

Mactan Export Processing Zone, 3rd Street, Mactan, Lapu-Lapu City.³

Petitioner is engaged in the business of manufacturing, assembling, processing, designing, exporting, buying and selling wholesale automotive wiring harnesses, electric wire assemblies, electric motors, electric switches, terminals and connectors, and other automotive assemblies and fittings. It is also engaged in warehousing and logistic service operations that include consolidating, storing, packaging, exporting, buying and selling automotive parts and components, and ensuring the suitable logistics requirements of its customers.⁴ As a Philippine Economic Zone Authority (PEZA)-registered enterprise, petitioner is entitled to the five percent (5%) special tax on gross income under Section 24 of Republic Act (RA) No. 7916, as amended by RA No. 8748 (PEZA Law, as amended).⁵

Respondent Commissioner of Internal Revenue is the head of the Bureau of Internal Revenue, the government agency officially responsible for the assessment and collection of all national internal revenue taxes, fees and charges. She holds office at the BIR National Office Building, Diliman, Quezon City.

Petitioner and Lear entered into an Intangibles Licensing Agreement⁶, whereby petitioner shall use the intangible property of Lear; which is required for the manufacturing and marketing of automotive wire harness products. As consideration, petitioner shall pay royalties to Lear.⁷

On April 6, 2005, petitioner, through Joaquin Cunanan & Co., sent a letter to the BIR to confirm whether the royalties paid by petitioner to Lear are deductible from the former's gross sales for purposes of computing its taxable income subject to 5% tax under the PEZA law, as amended.⁸

In response, the BIR, through then Deputy Commissioner Jose Mario C. Buñag, held in BIR Ruling DA-147-2005 dated April 13, 2005, that: ✓

³ Par. 1, Jointly Stipulated Facts, Joint Stipulation of Facts and Issues (JSFI), docket, p. 165.

⁴ Exhibits "A" and "A-1", docket, p. 921.

⁵ Exhibits "D" and "E", docket, pp. 927 and 929-930.

⁶ Exhibits "J" to "J-5", docket, pp. 1023-1034.

⁷ Exhibit "J-2", docket, p. 1025.

⁸ Exhibit "K", docket, pp. 1047-1052.

“Thus, the treatment of royalties depends on the consideration for which such fees were paid. When the royalties relate to a system or license, royalties are treated as general administrative expenses, which are not inventoriable costs. When, however, royalties are connected with a product design, logo, formula, or process, the payment is capitalized as part of inventories. Therefore, payments for royalties related to the transfer of technical information and manufacturing know-how should be considered as part of the cost of manufacturing the products. (BIR Ruling No. DA-147-04 dated March 29, 2004; and DA-017-05 dated January 19, 2005).

In view of the foregoing, this Office holds that the royalty payments made by LASN⁹ to Lear in consideration for the transfer of technology necessary for the continued production of LASN’s products are part of the cost of finished goods and are deductible from gross sales for purposes of computing its taxable gross income subject to 5% tax under Republic Act No. 7916.”¹⁰

CTA Case No. 8421

On August 14, 2008, by virtue of Letter of Authority (LOA) No. 200700007073¹¹ dated July 1, 2008, the BIR sent its First Notice¹² to petitioner requesting the submission of petitioner’s documents in relation to its investigation.

Petitioner received a Notice of Informal Conference from the BIR on January 19, 2011.¹³

On March 24, 2011, the BIR sent a Preliminary Assessment Notice (PAN)¹⁴ to petitioner, finding it liable to pay deficiency income tax and value-added tax (VAT) in the total amount of ₱241,677,782.37. Subsequently, petitioner received a Final Assessment Notice¹⁵ (FAN) from the BIR on April 13, 2011, finding it liable for deficiency income tax and VAT for taxable year 2007 in the total amount of ₱241,677,782.37. Consequently, petitioner protested the FAN on May 11, 2011.¹⁶ ✓

⁹ Petitioner herein.

¹⁰ Exhibit “L”, docket, pp. 885-887.

