AURELIO P. REYES,
Petitioner,

versus C.T.A. CASE NO. 42

THE COLLECTOR OF
INTERNAL REVENUE,
Respondent.

July 26/56

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D E C I S I O N

This is a petition for review of the decision of the Collector of Internal Revenue dated October 13, 1954 wherein the sum of ₱641,470.04 was assessed against petitioner as deficiency income tax for the calendar years 1946 to 1950, inclusive, together with the corresponding penalties.

The petitioner is a businessman, engaged in the optical, office equipment and haberdashery business. During the aforesaid years, petitioner filed his income tax returns reporting income on the basis of the "cash receipts and disbursement method" and paid the corresponding taxes thereon as follows:

Year	Net Income	Amount of tax paid
1946	no record	₱ 10,594.08
1947	₱19,160.98	1,332.37
1948	20,115.87	1,494.70
1949	18,559.64	1,230.14
1950	22,195.07	2,274.82

After an investigation previously conducted by internal revenue examiners, respondent Collector of Internal Revenue, on October 13, 1954, determined the income tax deficiencies of petitioner by means of the net worth method, computed in the following manner:

1946

Net worth as of December 31, 1946	₱187,677.98
Less: Net worth as of January 1, 1946.	134,597.00
Increase in net worth	₱ 53,080.00
Tax due thereon	₱ 11,104.29
Less: Amount of tax assessed	10,594.08
Deficiency tax due	510.21
50% surcharge	255.11
Total amount due	₱ 765.32

1947

Net worth as of December 31, 1947	₱386,009.45
Less: Net worth as of January 1, 1947.	187,677.98
Increase in net worth	₱198,331.47
Tax due thereon	₱ 67,479.22
Less: Amount of tax assessed	1,332.37
Deficiency tax due	₱ 66,146.85
50% surcharge	33,073.43
Total amount due.	₱ 99,220.28

1948

Net worth as of December 31, 1948	₱583,706.07
Less: Net worth as of January 1, 1948.	386,009.45
Increase in net worth	₱197,696.62
Tax due thereon	₱ 67,212.58
Less: Amount assessed.	1,494.70
Deficiency income tax due . . .	₱ 65,717.88
50% surcharge	32,858.94
Total amount due	₱ 98,576.82

1949

Net worth as of December 31, 1949	₱ 769,757.15
Less: Net worth as of January 1, 1949	583,706.07
Increase in net worth . . .	₱ 186,051.08
Tax due thereon	₱ 62,321.45
Less: Amount assessed. . .	1,314.14
Deficiency income tax due .	₱ 61,007.31
50% surcharge	30,503.66
Total amount due	₱ 91,510.97

1950

Net worth as of December 31, 1950	₱1,080,401.78
Less: Net worth as of January 1, 1950	769,757.15
Increase in net worth . . .	₱ 310,644.63
Tax due thereon	₱ 153,694.00
Less: Tax already assessed	₱ 2,297.00
Deficiency tax still due .	₱ 151,397.00
50% surcharge	75,699.00
Amount still due	₱ 227,096.00

Summary

1946	₱ 765.32
1947	99,220.28
1948	98,576.82
1949	91,510.97
1950	227,096.00
Total deficiency income tax. . . .	517,169.39
5% surcharge . . .	25,858.47
1% monthly interest from March 31, 1953 to October 31, 1954. .	98,262.18
Administrative penalty for late payment	180.00
Total Amount due as of October 31, 1954	₱641,470.04

The foregoing deficiency income tax assessment was arrived at after determining petitioner's taxable income on the basis of the net-worth method (also known as the inventory method), the legality of the use of which has been raised as one of the issues in this case. The assets and liabilities considered by respondent in the assessment under review are shown in the report of the income tax examiner who investigated the case (Exhibit W, petitioner; Exhibit 9, respondent).

On the same day that the deficiency tax assessment was issued, respondent issued a warrant of distraint and levy by virtue of which the properties of the petitioner were ordered to be seized and sold at public auction should the petitioner fail to pay the total amount demanded on or before November 10, 1954. Failing to secure a revision of the assessment, petitioner filed a petition with this Court on November 15, 1954 to set aside respondent's decision. The following day, he filed an urgent petition to restrain respondent from executing the warrant of distraint and levy issued to enforce collection of the assessment, it appearing that respondent issued instructions to the City Treasurer of Manila to proceed with the execution of said warrant. After preliminary hearing on this incident, this Court granted the injunction in its Resolution dated January 8, 1955, which has been appealed by respondent to the Supreme Court in G. R. L-8685, and is still pending consideration by said Court. The case now before us concerns the legality and correctness of the assessment.

The findings of respondent in regard to the net worth of petitioner being disputed by petitioner, the parties presented evidence to show the assets and liabilities of petitioner on the first and last days of each year beginning 1946 up to 1950. After trial, the following assets and liabilities of petitioner on January 1, 1946 have been admitted and their values recognized or conceded by the parties:

Assets	Cost
Admitted assets (real estate holdings as of January 1, 1946 (See Summary, Exh. MM-1)	
Lot - Rizal Ave. - Soler ... Exh. NN (Mortgage payable ₱30,000)	₱70,000.00
Lot - Felix Huertax .... Exh. PP	22,000.00
Lot - Laong Laan-Dos Castillas Exhibit QQ	56,000.00
Lot - 300-302 Cavite St..... Exh. RR	5,000.00
Lot - Lardizabâl .... Exh. SS	15,000.00
Lot - Raon Corner Sales .... Exh. XX	35,000.00
Lot - 1004 Magdalena .... Exh. CCC Schedule D of Exh. TT..........	3,000.00
Building at 1004 Magdalena, Schedule D of Exh. TT	8,080.00
Lot - 1500 Rizal Ave., Schedule D of Exh. TT	12,000.00
Building at 1500 Rizal Ave. Schedule D of Exh. Tt	27,570.00
Lot in San Juan, Rizal - Exhs. GGG & GGG-1	12.000.00
Cabiao, Nueva Ecija - Exh. HHH......	17,600.00
Lot in Orani, Bataan - Exh. III	10.000.00
Building at 312 Cavite - Exhs. JJJ ... and JJJ-1	9,000.00
	₱302,250.00

Liabilities

Admitted liabilities as of January 1, 1946 (See Mortgage payable on Lot at Rizal Avenue and Soler, see above)	₱30,000.00

The net worth of petitioner as of January 1, 1946, which was originally adopted by respondent as the opening net worth for purposes of the assessment was ₱134,597.00. It is apparent from respondent's memorandum (see page 86 and Annex 1 of Memorandum for respondent) that he is willing to concede that petitioner's opening net worth on said date was ₱310,630.00, thus paving the way for the modification of the assessment. Respondent also admits the following assets and liabilities of petitioner as of the end of the calendar years in question:

December 31, 1946

Admitted assets

Merchandise inventory - Miscellaneous	₱ 5,079.72
Merchandise inventory - Haberdashery - Local	20,053.28
Merchandise inventory - Haberdashery - Imported . . .	70,699.16
Merchandise inventory - Office equipment - Imported .	47,925.29
Merchandise inventory - optical goods - Local	8,072.33
Merchandise inventory -.Optical goods - Imported	21,414.12
Building fixtures	4,500.00
Optical equipment and apparatus	14,140.03
Auto & delivery trucks	18,050.40
Philippine Racing Club	27,500.00
Manila Surety & Fidelity Company	10,000.00
Real estate holdings	567,208.00

