REPUBLIC OF THE PHILIPPINES
COURT OF TAX APPEALS
QUEZON CITY

PORFIRIO V. ASCALON,
Petitioner,

-versus- C.T.A. CASE No. 2013

COMMISSIONER OF
INTERNAL REVENUE,
Respondent.
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DECISION

Petitioner has appealed from the decision of the respondent Commissioner of Internal Revenue assessing against and demanding from him payment of ₱65,663.35, representing 1964 deficiency income tax, inclusive of ½% monthly interest from April 20, 1965 to August 30, 1966.

Sometime in March, 1964, petitioner organized and formed Pandar Enterprises, Inc., a family and closed corporation, with an authorized capital of ₱1,000,000.00 divided into 10,000 shares of ₱100.00 per share. Their incorporators were petitioner Porfirio V. Ascalon; his wife, Amparo C. Ascalon; daughter, Ana Eva Ascalon de Jison; son-in-law, Dominador Jison, Jr.; and a relative, Carlos R. Ascalon. As shown by the articles of incorporation of Pandar Enterprises, Inc., petitioner and his wife subscribed to almost nine-tenth (9/10) of the capital stock of said corporation. The amounts of their subscriptions, paid-up subscriptions,

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and unpaid subscriptions are itemized as follows:

	Amount Subscribed	Paid-up Subscription	Unpaid Subscription
Porfirio V. Ascalon	₱90,000.00	₱22,500.00	₱67,500.00
Amparo C. Ascalon	89,900.00	22,475.00	67,425.00
Ana Eva A. Jison	10,000.00	2,500.00	7,500.00
Dominador Jison, Jr.	10,000.00	2,500.00	7,500.00
Carlos R. Ascalon	100.00	25.00	75.00
	₱200,000.00	₱50,000.00	₱150,000.00

On June 22, 1964, petitioner as lessor entered into a contract of "Lease, Acquisition of Rights and Expenses with Assumption of Obligations and Income" with the Pandar Enterprises, Inc. (Exh. 6, pp. 23-27, BIR records.) The lease was for a period of five (5) agricultural crop years, from 1963-1964 to 1967-68, inclusive, for agricultural lands, improvements, and equipments; and five (5) calendar years, from 1964 to 1968, inclusive, for urban and other real estate properties with a total book value of ₱602,293.92. The annual rental for the lease was ₱30,000.00 plus the amount of annual depreciation of all depreciable properties, improvements and equipment (Exh. 6, pp. 23-27, BIR records). The lease contract provides, among others, as follows:

> "That the LESSEE shall advance the sum of One Hundred Fifty Thousand Pesos (₱150,000) to the LESSOR chargeable against the rentals mentioned in the preceding paragraph.
>
> "That in view of the fact that the LESSOR has unpaid subscriptions to shares of stock of the LESSEE corporation standing in the name of Porfirio V. Ascalon

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and Amparo C. Ascalon in the total sum of One Hundred Thirty Four Thousand Nine Hundred Twenty Five Pesos as follows:

	Unpaid Subscription
Porfirio V. Ascalon	₱ 67,500.00
Amparo C. Ascalon	67,425.00
Total	₱134,925.00

part of the advanced rentals referred to above shall be applied to the said unpaid subscriptions and the same shall then be fully paid in which case the LESSEE shall issue in favor of the LESSOR the corresponding subscription to its shares of stock as fully paid shares.

"That the balance in the sum of Fifteen Thousand Seventy Five Pesos shall be paid by this LESSEE to the LESSOR upon the signing of this lease contract.

"That the LESSEE shall for all purposes immediately take over the operation of the properties herein leased. x x x." (Exh. 6, pp. 23-27, BIR rec.; Underlining supplied.)

In August, 1965, respondent caused the investigation of petitioner's 1964 income tax return. Subsequently, Revenue Examiner Noel C. Contreras recommended that a deficiency income tax of ₱62,528.21 be assessed against petitioner Porfirio V. Ascalon because the advance rental of ₱120,000.00 corresponding to the crop years 1964-1965, 1965-1966, 1966-1967 and 1967-1968 at the rate of ₱30,000.00 per annum mentioned in the lease contract should be considered as income taxable to petitioner-lessor in 1964. Out of the ₱150,000.00 rental income allegedly paid in advance by the lessee, petitioner declared in his 1964 income tax return an income of ₱30,000.00, leaving ₱120,000.00 as deferred income under the liabilities section of his balance sheet attached to the said return. (Exh. 1-B, p. 15, BIR rec.) The said amount of ₱120,000.00 was likewise reported and credited by the lessee, Pandar Enterprises, Inc., in its income tax return for 1964 as "Prepaid Rent" under the assets section of the balance sheet. (Exh. 11, p. 227, CTA rec.) For all the years subsequent to 1964, petitioner reported ₱30,000.00 as yearly rental income in his income tax returns and paid the income tax due thereon. The books of accounts of both petitioner-lessor and lessee corporation are kept under the accrual basis.

