Republic of the Philippines
Supreme Court
Manila

SECOND DIVISION

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

- versus -

PHILIPPINE DAILY INQUIRER, INC.,
Respondent.

G.R. No. 213943

Present:

CARPIO, *J.*, Chairperson,
PERALTA,
MENDOZA,
LEONEN, and
MARTIRES, *JJ.*

Promulgated:
22 MAR 2017

x- x

DECISION

CARPIO, *J.*:

The Case

Before the Court is a petition for review[1] assailing the 4 November 2013 Decision[2] and the 1 August 2014 Resolution[3] of the Court of Tax Appeals (CTA) *En Banc* in CTA EB Case No. 905. The CTA *En Banc* affirmed the 16 February 2012 Decision[4] and the 8 May 2012 Resolution[5] of the CTA First Division in CTA Case No. 7853 which granted the petition for review filed by Philippine Daily Inquirer, Inc. (PDI) and cancelled the Formal Letter of Demand dated 11 March 2008 and Assessment No. LN # 116-AS-04-00-00038-000526 issued by the Bureau of Internal Revenue (BIR) for deficiency Value Added Tax (VAT) and income tax for the taxable year 2004.

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1 Under Rule 45 of the 1997 Rules of Civil Procedure.

2 *Rollo*, pp. 98-128. Penned by Associate Justice Lovell R. Bautista, with Presiding Justice Roman G. Del Rosario and Associate Justices Juanito C. Castañeda, Jr., Erlinda P. Uy, Caesar A. Casanova, Esperanza R. Fabon-Victorino, Cielito N. Mindaro-Grulla, Amelia R. Cotangco-Manalastas, and Ma. Belen M. Ringpis-Liban concurring.

3 Id. at 133-135.

4 Id. at 137-164. Penned by Associate Justice Erlinda P. Uy, with Presiding Justice Ernesto D. Acosta and Associate Justice Esperanza R. Fabon-Victorino concurring.

5 Id. at 166-172.

The Antecedent Facts

The facts of this case, as presented by the CTA, are as follows:

PDI is a corporation engaged in the business of newspaper publication. On 15 April 2005, it filed its Annual Income Tax Return for taxable year 2004. Its Quarterly VAT Returns for the same year showed the following:

	Date of Filing
For the First Quarter	20 April 2004
For the Second Quarter	16 July 2004
For the Third Quarter	18 October 2004
For the Fourth Quarter	21 January 2005[6]

On 10 August 2006, PDI received a letter dated 30 June 2006 from Region 020 Large Taxpayers' Service of BIR under LN No. 116-AS-04-00-00038. BIR alleged that based on the computerized matching it conducted on the information and data provided by third party sources against PDI's declaration on its VAT Returns for taxable year 2004, there was an underdeclaration of domestic purchases from its suppliers amounting to ₱317,705,610.52. The BIR invited PDI to reconcile the deficiencies with BIR's Large Taxpayers Audit & Investigation Division I (BIR-LTAID). In response, PDI submitted reconciliation reports, attached to its letters dated 22 August 2006 and 19 December 2006, to BIR-LTAID. On 21 March 2007, PDI executed a Waiver of the Statute of Limitation (First Waiver) consenting to the assessment and/or collection of taxes for the year 2004 which may be found due after the investigation, at any time before or after the lapse of the period of limitations fixed by Sections 203 and 222 of the National Internal Revenue Code (NIRC) but not later than 30 June 2007. The First Waiver was received on 23 March 2007 by Nestor Valeroso (Valeroso), OIC-ACIR of the Large Taxpayer Service. In a letter dated 7 May 2007, PDI submitted additional partial reconciliation and explanations on the discrepancies found by the BIR. On 30 May 2007, PDI received a letter dated 28 May 2007 from Mr. Gerardo Florendo, Chief of the BIR-LTAID, informing it that the results of the evaluation relative to the matching of sales of its suppliers against its purchases for the taxable year 2004 had been submitted by Revenue Officer Narciso Laguerta under Group Supervisor Fe Caling. In the same letter, BIR invited PDI to an informal conference to present any objections that it might have on the BIR's findings. On 5 June 2007, PDI executed a Waiver of the Statute of Limitation (Second Waiver), which Valeroso accepted on 8 June 2007.

[6] Id. at 138.

In a Preliminary Assessment Notice (PAN) dated 15 October 2007 issued by the BIR-LTAID, PDI was assessed for alleged deficiency income tax and VAT for taxable year 2004 on the basis of LN No. 116-AS-04-00-00038. The PAN states:

COMPUTATION OF DEFICIENCY VAT

Undeclared Income		₱ 1,007,565.03
Add: Overdeclared input VAT		1,601,652.43
Total undeclared income per Investigation		₱ 2,609,217.46
Less: Attributable input tax		715,371.17
VAT still payable per investigation		₱ 1,893,846.29
Add: Increments -		
Interest from 1/26/05 to 11/15/07	₱1,062,629.37	
Compromise penalty	25,000.00	1,087,629.37
Amount Due and Collectible		₱ 2,981,475.66

COMPUTATION OF DEFICIENCY INCOME TAX

Undeclared Gross Income		₱ 10,075,650.28
Less: Cost of Sales		7,153,711.70
Undeclared Net Income		₱ 2,921,938.58
Multiply by income tax rate		32%
Income tax still due per investigation		₱ 935,020.35
Add: Increments -		
Interest from 4/16/05 to 11/15/07	₱ 483,648.88	
Compromise penalty	20,000.00	503,648.88
Amount Due and Collectible		₱ 1,438,669.23[7]

PDI received the PAN on 4 December 2007. In a letter dated 12 December 2007, PDI sought reconsideration of the PAN and expressed its willingness to execute another Waiver (Third Waiver), which it did on the same date, thus extending BIR's right to assess and/or collect from it until 30 April 2008. Romulo L. Aguila, Jr. (Aguila), OIC-Head Revenue Executive Assistant for the Large Taxpayers Service-Regular, accepted the Third Waiver on 20 December 2007.