Admitted liabilities

Loans payable	₱ 40,000.00
Acceptances payable	58,806.48
Notes payable (banks)	24,000.00
Overdrafts with banks	80,979.25
Accounts payable	19,552.62
Mortgage payable (see Annex "A" and Annex 1 of respective memoranda of parties)	160,000.00

December 31, 1947

Admitted assets

Merchandise inventory - Haberdashery - Local	26,315.62
Merchandise inventory - Office equipment - Local	63,979.21
Merchandise inventory - Optical goods - Local	18,372.57
Merchandise inventory - Optical goods - Imported	75,571.14
Auto & delivery trucks	11,842.00
Philippine Racing Club	67,600.00
Manila Fidelity & Surety Co.	10,000.00
Merchandise in transit:	
Haberdashery	28,194.37
Office equipment	25,671.80
Optical goods	92,861.74

Admitted liabilities

Loans Payable	49,500.00
Notes payable (banks)	65,500.00
Mortgage payable	270,931.00
Overdrafts with banks	217,258.05
Manila Jockey Club	1,440.00
Philippine Racing Club	850.00
Accounts payable	41,781.52
Acceptances payable	103,156.39

December 31, 1948

Admitted assets

Petty cash	1,000.00
Merchandise inventory - Haberdashery - Local	40,334.69
Merchandise inventory - Office equipment - Local	63,508.80
Merchandise inventory - Optical goods	19,583.27
Prepaid taxes	5,306.33
Demand deposit (P. B. C.)	304.58
Philippine Racing Club	264,726.00

Philippine Ready-Mix Concrete Corporation	25,000.00
Manila Surety & Fidelity Company	10,000.00

Admitted liabilities

Loans payable	44,500.00
Acceptances payable	164,203.54
Notes payable - banks	60,500.00
Overdrafts with banks	328,567.94
Manila Jockey Club	2,380.00
Philippine Racing Club	1,341.20
Accounts payable	18,655.30
Mortgage payable	220,931.00

December 31, 1949

Admitted assets

Petty cash	1,000.00
Accounts receivable	123,744.07
Merchandise inventory - Haberdashery - Local	36,775.98
Merchandise inventory - Office equipment - Local	63,346.25
Merchandise inventory - Optical goods - Local	7,161.20
Prepaid taxes	4,647.53
Demand deposit - P.B.C.	367.93
Philippine Racing Club	264,726.00
Manila Surety & Fidelity Co.	10,000.00
Philippine Ready-Mix Concrete Corporation	28,000.00

Admitted liabilities

Loans payable	25,000.00
Acceptances payable	211,724.03
Notes payable	101,730.00
Overdrafts with banks	327,815.28
Time loan - PNB Cabanatuan branch	14,000.00
Manila Jockey Club	1,700.00
Philippine Racing Club	26,713.23
Accounts payable	28,088.89

December 31, 1950

Admitted assets

Petty cash	1,000.00
Merchandise inventory - Haberdashery - Local	59,041.92
Merchandise inventory - Office equipment - Local	65,126.47

Merchandise inventory - Optical goods - Local	₱ 6,732.90
Demand deposit - P.B.C.	243.33
Prepaid taxes	4,292.11
Philippine Racing Club	376,925.00
Manila Surety & Fidelity Co.	10,000.00

Admitted liabilities

Loans payable	25,000.00
Acceptances payable	151,963.32
Notes payable - banks	65,585.30
Mortgage payable - C.B.C.	30,000.00
Overdrafts with banks	290,185.63
Time loan - PNB Cabanatuan branch	14,000.00
Manila Jockey Club	1,680.00
Philippine Racing Club	71,258.81
Accounts payable	23,998.31

In view of the stipulation of facts of the parties dated August 1, 1955 and the evidence adduced during the hearing as to the assets and liabilities of petitioner as of the end of the calendar years from 1946 to 1950, to which respondent himself has substantially acquiesced (see pp. 4, 8-9, 12-15 and Annex "1" of respondent's memorandum), the deficiency income tax assessment of petitioner is now open for revision after consideration first being taken of the factual and legal issues raised by petitioner.

The issues raised by the parties are:

1. The correctness of the net worth of petitioner at the beginning of 1946 and at the end of each of the calendar years 1946 to 1950 as found by respondent;

2. The legality of the net worth method of determining taxable income under our Income Tax Law;

3. The propriety of the imposition of the

fraud penalty (50% surcharge provided in Section 72, National Internal Revenue Code); and

4. The statute of limitations upon assessment and collection properly applicable to the case of petitioner.

Counsel for both parties gave prior consideration to the disputed assets and liabilities affecting the net worth of petitioner before discussing the legal issue relating to the validity of the use of the net worth method. For convenience, we shall consider the issues raised in the order presented by counsel for both parties.

The disputed assets and liabilities involved in the first issue are itemized as follows:

	Disputed Assets	Per petitioner	Per Respondent
	As of January 1, 1946		
1.	Building at Raon corner Sales	₱45,000.00	₱42,750.00
2.	Lot at 312 Cavite St.	2,008.00	---
3.	Depreciation of assets	---	(4,370.00)
	As of December 31, 1946		
4.	11 Race horses	---	36,135.00
5.	Depreciation of assets	---	(12,409.04)
	As of December 31, 1947		
6.	Merchandise inventory - Haberdashery	21,777.73	107,755.17
7.	Merchandise inventory office equipment	87,050.83	122,969.03
8.	Building fixtures	4,000.00	4,500.00

9.	Optical equipment	₱ 12,763.58	14,140.03
10.	Furniture and fixtures	17,267.18	18,050.00
11.	Depreciation of assets (negative)	---	(21,632.28)
12.	Real estate holdings	730,448.00	738,698.00
13.	Race horses	---	39,420.00
	As of Dec. 31, 1948		
14.	Merchandise inventory Haberdashery - Imported	46,498.15	138,985.09
15.	Merchandise inventory Office equipment - Imported	78,621,11	216,409/87
16.	Merchandise inventory Optical - Imported	93,861.93	155,719.08
17.	Building fixtures	3,500.00	4,500.00
18.	Optical equipment	11,170.83	14,140.03
19.	Furniture & fixtures	17,072.91	18,050.40
20.	Auto & delivery trucks	8,028.00	11,842.00
21.	Depreciation of assets (negative)	---	(39,256.02)
22.	Real estate holdings	762,708.00	767,208.00
23.	Race horses	---	39,420.00
	As of Dec. 31, 1949		
24.	Merchandise inventory - Haberdashery - Imported	75,643.94	173,538.61
25.	Merchandise inventory-Equipment - Imported	72,765.59	271,209.16
26.	Merchandise inventory - Optical - Imported	104,327.22	224,343.92
27.	Building fixtures	3,045.00	44,500.00
28.	Optical equipment	9,578.08	14,140.03
29.	Furniture & fixtures	14,984.01	18,050.40

