REPUBLIC OF THE PHILIPPINES
COURT OF TAX APPEALS
QUEZON CITY

UNIQUE DYEWORKS, INC.,
Petitioner,

- versus - **C.T.A. CASE NO. 5931**

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Promulgated:
JUN 26 2002

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DECISION

This judicial action seeks to declare as null and void Assessment Notice No. 56-24-000110-95 issued on January 26, 1999 and consequently, to cancel the 1995 deficiency income tax assessment in the amount of THREE MILLION TWO HUNDRED FIFTY SIX THOUSAND THIRTY ONE PESOS AND 57/100 (P 3,256,031.57).

The antecedent facts as culled from the records of the case are as follows:

Petitioner is a domestic corporation duly organized and existing under the laws of the Republic of the Philippines, with principal address at Molave Street, Ceris Subdivision, Canlubang, Calamba, Laguna. It is engaged in the business of manufacturing, dyeing, buying, selling, importing, exporting and otherwise dealing in, in wholesale quantities, accessories of wearing apparel of all kinds as well as all kinds of textiles and their end-use products *(Exhibit T)*. It was registered with the Bureau of Internal Revenue on January 26, 1995 with Taxpayer Identification No. 003-941-260-V *(Exhibit L)*. It was likewise registered with the Board of Investments (BOI) as a new

270

export producer of dyed fabrics and metal parts on a preferred non-pioneer status pursuant to the provisions of the Omnibus Investments Code of 1987 as shown by Certificate of Registration No. EP-95-185 dated September 4, 1995 *(Exhibit M)*.

In a Post Reporting Notice dated December 4, 1998, petitioner was informed that the investigation of its tax liabilities for the year 1995 found the corporation liable for deficiency income tax in the amount of P 3,256,031.57 *(Exhibit 7, p. 241, BIR Records)*. On January 8, 1999, petitioner requested for a reconsideration/reinvestigation of the proposed deficiency income tax assessment *(Exhibit 8, pp. 245-248, BIR Records)*.

On February 4, 1999, petitioner received from the respondent Assessment Notice No. 56-24-000110-95 dated January 26, 1999 assessing it for alleged deficiency income tax for the taxable year 1995 in the total amount of P 3,256,031.57, inclusive of surcharge, interest and compromise penalty, broken down as follows:

Tax Due	P 1,625,515.78
Add: Surcharge	403,878.95
Interest	1,211,636.84
Compromise Penalty	25,000.00
Total Amount Due	P 3,256,031.57

On March 2, 1999, petitioner filed a letter dated February 23, 1999 protesting the said deficiency income tax assessment and requesting that the same be withdrawn as it believes that it did not commit any omissions or violations of any statutory laws or rules and regulations that would justify the said assessment.

Through a letter dated August 4, 1999, Regional Director Ruben Buenaventura informed petitioner that "the contention and arguments of your external auditor cannot be

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given due consideration since we are governed by Sec. 203 of the Tax Code as amended – Period of Limitation upon assessment and collection" *(Annex C, Petition for Review)*.

Believing that no favorable response was accorded its protest, petitioner, on September 27, 1999 elevated the matter before this Court by way of a petition for review.

In his Answer, respondent raised the following Special and Affirmative Defenses:

"5. Considering the failure of the petitioner to comply with the mandatory requisites under Section 228 of the National Internal Revenue Code of 1997, the ***assessment issued against it for deficiency income tax for the year 1995 has already become final by operation of law for its failure to submit all relevant supporting documents within 60 days from filing of its protest.*** ***(Emphasis supplied)***

Thus, Section 228, Protesting of Assessment, partly states:

> "Such assessment may be protested administratively by filing a request for reconsideration or reinvestigation within thirty (30) days from receipt of the assessment in such form and manner as may be prescribed by implementing rules and regulations. ***Within sixty (60) days from filing of the protest, all relevant supporting documents shall have been submitted; otherwise the assessment shall become final.*** " **(Emphasis supplied).**

6. Since the assessment has become final, this honorable Court has no jurisdiction to act on the instant petition;

7. Assuming arguendo that the assessment has not become final by operation of law, respondent has rendered a decision on petitioner's protest in a letter dated August 4, 1999. **(Annex "C", Petition)**

8. In a Post Reporting Notice dated December 4, 1998, petitioner was informed of the law and the facts on which the assessment is made, in compliance with Section 228 of the Tax Code;

9. The BIR findings for the underdeclaration of gross sales of petitioner were based on its gross sales declared in its Annual

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Corporate Income Tax return for the year ended December 31, 1995 which are less than the amount declared in its Value Added Tax Returns covering the period from the 1st quarter to the 4th quarter of the same year.

