpayment)** | | | **Php** | **(11,852,215.60)** |

However, the Court notes that no basis was supplied by respondent in his disallowance of the excess tax credits. Accordingly, the same is invalid.

*7. 50% surcharge for false return - Php6,067,013.61*

The Court notes that respondent imposed the surcharge on petitioner's alleged deficiency income tax without stating the basis therefor. Following *Section 228 of the 1997 NIRC*[85], the Court disallows the imposition of the 50% surcharge as respondent failed to inform petitioner of the law and the facts on which the assessment was based.

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[83] *Records, Vol. 2, Exhibit* "P-6," p. 530.

[84] *Id., Exhibit* "P-7," *line 30,* p. 541.

[85] *Section 228 of the 1997 NIRC* provides:

> **Sec. 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 preassessment notice shall not be required in the following cases:
>
> xxx xxx xxx
>
> 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.

In sum, after taking into account all the valid line assessments for CY 2007, the Court holds that petitioner is not liable for any deficiency income tax for CY 2007.

Between the normal income tax and the Minimum Corporate Income Tax ("MCIT"), the MCIT is higher and should thus be imposed on petitioner pursuant to *Section 27(E)(1) of the 1997 NIRC*[86]. In applying the normal income tax, petitioner will have a net loss of Php201,179,763.57. On the other hand, in applying the MCIT, petitioner will have an overpayment of Php11,354,677.37. Either way, petitioner is not liable for any deficiency income tax for CY 2007 computed, as follows:

| | | MCIT | | Normal |
|---|---|---|---|---|
| Total Gross Income *per* ITR | Php | 28,503,578.24 | Php | 28,503,578.24 |
| Less: Deductions | | | | 301,675,214.99 |
| Taxable Income *per* return | Php | 28,503,578.24 | Php | (273,171,636.75) |
| Add: Disallowed Expenses | | | | |
| Fictitious Expenses-arising from bank overdrafts | | | | 68,343,845.64 |
| Bad Debts | | | | 2,665,255.75 |
| Miscellaneous | | | | 982,771.79 |
| Taxable income *per* investigation | Php | 28,503,578.24 | Php | (201,179,763.57) |
| MCIT Due (28,503,578.24 x 2%) | Php | 570,071.56 | | - |
| Less: Payments/Credits | | | | |
| Prior Year's Excess Credits | | 10,493,516.04 | | |
| Creditable Tax Withheld for the First Three Quarters | | 1,030,788.20 | | |
| Creditable Tax Withheld for the Fourth Quarter | | 400,444.69 | | |
| Total Tax Credits | Php | 1,431,232.89 | | |
| Tax Overpayment | **Php** | **(11,354,677.37)** | | |

**WHEREFORE,** premises considered, the instant Petition for Review is hereby **GRANTED**. Audit Result/Assessment Notice under Assessment No. VT-123-LA 7074-07-13-07 issued by respondent against petitioner for deficiency VAT for CY 2007 and Audit Result/Assessment Notice under Assessment No. IT-123-LA 7074-07-13-06 issued by respondent against petitioner for deficiency

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[86] *Section 27(E)(1) of the 1997 NIRC* provides:

**Sec. 27. *Rates of Income Tax on Domestic Corporations.* -**

xxx xxx xxx

(E) **Minimum Corporate Income Tax on Domestic Corporations.** -

(1) *Imposition of Tax.* - A minimum corporate income tax of two percent (2%) of the gross income as of the end of the taxable year, as defined herein, is hereby imposed on a corporation taxable under this Title, beginning on the fourth taxable year immediately following the year in which such corporation commenced its business operations, when the minimum income tax is greater than the tax computed under Subsection (A) of this Section for the taxable year.

income tax for CY 2007 are hereby **CANCELLED** and **WITHDRAWN**.

**SO ORDERED.**

**LOVELL R. BAUTISTA**
Associate Justice

**WE CONCUR:**

**ESPERANZA R. FABON-VICTORINO**
Associate Justice

**MA. BELEN M. RINGPIS-LIBAN**
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.

**LOVELL R. BAUTISTA**
Associate Justice
Chairperson

## CERTIFICATION

Pursuant to *Section 13 of Article VIII 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's Division.

**ROMAN G. DEL ROSARIO**
Presiding Justice