30.	Auto & delivery trucks	₱ 8,217.04	₱ 11,842.00
31.	Depreciation of assets (negative)	---	(40,078.76)
32.	Real estate holdings	270,458.00	277,208.00
33.	Race horses	36,135.00	65,700.00
	<u>As of Dec. 31, 1950</u>		
34.	Accounts receivable	148,435.97	175,799.67
35.	Merchandise inventory - Haberdashery - Imported	67,025.48	175,138.39
36.	Merchandise inventory - Office equipment - Imported	58,148.66	244,069.32
37.	Merchandise inventory - Optical goods - Imported	116,246.59	314,522.81
38.	Building fixtures	2,540.00	4,500.00
39.	Optical equipment & apparatus	7,985.33	14,140.03
40.	Furniture & fixtures	13,234.28	18,050.80
41.	Auto & delivery trucks	10,291.36	11,842.00
42.	Depreciation of assets (negative)	---	(45,737.00)
43.	Real estate holdings	217,558.00	226,558.00
44.	Philippine Ready-Mix Corporation	10,000.00	100,000.00

Petitioner claims to have incurred certain liabilities all, or portions of which, were outstanding as of the end of the taxable years 1946, 1947, 1948, 1949 and 1950. Respondent, however, did not consider said liabilities in the determination of petitioner's net worth claiming that the alleged loans are fictitious. The liabilities claimed by petitioner are itemized as follows:

Disputed Liabilities

Dec. 31, 1946

Francisco P. Reyes	₱25,000.00	
Pablo Bustamante	25,000.00	
Eulogio Rodriguez, Jr.	20,000.00	₱ 70,000.00

Dec. 31, 1947

Francisco P. Reyes	25,000.00	
Pablo Bustamante	25,000.00	
Eulogio Rodriquez, Jr.	10,000.00	60,000.00

Dec. 31, 1948

Francisco P. Reyes	20,000.00	
Pablo Bustamante	25,000.00	
Eulogio Rodriguez, Jr.	20,000.00	
Juan C. S. Viado	20,000.00	85,000.00

Dec. 31, 1949

Francisco P. Reyes	25,000.00	
Pablo Bustamante	25,000.00	
Eulogio Rodriquez, Jr.	10,000.00	60,000.00

Dec. 31, 1950

Francisco P. Reyes	25,000.00	
Pablo Bustamante	25,000.00	
Eulogio Rodriguez, Jr.	30,000.00	
Simeon Reyes	25,000.00	
Ramon Meneses	20,000.00	125,000.00

We shall consider each item of the disputed assets and liabilities listed above to determine whether or not the same should be properly taken into account in the determination of petitioner's net worth.

Building at corner of Reon and Sales Sts. (Item No. 1). - That this building is owned by petitioner is admitted by respondent, but it was taken up by respondent at ₱42,750.00 for the opening net worth. Petitioner, however, claims that the correct value of said property as of January 1, 1946 should be ₱45,000.00. We agree with petitioner that the value of the building which should be taken into account is ₱45,000.00. This is clearly shown by the fact that the contract price for the construction of the building was ₱45,000.00 (Exhibit AAAA-1)/ This amount also appears in the performance bond (Exh. AAAA). That this building was completed in December, 1945 is shown in petitioner's real property tax declaration (Exhibit BBBB). The cost is corroborated by petitioner's income tax return for 1947 which is a document <u>ante litis motam</u> (Exhibit OO-Petitioner; Exhibit 33 - Respondent on page 3 thereof, Schedule of Depreciation), which shows that the cost of the building is ₱45,000.00, so that as of December 31, 1947, it had a net book value of 40,500.00 after a yearly depreciation allowance of ₱2,250.00 for 1946 and 1947, or a total depreciation of ₱4,500.00 for two years.

<u>Land at 312 Cavite St. (Item No. 2)</u>.- Respondent claims that the sum of ₱2,008.00 (installments paid in 1945 and prior years on account of a lot at Cavite St. in Manila) should not be considered as part of the assets of petitioner in 1945, or as of January 1, 1946, because the lot was purchased by installment, and the last pay-

ment was made in 1946. In other words, amounts paid by way of installment are not assets of the purchaser in the year of payment; only the total amount, or the purchase price when paid in full, becomes an asset of the purchaser in the year the final installment is paid. We can not accept this view. We believe that in acquisitions of property by installment, all payments made during a year are part of the purchaser's assets in the year of payment, not in the year the final installment is paid. That petitioner acquired this land in 1932 by installment and not in lump sum is further corroborated by the fact that in 1933 he constructed a building thereon which was declared for tax purposes in the name of petitioner (Exhibits JJJ and JJJ-1), which building respondent admits as forming part of petitioner's opening net worth.

Race horses (Items Nos. 4, 13, 23, and 33).- According to respondent, the petitioner had 11 race horses as of December 31, 1946, valued each at ₱3,285.00, or ₱36,135.00, which petitioner denied at first because it was not in respondent's findings (Exh. W, Net Worth Summary for 1946 to 1950) or in the pleadings. However, evidence showing the number of horses at later dates indicates that some of the horses owned in 1948, 1949 or 1950 were already owned by petitioner in 1946. Considering that the evidence of respondent is one to prove the increase of petitioner's net worth for each of the years involved, and that respondent has admitted certain assets but nevertheless contends that the increase in net worth is much more than what petitioner is willing to admit, we believe that evidence in this respect is admissible if only to sustain the increase in net worth for each year as found by respondent in the decision subject of this appeal.

Respondent determined the value of each horse on the basis of the average cost of the dead horses claimed as losses by petitioner in his 1948 income tax return (Exh. YY). We note that this valuation appears to be the lowest of valuations placed upon horses claimed to have died in 1947, 1948 and 1950. We also note that petitioner has not been vocal about the correctness of the number and value of his horses during the period involved. It becomes necessary for us to review all the evidence on this point.

From petitioner's summary of horses disposed of in 1950 (Exh. TTT) he sold nine (9) horses with names listed therein (see also Exh. LL for dates of certificates of ownership), which according to his income tax return for the same year (p. 2, Exh. TT) had a cost of ₱27,400.00, or an average of ₱3,044.44 each. From the same summary (Exh. TTT), he claims to have lost three horses, two of which, "Night Queen" and "Black Chief", were valued at ₱9,200.00, or ₱4,600.00 each, as shown in his income tax return for 1950 (Exh. TT). From the same summary (Exh. TTT). we note that he gave away certain horses to his father-in-law, each having a cost of ₱3,000.00.

From the testimony of Jose Warren, an official of the Manila Jockey club, it appears that there were eleven (11) horses registered in the name of petitioner during 1946. This is admitted by petitioner. And petitioner likewise presented a list of horses registered in his name or in that of his wife since 1949, and those in petitioner's son and father-in-law.

From the foregoing, we find the following: (1) that petitioner owned horses named "Better Bet", "Buhawi", and "Requested" since 1946 until sold to William Li Yao in 1950, which horses were acquired by petitioner at a cost of ₱3,044.44 each; (2) that the horse "Black Chief" was first listed in the name of the petitioner or of his wife in 1946 and "Night Queen" in 1947, and that both were owned until the horses died in 1950, each having a cost of ₱4,600.00; (3) that petitioner acquired "Four Freedoms" and "Pearl Diver" in 1947, "Mirame" in 1948 and "Blue Eagle" and

"Black Night" in 1949, each at a cost of ₱3,044.44, which continued to be owned by petitioner until sold to William Li Yao in 1950; (4) that petitioner in 1949 acquired horses "Royal Beauty", "The Boss" and "Gilded Knight" at a cost of ₱3,000.00 each, which horses continued to be registered in the name of petitioner's wife in 1950, and were in fact re-registered in her name in 1951, and transfer of title to the first two named horses was made in favor of petitioner's father-in-law only in 1952 (Exh. SSS). We find that "Gilded Knight" could not have died in 1950 but probably thereafter since it was in fact registered as alive in 1951 (Exh. SSS). Hence, the total number and valuation of horses owned by petitioner during the period under review are as follows:

Date	No. of Horses	Valuation
December 31, 1946	4	₱13,733.32
December 31, 1947	7	24,422.20
December 31, 1948	8	27,466.64
December 31, 1949	13	42,555.52
December 31, 1950	3	9,000.00

While the respondent did not consider that petitioner had a balance of three (3) race horses still on hand as of December 31, 1950, we believe that this must have been due to oversight and since it is disclosed in petitioner's own evidence (Exhs. SSS and WWW), we have to consider this fact by petitioner's admission.