10. Pursuant to ***Section 29 (b)(1) of the Tax Code,*** business expenses in order to be deductible, must comply with the following, to wit:

    a. Must constitute an ordinary and necessary expense;
    b. Must be paid or incurred during the taxable year in carrying on any trade or business;
    c. Must be reasonable in amount;
    d. Must be sustained by adequate proof; and
    e. Must not be against the law or public policy.

    Petitioner, in this case manifestly failed to prove the preceding requirements of the law. Hence, its argument that in determining its gross profits, the cost of goods sold should be deducted from its gross sales is without merit. Instead, the cost of goods sold should be included in petitioner's gross sales for 1995 in order to determine the gross income derived by it.

11. Moreover, the gross sales of petitioner prior to November 6, 1995 cannot be capitalized and offset against the pre operating expenses, considering that it is deemed to have started its commercial operation from the date of issuance of its certificate of registration and not from its first importation of raw materials as alleged by petitioner;

12. The assessment issued against petitioner for deficiency income tax for the year 1995 was made in accordance with law and regulations;

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

The issues to be resolved in this case were stipulated by the parties to be as follows:

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1. Whether or not it is a requirement under the law that the respondent Bureau of Internal Revenue should inform Petitioner of the law and facts on which the assessment is made;

2. Whether or not the subject deficiency income tax assessment is null and void;

3. Whether or not Petitioner underdeclared its sales for the year ended December 31, 1995;

4. Whether or not the cost of goods sold is deductible from Petitioner's gross sales for 1995 in determining the latter's gross income;

5. Whether or not the respondent has rendered a decision on petitioner's protest;

6. Whether or not Petitioner submitted all relevant supporting documents to the Respondent.

As the first and second issues are interrelated, the same shall be resolved jointly. Section 228 of the Tax Code of 1997, which was already in force at the time the assessment in question was issued on January 26, 1999, provides:

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

Quite evident from the foregoing is the use of the word "shall" which connotes the mandatory nature of the said provision. Indubitably, compliance with the said provision requiring the BIR to inform the taxpayer of the facts and the law on which the assessment is based is compulsory. Otherwise, non-observance of the said provision would entirely affect the validity of the assessment. The purpose of the aforesaid requirement is to give the taxpayer the opportunity to refute the findings of the examiner and give a more accurate and detailed explanation regarding the proposed assessment(s) ***(Belle Corporation vs. Commissioner of Internal Revenue, CTA Case No. 5930, April 4, 2002)***.

Hence, petitioner, relying on the provisions of Section 228 of the Tax Code, now questions the validity of Assessment Notice No. 56-24-006110-95 as it allegedly failed to state the law and the facts on which the assessment was based.

We do not agree. From the facts so stated, we believe that there is sufficient compliance with Section 228 of the Tax Code. The tenor of the protest letter filed by petitioner on March 2, 1999 would indicate that petitioner clearly understood the nature of the assessment issued against it and knew for a fact that the deficiency assessment was brought about by the alleged underdeclaration of gross sales in the Annual Corporate Income tax Return.

As correctly pointed out by the respondent, petitioner could not have intelligently protested the assessment had it not been aware of the basis thereof. Consequently, it cannot be said that petitioner did not know the basis of the assessment when in fact, it even fully explained the reason why the imputed sales were not accordingly declared. This Court believes that the post reporting notice and the attached audit sheet, have verily met the purpose of apprising the taxpayer of the factual as well as the legal bases of the assessment. As ruled by this Court:

> "x x x petitioner was able to explain in detail and submit documents to support its claim that the assessments were erroneous. Verily, at the time the assessments were issued, petitioner knew very well the law and the facts on which they were based. The purpose of the law having been served, Section 228 of the Tax Code may be deemed to have been complied with.
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> Since we rule that by petitioner's actual knowledge of the bases of assessments, the requirement that section 228 of the Tax Code that "the taxpayer be informed of the law and facts on which the assessment is made" is deemed to have been complied, it follows then that the assessments x x x are not null and void, even if the same failed to state the law and facts on which they were based ***(Belle Corporation vs. Commissioner of Internal Revenue, supra).***

Thus, in the case at bar, the disputed assessment notice dated January 26, 1999 is valid as it complied with the requirements laid down in Section 228 of the Tax Code.

We now proceed to resolve the third issue of whether or not petitioner underdeclared its sales for the year ended December 31, 1995.

Records show that petitioner was assessed for the year 1995 a deficiency income tax liability of P3,256,031.57, inclusive of surcharge, interest and compromise penalty. Said assessment arose from petitioner's alleged failure to include in its gross sales for the year 1995 the sales prior to November 6, 1995 in the amount of P4,615,759.37.

On its part, petitioner believes that said sales should not be declared in the year 1995 because it was still in the pre-operating stage during the period March 1 to November 5, 1995. According to petitioner, the questioned sales were generated from test runs of the company's dyeing machines and they were mere incidental revenues,

276

which are allowed under the law to be capitalized and offset against the pre-operating expenses.