On 17 April 2008, PDI received a Formal Letter of Demand dated 11 March 2008 and an Audit Result/Assessment Notice from the BIR, demanding for the payment of alleged deficiency VAT and income tax, respectively, computed as follows:

1. COMPUTATION OF (DEFICIENCY) VAT

Undeclared Income	₱ 1,007,565.03
Add: Overdeclared input VAT	1,601,652.43
Total Undeclared Income per Investigation	₱ 2,609,217.46
Less: Attributable input tax	715,371.17
VAT still payable per investigation	₱ 1,893,846.29

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[7] Id. at 101.

Add: Increments -		
Interest from 1/26/05 to 11/15/07	₱1,235,929.28	
Compromise penalty	25,000.00	1,260,929.28
Amount Due and Collectible		₱ 3,154,775.56

2. COMPUTATION OF [DEFICIENCY INCOME TAX]

Undeclared Gross Income		₱ 10,075,650.28
Less: Cost of Sales		7,153,711.70
Undeclared Net Income		2,921,938.58
Multiply by income tax rate		32%
Income tax still due per investigation		₱ 935,020.35
Add: Increments -		
Interest from 4/16/05 to 11/15/07	₱ 569,209.65	
Compromise penalty	20,000.00	589,209.65
Amount Due and Collectible		₱ 1,524,229.99[8]

On 16 May 2008, PDI filed its protest. On 12 December 2008, PDI filed a Petition for Review against the Commissioner of Internal Revenue (CIR) alleging that the 180-day period within which the BIR should act on its protest had already lapsed.

The CTA First Division, quoting at length the CIR's Answer, presented the following facts:

> Petitioner Philippine Daily Inquirer is liable to pay the amount of Three Million One Hundred Fifty Four Thousand Seven Hundred Seventy Five Pesos and 56/100 (₱3,154,775.56) and One Million Five Hundred Twenty Four Thousand Two Hundred Twenty Nine Pesos and 99/100 (₱1,524,299.99) representing deficiency Value-Added Tax (VAT and Income Tax, respectively, for the taxable year 2004.
>
> 1. The VAT and income tax liabilities of petitioner in the aggregate amount of Four Million Six Hundred Seventy Nine Thousand and Five Pesos and 55/100 (₱4,679,005.55) arose on account of the issuance to petitioner of Letter Notice No. 116-AS-04-00-00038 dated June 30, 2006. Computerized matching conducted by respondent on information/data provided by third party sources against its declaration per VAT returns revealed the aforesaid discrepancies for taxable year 2004. The income and value-added tax liabilities were generated through the Reconciliation of Listing for Enforcement (RELIEF) system-Summary List of Sales and Purchases (SLSP) and Third Party Matching. Through the system, respondent was able to detect tax leaks through the matching of data available in the Integrated Tax Systems (ITS) with the information gathered from third party sources.
>
> On the basis of the consolidation and cross-referencing of third party information, discrepancy reports on sales and purchases were generated to uncover under-declared income and over-claimed purchases (goods and services).

[8] Id. at 102. The records show that there are discrepancies in the total amounts due from PDI as computed by the CTA and the amounts in the Formal Letter of Demand and Audit Result/Assessment Notice because of erroneous computation by the BIR. The amounts should be ₱3,154,775.57 and ₱1,525,230.00.

As explicitly provided under Revenue Memorandum Order (RMO) No. 42-2003:

> II. POLICIES
>
> [x x x]
>
> 2. In order to intensify enforcement, the power of the Commissioner to authorize the examination of the taxpayer and the assessment of the correct amount of tax is hereby ordered done through the so called '*no contact-audit-approach*'.
>
> 3. The '*no contact-audit-approach*' includes the process of computerized matching of sales and purchases data contained in the Schedules of Sales and Domestic Purchases, and Schedule of Importation submitted by VAT taxpayer under the RELIEF system pursuant to RR No. 7-95 as amended by RR Nos. 13-97, 7-99 and 8-2002. This may also include the matching of data from other information or returns filed by the taxpayers with the BIR such as Alphalist of Payees subject to Final or Creditable Withholding Taxes.
>
> 4. Even without conducting a detailed examination of taxpayer's books and records, the computerized/manual matching of sales and purchases/expenses will reveal discrepancies which shall be communicated to the concerned taxpayer through the issuance of a Letter Notice (LN) by the Commissioner.
>
> 5. LNs being served by the Bureau upon the taxpayer found to have understated their sales or over claimed their purchases/expenses <u>can be considered notice of audit or investigation</u> in so far as the amendment of any return is concerned which is the subject of such LN. A taxpayer is therefore disqualified from amending his return once an LN is served upon him.
>
> III. GUIDELINES
>
> x x x
>
> 5. The LN shall serve as a discrepancy notice to taxpayer similar to a Notice of Informal Conference, thus, the procedures defined in RR 12-99 should likewise be observed.

Furthermore, in CTA Case No. 7092 entitled '*BIG AA Corporation represented by Erlinda L. Stohner vs. Bureau of Internal Revenue*' dated February 22, 2006, the Honorable Court had the opportunity to say:

> 'Letter Notices issued against a taxpayer in connection with the information of under declaration of sales and purchases gathered through Third Party Information Program may be considered as a '**<u>notice of audit or investigation</u>**' in the absence of evident error or clear abuse of discretion.'

2. On the basis of the abovementioned LN and after a careful and extensive scrutiny of petitioner's documents, resulting deficiency in income and Value-added taxes led to the issuance of the Preliminary Assessment Notice (PAN) dated October 15, 2007 together with the Details of Discrepancies and subsequently, a Formal Letter of Demand (FLD) dated March 11, 2008.

Relative thereto, Section 203 of the National Internal Revenue Code (NIRC) explicitly provides:

> **'Section 203. Period of Limitation Upon Assessment and Collection of Taxes.**
>
> **<u>Except as provided in Section 222</u>**, internal revenue taxes shall be assessed **<u>within three (3) years after the last day prescribed by law for filing of the return</u>**, 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 i[s] filed beyond the period prescribed by law, the three (3) year period shall be counted from the day [t]he 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 filed on such day.'

