REPUBLIC OF THE PHILIPPINES
COURT OF TAX APPEALS
QUEZON CITY

FIRST DIVISION

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LANCASTER PHILIPPINES, INC., Petitioner,	**C.T.A. CASE NO. 6753** Members:
- versus -	**ACOSTA,** *Chairperson* **BAUTISTA,** and **CASANOVA,** *JJ.*
COMMISSIONER OF INTERNAL REVENUE, Respondent.	**Promulgated:** SEP 12 2007 1:00PM

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DECISION

ACOSTA, *P.J.*:

This case seeks the cancellation and withdrawal of the deficiency income tax assessment issued by respondent Commissioner of Internal Revenue against petitioner Lancaster Philippines, Inc., in the amount of **SIX MILLION FOUR HUNDRED SIXTY SIX THOUSAND SIXTY FIVE AND 50/100 (P6,466,065.50)** for the fiscal year April 1, 1998 to March 31, 1999.

Lancaster Philippines, Inc. (Petitioner) is a corporation duly organized and existing under the laws of the Republic of the Philippines.[1] It is engaged in the production, processing, and marketing of tobacco since 1963 here in the Philippines. Petitioner is a subsidiary of Lancaster Leaf Tobacco Company of Lancaster, Pennsylvania, U.S.A.[2]

[1] Paragraph 1, Joint Stipulation of Facts, Records, page 70
[2] Paragraph 3, Joint Stipulation of Facts, Records, page 71

On the other hand, respondent is the duly appointed Commissioner of Internal Revenue mandated by law and vested with the authority to administer, enforce and implement national internal revenue laws (National Internal Revenue Code, as amended), as well as, related statutes and their implementing rules and regulations.

On September 19, 2002, petitioner received a Preliminary Assessment Notice (PAN) dated September 16, 2002[3] from respondent demanding payment of its alleged deficiency income taxes in the amount of P6,466,065.50. For easy reference, hereunder is the computation of petitioner's tax deficiency, with its details of discrepancies, to wit:

INCOME TAX:	
Taxable Income per ITR	-0-
Add: Adjustments	
- Disallowed purchases	11,496,770.18
Adjusted Taxable Income per investigation	P11,496,770.18
INCOME TAX DUE – Basic	
April 1 – December 31, 1998 (9/12 x P11,496,770.18 x 34%)	P 2,913,676.40
January 1 – March 31, 1999 (3/12 x P11,496,770.18 x 33%)	948,483.54
Income tax still due per investigation	P 3,880,159.94
Interest (6/15/99 to 10/15/02) .66	2,560,905.56
Compromise Penalty	25,000.00
TOTAL DEFICIENCY INCOME TAX	**P 6,466,065.50**

DETAILS OF DISCREPANCIES
Assessment No. ________

A. **INCOME TAX (P3,880,159.94)** – Taxpayer's fiscal year covers April 1998 to March 1999. Verification of the books of accounts and pertinent documents disclosed that there was an overstatement of purchases for the year. Purchase Invoice Vouchers (PIVs) for February and March 1998 purchases amounting to P11,496,770.18 were included as part of purchases for taxable year 1998 in violation of Section 45 of the National Internal Revenue Code in relation to Section 43 of the same Code and Revenue Regulations No. 2 which states that the Crop-Basis method of reporting income may be used by a **farmer** engaged in producing crops which take more than one (1) year from the time of planting to the time of gathering and disposing of crop, in such a case, the entire cost of producing the crop is realized and that the taxable income should be computed upon the basis of the taxpayer's annual accounting period, (fiscal or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping with the books of taxpayer. Furthermore, it did not comply with the generally accepted principle of proper matching of cost and revenue.

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[3] Paragraph 4, Joint Stipulation of Facts, Records, page 71

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On October 3, 2002, petitioner filed its reply to the PAN, contending, among others, that for the past decades, it had used an entire tobacco-cropping season in determining its total purchases which covers a one (1) year period from October up to September of the following year. Accordingly, it has been adopting the 6-month timing difference to conform to the matching concept. Petitioner argued that this has been installed as part of their system and have consistently been applied in their accounting books.[4]

On November 6, 2002, petitioner received from respondent the Formal Letter of Demand and Audit Result/Assessment Notice LTAID II IT-98-00007, both dated October 11, 2002, reiterating petitioner's deficiency income tax liabilities in the aggregate amount of P6,466,065.50[5] per the Bureau's investigation of petitioner's books of accounts, pursuant to the Letter of Authority No. 00012289 dated September 30, 1999.

