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THIRD DIVISION

[G.R. No. 172231. February 12, 2007]

COMMISSIONER OF INTERNAL REVENUE, *petitioner, vs.* **ISABELA CULTURAL CORPORATION,** *respondent.*

SYLLABUS

1. TAXATION; TAX DEDUCTIONS; DEDUCTABILITY OF ORDINARY AND NECESSARY TRADE, BUSINESS OR PROFESSIONAL EXPENSES; REQUISITES. — The requisites for the deductibility of ordinary and necessary trade, business, or professional expenses, like expenses paid for legal and auditing services, are: (a) the expense must be ordinary and necessary; **(b) it must have been paid or incurred during the taxable year;** (c) it must have been paid or incurred in carrying on the trade or business of the taxpayer; and (d) it must be supported by receipts, records or other pertinent papers.

2. ID.; ID.; ID.; THAT IT MUST HAVE BEEN *PAID OR INCURRED* DURING THE TAXABLE YEAR; THE SAME *DEPENDENT UPON THE METHOD OF ACCOUNTING*. — The requisite that it must have been **paid or incurred** during the taxable year is further qualified by Section 45 of the National Internal Revenue Code (NIRC) which states that: "[t]he deduction provided for in this Title shall be taken for the taxable year in which 'paid or accrued' or 'paid or incurred,' **dependent upon the method of accounting** upon the basis of which the net income is computed x x x."

3. ID.; ID.; ID.; ACCRUAL METHOD OF ACCOUNTING; ELABORATED. — Accounting methods for tax purposes comprise a set of rules for determining when and how to report income and deductions. In the instant case, the accounting method used by ICC is the accrual method. Revenue Audit Memorandum Order No. 1-2000, provides that under the accrual method of accounting, expenses not being claimed as deductions by a taxpayer in the current year when they are incurred cannot be claimed as deduction from income for the succeeding year. Thus, a taxpayer who is authorized to deduct certain expenses

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and other allowable deductions for the current year but failed to do so cannot deduct the same for the next year. The accrual method relies upon the taxpayer's right to receive amounts or its obligation to pay them, in opposition to actual receipt or payment, which characterizes the cash method of accounting. Amounts of income accrue where the right to receive them become fixed, where there is created an enforceable liability. Similarly, liabilities are accrued when fixed and determinable in amount, without regard to indeterminacy merely of time of payment. For a taxpayer using the accrual method, the determinative question is, when do the facts present themselves in such a manner that the taxpayer must recognize income or expense? The accrual of income and expense is permitted when the all-events test has been met. This test requires: (1) fixing of a right to income or liability to pay; and (2) the availability of the reasonable accurate determination of such income or liability. The all-events test requires the right to income or liability be fixed, and the amount of such income or liability be determined with reasonable accuracy. However, the test does not demand that the amount of income or liability be known absolutely, only that a taxpayer has at his disposal the information necessary to compute the amount with reasonable accuracy. The all-events test is satisfied where computation remains uncertain, if its basis is unchangeable; the test is satisfied where a computation may be unknown, but is not as much as unknowable, within the taxable year. **The amount of liability does not have to be determined exactly; it must be determined with "reasonable accuracy." Accordingly, the term "reasonable accuracy" implies something less than an exact or completely accurate amount. The propriety of an accrual must be judged by the facts that a taxpayer knew, or could reasonably be expected to have known, at the closing of its books for the taxable year. Accrual method of accounting presents largely a question of fact; such that the taxpayer bears the burden of proof of establishing the accrual of an item of income or deduction.**

4. ID.; ID.; STRICTLY CONSTRUED. — It is a governing principle in taxation that tax exemptions must be construed in *strictissimi juris* against the taxpayer and liberally in favor of the taxing authority; and one who claims an exemption must be able to justify the same by the clearest grant of organic or statute

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law. An exemption from the common burden cannot be permitted to exist upon vague implications. And since a deduction for income tax purposes partakes of the nature of a tax exemption, then it must also be strictly construed.