However, Section 222 of the NIRC provides the exceptions as regards to the provisions laid down under Section 203. In particular, as shown under Section (1) thereof, the three (3) [year] period of limitation in making assessment shall **<u>not</u>** apply in cases where it involves **false or fraudulent return** or in cases where there is failure to file a return [by] the person obliged to file such return. Section 222(a) of the National Internal Revenue Code provides:

> **'Section 222. Exceptions as to Period of Limitation of Assessment and Collection of Taxes.**
>
> (a) In the case of a **<u>false or fraudulent return</u>** with intent to evade tax or **<u>failure to file a return</u>**, the tax may be assessed, or a proceeding in court for the collection of such tax may be filed without assessment, at any time **<u>within ten (10) years</u>** after the discovery of the falsity, fraud or omission; Provided, That in a fraud assessment which has become final and executor[y], [t]he fact of fraud shall be judicially taken cognizance of in the civil and criminal action for the collection thereof.'

Such being the case, the three (3) [year] period of limitation for the assessment of internal revenue tax liabilities reckoned from the last day prescribed by law for the filing of the return shall not apply in the case at hand for the simple reason that petitioner ***falsely*** filed the return for taxable year 2004. Such being the case, the applicable provision shall be Section 222(a) where the period of limitation provides that the assessment may be made within ten (10) years after the discovery of falsity, fraud or omission. In the case at hand, the reckoning period was from the time during which the LN dated June 30, 2006 was issued to petitioner. Indubitably, the Formal Letter of Demand dated March 11, 2008 was issued within the prescriptive period provided by law. Such being the case, the FLD is considered valid and has the force and effect of law.

3. On the basis of the investigation conducted by respondent through the RELIEF system, respondent though the FLD, outlined how the tax liabilities in the aggregate amount of ₱4,679,005.55 representing income and VAT liabilities were arrived at. Upon matching the data gathered from respondent's Integrated Tax System (ITS) against the Summary of List of Purchases (SLP) attached to the Quarterly VAT returns filed with respondent, the following discrepancies remain unsettled despite petitioner's submission of supporting documents:

(a) An excess of SLP over the Letter Notices (LN) in the amount of ₱1,601,652.43 from the following suppliers:

	Per SLP	**Per LN**	**Discrepancy**
Alliance Media Printing Corp.	109,073,375.58	107,640,812.95	1,432,562.63
Citimotors Inc.	70,454.55	70,056.65	397.90
Diamond Motors Corp.	288,181.82	142,363.64	145,818.18
Western Marketing Corp.	30,830.99	7,957.27	22,873.72
Total	**109,462,842.94**	**107,861,190.51**	**1,601,652.43**

(b) On the other hand, it is likewise evident than an excess of LN over the SLP also occurred in the total amount of Seven Hundred Fifteen Thousand Three Hundred Seventy One Pesos and 17/100 (₱715,371.17). The details of which are shown hereunder:

	Per SLP	**Per LN**	**Discrepancy**
Grasco Industries Inc.		202.55	(202.55)
Harrison Communications Inc.	18,157.89	398,331.12	(380,173.23)
Makati Property Ventures		64.55	(64.55)
Mc[C]an[n] Erikson Phils. Inc.		204,769.38	(204,769.38)
Millennium Cars Inc.		89,545.45	(89,545.45)
WPP Marketing Communications Inc.		40,616.01	(40,616.01)
Total	**18,157.89**	**733,529.06**	**(715,371.17)**

On the basis of the aforesaid investigation, it can be observed that the SLP which petitioner attached as supporting documents upon filing the quarterly VAT return revealed the declared amount of ₱109,462,842.94 as its input VAT for purchases incurred. However, on the basis of the LN, its suppliers recorded in its books of account the aggregate amount of ₱107,861,190.51 as its corresponding VAT. Suffice it to say, the over-declared VAT input tax on the part of petitioner led to the under declaration of VAT payable in the amount of ₱1,601,652.43 for the taxable year 2004. Therefore, petitioner is liable to pay said outstanding VAT. In addition, the amount of ₱10,075,650.28 which resulted from the excess of the LN over the SLP amounting to ₱715,371.17 must be likewise added to arrive at the total VAT liability of P3,154,775.56 *(including increments up to April 30, 2008)*. Details of the computation are shown in the FLD.

As stated earlier, the excess of LN over the SLP in the amount of ₱715,371.17 resulted to under-declared input tax on the part of petitioner which led to an under[-]declared purchases of ₱7,153,711.70, arrived at by dividing ₱715,371.17 by the VAT rate of 10%. As can be gleaned from the LN, suppliers declared in its books of accounts output VAT for sales made to petitioner. However, in petitioner's SLP, no declaration of such amount incurred for the taxable year 2004 was shown. Such being the case, petitioner under-declared its purchases that resulted to the under-declared amount of Input VAT. If petitioner has under[-]declared its purchases, it would likewise have under-declared its Gross Income which will be worked back by using the ratio of Cost of Sales against its Gross Income per Income Tax Return. In the case at hand, the ratio of Cost of Sales against its Gross Income per Income Tax Return filed for taxable year 2004 is 71%. If petitioner divides the amount of ₱7,153,711.70 by the cost ratio of 71%, the under-declared Gross Income of ₱10,075,650.28 will be arrived at. Such being the case, petitioner would then be liable to pay the corresponding income tax for the under-declared Net [I]ncome at the rate of 32%. Net Income was arrived at by deducting from the Gross Income of ₱10,075,650.28 the corresponding Cost of Sales of ₱7,153,711.70. Hence, the amount of income tax still to be paid is ₱1,524,229.99 *(including additional increments until April 30, 2008)*. For ready reference of this Honorable Court, the full details of the aforesaid computation are shown in the Formal Letter of Demand issued to petitioner.

4. Petitioner emphasized that it is a service company deriving its main source of income from newspaper and ***advertising sales***, thus any understatement of expenses or purchases (also mostly from services) does not mean it understated its sales. It goes further by saying that its transactions pertaining mostly to services and goods must be reflected as Operating Expenses and not as part of the Cost of Sales. It revealed that Harrison Communications Inc., McCann Erikson Inc., WPP Marketing Corporation are some of the advertising agencies which rendered direct professional services to petitioner in the form of marketing or promotional purposes. To bolster its claim, it likewise stated that the transactions with aforesaid three (3) main entities should not be treated as cost of sales since what these entities provided were '*not materials*' in order for petitioner to gain income that can be both taxable under the income tax and VAT provisions.