¹¹ Exhibit “1”, BIR Records, Folder 1, p. 1.

¹² Exhibit “2”, BIR Records, Folder 1, p. 8.

¹³ Exhibit “3”, BIR Records, Folder 1, p. 429.

¹⁴ Exhibit “4”, BIR Records, Folder 1, pp. 759-763.

¹⁵ Exhibit “G”, docket, pp. 959-965; Exhibit “5”, BIR Records, Folder 1, pp. 775-779.

¹⁶ Exhibit “H”, docket, pp. 973-994.

On January 4, 2012, petitioner received the Final Decision on Disputed Assessment (FDDA)¹⁷ from the BIR, finding it liable only for deficiency income tax in the amount of ₱33,139,425.51 for taxable year 2007. As a consequence, petitioner filed a Petition for Review before this Court on February 1, 2012, later docketed as CTA Case No. 8421.

In her Answer¹⁸ filed on March 28, 2012, respondent raised the following special and affirmative defenses:

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7.3.1 The costing of the inventories written-off were disallowed because it has no prior BIR approval nor request for a representative from the BIR was made in order to witness the actual write-off. In a claim for deduction from gross income on account of a taxpayer's destruction of its inventories due to obsolescence, there is a substantiation requirement to be satisfied. That is, the issuance by the BIR of a document that affirms the fact that the subject inventory was indeed destroyed. In the regular and legal course of things, the BIR is simply notified by the taxpayer and a representative is sent by the former on a specified date to witness and attest to the destruction of the inventory.

The issuance by the BIR of this document is the only common sensical requirement that effectively substantiates a claim that inventory was destroyed. Otherwise, the government would be left with no recourse but to accept a regime where taxpayers substantiate self-serving claims through their own records and their own interested witnesses. This attestation by the BIR is the substantiation required under Section 34 of the NIRC.

Since there was no prior BIR approval nor was there a request for a BIR representative who would witness the actual write-off as part of the substantiation requirement provided by law, it is respectfully submitted that the cost of inventories written-off were not reliable and cannot be allowed as deduction from petitioner's gross income. Further, there was no clear and convincing evidence as to the costing of the inventories written-off that was presented for verification.

7.3.2 The Royalty Expense was likewise disallowed because Royalty fee is not an allowable item of deduction from gross income to be subjected to the 5% preferential tax rate. Moreso, Royalty fees do not fall within the definition of 'cost' under the PEZA Law and Tax Code, being a consideration for the license of the property under an

¹⁷ Exhibit “I”, docket, pp. 1017-1019; Exhibit “7”, BIR Records, Folder 1, pp. 1012-1014.

¹⁸ Docket (CTA Case No. 8421), pp. 95-107.

Intangibles Licensing Agreement, which should be treated as administrative expense for income tax purposes.

Petitioner claimed as part of the costs of its finished goods royalty fees and it deducted said royalty fees from its taxable income on the basis of BIR Ruling DA-147-05. Respondent humbly submits that petitioner's reliance on BIR Ruling DA-147-05 has no legal basis as BIR Ruling DA-147-05 issued to petitioner cannot be enforced for it has not only expanded, but likewise misapplied the PEZA Law and Revenue Regulations 11-2005 with respect to the deductibility of Royalties. It is to be noted that the basis for the issuance of BIR Ruling DA-147-05 was the Statement of Financial Accounting Standards (SFAS) No. 4, Summary of Generally Accepted Accounting Principles on Inventories. The cost of inventories or finished goods is defined in paragraph 4 of the SFAS, *to wit*:

'In general, cost is the price paid or consideration given to acquire an asset. As applied to inventories, it represents the direct and indirect expenditures for items purchased, produced or in the process of production including the cost of production overhead. It constitutes the sum of the applicable expenditures and charges directly or indirectly incurred in bringing the inventory items to their existing condition and location.'