Merchandise Inventories (Items Nos. 6 and 7/1947/ ; Nos 14, 15 and 16 /1948/; Nos. 24, 25 and 26 /1949/; and Nos. 35 and 37 /1950/).- Petitioner submitted evidence to prove that errors were committed in the preparation of his merchandise inventories for the years 1947, 1948, 1949 and 1950 in that, instead of reflecting the cost of acquisition of imported goods, the dealers' prices were used, and the inventories contained duplications and sometimes triplications of various items of merchandise. If this is correct, the net worth of petitioner during those years would be reduced and the taxable income would also be correspondingly reduced.

Section 36 of the Revenue Code, requiring the taking of inventories, provides-

> "SEC. 36. Inventories. -- Whenever in the judgment of the Collector of Internal Revenue, the use of inventories is necessary in order to determine clearly the income of any taxpayer, inventories shall be taken by such taxpayer upon such basis as the Secretary of Finance may, by regulations, prescribe, as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income."

The law requires the taking of inventories if they are necessary "to determine clearly the income of any taxpayer," such inventories to be taken "upon such basis as the Secretary of Finance may, by regulations, prescribe, as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income." The regulations promulgated by the Secretary of Finance requires the use of inventories "in every case in which the production, purchase, or sale of merchandise is an income producing factor." (Section 144, Revenue Regulations No. 2, 39 O. G. 325.)

In order that an inventory may satisfy the requirements of the law and regulations, (1) it must conform as nearly as possible to the best accounting practice in the trade or business, and (2) it must clearly reflect the income of the taxpayer. An d in order that an inventory may clearly reflect the income of the taxpayer, the merchandise must be valued (1)at cost or (2) at cost or market price, whichever is lower. (Sec. 145, Revenue Regulations Nos. 2) The term "cost" means, in the case of merchandise purchased since the beginning of the taxable year -

> "x x x the invoice price less trade or other discounts, except strictly cash discounts approximating a fair interest rate, which may be deducted or not at the option of the taxpayer, provided a consistent course is followed. To this net invoice price should be added transportation or other necessary charges incurred in acquiring possession of the goods." (Sec. 146, Revenue Regulations No. 2.)

That the cost should be the proper basis of the valuation of the inventories of petitioner is not disputed by respondent. However, it is alleged on behalf of respondent that the valuation used in the inventories of petitioner is the cost and not the dealers' price as claimed by petitioner. The question to be decided, therefore, is whether or not the actual cost of the merchandise in question was used in said inventories.

Petitioner presented evidence during the trial to prove that the dealers' price was used as basis in the valuation of his merchandise inventories. Evidence was also adduced as to the actual cost of the merchandise. No evidence was presented by respondent to rebut the evidence for the petitioner. Respondent relies on the certifications made by petitioner contained in the audit reports to the effect that the inventories were taken under his personal supervision and priced at cost. He also sought to impugn the credibility and competency of the witnesses for petitioner who testified to the fact that the valuation used was the dealers' price and not the cost. Likewise, it is alleged that having certified to the correctness of the inventories, petitioner is estopped from claiming the incorrectness of such inventories. Finally, it is argued that the correction of the inventories as desired by petitioner would result in petitioner having sustained huge losses, which is incredible considering the increase in his net worth.

To prove that a mustake was committed in the pricing of merchandise inventories, withnesses were presented to show that the priging was based on the dealer's prices appearing in price lists supplied by Purim Javier, chief clerk of the A. P. Reyes Optical Co. Javier appears to have been the source of the error because whenever he ordered the taking of an inventory he supplied the persons doing the inventory work with a price list containing the dealers' and retailers' prices. That the dealers' prices were used and not the actual cost has been sufficiently established by the documents presented as evidence.

Duplications and triplications in the listing of various items of merchandise have also been clearly established by the testimony of witnesses and the documents presented as exhibits.

But respondent insists that petitioner having "admitted and certified under oath both in his letter to his own auditors and in his income tax returns that the inventories declared therein were valued at cost, petitioner must be bound by his own admission. Sec. 7, Rules 123, Rules of Court; 62 Moran Vol. 3.)" We can not agree with this line of reasoning. Respondent has sought to establish that the books and records of petitioner are not correct and do not reflect his true income, and, consequently, he has resorted to the net worth method to determine petitioner's taxable income. Certainly, petitioner is also entitled to prove, if he can, errors in the same books and records which would tend to reduce his liability. The right to prove mistakes in a taxpayer's books and records can not be a one-sided affair. Any assessment of a deficiency tax based on the incorrectness of a taxpayer's books and records would be unjust if the taxpayer can not be permitted to prove errors in the same books and records to show a lesser tax. Moreover, if the position taken by counsel for the Government in this case is correct, Sections 306 and 309 of the Revenue Code, which authorize refunds or credits of internal revenue taxes erroneously or illegally paid, would be but an empty gesture on the part of the Government, for taxpayers can not be permitted to prove mistakes in their records to show the erroneous payment of such taxes.

Respondent has argued that if the actual cost of petitioner's merchandise inventories were as claimed by the latter, he would have suffered huge losses during the period in question, which is quite incredible. Respondent posed this question: "If petitioner sustained such losses, where did he get the money to acquire those assets which he piled up during those years?" It would really be difficult to answer this question if the income tax returns of petitioner were to be considered. But respondent has shown that petitioner's income tax returns are not correct, and after giving petitioner credit for the discrepancies found in his inventories, petitioner still appears to have derived considerable profits as will hereafter be shown.

We are, therefore, constrained to sustain the stand of petitioner as regards the actual cost of his merchandise inventories which must be taken into account in the determination of his net worth. (See pages 41-44 of this decision)

One other point which might be stated in favor of petitioner is the fact that the original inventories were submitted to respondent. The said original inventories must have been submitted to respondent at the end of each year, pursuant to Section 13 of Revenue Regulations No. V-1, or the Bookkeeping Regulations (43 O. G. 4563). The invoices which would prove beyond doubt the actual cost of the imported merchandise in question were also submitted by petitioner to respondent when the case was being investigated by an examiner of the Bureau of Internal Revenue. The original inventories could not be submitted by respondent at the trial, while only a portion of the invoices was produced. This does not speak well of the stand taken by respondent in this case.