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Corollary thereto, Section 27 E(4) of the NIRC specifically provides:

> '(4) **Gross Income Defined**. For purposes of applying the minimum corporate income tax provided under Section (E) hereof, the term '**gross income**' shall mean gross sales less sales returns, discounts and allowances and cost of goods sold. '**Cost of goods sold**' shall include business expenses **<u>directly incurred</u>** to produce the merchandise to bring them to their present location and use.
>
> x x x
>
> In the case of taxpayers engaged in the sale of service, '**gross income**' means gross receipts less sales returns, allowances, discounts and cost of services. '**Cost of services**' shall mean **<u>direct costs and expenses necessarily incurred to provide the services required by the customers and clients</u>** including (a) salaries and employee benefits of personnel, consultants and specialists directly rendering the service and (b) cost of facilities directly utilized in providing the service such as depreciation or rental of equipment used and cost of supplies.'

Petitioner, by its own admission, is a service-oriented company which derives its income from sale of newspaper and advertisement. It is without doubt that in selling newspapers to the public, it necessarily incurs direct costs to bring about the merchandise it sells to its present state and/or condition. In the same vein, in selling advertisements to clients/customers, it likewise incurs direct costs for the rendition of services in the process. On the basis of the aforesaid provision of the NIRC, 'cost of services' include[s] **<u>direct costs and expenses</u>** necessarily incurred to provide the services required by its customers or clients. Applying the same at hand, in order for petitioner to boost its sales on advertisement, it would actually employ services of companies which would handle the promotion and marketing of the services it is offering. The direct and professional services rendered by the three (3) advertising companies namely Harrison Communications Inc., McCann Erikson Inc. and WPP Marketing Corporation should be considered as part of the cost of advertisement sales/services by petitioner.

In view of the foregoing, the amount of discrepancy that resulted on account of the under-declared input tax of ₱715,371.17 should be treated as Cost of Sales of services and not just an ordinary operating expenses because the services provided by the aforementioned three (3) advertising agencies are direct costs and expenses necessary to bring about the advertisement sales of petitioner."[9]

After the presentation of oral and documentary evidence and submission of the parties' respective Memoranda, the case was submitted for resolution.

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[9] Id. at 142-147. Citations omitted. Boldfacing and underscoring in the original.

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The Decision of the CTA First Division

The CTA First Division resolved the following issues raised by the parties:

> 1. Whether or not respondent's authority to issue an assessment against petitioner for deficiency value-added and income taxes has prescribed;
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> 2. Whether or not respondent erred in assessing petitioner deficiency value-added tax and income tax for calendar year 2004;
>
> 3. Whether petitioner is liable to pay the aggregate amount of Four Million Six Hundred Seventy Nine Thousand Five Pesos and 55/100 (Php 4,679,005.55) representing alleged deficiency income and value-added tax for taxable year 2004, including interest and compromise penalty from 30 April 2008 until fully paid pursuant to Sections 248 and 249 of the Tax Code, arising from discrepancies which were generated through the Reconciliation of Listing for Enforcement (RELIEF) System-Summary List of Sales and Purchases and Third Party Matching of Data available in the Integrated Tax System (ITS) of respondent against information gathered from third party sources;
>
> 4. Whether the fees paid to the three (3) advertising agencies, namely Harrison Communications Inc., McCann Erikson Inc., and WPP Marketing Corporation are considered part of the cost of sales made by petitioner for taxable year 2004;
>
> 5. Whether Section 222 of the Tax Code is applicable in the case at hand;
>
> 6. Whether the Formal Letter of Demand dated 11 March 2008 was issued within the prescriptive period provided by law; and
>
> 7. Whether or not petitioner should be assessed a compromise penalty.[10]

In its 16 February 2012 Decision, the CTA First Division ruled in favor of PDI.

The CTA First Division ruled that the period of limitation in the assessment and collection of taxes is governed by Section 203 of the NIRC which provides:

> 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

[10] Id. at 148-149.

> 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.

The CTA First Division ruled that internal revenue taxes must be assessed on time. It added that the period of assessment must not extend indefinitely because doing so will deprive the taxpayer of the assurance that it will not be subjected to further investigation after the expiration of a reasonable period of time. Nevertheless, the CTA First Division noted that the three-year prescriptive period under Section 203 of the NIRC applies only when the returns are filed pursuant to legal requirements. The CTA First Division explained that for false or fraudulent tax returns, or for failure to file returns, the prescriptive period is 10 years after the discovery of the falsity or fraud, or from failure to file tax returns. It also added that in the absence of a false or fraudulent return, or where a return has been filed, the period of limitation may still be extended in cases where the taxpayer and the CIR have agreed in writing, prior to the expiration of the period prescribed under Section 203 of the NIRC, to an assessment within the time agreed upon.

In ruling on the prescriptive period, the CTA First Division had to determine whether PDI's tax returns were false or fraudulent. The CTA First Division ruled that in ascertaining the correctness of any return, or in determining the tax liability of any person, the CIR is authorized to obtain information, on a regular basis, from any person other than the taxpayer subject of the audit or investigation. It further ruled that the CIR may rely on the information obtained from third parties in issuing assessments to taxpayers, and that the CIR enjoys the presumption of regularity in obtaining such information. Further, the CTA First Division stated that the determinations and assessments of the CIR are presumed correct and made in good faith, and it is the duty of the taxpayer to prove otherwise. The CTA First Division then ruled that in this case, PDI introduced proof that the determination made by the CIR on the supposed overdeclared input tax of ₱1,601,652.43 is not correct. The CTA First Division ruled that the CIR failed to disprove the findings submitted by the Independent Certified Public Accountant (ICPA) that supported PDI's assertions.