Corollary thereto, paragraph 5 of the SFAS provided for the definition of production overhead which reads as follows:

'Production overhead should be included as part of inventory cost; it is composed of costs incurred for production other than direct materials and labor and includes both variable and fixed expenses. Examples are indirect materials and indirect labor, depreciation and maintenance of factory buildings and equipment, and the cost of factory management and administration.'

It is noteworthy that the deduction of Royalties represents a loss of revenue to the government and must not rest on vague inference. Section 2, Rule XX of Republic Act 7916 (RA 7916, *for brevity*), as resonated in Revenue Regulations 11-2005, does not specifically allow Royalty fees as deductible. Rule 1 of RA 7916 provides for the definition of Gross Income as:

'Gross Income' for purposes of computing the special tax due under Section 24 of the Act refers to gross sales or gross revenues derived

from business activity within the ECOZONE, net of sales discounts, sales returns and allowances and minus costs of sales or direct costs but before any deduction is made for administrative expenses or incidental losses during a given taxable period. The allowable deductions from 'gross income' are specifically enumerated under Section 2, Rule XX of these Rules.'

Consequently, Section 2, Rule 1 of the Rules and Regulations to Implement Republic Act No. 7916 (the PEZA Law), otherwise known as 'The Special Economic Zone Act of 1995' specifically enumerates the allowable deductions in computing the gross income subject to the preferential tax rate of 5%, thus:

RULE XX
Gross Income Taxation

SECTION 1. xxx

SECTION 2. Gross Income Earned; Allowable Deductions. – For purposes of these Rules, Gross Income earned shall be as defined in Section 2(nn), Rule 1 of these Rules subject to the following allowable deductions for specific types of enterprises:

1. ECOZONE Export Enterprises, Free Trade Enterprises and Domestic Market Enterprises
 - Direct salaries, wages or labor expenses
 - Production supervision salaries
 - Raw materials used in the manufacture of products
 - Goods in process (intermediate goods)
 - Finished goods
 - Supplies and fuel used in production
 - Depreciation of machinery and equipment used in production, and buildings owned or constructed by an ECOZONE Enterprise
 - Rent and utility charges associated with building, equipment and warehouses, or handling of goods
 - Financing charges associated with fixed assets

It is clear from the foregoing that nowhere in the provisions of the PEZA Law nor in Revenue Regulations No. 11-2005 that the Royalty fees are considered allowable deduction. xxx

Worth stressing that any erroneous application and enforcement of tax laws (*i.e., misapplication and erroneous expansion of PEZA Law and Revenue Regulations No. 11-2005*) by public officers does not preclude the subsequent correct application of such laws. Thus the Honorable Supreme Court had the occasion to reiterate the legal principle that estoppel generally finds no application against

the State when it acts to rectify mistakes, errors, irregularities, or illegal acts, of its officials and agents, irrespective of rank. xxx

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10. Well-settled is the rule that tax assessments are entitled to the presumption of correctness and made in good faith. The taxpayer has the duty to prove otherwise. In the absence of proof of any irregularities in the performance of duties, an assessment duly made by a Bureau of Internal Revenue examiner, and approved by his superior officers will not be disturbed. All presumptions are in favor of the correctness of tax assessments (*Sy Po vs. Court of Tax Appeals*). Dereliction on the part of petitioner to satisfactorily overcome the presumption of regularity and correctness of the assessment will justify the judicial upholding of said assessment notices.”

CTA Case No. 8561

Petitioner likewise received two notices from the BIR, pursuant to Letter of Authority (LOA) No. 200900007522¹⁹ dated April 15, 2010, requesting the submission of petitioner’s documents in relation to the BIR’s examination of petitioner’s books of accounts and other accounting records for all internal revenue taxes for taxable year 2008.

On February 6, 2012, petitioner received a Preliminary Assessment Notice (PAN)²⁰ from the BIR, informing it that it was found liable for deficiency taxes in the total amount of ₱1,691,740,832.09. Petitioner then contested the PAN on February 21, 2012 via letter dated February 20, 2012 addressed to the BIR Large Taxpayers District Office-Cebu.