Building fixtures, optical equipment, furniture and fixtures, and auto delivery trucks; depreciation of assets (Items Nos. 2 and 5, 8 to 11 for 1947; Items Nos. 17 to 21 for 1948; Items Nos. 27 to 31 for 1949 and Items Nos. 38 to 42 for 1950).- Petitioner in this case appears to have agreed with the items and amounts regarding building fixtures, optical equipment, furniture and fixtures and auto delivery trucks appearing in the report of Examiner Cosico (Exh. W), which was made the basis of respondent's decision. Since no evidence has been submitted to controvert the said items, we must sustain the items as they appear in the said Exhibit W, and therefore sustain petitioner's view on such items. At any rate, respondent appears to have agreed to the computation, but he has separated the portion in regard to depreciation and treated the same as a liability. Since it is a generally accepted accounting procedure to deduct depreciation directly from the value of the asset involved, rather than carry the depreciation as a liability in the statement of assets and liabilities (Finley & Miller, Principles of Accounting-Intermediate, 1953 ed. pp. 126, 415), the separate items for depreciation of depreciable assets should be disregarded.]

Real estate holdings (Item Nos. 12, 22, 32 and 43). - The difference in the items of real estate holdings for each of the years 1947, 1948, 1949 and 1950 is attributable to the fact that petitioner deducted the accumulated depreciation at the rate of ₱2,250.00 a year on the building at the corner of Raon and Sales Sts., Whereas the same amount is carried as a liability and included in the item under depreciation or depreciable assets. Since the question is similar to the one involved in the preceding items (Items Nos. 8-11 for 1947; Items Nos. 17-21 for 1948; etc.), suffice it to say that the petitioner's presentation is more in line with regular accounting procedure; and since there would be no diference in the final analysis, we believe that the figures presented by petitioner on this point, for clarity and consistency, must have to be sustained.

Accounts receivable (Item No. 34). - The petitioner did not dispute the report of Examiner Cosico as to the balance of ₱148,435.97 relating to accounts receivable as of December 31, 1950 (see Exh. W). However, respondent presented the Balance Sheet of petitioner as of December 31, 1950, prepared by petitioner's accountant (Exh. 12, p. 28, Vol. 3, B.I.R.

records) which shows the amount of accounts receivable at ₱17$,799.67. We consider and hold the latter amount as correct, because it appears to conform with petitioner's own books of account as prepared by an independent certified accountant, the statement having been made <u>ante litis motam</u>.

<u>Philippine Ready-Mix Concrete Corporation shares of stock (Item No. 44)</u>.-Petitioner appears to have acquired in March, 1950, 100,000 shares of stock for ₱100,000.00. This amount of ₱100.000.00 was treated by respondent as part of the assets of petitioner as of December 31, 1950. On the other hand, it is contended by petitioner that he sold 90,000 shares to Atty. E. A. Picazo sometime in September, 1950 with the right to repurchase reserved by petitioner until December 20, 1950. Petitioner having failed to exercise the option to repurchase, Atty. Picazo became the absolute owner of the said shares of stock after December 20, 1950. Therefore, petitioner claims that he owned only ₱10,000.00 worth of the shares of stock of the Philippine Ready-Mix Concrete Corporation as of December 31, 1950, instead of ₱100?000.00 as claimed by respondent.

Atty. Picazo, who was presented as a witness, testified that he bought the 90,000 shares of stock in question from petitioner, as evidenced by a document of sale (Exh. E). The price paid, according to the document of sale, was ₱35,000.00, much below the par value of ₱90,000.00. The certificates of stock were delivered to him on September 1, 1950 endorsed in blank. The witness also testified that he instructed his secretary to send the deed of sale to the Philippine Ready-Mix Concrete Corporation for notification or registration. But the secretary of the corporation testified that the alleged transfer of the shares of stock in question had never been registered in the books of the corporation up to the date when he testified in August, 1955.

Respondent maintains that "the alleged sale of the shares was fictitious and that witness Picazo was biased because of his business relationship and friendship with petitioner (p. 7, t.s.n., August 3, 1955 hearing)", Picazo being "the secretary of the Philippine Racing Club of which petitioner is the president."

While friendship and business relationship do not necessarily make a person a biased witness for his friend and business associate, the evidence of record in this case in support of the sale or transfer of the said shares of stock is not very convincing. Considering that the buyer is a well known lawyer, it seems incredible that he would not take proper steps to have his shares of stock registered in his name. The allegation that he merely entrusted the duty of registering the sale to his secretary may be accepted as correct; but not having received the new certificates of stock in his name after a considerable length of time, he should have taken personal interest in the matter to have the sale or transfer duly registered in the books of the corporation. Petitioner would justify Atty. Picazo's lack of interest in said shares of stock, after purchasing the same a few months before, to the precarious financial situation of the corporation. But Atty. Picazo bought the said shares of stock for ₱35,000.00, and ₱35,000.00, by any standard, is not an insignificant amount which may be lightly disregarded.

Moreover, nowhere in the books and records of petitioner does the alleged sale of the said shares of stock appear; neither was the loss of ₱55,000.00 resulting from the sale of said shares of stock reported by petitioner in his 1950 income tax return.

We are, therefore, of the opinion that the preponderance of the evidence in this case leans heavily in favor of the stand of respondent. Accordingly, the sum of ₱100,000.00 representing the cost of acquisition of said shares of stock by petitioner, has been properly treated by respondent as part of the former's assets as of December 31, 1950.

Disputed liabilities.-Respondent disallowed the deduction from the assets of petitioner of certain liabilities amounting to ₱70,000.00 as of December 31, 1946; ₱60,000.00, as of December 31, 1947; ₱85,000.00, as of December 31, 1948; ₱60,000.00, as of December 31, 1949; and ₱125,000.00, as of December 31, 1950. These amounts were allegedly personal loans secured from Francisco P. Reyes, Pablo Bustamante, Congressman Eulogio Rodriguez, Jr., Juan C. S. Viado, Simeon Reyes, and Ramon Meneses.

The alleged loan secured from Francisco P. Reyes in 1946 is not evidenced by any promissory note, but it is claimed that it was paid in 1952, presumably after the case of petitioner had been ordered investigated, by means of a check drawn on the China Banking Corporation (Exh. G). But the records of petitioner do not show clearly that such a loan was secured from his brother.

A loan of ₱25,000.00 was also allegedly secured from Pablo Bustamante in 1946. It is claimed that a promissory note was issued evidencing the loan, but that it was destroyed or lost when the loan was paid in 1952. Payment is alleged to have been made by means of a check drawn on the Prudencial Bank and Trust Co., dated December 15, 1952, which check was kept in the wallet of the payee for about 30 to 45 days, after which it was indorsed to the Philippine Racing Club and paid by the latter in January, 1953. In further evidence of the payment of the loan, a voucher of the Aurelio P. Reyes Department Store (Exh. C) was presented. No similar voucher was made or issued in the case of the loan secured from Francisco P. Reyes. No record of entry regarding this loan appears in the books of petitioner.