The CTA First Division rejected the CIR's theory that since there was an underdeclaration of the input tax and of purchases, it translates to taxable income for tax purposes and taxable gross receipts for VAT purposes. According to the CTA First Division, the following elements must be present in the imposition of income tax: (1) there must be gain or profit; (2) the gain or profit is realized or received, actually or constructively; and (3) it is not exempted by law or treaty from income tax. In this case, the CTA First Division ruled that in the imposition or assessment of income tax, it must be clear that there was an income and the income was received by the taxpayer. The basis could not be merely an underdeclaration of purchases. The CTA

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First Division added that for income tax purposes, a taxpayer may either deduct from its gross income a lesser amount, or not claim any deduction at all. It stated that what is prohibited is to claim a deduction beyond the amount authorized by law. According to the CTA First Division, even when there was underdeclaration of input tax, which means there was an underdeclaration of purchases and expenses, the same is not prohibited by law.

As regards the VAT assessment, the CTA First Division ruled that the 10% VAT is assessed on "gross receipts derived from the sale or exchange of services." As such, it is critical to show that the taxpayer received an amount of money or its equivalent, and not only that there was underdeclared input taxes or purchases. The CTA First Division ruled that it was an error for the CIR to impose a deficiency income tax based on the underdeclared input tax, and the income tax return cannot be treated as false. Thus, the CTA First Division ruled that the prescriptive period applicable to the case is the three-year period, and the deficiency income tax assessment issued by the BIR beyond the three-year prescriptive period is void.

The CTA First Division further ruled that Section 222(b) of the NIRC authorizes the extension of the original three-year prescriptive period by the execution of a valid waiver upon the agreement in writing between the taxpayer and the BIR, provided: (1) the agreement was made before the expiration of the three-year period and (2) the guidelines in the proper execution of the waiver are strictly followed. The CTA First Division found that while the First and Second Waivers were executed in three copies, the BIR failed to provide the office accepting the waivers with their respective third copies. The CTA First Division found that the third copies were still attached to the docket of the case. The CTA First Division also found that the BIR failed to prove that the Third Waiver was executed in three copies. Further, the revenue official who accepted the Third Waiver was not authorized to do so. The CTA First Division also noted that the Second Waiver would have expired on 31 December 2007 but the Third Waiver was already executed on 20 December 2007, meaning there was enough time to have it signed by the ACIR of the Large Taxpayers Service. The CTA First Division concluded that due to the defects in the Waivers, the three-year period within which to assess PDI was not extended. The CTA First Division further ruled that the compromise penalties should likewise be cancelled. The dispositive portion of the CTA First Division's Decision reads:

> WHEREFORE, premises considered, the instant Petition for Review is hereby GRANTED. The Formal Letter of Demand dated March 11, 2008 and Assessment No. LN # 116-AS-04-00-00038-[000526] for calendar year 2004 issued by the BIR against petitioner are hereby CANCELLED and SET ASIDE.

SO ORDERED.[11]

The CIR filed a motion for reconsideration. In its 8 May 2012 Resolution, the CTA First Division denied the motion for lack of merit.

The CIR filed a petition for review before the CTA *En Banc*.

<u>The Decision of the CTA *En Banc*</u>

In its 4 November 2013 Decision, the CTA *En Banc* cited the CTA First Division's Decision extensively. The CTA *En Banc* ruled that it found no reason to depart from the CTA First Division's findings. The CTA *En Banc* held that PDI sufficiently discharged its burden of proving that the VAT assessment and the Income Tax assessment made by the CIR were not correct. The CTA *En Banc* ruled that the presumptions of correctness and regularity cited by the CIR were overturned by the evidence presented by PDI particularly, the final report of the ICPA, accounts payable, check vouchers, invoices, official receipts, and credit memoranda. The CTA *En Banc* noted that the CIR did not present any evidence to the contrary. The CTA *En Banc* rejected the CIR's allegation that PDI made a false return and held that the three-year prescriptive period based on Section 203, in relation to Section 222(a) of the NIRC, as amended, should apply in this case. The CTA *En Banc* likewise sustained the CTA First Division's ruling that the Waivers issued by PDI were defective and could not extend the three-year prescriptive period. The CTA *En Banc* also sustained the CTA First Division's ruling that it can resolve the issue of prescription because the CIR did not contest it when it was raised by PDI.

The dispositive portion of the CTA *En Banc*'s Decision reads:

> WHEREFORE, premises considered, the Petition for Review is hereby DENIED for lack of merit. Accordingly, the Decision and Resolution dated February 16, 2012 and May 8, 2012, respectively, are hereby AFFIRMED *in toto*.
>
> SO ORDERED.[12]

The CIR filed a motion for reconsideration. In its 1 August 2014 Resolution, the CTA *En Banc* denied the motion for lack of merit.

Hence, the CIR filed a petition for review on certiorari before this Court.

[11] Id. at 163.
[12] Id. at 127.

The Issues

The CIR raised the following issues in her petition:

> (1) The CTA *En Banc* erred in ruling that petitioner's assessment for deficiency VAT and income tax was adequately controverted by respondent;
>
> (2) The CTA *En Banc* erred in ruling that the petitioner's right to assess respondent for deficiency VAT and income tax has prescribed; and
>
> (3) The CTA *En Banc* erred in ruling that respondent is not estopped from raising the defense of prescription.[13]

The Ruling of this Court

BIR's assessment was not adequately controverted by PDI

Reconciliation of Listing for Enforcement (RELIEF) System is an information technology tool used by the BIR to improve tax administration.[14] The system was created -

> x x x to support third party information program and voluntary assessment program of the Bureau through the cross-referencing of third party information from the taxpayers' Summary Lists of Sales and Purchases prescribed to be submitted on a quarterly basis pursuant to Revenue Regulations Nos. 7-95, as amended by RR 13-97, RR 7-99 and RR 8-2002.[15]

In addition -

> [RELIEF] can detect tax leaks by matching the data available under the Bureau's Integrated Tax System (ITS) with data gathered from third party sources (i.e. Schedules of Sales and Domestic Purchases, and Schedule of Importations submitted by VAT taxpayers pursuant to RR No. 7-95, as amended by RR Nos. 13-97, 7-99 and 8-2002).
>
> Through the consolidation and cross-referencing of third party information, discrepancy reports on sales and purchases can be generated to uncover under declared income and over claimed purchases (goods and services). Timely recognition and accurate reporting of unregistered taxpayers and non-filers can be made possible.[16]

Using the RELIEF system, the BIR assessed PDI for deficiency VAT and income tax amounting to ₱3,154,775.57 and ₱1,525,230.00, respectively. According to the BIR, the computerized matching conducted

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[13] Id. at 58.
[14] See Revenue Memorandum Order No. 4-2003, 20 February 2003.
[15] Id.
[16] BIR Revenue Memorandum Order No. 30-2003, 18 September 2003.

by its office, using information and data from third party sources against PDI's VAT returns for 2004 showed an underdeclaration of domestic purchases from its suppliers amounting to ₱317,705,610.52. PDI denied the allegation.