Petitioner then filed its formal protest on December 2, 2002, questioning the validity of the said deficiency tax assessment.[6] It alleged that contrary to respondent's findings, its purchases should not have been disallowed since the same conform to the cited provisions of law. Subsequently, on January 27, 2003, petitioner filed its Supplemental Protest[7] with supporting documents to substantiate its arguments against the deficiency tax assessment.

Having received no reply from respondent on its protest and before it could be barred by prescription, petitioner then elevated this instant Petition for Review on August 21, 2003.

On September 24, 2003, respondent filed his Answer, raising the following as his Special and Affirmative Defenses:

> "4. In the examination of the books of accounts and pertinent documents of petitioner, overstated purchases were added back to taxable income for purposes of computing the income tax due for the year. Though it was being contested by petitioner, alleging that the

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[4] Paragraph 5, Joint Stipulation of Facts, Records, page 71
[5] Paragraph 6, Joint Stipulation of Facts, Records, page 71
[6] Paragraph 7, Joint Stipulation of Facts, Records, page 72
[7] Paragraph 8, Joint Stipulation of Facts, Records, page 72

Purchase Invoice Vouchers of February and March 1998 should form part of its purchases for taxable year 1998 for the reason that it uses the tobacco-cropping season in determining its purchases, it was disallowed for being in violation of Section 43 of the Tax Code which requires that the taxable income should be computed upon the basis of the taxpayer's annual accounting period (fiscal or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer. Furthermore, it did not comply with the generally accepted accounting principle of proper matching of cost and revenue.

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

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

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

In its Reply filed on October 24, 2003, petitioner maintains that the posting of its Purchase Invoice Vouchers (PIV) as part of its purchases for the taxable year 1998 is in accordance with Section 43 of the Tax Code, as amended, and with the generally accepted accounting principle of proper matching of cost and revenue. Petitioner contends that, contrary to respondent's argument, it had made clear from the start of its operations that it had employed the regular accounting method by using the entire tobacco-cropping season in its determination of the total purchases, which covers a one (1) year period from October up to September of the following year, while adopting in the process a 6-month timing difference to conform with the matching concept. In fact, the provisions of Revenue Regulations No. 2, as amended, which was used as basis by respondent clearly show that the purchases it made are allowed. Petitioner submits that there is no problem in issuing the subject PIVs considering that the same were still within the crop year covered, viz., October 1997 to September 1998.

After trial and submission by both parties of their respective Memorandum, this case was submitted for decision on September 21, 2006.

The issues for resolution are as follows:

1. Whether or not respondent exceeded its Letter of Authority by investigating period not covered therein.
2. Whether or not petitioner overstated its purchases by including purchases made beyond the fiscal year period from April 1, 1998 to March 31, 1999.

At this point, it is necessary to first discuss the validity of the Letter of Authority No. 00012289 dated September 30, 1999, which was used by respondent's revenue officers as basis of their authority to examine petitioner's books of accounts; the result of which was the basis of the subject deficiency tax assessment.

Pursuant to Revenue Audit Memorandum Order (RAMO) No. 2-95[8], a Letter of Authority authorizes or empowers a designated revenue officer to examine, verify and scrutinize a taxpayer's books and records, in relation to his internal revenue tax liabilities, **for a particular period**.

Records would reveal that respondent's alleged authority[9] to examine petitioner's books of accounts which eventually led to his issuance of an assessment of deficiency income taxes against petitioner was pursuant to the Letter of Authority (LOA) No. 00012289 dated September 30, 1999. The said LOA was issued giving the revenue examiners of the Bureau of Internal Revenue the authority to examine the books of accounts of petitioner for the **taxable year 1998**. In this case, given that petitioner adopts a fiscal year which starts

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[8] VIII(C)(b)(b.2)
[9] Annex "A", Petition for Review; Exhibit "I"

from April 1 and ends March 31 of the following year, it follows then that the **taxable year 1998** referred to in the LOA is the **fiscal year covering the period from April 1, 1997 to March 31, 1998**. To rule otherwise would effectively allow respondent to examine petitioner's books of accounts not only those covered for the year 1998, but extends to those made during the year 1999. Hence, per the LOA No. 00012289, the revenue examiners' authority to investigate petitioner's books was limited only to its transactions covering the **fiscal period from April 1, 1997 to March 31, 1998**.