5. CIVIL LAW; SPECIAL CONTRACTS; LOAN; INTERESTS; UNLESS STIPULATED, INTEREST DUE SHOULD NOT FURTHER EARN INTEREST. — Anent the purported understatement of interest income from the promissory notes of Realty Investment, Inc., we sustain the findings of the CTA and the Court of Appeals that no such understatement exists and that only simple interest computation and not a compounded one should have been applied by the BIR. There is indeed no stipulation between the latter and ICC on the application of compounded interest. Under Article 1959 of the Civil Code, unless there is a stipulation to the contrary, interest due should not further earn interest.

APPEARANCES OF COUNSEL

The Solicitor General for petitioner.

Narciso Jimenez Gonzales Liwanag Bello Valdez and Caluya and Fernandez for respondent.

D E C I S I O N

YNARES-SANTIAGO, *J.*:

Petitioner Commissioner of Internal Revenue (CIR) assails the September 30, 2005 Decision[1] of the Court of Appeals in CA-G.R. SP No. 78426 affirming the February 26, 2003 Decision[2] of the Court of Tax Appeals (CTA) in CTA Case No. 5211, which cancelled and set aside the Assessment Notices for deficiency income tax and expanded withholding tax issued by the Bureau of Internal Revenue (BIR) against respondent Isabela Cultural Corporation (ICC).

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[1] *Rollo*, pp. 48-59. Penned by Associate Justice Delilah Vidallon-Magtolis and concurred in by Associate Justices Bienvenido L. Reyes and Josefina Guevara-Salonga.

[2] *Id.* at 165-181.

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The facts show that on February 23, 1990, ICC, a domestic corporation, received from the BIR Assessment Notice No. FAS-1-86-90-000680 for deficiency income tax in the amount of ₱333,196.86, and Assessment Notice No. FAS-1-86-90-000681 for deficiency expanded withholding tax in the amount of ₱4,897.79, inclusive of surcharges and interest, both for the taxable year 1986.

The deficiency income tax of **₱333,196.86**, arose from:

(1) The BIR's disallowance of ICC's claimed expense deductions for professional and security services billed to and paid by ICC in 1986, to wit:

(a) Expenses for the auditing services of SGV & Co.,[3] for the year ending December 31, 1985;[4]

(b) Expenses for the legal services [inclusive of retainer fees] of the law firm Bengzon Zarraga Narciso Cudala Pecson Azcuna & Bengson for the years 1984 and 1985.[5]

(c) Expense for security services of El Tigre Security & Investigation Agency for the months of April and May 1986.[6]

(2) The alleged understatement of ICC's interest income on the three promissory notes due from Realty Investment, Inc.

The deficiency expanded withholding tax of **₱4,897.79** (inclusive of interest and surcharge) was allegedly due to the failure of ICC to withhold 1% expanded withholding tax on its claimed ₱244,890.00 deduction for security services.[7]

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[3] Sycip, Gorres, Velayo & Co.

[4] Exhibits "O" to "T", records, pp. 128-133.

[5] Exhibits "U" to "DD", *id*. at 134-143.

[6] Exhibits "EE" to "II", *id*. at 144-148.

[7] *Rollo*, p. 56.

The following is an itemized schedule of ICC's deficiency assessment:

Taxable income (loss) per return	₱(114,345.00)
Add: Additional Taxable Income	
(1) Interest income	**₱429,187.47**

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On March 23, 1990, ICC sought a reconsideration of the subject assessments. On February 9, 1995, however, it received a final notice before seizure demanding payment of the amounts stated in the said notices. Hence, it brought the case to the CTA which held that the petition is premature because the final notice of assessment cannot be considered as a final decision appealable to the tax court. This was reversed by the Court of Appeals holding that a demand letter of the BIR reiterating the payment of deficiency tax, amounts to a final decision on the protested assessment and may therefore be questioned before the CTA. This conclusion was sustained by this Court on July 1, 2001, in G.R. No. 135210.[8] The case was thus remanded to the CTA for further proceedings.