However, the revenue examiner asserts that petitioner underdeclared its sales for 1995 because the gross sales declared in the 1995 ITR is less than the total sales declared in the quarterly VAT returns.

The deficiency income tax assessment was computed as follows:

Sales per ITR (Exhbits N, N-1)			P2,517,636.00
Sales per VAT Returns			
PERIOD COVERED	**EXHIBIT**	**AMOUNT**	
Jan-Mar '95	P	P -	
Apr-Jun '95	Q	2,187,088.42	
Jul-Sep '95	R	1,493,805.69	
Oct-Dec '95	S	3,452,501.26	7,133,395.37
Undeclared Sales			**P 4,615,759.37**
Multiply by income tax rate			35%
Tax Due			P 1,615,515.78
Add: Surcharge			403,878.95
Interest			1,211,636.84
Compromise Penalty			25,000.00
Total Amount Due			**P 3,256,031.57**

We do not subscribe to petitioner's view that the incidental revenues incurred during the aforesaid stage of operation should not be included in its gross income. This Court is not convinced by petitioner's allegation that it only started its commercial operations on November 6, 1995. This fact is belied by the existence of Invoice No. 311 *(Exhibit FF)*, which invoice number indicates that petitioner had issued more than three

277

hundred invoices prior to the aforementioned sale. Thus, petitioner recorded more than three hundred sales transactions prior to November 6, 1995, as shown in petitioner's letter to respondent dated December 01, 1997 *(BIR Records, p. 226)*.

Issuance of sales invoices is an indication that an organized company has started its commercial operations. Since petitioner has recorded sales transactions prior to November 6, 1995, its operations can no longer be considered as pre-operating.

For reasons aforestated, the questioned sales should be included as part of its gross sales for the taxable year 1995.

Apropos the fourth issue, petitioner questioned the computation of the revenue examiner in arriving at the 1995 deficiency income tax assessment.

According to petitioner, respondent erred in not considering the cost of sales and the corresponding allowable expenses as deductions from gross sales in computing petitioner's taxable income. We agree.

Having considered the questioned sales as included as part of the gross income, it is axiomatic, therefore, that the corresponding cost of sales and expenses should likewise be considered as deductions to arrive at taxable income pursuant to Section 27 in relation to Sections 28 and 29 of the 1995 Tax Code, which are hereunder quoted as follows:

> "**SECTION 27.** *Taxable Income.* – The term "taxable income" means the pertinent items of gross income specified in this Code less the deductions, if any, authorized by such types of income by this Code or other special laws: *Provided*, That for purposes of Section 21 (b) "taxable income" means gross income from all sources without the Philippines less the deductions allowed in Section 29 (m). (As amended by E.O. No. 37) (Underlining supplied)"

278

> **"SECTION 28.** *Gross Income.* -(a) General definition.-Gross income means all income from whatever source derived, including (but not limited to) the following items:
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> (1) Compensation for services, including, fees, commissions, and similar items;
> **(2) Gross income derived from business;**
> (3) Gains derived from dealings in property;
> (4) Interest;
> (5) Rents;
> (6) Royalties;
> (7) Dividends;
> (8) Annuities;
> (9) Prizes and winnings;
> (10) Pensions; and
> *(11)* Partner's distributive share of the gross income of general professional partnership."*(emphasis supplied)*
>
> "**Section 29.** *Deductions from gross income.* - In computing taxable income subject to tax under Sections 21(a), 24(a), (b) and (c); and 25 (a)(1), there shall be allowed as deductions the items specified in paragraphs (a) to (i) of this section: Provided, however, That in computing taxable income subject to tax under Section 21 (f) in the case of individuals engaged in business or practice of profession, only the following direct costs shall be allowed as deductions:"
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> x x x

Gross income from business is commonly expressed in a formula: Total sales less cost of goods sold, plus any income derived from other sources, equals gross income. It is recognized that the cost of goods sold is to be excluded from gross receipts in arriving at gross income. ***(Mertens, Law of Federal Income Taxation, Vol. 1, Chap. 5 p. 23)***

As can be gleaned from the records, the cost of sales and expenses relative to the undeclared sales were not deducted to arrive at the taxable income. These should have been deducted from the gross receipts. Thus, the proper computation should be:

Gross Sales per ITR	P 2,517,636.00
Add: Sales prior to Nov. 6, 1995	4,615,759.37

279

Total Assessed Sales		P 7,133,395.37
Less: Cost of Sales		
(a) Per ITR	P 3,316,695.00	
(b) Prior to Nov. 6, 1995 (Exhibit HH)	5,810,953.00	9,127,648.00
Loss		(P 1,994,252.63)
Less: Operating Expenses		1,293,386.00
Net Loss		(P 3,287,638.63)

It must be pointed out that even with the inclusion of the undeclared sales, petitioner would still end up in a net loss position and would thereby not be subject to income tax.