However, the subject deficiency income tax assessment of P6,466,065.50, as stated on the assailed assessment notice,[10] was based on petitioner's transactions/purchases made during **the fiscal year April 1, 1998 to March 31, 1999**. As mentioned earlier, under the said LOA, the revenue examiners were authorized to examine petitioner's books of accounts and other accounting records for the period **"1998"**. A close examination of the Formal Demand Letter and Assessment Notice indicates that respondent's basis in arriving at the deficiency income tax assessment against petitioner was its transactions/purchases for the fiscal year covered from **April 1, 1998 to March 31, 1999**. Obviously, the revenue examiners exceeded their authority when they issued the assessment against petitioner for deficiency income taxes. Consequently, the subject deficiency income tax assessment of P6,466,065.50 should be considered without force and effect considering that a deficiency assessment issued without a valid authority is a nullity.[11]

On a different point, even assuming that there was a valid authority issued by respondent, the deficiency income tax assessment of P6,466,065.50 should still be cancelled on substantive ground.

Respondent alleges that petitioner overstated its purchases for the fiscal year covered from April 1, 1998 to March 31, 1999, by including purchases made for the months

[10] Exhibits "I" and "I-1"
[11] Sony Philippines, Inc. vs. Commissioner of Internal Revenue, CTA Case No. 6185, October 26, 2004.

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of February and March 1998 in the amount of P11,496,770.18. Such inclusion violates Section 45, in relation to Section 43 of the National Internal Revenue Code (NIRC) of 1997, as amended, and Revenue Regulations No. 2. Likewise, the same fails to comply with the generally accepted accounting principle of matching of cost and revenue.

Petitioner, on the other hand, maintains that a closer perusal of Section 45 of Revenue Regulations No. 2, taken in conjunction with Section 45 of the Revised Internal Revenue Code, would in fact clearly show that the purchases being questioned comply with the said provisions of law.

This Court agrees with petitioner.

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

> "**SEC. 43. General Rule.- The taxable income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer**; but if no such method of accounting has been employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner clearly reflects the income. If the taxpayer's annual accounting period is other than a fiscal year, as defined in Section 22(Q), or if the taxpayer has no annual accounting period, or does not keep books, or if the taxpayer is an individual, the taxable income shall be computed on the basis of the calendar year." (*Emphasis supplied*)
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> "**SEC. 45. *Period for which Deductions and Credits Taken*.**- The deductions provided for in this Title shall be taken for the taxable year in which 'paid or accrued' or 'paid or incurred,' dependent upon the method of accounting upon the basis of which the net income is computed, **unless in order to clearly reflect the income, the deductions should be taken as of a different period**. In the case of the death of a taxpayer, there shall be allowed as deductions for the taxable period in which falls the date of death, amounts accrued up to the date of his death if not otherwise properly allowable in respect of such period or a prior period." (*Emphasis supplied*)

Relative thereto, Section 45 of Revenue Regulations No. 2, as amended, states that:

> "SEC. 45. *Gross income of farmers.* –
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> xxx If a farmer is engaged in producing crops which take more than a year from the time of planting to the time of gathering and disposing, the income therefrom may be computed upon the crop basis; but in any such

> cases **the entire cost of producing the crop must be taken as a deduction in the year in which the gross income from the crop is realized.**" (*Emphasis supplied*)

Based on records, petitioner, being engaged in the production of tobacco, uses the crop year basis accounting method. This method is recognized by the NIRC of 1997, as amended and is defined under Revenue Audit Memorandum 2-95, thus:

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

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

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

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

SO ORDERED.

ERNESTO D. ACOSTA
Presiding Justice

WE CONCUR:

LOVELL R. BAUTISTA
Associate Justice

CAESAR A. CASANOVA
Associate Justice

CERTIFICATION

Pursuant to Article VIII, Section 13 of the Constitution, it is hereby certified that the conclusions in the above Decision were reached in consultation before the case was assigned to the writer of the opinion of the Court's Division.

ERNESTO D. ACOSTA
Presiding Justice
Chairman, First Division