On May 2, 2012, petitioner received a Formal Letter of Demand from the BIR, finding it liable for deficiency taxes for taxable year 2008 in the total amount of ₱35,665,416.95.²¹ Petitioner then filed a protest letter on May 30, 2012.²²

On September 27, 2012, petitioner received the FDDA²³ from the BIR, finding it liable for deficiency income tax, among other deficiency taxes, for taxable year 2008. After payment /

¹⁹ Exhibit “R-9”, BIR Records, Folder 2, p. 1.

²⁰ BIR Records, Folder 2, pp. 602-606.

²¹ Par. 3, Petition for Review, docket (CTA Case No. 8561), p. 7; Exhibit “Q”, docket, pp. 1120-1123.

²² Par. 4, Petition for Review, docket (CTA Case No. 8561), p. 7; Exhibit “R”, docket, pp. 1130-1143.

²³ Exhibit “S”, docket, pp. 1144-1148.

by petitioner or cancellation by respondent of the other tax assessments, the deficiency tax assessment for taxable year 2008 was reduced to ₱21,138,104.97.²⁴

Petitioner sought judicial redress by filing a Petition for Review before this Court on October 24, 2012, later docketed as CTA Case No. 8561.

In her Answer²⁵ for CTA Case No. 8561 filed on February 12, 2013, respondent argued, among others, that petitioner was properly apprised of its deficiency income tax liabilities, that BIR Ruling No. 014-2012 is applicable to the present case, and that the presumption under the law is in favor of the correctness of tax assessments.

Consolidated Cases

The assessments under CTA Case No. 8421 and CTA Case No. 8561 are as follows:

For taxable year 2007

| | <u>Special Rate</u> | <u>Regular Rate</u> |
|-------------------------------------|-------------------------|-----------------------------|
| Taxable Income per Return | 1,759,234,964.00 | 3,164,792.00 |
| Add: Disallowance | | |
| (1) Cost of Inventory Scrapped | 54,058,006.00 | |
| (2) Royalty Expense | 326,435,578.00 | |
| Taxable Income per Investigation | <u>2,139,728,548.00</u> | <u>3,164,792.00</u> |
| Income Tax Due Thereon | <u>106,986,427.40</u> | <u>1,107,677.20</u> |
| Income Tax Due | | 108,094,104.60 |
| Less: Tax Credits/Payments | | |
| Payments | 53,884,727.26 | |
| Share of other agencies | <u>35,184,699.28</u> | <u>89,069,426.54</u> |
| Deficiency Income Tax | | 19,024,678.06 |
| Interest - 04/16/2008 to 12/31/2011 | | <u>14,114,747.45</u> |
| Deficiency Income Tax Due | | <u><u>33,139,425.51</u></u> |

For taxable year 2008

| | <u>Special Rate 5%</u> | <u>Regular Rate 35%</u> |
|-----------------------------------|-----------------------------|-------------------------|
| Taxable Income per Return | 1,036,143,325.00 | 1,523,161.00 |
| Add: Disallowance | | |
| Royalty Expense | 254,802,119.00 | |
| Taxable Income | <u>1,290,945,444.00</u> | <u>1,523,161.00</u> |
| Rate | 5% | 35% |
| Amount Due | 64,547,272.20 | 533,106.35 |
| Paid per ITR | <u>51,807,166.00</u> | <u>533,106.00</u> |
| Income Tax Due | 12,740,106.20 | 0.35 |
| Add: Interest 4.14.2009-7.30.2012 | <u>8,397,998.77</u> | <u>.23</u> |
| Total Income Tax Due | <u><u>21,138,104.97</u></u> | <u><u>0.58</u></u> |

²⁴ Par. 5, Petition for Review, docket (CTA Case No. 8561), pp. 7-8.

²⁵ Docket (CTA Case No. 8561), pp. 111-118.

In the Resolution dated February 21, 2013, this Court granted petitioner's motion to consolidate CTA Case No. 8421 with CTA Case No. 8561.