In ruling on the case, the CTA recognized that the BIR may obtain information from third party sources in assessing taxpayers. The CTA also stated that the BIR enjoyed a presumption of regularity in obtaining the information, and its assessments are presumed correct and made in good faith. Indeed, the burden to controvert the assessments made by the BIR lies with the taxpayer. In this case, the CTA rejected BIR's finding that PDI underdeclared its input tax and purchases. According to the CTA, PDI was able to disprove BIR's assessments.

The general rule is that findings of fact of the CTA are not to be disturbed by this Court unless clearly shown to be unsupported by substantial evidence.[17] Since by the very nature of its functions, the CTA has developed an expertise to resolve tax issues, the Court will not set aside lightly the conclusions reached by them, unless there has been an abuse or improvident exercise of authority.[18]

In reaching their conclusions, the CTA First Division and *En Banc* relied on the report submitted by the ICPA. According to the CTA, the BIR failed to rebut the ICPA report. After going over the ICPA report, as well as the affidavit summarizing the examination submitted by Jerome Antonio B. Constantino (Constantino), a Certified Public Accountant and the Managing Partner of the firm that conducted the examination, this Court notes that:

> (1) Purchases made from Harrison Communications, Inc. were recorded as general and administrative expenses and selling expenses in the 2004 General Ledger and 2004 Audited Financial Statements and not as cost of sales;[19]
>
> (2) The 2004 purchases from Harrison Communications, Inc. and McCann Erickson, Inc. were recorded in PDI's book in 2005 and 2006 as "Summary List of Purchases." There was a discrepancy between the purchases from Harrison Communications, Inc. and McCann Erickson, Inc. and the BIR's Letter Notice amounting to ₱150,203.29 and ₱191,406.02, respectively, but the ICPA was not able to account for the difference because according to PDI, the details were not provided in the BIR's Letter Notice;[20]

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[17] *Commissioner of Internal Revenue v. Team Sual Corporation*, 739 Phil. 215 (2014).
[18] Id.
[19] CTA *rollo*, p. 147.
[20] Id. at 147-148.

> (3) Promotional services purchased from Harrison Communications, Inc. and McCann Erickson, Inc. in 2004 were recorded in PDI's books in 2005 and 2006. According to Constantino, the VAT input on purchases from Harrison Communications, Inc. and McCann Erickson, Inc. recorded in 2005 and 2006, amounting to ₱206,713.63 and ₱13,363.36, respectively, were supported only by photocopies of sales invoices because PDI claimed that it could not find the original documents despite diligent efforts to locate them;[21]
>
> (4) Constantino reported that no input taxes were recorded in 2004 from McCann Erickson, Inc., Millennium Cars, Inc., WPP Marketing Communications, Inc., Grasco Industries, Inc., and Makati Property Ventures. Constantino was not able to vouch for supporting documents for purchase transactions from WPP Marketing Communications, Inc., Grasco Industries, Inc., and Makati Property Ventures. He established that the purchase from Millennium Cars, Inc. was for a car loan account for an employee and was recorded to Advances to Officers and Employees;[22]
>
> (5) Alliance Media Printing, Inc.'s erroneous posting of data in the BIR RELIEF caused the discrepancies in the analysis of suppliers' sales and purchases made by PDI.[23]

The foregoing showed that there were discrepancies that PDI were able to explain. In particular, the ICPA report showed that the purchase from Millennium Cars, Inc. was made on behalf of an employee as a loan. In addition, the underdeclared input tax insofar as Alliance Printing, Inc. is concerned was due to the latter's erroneous posting of data, a fact that the corporation admitted. However, there are still issues that need to be resolved. In particular, PDI failed to justify its erroneous listing of purchases from Harrison Communications, Inc., McCann Erickson, Inc., and WPP Marketing Corporation as general and administrative expenses.

The CIR pointed out that PDI could not treat purchases from Harrison Communications, Inc. and McCann Erickson, Inc. as general and administrative expenses. Indeed, Section 27(E)(4) of the NIRC provides:

> x x x x
>
> (4) Gross Income Defined. For purposes of applying the minimum corporate income tax provided under Subsection (E) hereof, the term "gross income" shall mean gross sales less sales returns, discounts and allowances and cost of goods sold. "Cost of goods sold" shall include business expenses directly incurred to produce the merchandise to bring them to their present

[21] Id. at 148.
[22] Id. at 148, 150.
[23] Id. at 149-150.

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> location and use.
>
> x x x x
>
> In the case of taxpayers engaged in the sale of service, "gross income" means gross receipts less sales returns, allowances, discounts and cost of services. "Cost of services" shall mean direct costs and expenses necessarily incurred to provide the services required by the customers and clients including (a) salaries and employee benefits of personnel, consultants and specialists directly rendering the service and (b) cost of facilities directly utilized in providing the service such as depreciation or rental of equipment used and cost of supplies: *Provided*, however, That in the case of banks, "cost of services" shall include interest expense.

The ICPA report found nothing wrong in the entries. However, as pointed out by the Office of the Solicitor General, PDI is a service-oriented company that derives its income from the sale of newspapers and advertisements. The services rendered by Harrison Communications, Inc., McCann Erickson, Inc., and WPP Marketing Corporation were meant to promote and market the advertising services offered by PDI. As such, their services should be considered part of cost of services instead of general and administrative expenses and operating expenses.

Such finding would ordinarily call for a recomputation. However, we need to resolve first whether the BIR's assessment was made within the prescriptive period.

Prescription and Estoppel

We will discuss the second and third issues jointly.