The circumstances surrounding the alleged loans secured from Congressman Eulogio Rodriguez, Jr. are described in sufficient detail in the memorandum of counsel for petitioner, from which we quote:

> "C.- Eulogio Rodriguez, Jr. Loan of ₱20,000.00 - The deposition of Congressman Eulogio Rodriguez, Jr. was submitted and admitted in evidence as Exhibit "V". During the deposition, counsel for respondent who were present subjected the witness to cross-examination. The testimony of Congressman Eulogio Rodriguez, Jr. was clear that in 1946 he accommodated the petitioner with a loan of ₱20,000.00, which he gave in cash and for which the petitioner executed a 'vale' (Deposition t.s.n., p. 3). That loan of ₱20,000.00 was reduced to only ₱10,000.00 in 1947, because of a payment of ₱10,000.00 (Affidavit of Congressman Rodriguez, Jr., par. 2, Exh. S). In 1948, the loan was again increased to the original amount of ₱20,000.00 (Affidavit, Par. 3, Exh. S). Again, in 1949, the petitioner made a partial payment of ₱10,000.00, reducing the loan to ₱10,000.00 (Affidavit, par. 4, Esh. S), and in 1950, the petitioner once more borrowed an additional amount of ₱20,000.00, increasing the total outstanding loan to ₱30,000.00 as of December 31, 1950 (Affidavit, Par. 5, Exh. S). The contents of his affidavit, which was admitted as Exh. S, were all confirmed by him during the deposition (Deposition, t.s.n., p. 3). Congressman Rodriguez, Jr. testified that he

had been paid by the petitioner in the sum of ₱25,000.00, which he acknowledged by signing a voucher presented to him (Exh. T). The voucher, dated in 1952, indicates that the payment was made with Prudential Bank & Trust Co. Check No. BO-3938, dated in 1952, in the sum of ₱25,000.00 (Exh. U). He testified, however, that he asked the petitioner to have the check cashed for him, after which the cash was delivered to him by Mr. Aurelio P. Reyes (Deposition, t.s.n., p. 4). The testimony of Congressman Rodriguez confirms the explanation of the petitioner for the appearance of his indorsement at the back of the check (Exh. U). The petitioner previously testified that he indorsed the check because he cashed the check with the Bank upon request of Congressman Rodriguez (t.s.n., p. 235)." (pp. 11-12.)

Congressman Rodriguez testified that the loan of ₱20,000.00 made by him to petitioner in 1946 was taken into account by the Bureau of Internal Revenue when an assessment for deficiency income tax was issued against him. This is not denied by respondent.

Juan C. S. Viado, bookkeeper of petitioner, allegedly loaned to petitioner the sum of ₱20,000.-00 in cash sometime in 1948, which was evidenced by a promissory note. The note was paid in 1949, also in cash, and the promissory note was returned to petitioner. Viado claims that the sum of ₱20,000.00 is part of his share of the proceeds of the sale of a property owned in common by him and his brothers, which property was sold in 1948. The examiner of the Bureau of Internal Revenue, who investigated the case of petitioner, testified, however, that when he interviewed Viado before his report was submitted, the latter told him that the said ₱20,000.00 was part of his savings out of his salaries. He was receiving a salary of ₱125.00 a month from petitioner. No voucher was made or issued by petitioner when payment was made, and no entry about the loan appears in his records.

Simeon Reyes also allegedly loaned to petitioner the sum of ₱25,000.00 in 1950, evidenced by a promissory note, which was paid by means of a check drawn on the Prudential Bank and Trust Co., dated October 13, 1952. No voucher is alleged to have been made or issued and the account is not recorded in petitioner's books or records.

The loan of ₱20,000.00 secured from Ramon Meneses in 1950 was given by the lender to Mrs. Aurelio P. Reyes. The circumstances surrounding the loan are related in the memorandum of counsel for petitioner, as follows:

> "Mrs. Aurelio P. Reyes testified that she borrowed ₱20,000.00 from Mr. Ramon Meneses sometime in the early part of 1950, around March or April (t.s.n., p. 58). In acknowledgment of the loan, she gave him a promissory note, which she has failed to locate, since it was returned to her upon partial payment of the original loan. A partial payment of ₱7,000.00 was made sometime in 1951 (t.s.n., p. 59) and the balance of ₱13,000.00 is evidenced by a promissory note, dated April 4, 1951, which has been admitted in evidence as Exhibit'J'. Mrs. Aurelio

P. Reyes was able, however, to produce the receipt issued by Mr. Ramon Meneses on October 3, 1950, acknowledging payment of ₱1,200.00 as interest for the loan of ₱20,000.00 (Exh. 'H'). We respectfully submit that the interest of ₱1,200.00 computed at the original rate of interest of 12% per annum (t.s.n., p. 66) corresponds to interest for six months and did sufficiently establish that the loan was originally incurred sometime in April of 1950 which is just six months before October 3, 1950. Stated otherwise, 6% interest on ₱20,000.00 is ₱1,200.00, which was paid as per Exh. 'H'. Besides the receipt, Exhibit 'H', the bank statement of the petitioner showing the debit of a check in a similar amount of ₱1,200.00 on October 5, 1950 was introduced in evidence as Exhibit 'K' and the particular entry in the bank statement referring to Check No. 382520 for ₱1,200.00 which was debited by the bank on October 5, 1950 was marked in red pencil as Exhibit 'K-1'.

"That the original loan was ₱20,000.00 and that the promissory note of ₱13,000.00 executed on April 4, 1951 (Exh.'J') was merely a renewal for the balance is further proven by another bank statement of the petitioner produced by the witness showing the debit of ₱7,000.00 on October 5, 1951 (Exh. 'l'). The particular check showint the debit of ₱7,000.00 on April 5, 1951 has been enclosed in red pencil and marked as Exh. 'l-l'. Various other checks which had been used by the petitioner on his wife to make partial payments on account of the principal and interest on the loan were produced before this Honorable Court and admitted as Exhibits L, M, N, O, P.Q, and R. These checks have all been properly endorsed by Mr. Ramon Meneses. The witness further testified that at the time she was under cross-examination, there was still an outstanding liability in favor of Mr. Meneses in the sum of ₱7,000.00, more or less (t.s.n., pp. 66-67)."

We have gone over carefully the evidence pro and con concerning the contested liabilities, and we agree with respondent that the existence of the said loans, except those secured by petitioner from Congressman Eulogio Rodriguez, Jr. and Ramon Meneses, have not been clearly established. While it is true that in most cases promissory notes or "vales" were issued covering the loans, and sometimes payments were allegedly evidenced by means of checks and vouchers, there is nothing in the records of petitioner to indicate that the loans were actually secured from the persons already mentioned. Petitioner admittedly has varied business interests. He has books and records. For his own protection, even his private loans should be recorded to prove that the loans are bona fide transactions.

It may be argued that personal transactions not connected with the regular business of the taxpayer are not required to be recorded. This is the theory relied upon by counsel for petitioner in justifying the failure of their client to record said loans. This is not exactly correct as we shall presently show.

Section 334 of the National Internal Revenue Code provides:

> "SEC. 334. Corporations, companies, partnerships, or persons required to keep books of accounts. - All corporations, companies, partnerships, or persons required by law to pay internal revenue taxes shall keep a

> journal and a ledger, or their equivalents: Provided, however, That those whose gross quarterly sales, earnings, receipts, or output do not exceed fime thousand pesoe shall keep and use a simplified set of Bookkeeping Records duly authorized by the Secretary of Finance wherein all transactions and results of operations are shown and from which all taxes due the Government may readily and accurately be ascertained and determined anytime of the year: And provided, further, That in the case of corporations, companies, partnerships or persons whose gross quarterly sales, earnings, receipts or output exceed twenty-five thousand pesos, shall have their Books of Accounts audited and examined yearly by Independent Certified Public Accountants and their income tax returns accompanied with certified balance sheets, profit and loss statements, schedules listing income-producing properties and the corresponding incomes therefrom and other relevant statements. (As amended by sec. 2, Republic Act No. 438; sec. 1, Republic Act No. 658.)"