During trial, petitioner presented Mr. Anthony C. Cheng²⁶ - Finance Director of petitioner, Ms. Helena Agnes Valderama²⁷ - professor at the Virata School of Business, University of the Philippines Diliman, and Mr. John Duncan²⁸ - Tax Manager of Lear from 2001 to 2005 as its witnesses.

Petitioner likewise made its Formal Offer of Evidence.²⁹ In the Court's Resolution³⁰ dated December 6, 2013, the Court admitted Exhibits "A", "A-Deposition", "A-1", "B", "B-Deposition", "B-1", "C", "C-Deposition", "D", "D-Deposition", "E", "E-Deposition", "F", "F-Deposition" - "F-12-Deposition (inclusive of submarkings)", "G", "G-Deposition" - "G-6-Deposition", "H", "H-Deposition" - "H-21-Deposition (inclusive of submarkings)", "I", "I-Deposition" - "I-2-Deposition", "J", "J-Deposition" - "J-11-Deposition (inclusive of submarkings)", "J-Duncan" - "J-Duncan-25 (inclusive of submarkings)", "K", "K-Deposition" - "K-2-Deposition", "L", "L-Deposition" - "L-2-Deposition (inclusive of submarkings)", "N", "N-Deposition", "O", "O-Deposition" - "O-16-Deposition (inclusive of submarkings)", "P", "P-Deposition" - "P-10-Deposition", "P-1", "Q-Deposition" - "Q-9-Deposition", "R-Deposition" - "R-13-Deposition (inclusive of submarkings)", "S-Deposition", "S-5-Deposition", "T-Deposition" - "T-9-Deposition (inclusive of submarkings)", "U-Deposition" - "U-21-Deposition (inclusive of submarkings)", "Y", "Y-31", "Z" - "Z-56", "AA" - "AA-4", "BB" - "BB-5", "BB-3-A", "CC", "DD", "DD-1", "EE", "EE-1", "FF", "GG", "HH", and "II". However, Exhibits "V-Deposition" - "V-3-Deposition (inclusive of submarkings)", "W-Deposition" - "W-1-Deposition (inclusive of submarkings)", and "X-Deposition (inclusive of submarkings)" were denied for failure of petitioner to show whether these pieces of evidence were originals, certified true copies or photocopies.

On December 26, 2013, petitioner filed its Motion for Reconsideration (of the Resolution dated December 6, 2013).³¹ ✓

²⁶ Minutes of the Hearing dated September 5, 2012, docket, p. 256.

²⁷ Minutes of the Hearing dated September 4, 2013, docket, p. 875.

²⁸ Minutes of the Hearing dated September 23, 2013, docket, p. 884.

²⁹ Docket, pp. 902-920.

³⁰ Docket, pp. 1420-1421.

³¹ Docket, pp. 1423-1434.

In the Resolution³² dated February 19, 2014, the Court admitted Exhibits “V-Deposition” – “V-3-Deposition (inclusive of submarkings)”, “W-Deposition” – “W-1-Deposition (inclusive of submarkings)”, and “X-Deposition (inclusive of submarkings)”.

On the other hand, respondent presented Revenue Officers Ferly Ann B. Paez³³ and Ms. Vivian F. Pollisco³⁴ as witnesses.

On April 4, 2014, respondent filed her Formal Offer of Exhibits (with Motion to Admit)³⁵, and on May 23, 2014, the Court issued a Resolution admitting Exhibits “1” to “20”. In the same Resolution, the Court ordered the parties to submit their respective memoranda.

The case was submitted for decision on July 15, 2014,³⁶ considering petitioner’s Memorandum³⁷ filed on July 10, 2014 and respondent’s failure to file her memorandum.

ISSUES

The parties submitted the following issues³⁸ for resolution of the Court:

I.

Whether prior BIR approval and/or the presence of a representative from the BIR is necessary before an inventory write-off could be made and claimed as deduction for income tax purposes.