The CIR alleges that PDI filed a false or fraudulent return. As such, Section 222 of the NIRC should apply to this case and the applicable prescriptive period is 10 years from the discovery of the falsity of the return. The CIR argues that the ten-year period starts from the time of the issuance of its Letter Notice on 10 August 2006. As such, the assessment made through the Formal Letter of Demand dated 11 March 2008 is within the prescriptive period.

We do not agree.

Under Section 203 of the NIRC, the prescriptive period to assess is set at three years. This rule is subject to the exceptions provided under Section 222 of the NIRC. The CIR invokes Section 222(a) which provides:

[signature]

> SEC. 222. *Exceptions as to Period of Limitation of Assessment and Collection of Taxes*. –
>
> > (a) In the case of a false or fraudulent return with intent to evade tax or of failure to file a return, the tax may be assessed, or a proceeding in court for the collection of such tax may be filed without assessment, at any time within ten (10) years after the discovery of the falsity, fraud or omission: *Provided*, That in a fraud assessment which has become final and executory, the fact of fraud shall be judicially taken cognizance of in the civil or criminal action for the collection thereof.

In *Commissioner of Internal Revenue v. Javier*,[24] this Court ruled that fraud is never imputed. The Court stated that it will not sustain findings of fraud upon circumstances which, at most, create only suspicion.[25] The Court added that the mere understatement of a tax is not itself proof of fraud for the purpose of tax evasion.[26] The Court explained:

> x x x. The fraud contemplated by law is actual and not constructive. It must be intentional fraud, consisting of deception willfully and deliberately done or resorted to in order to induce another to give up some legal right. Negligence, whether slight or gross, is not equivalent to fraud with intent to evade the tax contemplated by law. It must amount to intentional wrong-doing with the sole object of avoiding the tax. x x x.[27]

In *Samar-I Electric Cooperative v. Commissioner of Internal Revenue*,[28] the Court differentiated between false and fraudulent returns. Quoting *Aznar v. Court of Tax Appeals*,[29] the Court explained in *Samar-I* the acts or omissions that may constitute falsity, thus:

> Petitioner argues that Sec. 332 of the NIRC does not apply because the taxpayer did not file false and fraudulent returns with intent to evade tax, while respondent Commissioner of Internal Revenue insists contrariwise, with respondent Court of Tax Appeals concluding that the very "substantial underdeclarations of income for six consecutive years eloquently demonstrate the falsity or fraudulence of the income tax returns with an intent to evade the payment of tax."
>
> To our minds we can dispense with these controversial arguments on facts, although we do not deny that the findings of facts by the Court of Tax Appeals, supported as they are by very substantial evidence, carry great weight, by resorting to a proper interpretation of Section 332 of the NIRC. We believe that the proper and reasonable interpretation of said provision should be that in the three different cases of (1) false return, (2) fraudulent return with intent to evade tax, (3) failure to file a return, the tax may be assessed, or a proceeding in court for the collection of such tax may be begun without assessment, at any time within ten years after the discovery of the (1) falsity, (2) fraud, (3) omission. Our stand that the law should be

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24 See *Commissioner of Internal Revenue v. Javier, Jr.*, 276 Phil. 914 (1991).
25 Id.
26 Id.
27 Id. at 921-922, citing *Aznar v. Court of Tax Appeals*, 157 Phil. 510 (1974).
28 G.R. No. 193100, 10 December 2014, 744 SCRA 459.
29 157 Phil. 510 (1974).

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> interpreted to mean a separation of the three different situations of false return, fraudulent return with intent to evade tax, and failure to file a return is strengthened immeasurably by the last portion of the provision which segregates the situation into three different classes, namely "falsity," "fraud," and "omission." That there is a difference between "false return" and "fraudulent return" cannot be denied. While the first implies deviation from the truth, whether intentional or not, the second implies intentional or deceitful entry with intent to evade the taxes due.
>
> The ordinary period of prescription of 5 years within which to assess tax liabilities under Sec. 331 of the NIRC should be applicable to normal circumstances, but whenever the government is placed at a disadvantage so as to prevent its lawful agents from proper assessment of tax liabilities due to false returns, fraudulent return intended to evade payment of tax or failure to file returns, the period of ten years provided for in Sec. 332(a) NIRC, from the time of discovery of the falsity, fraud or omission even seems to be inadequate and should be the one enforced.[30]

Thus, while the filing of a fraudulent return necessarily implies that the act of the taxpayer was intentional and done with intent to evade the taxes due, the filing of a false return can be intentional or due to honest mistake. In *CIR v. B.F. Goodrich Phils., Inc.*,[31] the Court stated that the entry of wrong information due to mistake, carelessness, or ignorance, without intent to evade tax, does not constitute a false return. In this case, we do not find enough evidence to prove fraud or intentional falsity on the part of PDI.

Since the case does not fall under the exceptions, Section 203 of the NIRC should apply. It provides:

> 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.

Indeed, the Waivers executed by the BIR and PDI were meant to extend the three-year prescriptive period, and would have extended such period were it not for the defects found by the CTA. This further shows that at the outset, the BIR did not find any ground that would make the assessment fall under the exceptions.

In *Commissioner of Internal Revenue v. Kudos Metal Corporation*,[32] the Court ruled:

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[30] *Samar-I Electric Cooperative v. Commissioner of Internal Revenue,* supra note 28 at 470-471.

[31] 363 Phil. 169 (1999).

[32] 634 Phil. 314 (2010).