On February 26, 2003, the CTA rendered a decision canceling and setting aside the assessment notices issued against ICC. It

(2) Other income		
Rent income	9,169.64	
Investment service income	23,725.36	
(3) Disallowance of prior year's expenses		
(a) Professional fees (1985)	**496,409.77**	
(b) Security services (1985)	**41,814.00**	1,000,306.24
Net Taxable Income per investigation		₱885,961.24
Tax due thereon		₱310,086.43
Less: Tax Paid		143,488.00
Balance		₱166,598.43
Add: 25% Surcharge		41,649.61
Sub-total		₱208,248.04
Add: 60% Interest		124,948.82
Total Amount Due and Collectible	**₱333,196.86**	
Expanded Withholding Tax		
Security Services		₱2,448.90
Add: 25% Surcharge		612.22
Sub-total		₱3,061.12
Add: 60% Interest		1,836.67
Total Amount Due and Collectible		**₱4,897.79**

(CTA Decision, *Rollo*, p. 174)

[8] *Commissioner of Internal Revenue v. Isabela Cultural Corporation*, 413 Phil. 376.

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held that the claimed deductions for professional and security services were properly claimed by ICC in 1986 because it was only in the said year when the bills demanding payment were sent to ICC. Hence, even if some of these professional services were rendered to ICC in 1984 or 1985, it could not declare the same as deduction for the said years as the amount thereof could not be determined at that time.

The CTA also held that ICC did not understate its interest income on the subject promissory notes. It found that it was the BIR which made an overstatement of said income when it compounded the interest income receivable by ICC from the promissory notes of Realty Investment, Inc., despite the absence of a stipulation in the contract providing for a compounded interest; nor of a circumstance, like delay in payment or breach of contract, that would justify the application of compounded interest.

Likewise, the CTA found that ICC in fact withheld 1% expanded withholding tax on its claimed deduction for security services as shown by the various payment orders and confirmation receipts it presented as evidence. The dispositive portion of the CTA's Decision, reads:

> WHEREFORE, in view of all the foregoing, Assessment Notice No. FAS-1-86-90-000680 for deficiency income tax in the amount of ₱333,196.86, and Assessment Notice No. FAS-1-86-90-000681 for deficiency expanded withholding tax in the amount of ₱4,897.79, inclusive of surcharges and interest, both for the taxable year 1986, are hereby CANCELLED and SET ASIDE.
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> SO ORDERED.[9]

Petitioner filed a petition for review with the Court of Appeals, which affirmed the CTA decision,[10] holding that although the

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[9] *Rollo*, p. 181.

[10] The dispositive portion of the Court of Appeal's Decision, states:

> WHEREFORE, the petition is hereby DISMISSED for lack of merit and the decision appealed from is hereby AFFIRMED.
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> SO ORDERED. (*Id*. at 59)

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professional services (legal and auditing services) were rendered to ICC in 1984 and 1985, the cost of the services was not yet determinable at that time, hence, it could be considered as deductible expenses only in 1986 when ICC received the billing statements for said services. It further ruled that ICC did not understate its interest income from the promissory notes of Realty Investment, Inc., and that ICC properly withheld and remitted taxes on the payments for security services for the taxable year 1986.

Hence, petitioner, through the Office of the Solicitor General, filed the instant petition contending that since ICC is using the accrual method of accounting, the expenses for the professional services that accrued in 1984 and 1985, should have been declared as deductions from income during the said years and the failure of ICC to do so bars it from claiming said expenses as deduction for the taxable year 1986. As to the alleged deficiency interest income and failure to withhold expanded withholding tax assessment, petitioner invoked the presumption that the assessment notices issued by the BIR are valid.

The issue for resolution is whether the Court of Appeals correctly: (1) sustained the deduction of the expenses for professional and security services from ICC's gross income; and (2) held that ICC did not understate its interest income from the promissory notes of Realty Investment, Inc; and that ICC withheld the required 1% withholding tax from the deductions for security services.

The requisites for the deductibility of ordinary and necessary trade, business, or professional expenses, like expenses paid for legal and auditing services, are: (a) the expense must be ordinary and necessary; **(b) it must have been paid or incurred during the taxable year**; (c) it must have been paid or incurred in carrying on the trade or business of the taxpayer; and (d) it must be supported by receipts, records or other pertinent papers.[11]

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[11] *Commissioner of Internal Revenue v. General Foods (Phils.), Inc.*, G.R. No. 143672, April 24, 2003, 401 SCRA 545, 551.