II.

Whether BIR Ruling DA-147-2005 remains in effect and therefore whether it protects the petitioner from income tax liability arising from the Royalty Fees paid by petitioner under the Intangibles Licensing Agreement. ✓

³² Docket, pp. 1447-1448.

³³ Minutes of the Hearing dated December 9, 2013, docket, p. 1422.

³⁴ Minutes of the Hearing dated February 26, 2014, docket, p. 1463.

³⁵ Docket, pp. 1468-1482

³⁶ Resolution dated July 15, 2014, docket, p. 1546

³⁷ Memorandum for the Petitioner, docket, pp. 1494-1544

³⁸ Jointly Stipulated Issues, JSFI, docket, p. 167

III.

Assuming arguendo that BIR Ruling DA-147-2005 was revoked with the issuance of the Final Assessment Notice in 2011, whether it still operated with protective effect with respect to the income tax liability of petitioner for the years prior to such revocation, including for the year 2007, the taxable year subject of the assessment in this case.

IV.

Whether the Royalty Fees may be considered as part of cost of sales as an allowable deduction for purposes of computing the 5% gross income tax.

V.

Whether petitioner is liable for deficiency income tax for taxable year 2007 in the aggregate amount of Thirty-Three Million One Hundred Thirty-Nine Thousand Four Hundred Twenty-Five Pesos and 51/100 (P33,139,425.51) including penalties, surcharges and interest.

There are two main issues to be resolved by the Court, namely: (1) whether petitioner's royalty fees to Lear may be considered as an allowable deduction for purposes of computing the 5% gross income tax; and (2) whether petitioner's inventory write-off could be claimed as a deduction for income tax purposes.

DISCUSSION/RULING

Whether petitioner's royalty fees to Lear may be considered as an allowable deduction for purposes of computing the 5% gross income tax

Petitioner argues that it relied on BIR Ruling DA-147-2005 dated April 13, 2005, where it was held that the royalties paid are deductible from gross sales for purposes of computing its taxable gross income subject to 5% tax under the PEZA Law, as amended. As such, it included its royalty payments to Lear as part of the cost of finished goods. ✓

On the other hand, respondent contends that Section 2 of Rule XX of the Rules and Regulations to Implement the PEZA Law does not mention royalty fee as an allowable deduction and as such, it cannot be considered as an allowable deduction.

The Court agrees with petitioner.

Section 2 of Rule XX of the Rules and Regulations implementing Republic Act No. 7916 (the PEZA Law) provides:

“RULE XX
Gross Income Taxation

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SECTION 2. *Gross Income Earned; Allowable Deductions.* – For purposes of these Rules, Gross Income earned shall be as defined in Section 2(nn), Rule I of these Rules subject to the following allowable deductions for specific types of enterprises:

1. ECOZONE Export Enterprises, Free Trade Enterprises and Domestic Market Enterprises
 - Direct salaries, wages or labor expenses
 - Production supervision salaries
 - Raw materials used in the manufacture of products
 - Goods in process (intermediate goods)
 - Finished goods
 - Supplies and fuels used in production
 - Depreciation of machinery and equipment used in production, and buildings owned or constructed by an ECOZONE Enterprise
 - Rent and utility charges associated with building, equipment and warehouses, or handling of goods
 - Financing charges associated with fixed assets”

On February 15, 2005, the BIR issued Revenue Regulations (RR) No. 2-2005, the pertinent parts of which are quoted as follows:

“SECTION 7. *Gross income earned.* – xxx

For purposes of computing the total five percent (5%) tax rate imposed by Republic Act No. 7227, Republic Act No. 7903, Republic Act No. 7922 and Republic Act No. 7916, the cost of sales or direct cost **shall consist only of the following cost or expense items** which shall be computed

in accordance with Generally Accepted Accounting Principles (GAAP):” (*Emphasis supplied*)

The BIR issued RR No. 11-2005 on April 25, 2005, removing the exclusivity of the items enumerated as direct costs under RR No. 2-2005, to wit:

“For purposes of computing the total five percent (5%) tax rate imposed, the following direct costs are included in the allowable deductions to arrive at gross income earned for specific types of enterprises:”

Section 2 of Rule XX of the PEZA Implementing Rules enumerates the allowable deductions for purposes of computing the 5% tax rate on gross income of PEZA-registered enterprises. It is noteworthy that the Rules did not limit, but merely enumerated the allowable deductions. Subsequently, RR No. 2-2005 limited the direct costs to the enumeration of allowable deductions therein. As it stands, RR No. 11-2005 removed the exclusivity of the allowable deductions from gross income.

In *East Asia Utilities Corporation vs. Commissioner of Internal Revenue*³⁹, this Court discussed the PEZA Law, as amended, in relation to RR Nos. 2-2005 and 11-2005 *vis-a-vis* the allowable deductions, in this wise:

“It is clear from the amendment made under RR No. 11-05 that the list is not meant to be all-inclusive but merely enumerates the expenses that can be considered as direct costs. PEZA-registered enterprises may be allowed to deduct expenses which are in the nature of direct costs even though the same are not included in the list.

The criteria in determining whether the item of cost or expense should be part of direct cost is the direct relation of such item in the rendition of the PEZA-registered services. If the item of cost or expense can be directly attributed in providing the PEZA-registered services, then it should be treated as direct cost.”

Thus, there is no merit in respondent’s argument that royalty fees are not considered as allowable deduction for purposes of computing the 5% tax on gross income of petitioner. Applying RR No. 11-2005 and the ruling of this/

³⁹ CTA Case No. 8179, May 21, 2014

Court in the *East Asia* case, any item of cost or expense which is directly attributable to the rendition of the PEZA-registered services shall be treated as direct cost.

Moreover, it should be noted that BIR Ruling DA-147-2005 is binding upon respondent.

In the case of *Commissioner of Internal Revenue vs. Philippine Health Care Providers, Inc.*⁴⁰, the Supreme Court explained the binding effect of a BIR Ruling, *viz.*:

“In *ABS-CBN Broadcasting Corp. v. Court of Tax Appeals*, this Court held that under Section 246 of the 1997 Tax Code, **the Commissioner of Internal Revenue is precluded from adopting a position contrary to one previously taken where injustice would result to the taxpayer.** Hence, where an assessment for deficiency withholding income taxes was made, three years after a new BIR Circular reversed a previous one upon which the taxpayer had relied upon, such an assessment was prejudicial to the taxpayer. To rule otherwise, opined the Court, would be contrary to the tenets of good faith, equity, and fair play.

This Court has consistently reaffirmed its ruling in *ABS-CBN Broadcasting Corp.* in the later cases of *Commissioner of Internal Revenue v. Borroughs, Ltd.*, *Commissioner of Internal Revenue v. Mega Gen. Mdsg. Corp.*, *Commissioner of Internal Revenue v. Telefunken Semiconductor (Phils.) Inc.*, and *Commissioner of Internal Revenue v. Court of Appeals*. The rule is that the BIR rulings have no retroactive effect where a grossly unfair deal would result to the prejudice of the taxpayer, as in this case.”

Here, the BIR, through BIR Ruling DA-147-2005, confirmed that the royalties paid by petitioner to Lear are considered as deductions. Hence, respondent cannot adopt a position contrary to her position in BIR Ruling DA-147-2005 by the mere expediency of issuing a deficiency assessment. To allow this would cause undue prejudice to petitioner which merely relied in good faith on the subject Ruling.

Considering the foregoing, the Court rules that petitioner's royalty payments to Lear should be considered as an allowable deduction for purposes of computing the 5% tax on gross income. ✓

⁴⁰ G.R. No. 168129, April 24, 2007.