On November 2, 1965, the BIR Regional Director at Bacolod City sent a preliminary five-day letter advising petitioner of the examiner's findings and recommendations. On August 30, 1966, respondent assessed against and demanded from petitioner payment of ₱65,663.35 as 1964 deficiency income tax, inclusive of interest. The deficiency tax was arrived at by adding the rental income of ₱120,000.00 to petitioner's 1964 net income of ₱56,132.21.

Petitioner protested the assessment in his various letters to respondent. The protest was premised on the grounds that (1) petitioner did not receive ₱120,000.00 as advance rental in 1964; (2) lessee corporation could

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not possibly have paid ₱120,000.00 to petitioner-lessor considering the meager financial resources of the lessee corporation in 1964; (3) petitioner and his wife could not have possibly paid for their unpaid subscriptions of ₱134,925.00 in 1964 because of their financial incapacity to do so; (4) no receipt was issued to petitioner-lessor or his wife for ₱134,925.00 corresponding to their unpaid subscriptions; (5) no certificates of stock were issued by Pandar Enterprises, Inc. to petitioner and his wife; (6) upon lessee's failure to advance ₱150,000.00 to herein petitioner, both lessor and lessee executed a supplementary lease contract to show the real intentions of the parties in the original contract of lease; and (7) the books and records of both petitioner and lessee-corporation were adjusted to reflect parties' intention with respect to the advance rental of ₱150,000.00.

On November 28, 1968, respondent denied petitioner's protest and ruled that the advance rental of ₱150,000.00 forms part of petitioner's 1964 taxable income. Hence, this appeal.

The issues posed for resolution are the following:

> (1) Whether or not Pandar Enterprises, Inc. has the financial capability to advance the rental of ₱150,000.00 to petitioner in 1964;
>
> (2) Whether or not the rental of ₱150,000.00 found in the lease contract and allegedly advanced by

Pandar Enterprises, Inc. to petitioner constitutes taxable income of the latter in 1964; and

(3) Whether or not the right of the Government to assess petitioner's 1964 income tax has prescribed.

First and Second Issues:

The first and second issues being interrelated, we will discuss them jointly.

Petitioner contends that the lessee-corporation was not in a position to pay an advance rental of ₱150,000.00 to petitioner in 1964 because at that time the corporation has a paid-up capital of only ₱50,000.00. Respondent, however, argues that the "financial capability" of lessee-corporation cannot in any way affect the validity and efficacy of the lease contract because under the terms thereof only ₱15,075.00 shall be paid by the lessee-corporation to petitioner upon signing of the contract.

The question of whether or not the lessee-corporation was in a financial position in 1964 to pay in cash the amount of ₱150,000.00 as advance rental should be answered in the negative because at that time it has only a paid-up capital of ₱50,000.00. But the lessee-corporation is not required by the lessor to pay in cold cash the advance rental of ₱150,000.00. What was to be used by the lessee for the payment thereof was the par value of the unpaid shares of stock of the lessor in the lessee corporation which does not involve any cash payment. It would appear, therefore, that the ownership of the corporate shares of stock valued at ₱150,000.00 was acquired by the lessor after the perfection of the contract in 1964.

Section 29 of the National Internal Revenue Code defines "gross income" as including "income derived from any source whatever." As the par value of the corporate shares of stock to be paid to the lessor under the lease contract is measurable in terms of money, it may be said that the advance rental of ₱150,000.00 was paid to the lessor-petitioner in 1964. Under the facts obtaining in this case, the following accounting entries may be made, to wit:

PORFIRIO V. ASCALON

Stocks --------------	₱150,000.00	
Subscription Payable -----------		₱150,000.00

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Subscription Payable --	₱150,000.00	
Rental Income (1964) -----------		₱ 30,000.00
Deferred Income --------------		120,000.00

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PANDAR ENTERPRISES, INC.

Subscription Receivable-	₱150,000.00	
Capital Stock ----------------		₱150,000.00

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Rental Expense --------	₱ 30,000.00	
Prepaid Rent --------	120,000.00	
Subscription Receivable --------		₱150,000.00

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In determining the net income of petitioner in this case, the method of accounting regularly employed by him, if it clearly reflects income, shall be considered. Unless such method dictates otherwise, all receipts shall be included in gross income for the year when they are actually received. Depending also on such method of accounting, deductions are to be taken for the year in which "paid or accrued" or "paid or incurred."