Anent the fifth issue of whether or not the respondent has rendered a decision on petitioner's protest, we answer in the negative. The BIR's letter-reply to the protest *(Annex C, Petition for Review),* dated August 4, 1999 cannot be considered the final decision appealable to this Court. A close reading of the said letter would reveal that it is bereft of the tenor of finality as it does not indicate in clear and unequivocal language that his action on the protest letter constitutes a final determination by the BIR on the disputed assessment. A mere reiteration to the petitioner to settle the tax liabilities due and demandable does not suffice. Indubitably, no final decision yet was rendered by the Commissioner on petitioner's protest.

Taking cue from the tenor of the letter-reply dated August 4, 1999, petitioner again filed a letter to the BIR requesting for a compromise on the ground of financial incapacity. Since then, nothing has been heard from the respondent. It is evident that the scenario besetting the case at bar contemplates a situation where the Commissioner did not act upon the protest.

280

The pertinent provision would now be Section 228 (last paragraph) of the Tax Code, particularly the 30-day period within which to appeal to this Court in case there is no action on the part of the respondent, thus:

> "**Section 228.** *Protesting of assessment.* -
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> x x x x x x
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> If the protest is denied in whole or in part, or is not acted upon within one hundred eighty (180) days from submission of documents, the taxpayer adversely affected by the decision or inaction may appeal to the Court of Tax appeals within (30) days from receipt of the said decision, or from the lapse of the one hundred (180)-day period; otherwise, the decision shall become final, executory and demandable."

Petitioner filed its letter of protest on March 2, 1999 and respondent failed to act thereon. Considering that there was no such action, petitioner had 30 days from August 29, 1999, the lapse of the 180-day period under Section 228 of the Tax Code, within which to appeal to this Court. The filing by the petitioner of the petition for review in this Court on September 27, 1999 was well within the 30-day period mandated by law.

The last issue was brought forth because of respondent's contention (in his answer) that the assessment issued against the petitioner has already become final by operation of law for its failure to submit all relevant supporting documents within sixty (60) days from filing of its protest as provided for in Section 228 of the Tax Code.

We do not agree. Even before the formal assessment was issued, petitioner had already submitted all relevant documents to the BIR for their perusal. As a matter of fact, petitioner made certain that all their book of accounts and financial records should be available to the BIR for inspection *(TSN, March 16, 2000, pp. 15-16)*.

To show proof that they have submitted all relevant documents pertaining to their operation, petitioner presented the cover letters (Exhibits B, D, E, F & G) stamped received by the Office of the Revenue District Officer of Calamba, Laguna listing the documents submitted to that office, such as the Monthly and Quarterly VAT Returns, Annual Information Return of Income Tax Withheld on Compensation, Expanded and Final Withholding Taxes, Alphabetical List of Employees, Summary of Creditable Income Taxes withheld, List of Ending Inventory, BOI and SEC Registration, Schedule of Importation, Bank Statements and Deposit Slips, Cash Disbursement Book, Sales Book, Official Receipts and Promissory Note, 1995 Sales Invoices, Letter of Credit, SGV Adjustments and BOI Reports and Photocopies of 1995 Remittances.

In case the respondent felt that said documents were insufficient, he could have requested the petitioner to submit what is lacking. After investigation in this case, respondent never required petitioner to submit additional documents determined by him to be needed to resolve petitioner's protest. Of course, petitioner is not required to submit other evidence, which he feels will be unnecessary to his protest. As aptly ruled by this Court in the case of ***Standard Chartered Bank-Philippine Branches vs. Commissioner of Internal Revenue, CTA Case 5696, August 16, 2001,***

> "x x x As stated earlier, the determination of the relevant supporting documents" initially rests upon the one who filed the protest, the petitioner. However, in cases where the BIR finds that additional documents must be submitted, it should have informed the taxpayer-protester to submit whatever documents are lacking in order that a complete determination of the propriety of the assessment may be had. Thus, Respondent has been remiss in informing the petitioner of any other additional supporting documents to be submitted which fact should not unduly prejudice petitioner's protest."

282

Based on the foregoing findings, the deficiency income tax assessment issued against the petitioner should be cancelled.

WHEREFORE, in view of the foregoing, the Petition for Review is hereby **GRANTED**. Accordingly, Assessment Notice No. 56-24-000110-95 issued by respondent against the petitioner on January 26, 1999 is hereby **CANCELLED AND SET ASIDE**.

SO ORDERED.

Juanito C. Castañeda, Jr.
JUANITO C. CASTAÑEDA, JR.
Associate Judge

I CONCUR:

ERNESTO D. ACOSTA
Presiding Judge

CERTIFICATION

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

ERNESTO D. ACOSTA
Presiding Judge

283