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The requisite that it must have been **paid or incurred** during the taxable year is further qualified by Section 45 of the National Internal Revenue Code (NIRC) which states that: "[t]he deduction provided for in this Title shall be taken for the taxable year in which 'paid or accrued' or 'paid or incurred,' **dependent upon the method of accounting** upon the basis of which the net income is computed x x x."

Accounting methods for tax purposes comprise a set of rules for determining when and how to report income and deductions.[12] In the instant case, the accounting method used by ICC is the accrual method.

Revenue Audit Memorandum Order No. 1-2000, provides that under the accrual method of accounting, expenses not being claimed as deductions by a taxpayer in the current year when they are incurred cannot be claimed as deduction from income for the succeeding year. Thus, a taxpayer who is authorized to deduct certain expenses and other allowable deductions for the current year but failed to do so cannot deduct the same for the next year.[13]

The accrual method relies upon the taxpayer's right to receive amounts or its obligation to pay them, in opposition to actual receipt or payment, which characterizes the cash method of accounting. Amounts of income accrue where the right to receive them become fixed, where there is created an enforceable liability. Similarly, liabilities are accrued when fixed and determinable in amount, without regard to indeterminacy merely of time of payment.[14]

For a taxpayer using the accrual method, the determinative question is, when do the facts present themselves in such a manner that the taxpayer must recognize income or expense?

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[12] De Leon, *The National Internal Revenue Code*, Annotated, vol. I, 2003 edition, p. 443.

[13] Chapter II-B.

[14] Mertens Law of Federal Income Taxation, Vol. 2 (1996), Cash and Accrual Methods, Chapter 12A, § 12A:51, p. 12A-77.

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The accrual of income and expense is permitted when the all-events test has been met. This test requires: (1) fixing of a right to income or liability to pay; and (2) the availability of the reasonable accurate determination of such income or liability.

The all-events test requires the right to income or liability be fixed, and the amount of such income or liability be determined with reasonable accuracy. However, the test does not demand that the amount of income or liability be known absolutely, only that a taxpayer has at his disposal the information necessary to compute the amount with reasonable accuracy. The all-events test is satisfied where computation remains uncertain, if its basis is unchangeable; the test is satisfied where a computation may be unknown, but is not as much as unknowable, within the taxable year. **The amount of liability does not have to be determined exactly; it must be determined with "reasonable accuracy." Accordingly, the term "reasonable accuracy" implies something less than an exact or completely accurate amount.**[15]

The propriety of an accrual must be judged by the facts that a taxpayer knew, or could reasonably be expected to have known, at the closing of its books for the taxable year.[16] **Accrual method of accounting presents largely a question of fact; such that the taxpayer bears the burden of proof of establishing the accrual of an item of income or deduction.**[17]

Corollarily, it is a governing principle in taxation that tax exemptions must be construed in *strictissimi juris* against the taxpayer and liberally in favor of the taxing authority; and one who claims an exemption must be able to justify the same by the clearest grant of organic or statute law. An exemption from the common burden cannot be permitted to exist upon vague implications. And since a deduction for income tax purposes

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[15] *Id.* at 12A:58, p. 12A-87.

[16] *Id.* at 12A:55, p. 12A-82.

[17] *Id.* at 12A:51, p. 12A-77.

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partakes of the nature of a tax exemption, then it must also be strictly construed.[18]

In the instant case, the expenses for professional fees consist of expenses for legal and auditing services. The expenses for legal services pertain to the 1984 and 1985 legal and retainer fees of the law firm Bengzon Zarraga Narciso Cudala Pecson Azcuna & Bengson, and for reimbursement of the expenses of said firm in connection with ICC's tax problems for the year 1984. As testified by the Treasurer of ICC, the firm has been its counsel since the 1960's.[19] From the nature of the claimed deductions and the span of time during which the firm was retained, ICC can be expected to have reasonably known the retainer fees charged by the firm as well as the compensation for its legal services. The failure to determine the exact amount of the expense during the taxable year when they could have been claimed as deductions cannot thus be attributed solely to the delayed billing of these liabilities by the firm. For one, ICC, in the exercise of due diligence could have inquired into the amount of their obligation to the firm, especially so that it is using the accrual method of accounting. For another, it could have reasonably determined the amount of legal and retainer fees owing to its familiarity with the rates charged by their long time legal consultant.