No uniform method of accounting is prescribed in Section 38 of the National Internal Revenue Code, in relation to Sec. 166 of the Income Tax Regulations. Consequently, each taxpayer shall adopt such forms and methods of accounting best suited for his purpose. There are, however, two principal methods of accounting widely used by taxpayers, namely:

(1) The cash receipts and disbursements method better known as the "cash basis" method; and

(2) The accrual basis method.

Cash Method.

If the income is determined purely by reference to the changes in the cash position of a taxpayer, it is said that he employs a "cash method" or that his income is determined on the "cash receipts and cash disbursements basis." In short, this method consists of determining the amount of cash received, and the amount of cash expended. The excess of the receipts over expenditures is income and the excess of expenditures over receipts is a loss.

A cash basis taxpayer may be required in some cases to add to his income actually received the amount of other income considered to have been constructively received. For instance, interests on time and savings bank deposits are income to the depositor when credited, even though he is on the cash basis.

Constructive receipt.

It means that while the income is not actually in the possession of the taxpayer, it is so much within his control and disposition amounting to actual receipt.

Accrual Method.

This is the method of determining income by allotting income and expenses to the period in which earned or incurred, regardless of when received or paid.

The basic rules in the accrual method are:

(1) The right to receive an item of income (as distinguished from actual receipt) determines its inclusion in gross income under the accrual method.

(2) A deduction cannot be accrued until an actual liability is incurred.

After discussing briefly the two methods of accounting relevant to this case, we are going to determine whether the advance rental of ₱150,000.00 allegedly received by petitioner Porfirio V. Ascalon in 1964 is taxable to him in that year despite the fact that he is on the accrual basis of accounting.

Following the accrual method of accounting, petitioner has reported and included the annual rental of ₱30,000.00 in his income tax returns for the crop-years 1964, 1965, 1966, 1967, and 1968 and has paid the income taxes correspondingly to the 5-year period. The annual declaration of rental income and the yearly payment of income tax were disregarded by respondent because, in the balance sheet attached to petitioner's 1964 income tax return, Mr. Ascalon declared only ₱30,000.00 as rental income in 1964 and treated the balance of ₱120,000.00 as deferred income under the liabilities section of his balance sheet; the said amount was likewise reported and credited by the lessee, Pandar Enterprises, Inc., in its 1964 income tax return as "Prepaid Rent".

Ordinarily, income is constructively received if duly credited on the books of the taxpayer. On this point, Revenue Regulations No. 2 of the Department of Finance, otherwise known as the Income Tax Regulations, provide:

> "Sec. 52. Income constructively received. - Income which is credited to the account of or set apart for a taxpayer and which may be drawn upon by him at any time is subject to tax for the year during which so credited or set apart, although not then actually reduced to possession. To constitute receipt in such a case the income must be credited to the taxpayer without any substantial limitation or restriction as to the time or manner of payment or condition upon which payment is to be made. A book entry, if made, should indicate an absolute transfer from one account to another. If the income is not credited, but is set apart, such income must be unqualifiedly subject to the demand of the taxpayer. Where a corporation contingently credits its employees with bonus stock, but the stock is not available to such employees until some future date, the mere crediting on the books of the corporation does not constitute receipt." (Revenue Regulations No. 2, Sec. 52.)

Section 52 of the Income Tax Regulations appears to be an exception to the methods governing cash or accrual basis of accounting income.

But mere crediting of an income to the taxpayer is not sufficient to constitute constructive receipt. It must be shown that (1) the income is available to him; (2) the debtor is able and ready to pay him; (3) his right to receive is not restricted; and (4) his failure to receive is the result of the exercise of his own choice. (C. E. Gullet, 31 BTA 1067; William Parris, 20 BTA, 320.)

On the part of Pandar Enterprises, Inc., the prepaid rent of ₱120,000.00 should be treated as capital expenditure. It cannot deduct in 1964 the full amount of prepaid rent as a business expense but it must deduct them proportionately over the remaining four (4) years of the lease, that is, 1965, 1966, 1967 and 1968. This procedure should be followed even though the prepaid rent of ₱120,000.00 had been taxed in full to the lessor in the year of receipt (See Pig & Whistle Co., 9 BTA 668; Main & McKinney Building Co. v. Commissioner, 113 F. 2d, 81).