Section 222(b) of the NIRC provides that the period to assess and collect taxes may only be extended upon a written agreement between the CIR and the taxpayer executed before the expiration of the three-year period. RMO 20-90 issued on April 4, 1990 and RDAO 05-01 issued on August 2, 2001 lay down the procedure for the proper execution of the waiver, to wit:

> 1. The waiver must be in the proper form prescribed by RMO 20-90. The phrase "but not after ____ 19__", which indicates the expiry date of the period agreed upon to assess/collect the tax after the regular three-year period of prescription, should be filled up.
>
> 2. The waiver must be signed by the taxpayer himself or his duly authorized representative. In the case of a corporation, the waiver must be signed by any of its responsible officials. In case the authority is delegated by the taxpayer to a representative, such delegation should be in writing and duly notarized.
>
> 3. The waiver should be duly notarized.
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> 4. The CIR or the revenue official authorized by him must sign the waiver indicating that the BIR has accepted and agreed to the waiver. The date of such acceptance by the BIR should be indicated. However, before signing the waiver, the CIR or the revenue official authorized by him must make sure that the waiver is in the prescribed form, duly notarized, and executed by the taxpayer or his duly authorized representative.
>
> 5. Both the date of execution by the taxpayer and date of acceptance by the Bureau should be before the expiration of the period of prescription or before the lapse of the period agreed upon in case a subsequent agreement is executed.
>
> 6. The waiver must be executed in three copies, the original copy to be attached to the docket of the case, the second copy for the taxpayer and the third copy for the Office accepting the waiver. The fact of receipt by the taxpayer of his/her file copy must be indicated in the original copy to show that the taxpayer was notified of the acceptance of the BIR and the perfection of the agreement.[33]

In this case, the CTA found that contrary to PDI's allegations, the First and Second Waivers were executed in three copies. However, the CTA also found that the CIR failed to provide the office accepting the First and Second Waivers with their respective third copies, as the CTA found them still attached to the docket of the case. In addition, the CTA found that the Third Waiver was not executed in three copies.

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[33] Id. at 323-326.

The failure to provide the office accepting the waiver with the third copy violates RMO 20-90 and RDAO 05-01. Therefore, the First Waiver was not properly executed on 21 March 2007 and thus, could not have extended the three-year prescriptive period to assess and collect taxes for the year 2004. To make matters worse, the CIR committed the same error in the execution of the Second Waiver on 5 June 2007. Even if we consider that the First Waiver was validly executed, the Second Waiver failed to extend the prescriptive period because its execution was contrary to the procedure set forth in RMO 20-90 and RDAO 05-01. Granting further that the First and Second Waivers were validly executed, the Third Waiver executed on 12 December 2007 still failed to extend the three-year prescriptive period because it was not executed in three copies. In short, the records of the case showed that the CIR's three-year prescriptive period to assess deficiency tax had already prescribed due to the defects of all the Waivers.

In *Commissioner of Internal Revenue v. The Stanley Works Sales (Phils.), Incorporated*,[34] the Court explained the nature of a waiver of assessment. The Court said:

> In *Philippine Journalist, Inc. v. Commissioner of Internal Revenue*, the Court categorically stated that a Waiver must strictly conform to RMO No. 20-90. The mandatory nature of the requirements set forth in RMO No. 20-90, as ruled upon by this Court, was recognized by the BIR itself in the latter's subsequent issuances, namely, Revenue Memorandum Circular (RMC) Nos. 6-2005 and 29-2012. Thus, the BIR cannot claim the benefits of extending the period to collect the deficiency tax as a consequence of the Waiver when, in truth it was the BIR's inaction which is the proximate cause of the defects of the Waiver. The BIR has the burden of ensuring compliance with the requirements of RMO No. 20-90 as they have the burden of securing the right of the government to assess and collect tax deficiencies. This right would prescribe absent any showing of a valid extension of the period set by the law.
>
> To emphasize, the Waiver was not a unilateral act of the taxpayer; hence, the BIR must act on it, either by conforming to or by disagreeing with the extension. A waiver of the statute of limitations, whether on assessment or collection, should not be construed as a waiver of the right to invoke the defense of prescription but, rather, an agreement between the taxpayer and the BIR to extend the period to a date certain, within which the latter could still assess or collect taxes due. The waiver does not imply that the taxpayer relinquishes the right to invoke prescription unequivocally.
>
> Although we recognize that the power of taxation is deemed inherent in order to support the government, tax provisions are not all about raising revenue. Our legislature has provided safeguards and remedies beneficial to both the taxpayer, to protect against abuse; and the government, to promptly act for the availability and recovery of revenues. A statute of limitations on the assessment and collection of internal revenue taxes was adopted to serve a purpose that would benefit both the taxpayer and the government.[35]

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[34] G.R. No. 187589, 3 December 2014, 743 SCRA 642.

[35] Id. at 653-654. Citations omitted.

Clearly, the defects in the Waivers resulted to the non-extension of the period to assess or collect taxes, and made the assessments issued by the BIR beyond the three-year prescriptive period void.[36]

The CIR also argues that PDI is estopped from questioning the validity of the Waivers. We do not agree. As stated by the CTA, the BIR cannot shift the blame to the taxpayer for issuing defective waivers.[37] The Court has ruled that the BIR cannot hide behind the doctrine of estoppel to cover its failure to comply with RMO 20-90 and RDAO 05-01 which were issued by the BIR itself.[38] A waiver of the statute of limitations is a derogation of the taxpayer's right to security against prolonged and unscrupulous investigations and thus, it must be carefully and strictly construed.[39]

Since the three Waivers in this case are defective, they do not produce any effect and did not suspend the three-year prescriptive period under Section 203 of the NIRC. As such, we sustain the cancellation of the Formal Letter of Demand dated 11 March 2008 and Assessment No. LN # 116-AS-04-00-00038-000526 for taxable year 2004 issued by the BIR against PDI.

WHEREFORE, we **DENY** the petition.

SO ORDERED.

ANTONIO T. CARPIO
Associate Justice

WE CONCUR:

DIOSDADO M. PERALTA
Associate Justice

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[36] *Commissioner of Internal Revenue v. Kudos Metal Corporation*, supra note 32.
[37] *Rollo*, p. 126.
[38] *Commissioner of Internal Revenue v. Kudos Metal Corporation*, supra note 32.
[39] Id.

JOSE CATRAL MENDOZA
Associate Justice

MARVIC M.V.F. LEONEN
Associate Justice

SAMUEL R. MARTIRES
Associate Justice

ATTESTATION

I attest that the conclusions in the above Decision had been reached in consultation before the case was assigned to the writer of the opinion of the Court's Division.

ANTONIO T. CARPIO
Associate Justice
Chairperson

CERTIFICATION

Pursuant to Section 13, Article VIII of the Constitution, and the Division Chairperson's Attestation, I certify that the conclusions in the above Decision had been reached in consultation before the case was assigned to the writer of the opinion of the Court's Division.

MARIA LOURDES P. A. SERENO
Chief Justice