Section 334 of the Revenue Code, in clear and unmistakable language, provides that all persons required by law to pay internal revenue taxes, and this obviously includes income tax, must keep a journal and a ledger, or their equivalents. However, where the gross quarterly sales, earnings, receipts, or output do not exceed fime thousand pesos, such persons are required to keep and use a simplified set of bookkeeping records wherein all transactions and results of operations must be shown. The reason for these requirements is stated in the law itself - in order that all taxes due the Government may readily and accurately be ascertained and determined anytime of the year. Undoubtedly, if petitioner's private or personal transactions are not recorded in his books, the income tax due the Government from him can not be readily and accurately ascertained and determined anytime of the year. That the personal loans in question affect the determination of petitioner's income tax is attested by his attempt to prove the existence of such loans to minimize or reduce the deficiency income tax assessed against him.

In expressing the opinion that even personal transactions of a person regularly engaged in business must be recorded, in order to reflect his true income and his tax liabilities, and that in the absence of appropriate entries in his books or records, such personal transactions may be disregarded for tax purposes, we do not mean to imply that all such transaction must be disregarded irrespective of the weight of evidence presented in support thereof. We believe that in the case of personal loans, it is not enough to prove the existence of such loans by the presentation of promissory notes or "vales" signed by the borrower, or of checks or vouchers evidencing payment. By the very nature of loan transactions between individuals such transactions are easily concocted, specially between friends and relatives, and promissory notes, "vales", checks, or other similar written documents, in the absence of other relevant evidence, deserve scant consideration. This is specially true where the supposed borrower has a pending tax assessment. In order that such transactions may be properly considered, it is essential that the existence thereof must be proven by clear and convincing evidence independent of promissory notes, "vales", checks or other similar documents.

In the instant case, only the loans secured by petitioner from Congressman Rodriguez and Ramon Meneses appear to have been satisfactorily proven by corroborative evidence independent of the promissory notes or "vales" signed by the borrower, petitioner herein. The loan given by Congressman Rodriguez to petitioner was proven not only by means of the "vale" executed by petitioner. It was shown that the loan was taken into consideration by respondent himself in the assessment of the deficiency income tax against Congressman Rodriguez. It would be inconsistent for respondent to reject the same loan as a liability of petitioner. With respect to the loan secured from Ramon Meneses, it has been shown that interest was paid and a receipt covering payment of interest was submitted in evidence. The receipt appears to have been executed and delivered to the wife of petitioner on October 3, 1950, before the case of petitioner was investigated by an examiner of the Bureau of Internal Revenue. The existence of the other alleged loans not having been satisfactorily proven, we are constrained to sustain the stand of respondent in rejecting the same. Accordingly, only the loans secured from Congressman Rodriguez and Ramon Meneses may be admitted as part of the liabilities of petitioner in the years in which they appear to have been outstanding.

The foregoing disposes of the first issue in regard to the correctness of the net worth of petitioner at the beginning of 1946 and at the end of each of the taxable years 1946 and 1950 as determined by respondent. In accordance with the agreement of the parties as regards certain assets and liabilities and the foregoing opinion on the disputed items, the determination by respondent of the net worth of petitioner during the period under review and the corresponding deficiency income tax and surcharge due must have to be revised in line with the following computation:

(Continued to page 40)

Beginning Net Worth of Petitioner
on January 1, 1946

Assets -

Assets admitted by parties	₱302,250.00
Plus assets proven at trial:	
(1) Building	45,000.00
(2) Installments paid on a lot	2,008.00
Total assets	₱349,258.00

Liabilities -

Liabilities admitted by parties	30,000.00
Net worth as of Jan. 1, 1946	₱319,258.00

Increase in Net Worth
and Deficiency Tax Due
in 1946

Assets

Assets admitted by parties	₱814,642.33
Plus assets proven at trial:	
Race horses	13,733.32
Total assets	₱828,375.65

Liabilities -

Liabilities admitted by parties	383,338.35
Plus liabilities proven at trial	20,000.00
Total liabilities	₱403,338.35
Net worth as of Dec. 31, 1946	₱425,037.30
Less net worth as of Jan. 1, 1946	319,258.00
Increase in net worth in 1946	₱105,779.30
Plus non-deductible expenditures:	
Personal, living and family expenses	6,500.00
Gross income	₱112,279.30
Less personal exemptions	6,500.00
Net Taxable income in 1946	₱105,779.30
Tax due	₱ 29,491.72
Less tax already paid	10,594.08
Deficiency Tax	₱ 18,897.64
Add 50% surcharge	9,448.82
Deficiency tax and surcharge	₱ 28,346.46

Increase in Net Worth
and Deficiency Tax Due
in 1947

Assets -

Assets admitted by parties	₱420,408.45
Plus assets proven at trial:	
(1) Merchandise inventories -	
Haberdasheries - Imported	21,777.73
Office equipment - Imported	87,050.83
(2) Building fixtures	4,000.00
(3) Optical equipment and apparatus	12,763.58
(4) Furniture & fixtures	17,267.18
(5) Real estate holdings	736,448.00
(6) Race horses	24,422.20
Total assets	₱1,324,137.97

Liabilities -

Liabilities admitted by parties	750,416.96
Plus liabilities proven at trial	10,000.00
Total liabilities	₱760,416.96

Net worth as of Dec. 31, 1947	₱563,721.01
Less net worth as of Jan. 1, 1947	425,037.30
Increase in net worth in 1947	₱138,683.71
Plus non-deductible expenditures:	
Personal living & family expenses	6,500.00
Income tax paid in 1946	10,594.08
Gross income	₱155,777.79
Less personal exemptions	6,500.00
Net taxable income in 1947	₱149,277.79
Tax due	₱ 46,891.11
Less tax already paid	1,332.37
Deficiency tax	₱ 45,558.74
Add 50% surcharge	22,779.37
Deficiency tax and surcharge	₱ 68,338.11

(continued to page 42)

Increase in Net Worth
and Deficiency Tax Due
in 1948

Assets -	
Assets admitted by parties	₱429,763.67
Plus assets proven at trial:	
(1) Merchandise inventories -	
Haberdasheries - Imported	46,498.15
Office equipment "	78,621.11
Optical equipment "	93,861.93
(2) Building fixtures	3,500.00
(3) Optical equipment and apparatus	11,170.83
(4) Furniture & Fixtures	17,072.91
(5) Auto and delivery trucks	8,028.00
(6) Real estate holdings	762,708.00
(7) Race horses	27,466.64
Total assets	₱1,478,691.24
Liabilities -	
Liabilities admitted by parties	841,078.98
Plus liabilities proven at trial	20,000.00
Total liabilities	₱861,078.98
Net worth as of Dec. 31, 1948	₱617,612.26
Less net worth as of Jan. 1, 1948	563,721.01
Increase in net worth in 1948	₱ 53,891.25
Plus non-deductible expenditures:	
Personal, living and family expenses	6,500.00
Income tax paid in 1947	1,332.37
Gross income	₱ 61,723.62
Less deductible items:	
Personal exemptions	6,500.00
50% of capital gain	6,125.00
Net taxable income in 1948	₱ 49,098.62
Tax due	₱ 9,927.61
Less tax already paid	1,494.70
Deficiency tax	₱ 8,432.91
Add 50% surcharge	4,216.45
Deficiency tax and surcharge	₱ 12,649.36