On the part of Mr. Porfirio V. Ascalon, the advance payment of ₱150,000.00 is taxable income to him in 1964 if the said payment is actually and in reality pre-paid rental. And this is true even though Mr. Ascalon is on the accrual or the cash method of accounting. (Hyde Park Realty, Inc. v. Commissioner, 211 F. 2d 462; Cf. Evansville Courier v. Commissioner, 62 F ed 232.) The lessor in either case is required to include the entire amount of the advance rental in his gross income in 1964 when such advance rental was received by him. However, the advance payment or prepaid rental is taxable to the lessor only if he receives them under a claim or right and without restriction as to its use. (Renwick v. United States, 87 F. 2d. 123 (CCA 7th, 1936); Hort v. Commissioner, 313 U. S. 28, 85

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L. Ed. 1168, 61 S. Ct. 757 (1941); Neils Schultz, 44 BTA 146; Edwin B. DeGolia, 40 BTA 845; Warren Service Corp., 39 BTA 856; George E. Baker Estate, 13 BTA 562; 2 Mertens, Federal Income Taxation, 171, 1942 ed.7 Otherwise, such advance rental should be apportioned over the term of the lease. (O'Day Investment Co., 13 BTA 1230; Louis Rothenberg, 5 BTA 666; R. H. Hazlett, 10 BTA 332; Roby Realty Co., 19 BTA 696; A. T. Schiro, Inc., 20 BTA 1026; Douglas Properties, Inc., 21 BTA 347; William Penn. Hotel Co., 23 BTA 566; Michigan Central R. R. Co., 28 BTA 437; Allie M. Turbeville, 31 BTA 283; Crile v. Commissioner, 55 F. 2d 804; and Jennings & Co., Inc. v. Commissioner, 59 F. 2d 32.) In one case, however, it has been held that where payment to be applied to the rent for the last year of the term of the lease is made to the lessor upon the execution of the lease and is received under a present claim of full ownership and subject to his unfettered command, the payment is income to the lessor in the year of receipt. ∠Hirsch Improvement Co., BTA Memo. Op., DKT 105492 (Oct. 6, 1942). aff'd 143 F 2d (CCA 2d, 1944).7

In determining whether the advance rental of ₱150,000.00 was constructively received by petitioner in 1964, the following questions may be asked: (1) Is the rental income of ₱150,000.00 available to petitioner? (2) Is the debtor Pandar Enterprises, Inc. able and ready to pay him? (3) Is the right of petitioner to receive the rental income of ₱150,000.00 not restricted? and (4) Is the failure of petitioner to receive the advance rental the result of the exercise of his own choice? These questions should be answered in the negative.

The alleged advance rental of ₱150,000.00 is not available to petitioner in 1964 because at that time, Pandar Enterprises, Inc. has only a paid-up capital of ₱50,000.00. The shares of stock of the said corporation with a par value of ₱150,000.00 is likewise not available to petitioner inasmuch as the immediate issuance thereof is subject to certain conditions imposed in the miscellaneous lease contract which provides, among others, as follows:

> "x x x. That since most of the properties herein are mortgaged to the Philippine National Bank for crop loan purposes in order not to hamper the operation of the enterprise, the LESSOR shall continue to deal with the said bank in his own name but <u>this contract shall be submittedto the Philippine National Bank in order to approve the assumption of the accounts of the LESSEE herein for which the properties mortgaged to the Philippine National Bank shall continue to be mortgaged for crop and other loan purposes</u>. (Underlining supplied; p. 68 CTA rec.)

It is clear from the foregoing stipulations that

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Pandar Enterprises, Inc. is not ready to pay petitioner in shares of stock valued at ₱150,000.00 and that petitioner does not have the right or unfettered command to receive the advance rental of ₱150,000.00 because the payment thereof is subject to certain restrictions - the approval by the Philippine National Bank of the contract of "Lease, Acquisition of Rights and Expenses with Assumption of Obligations and Income" executed by and between petitioner Porfirio V. Ascalon and Pandar Enterprises, Inc.

Accordingly, we hold that the disputed rental of ₱150,000.00 was not constructively received by petitioner in 1964 because there can be no constructive receipt of the advance rental until the condition or restriction imposed by the lease contract is removed. (See Sec. 52, Income Tax Regulations; C. T. XX-1, 179; Richard Estate v. Commissioner, 1 50 F /2d/ 837; Olson, 24 BTA 702, aff'd 67 F /2d/ 726, certiorari denied, 292 U. S. 637; Denny, 33 BTA 738.)

In the light of the resolution of this Court on the first and second issues, we deem it unnecessary to pass on the third issue.

WHEREFORE, the decision of the respondent Commissioner of Internal Revenue holding petitioner subject to the 1964 deficiency income tax of ₱65,663.35, inclusive of interest, is reversed. Accordingly, the said assessment is hereby cancelled and declared of no force and effect. Without pronouncement as to costs.

SO ORDERED.

Quezon City, April 25, 1973.

ESTANISLAO R. ALVAREZ
Associate Judge

WE CONCUR:

ROMAN M. UMALI
Presiding Judge

RAMON L. AVANCEÑA
Associate Judge

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