As previously stated, the accrual method presents largely a question of fact and that the taxpayer bears the burden of establishing the accrual of an expense or income. However, ICC failed to discharge this burden. As to when the firm's performance of its services in connection with the 1984 tax problems were completed, or whether ICC exercised reasonable diligence to inquire about the amount of its liability, or whether it does or does not possess the information necessary to compute the amount of said liability with *reasonable* accuracy, are questions of fact which ICC never established. It simply relied

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[18] *Commissioner of Internal Revenue v. General Foods (Phils.), Inc.*, *supra* note 11 at 550.

[19] TSN, July 20, 1995, p. 86.

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on the defense of delayed billing by the firm and the company, which under the circumstances, is not sufficient to exempt it from being charged with knowledge of the reasonable amount of the expenses for legal and auditing services.

In the same vein, the professional fees of SGV & Co. for auditing the financial statements of ICC for the year 1985 cannot be validly claimed as expense deductions in 1986. This is so because ICC failed to present evidence showing that even with only "reasonable accuracy," as the standard to ascertain its liability to SGV & Co. in the year 1985, it cannot determine the professional fees which said company would charge for its services.

ICC thus failed to discharge the burden of proving that the claimed expense deductions for the professional services were allowable deductions for the taxable year 1986. Hence, per Revenue Audit Memorandum Order No. 1-2000, they cannot be validly deducted from its gross income for the said year and were therefore properly disallowed by the BIR.

As to the expenses for security services, the records show that these expenses were incurred by ICC in 1986[20] and could therefore be properly claimed as deductions for the said year.

Anent the purported understatement of interest income from the promissory notes of Realty Investment, Inc., we sustain the findings of the CTA and the Court of Appeals that no such understatement exists and that only simple interest computation and not a compounded one should have been applied by the BIR. There is indeed no stipulation between the latter and ICC on the application of compounded interest.[21] Under Article 1959 of the Civil Code, unless there is a stipulation to the contrary, interest due should not further earn interest.

Likewise, the findings of the CTA and the Court of Appeals that ICC truly withheld the required withholding tax from its claimed deductions for security services and remitted the same to the BIR is supported by payment order and confirmation

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[20] Exhibits "EE" to "II", records, pp. 144-148.

[21] Exhibits "E" to "J", *id*. at 119 to 123.

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receipts.[22] Hence, the Assessment Notice for deficiency expanded withholding tax was properly cancelled and set aside.

In sum, Assessment Notice No. FAS-1-86-90-000680 in the amount of ₱333,196.86 for deficiency income tax should be cancelled and set aside but only insofar as the claimed deductions of ICC for security services. Said Assessment is valid as to the BIR's disallowance of ICC's expenses for professional services. The Court of Appeal's cancellation of Assessment Notice No. FAS-1-86-90-000681 in the amount of ₱4,897.79 for deficiency expanded withholding tax, is sustained.

WHEREFORE, the petition is *PARTIALLY GRANTED*. The September 30, 2005 Decision of the Court of Appeals in CA-G.R. SP No. 78426, is *AFFIRMED* with the *MODIFICATION* that Assessment Notice No. FAS-1-86-90-000680, which disallowed the expense deduction of Isabela Cultural Corporation for professional and security services, is declared valid only insofar as the expenses for the professional fees of SGV & Co. and of the law firm, Bengzon Zarraga Narciso Cudala Pecson Azcuna & Bengson, are concerned. The decision is affirmed in all other respects.

The case is remanded to the BIR for the computation of Isabela Cultural Corporation's liability under Assessment Notice No. FAS-1-86-90-000680.

SO ORDERED.

Austria-Martinez, Callejo, Sr., and *Chico-Nazario, JJ.,* concur.

Nachura, J., on leave.

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[22] Exhibits "QQ" to "WW", *id.* at 171-191.