In the present case, petitioner failed to submit any evidence to prove any of the above-enumerated requisites for claiming ordinary loss as a deduction. Therefore, the Court is constrained to declare that petitioner's inventory write-off cannot be claimed as a deduction for income tax purposes. Consequently, petitioner is liable to pay basic deficiency income tax for taxable year 2007 in the amount of ₱2,702,899.16, computed as follows:

| | <u>Special Rate</u> | <u>Regular Rate</u> |
|----------------------------------|-------------------------|------------------------------|
| Taxable Income per Return | ₱1,759,234,964.00 | ₱ 3,164,792.00 |
| Add: Disallowance | | |
| (1) Cost of Inventory Scrapped | 54,058,006.00 | |
| (2) Royalty Expense | - | |
| Taxable Income per Investigation | <u>1,813,292,970.00</u> | <u>3,164,792.00</u> |
| Income Tax Due Thereon | <u>90,664,648.50</u> | <u>1,107,677.20</u> |
| Income Tax Due | | 91,772,325.70 |
| Less: Tax Credits/Payments | | |
| Payments | 53,884,727.26 | |
| Share of other agencies | <u>35,184,699.28</u> | <u>89,069,426.54</u> |
| Deficiency Income Tax | | <u>₱ 2,702,899.16</u> |

WHEREFORE, premises considered, the instant Petition for Review is hereby **PARTIALLY GRANTED**. Accordingly, the deficiency income tax assessment for taxable year 2008 in the amount of ₱21,138,104.97 is hereby **CANCELLED**, while the deficiency income tax assessment for taxable year 2007 is hereby **PARTIALLY UPHELD**. Petitioner is **ORDERED TO PAY** basic deficiency 5% gross income tax for the year 2007 in the amount of **THREE MILLION THREE HUNDRED SEVENTY-EIGHT THOUSAND SIX HUNDRED TWENTY-THREE AND 95/100 PESOS (₱3,378,623.95)**, inclusive of the twenty-five percent (25%) surcharge imposed under Section 248(A)(3) of the NIRC of 1997, as amended, computed as follows:

| | Basic Tax | 25% Surcharge | Total |
|----------------------------|------------------|----------------------|---------------|
| Deficiency Income Tax (5%) | ₱2,702,899.16 | ₱675,724.79 | ₱3,378,623.95 |

In addition, petitioner is **ORDERED TO PAY**:

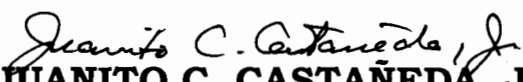
a. Deficiency interest at the rate of twenty percent (20%) per annum on the basic deficiency income tax of ₱2,702,899.16 computed from April 15, 2008 until full payment thereof pursuant to Section 249(B) of the NIRC of 1997; and ✓

b. Delinquency interest at the rate of 20% per annum on the amount of the ₱3,378,623.95, representing the basic deficiency income tax of ₱2,702,899.16 and 25% surcharge of ₱675,724.79, computed from January 4, 2012⁴² until full payment thereof pursuant to Section 249(C)(3) of the NIRC of 1997, as amended.

SO ORDERED.


AMELIA R. COTANGCO-MANALASTAS
Associate Justice

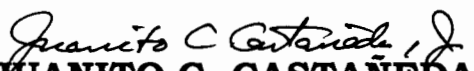
WE CONCUR:


JUANITO C. CASTAÑEDA, JR.
Associate Justice

(On Official Business)
CAESAR A. CASANOVA
Associate Justice

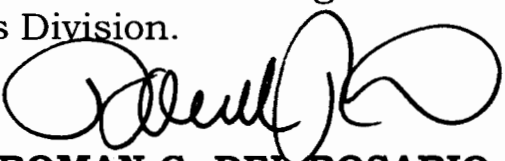
ATTESTATION

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


JUANITO C. CASTAÑEDA, JR.
Associate Justice
Chairperson

CERTIFICATION

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


ROMAN G. DEL ROSARIO
Presiding Justice

⁴² Exhibit "I", docket, pp. 1017-1019; Exhibit "7", BIR Records, Folder 1, pp. 1012-1014.