<u>Increase in Net Worth
and Deficiency Tax Due
in 1949</u>

Assets -

Assets admitted by parties		₱539,768.96
Plus assets proven at trial:		
(1) Merchandise inventories -		
Haberdasheries - Imported		75,643.94
Office equipment "		72,765.59
Optical equipment "		104,327.22
(2) Building fixtures		3,045.00
(3) Optical equipment & apparatus		9,578.08
(4) Furniture & fixtures		14,984.01
(5) Auto & delivery trucks		8,271.04
(6) Real estate holdings		270,458.00
(7) Race horses		42,555.52
Total assets		₱1,141,397.36

Liabilities -

Liabilities admitted by parties	₱	736,771.53
Plus liabilities proven at trial		10,000.00
Total liabilities	₱	746,771.53
Net worth as of Dec. 31, 1949	₱	394,625.83
Less net worth as of Jan. 1, 1949		617,612.26
Decrease in net worth in 1949	₱	222,986.43
Less non-deductible expenditures:		
Personal, living and family expenses		6,500.00
Income tax paid in 1948		1,494.70
Gross loss	₱	214,991.73
Add deductible items:		
Personal exemptions		6,500.00
War damage compensation		8,256.96
Net loss in 1949	₱	229,748.69

No deficiency tax due.

(continued to page 44)

Increase in Net Worth
and Deficiency Tax Due
in 1950

Assets -		
Assets admitted by parties	₱	523,361.73
Plus assets proven at trial:		
(1) Accounts receivable		175,799.67
(2) Merchandise inventories -		
Haberdasheries - Imported		67,025.48
Office equipment "		58,148.66
Optical equipment "		116,246.59
(3) Building fixtures		2,540.00
(4) Optical equipment and apparatus		7,985.33
(5) Furniture & fixtures		13,234.28
(6) Auto & delivery trucks		10,291.36
(7) Real estate holdings		217,558.00
(8) Philippine Ready-Mix Concrete Corporation stocks		100,000.00
(9) Race horses		9,000.00
Total assets	₱	1,301,191.10
Liabilities -		
Liabilities admitted by parties		673,669.37
Plus liabilities proven at trial	₱	50,000.00
Total liabilities	₱	723,669.37
Net worth as of Dec. 31, 1950	₱	577,521.73
Less net worth as of Jan. 1, 1950		394,625.83
Increase in net worth in 1950	₱	182,895.90
Plus non-deductible expenditures		
Personal, living and family expenses		7,800.00
Income tax paid in 1949		1,230.14
Gross income	₱	191,926.04
Less deductible items:		
Personal exemptions		7,800.00
50% of capital gain		17,725.00
War damage compensation		4,817.34
Net taxable income in 1950	₱	161,583.70
Tax due	₱	69,891.00
Less tax already paid		2,274.82
Deficiency tax	₱	67,616.18
Add 50% surcharge		33,808.09
Deficiency tax and surcharge	₱	101,424.27

Total Deficiency Tax and Surcharge Due

1946	₱ 28,346.46
1947	68,338.11
1948	12,649.36
1949	none
1950	101,424.27
Total	₱210,758.20

The second issue relates to the legality of the net worth method of determining taxable income under our Income Tax Law (Title II of the National Internal Revenue Code).

Respondent in this case assessed against petitioner deficiency income tax for the years from 1946 to 1950. Although petitioner filed income tax returns for those years and paid income tax on his net incomes as reflected in his returns, respondent found, after investigation by an income tax examiner of the Bureau of Internal Revenue, that the former had considerable amounts of unreported income not recorded in his books nor reflected in his income tax returns. For this reason, respondent determined petitioner's taxable income for those years by means of the net worth method.

The formula for determining the taxable net income of a taxpayer by means of the net worth method is as follows: increase in net worth, plus non-deductible disbursements, minus non-taxable receipts equals taxable net income. (See Perez v. Araneta, B.T.A. No. 189, decided by this Court on February 13, 1956, and authorities cited therein.) The procedure for determining taxable net income under this formula has been described in a recent decision of the U.S. Supreme Court, viz:

"In a typical net worth prosecution the Government, having concluded that the taxpayer's records are inadequate as a basis for determining income tax liability attempts to establish an 'opening net worth' or total net value of the taxpayer's assets at the beginning of a given year. It then proves increases in the taxpayer's net worth for each succeeding year during the period under examination and calculates the difference between the adjusted net values of the taxpayer's assets at the beginning and end of each of the years involved. The taxpayer's non-deductible expenditures, including living expenses, are added to these increases, and if the resulting figure for any year is substantially greater than the taxable income reported by the taxpayer for that year, the Government claims the excess represents unreported taxable income. In addition, it asks the jury to infer willfulness from this understatement, when taken in connection with direct evidence of 'conduct, the likely result of which would be to mislead or conceal.' Spies v. United States, 317 US 492, 499, 87 L. ed. 418, 423, 63 S. Ct. 364." (Holland v. U. S., 348 US 121, cited in Perez v. Araneta, supra.)

Respondent claims that his authority to use the net worth method is sanctioned by Sections 15 and 38 of the Revenue Code. Section 15 empowers the Collector of Internal Revenue to "assess the proper tax on the best evidence obtainable" when a report required by law as a basis for the assessment of any national internal-revenue tax shall not be forthcoming within the time fixed by law or regulation, or when there is reason to believed that any such report is false, incomplete, or erroneous. Section 38 provides that the net income of a taxpayer shall be computed on the basis of his annual accounting period in accordance with the method of accounting regularly employed by him in keeping his books, but if no such method of accounting has been employed, <u>or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Collector of Internal Revenue does clearly reflect the income.</u>

Section 15 of the Revenue Code appears in Title 1 under the heading "Organization of Bureau and is, therefore, a general provision which is applicable to all internal revenue taxes, while Section 38 is embodied in Title 11 of the Code under the heading "Income Tax" and is applicable solely to income taxes. But while Section 15 is a general provision and Sec. 38 is specially applicable to income taxes, there is nothing in the two sections from which any implication may be drawn that Section 15 has no application to income taxes. The two sections are complementary to and not inconsistent with each other.

Section 38 is a copy of Section 41 of the U. S. Internal RevenueCode of 1939 (Sec. 446 of the U. S. Code of 1954). While we agree with counsel for petitioner that decisions of the U. S. Supreme Court in net worth cases are not binding in this jurisdiction, such decisions have a strong persuasive forde and are generally fôllowed and applied by our courts. (See Perez v. Araneta, supra.) In fact the memoranda submitted by counsel fæ petitioner are replete with citations of American decisions which have been cited in support of the stand taken by them.

The legality of the use of the net worth method is being assailed on three main grounds, viz:

(1) "Increase in Net Worth" is not synonymous to "Net Income";

(2) The taxpayer's method of accounting should be followed; and

(3) The inventory (or net worth) method is grossly inaccurate and arbitrary.

We agree that "increase in net wæth" is not synonymous to "net income" as the latter term is defined in Section 28 of the Revenue Code. Where, however, the net income of a taxpayer can not be determined from the income tax returns which he is required to file, or from his books and records, experience both here and in the United States has shown that the use of the net worth method is a reasonable means of determining net income.

That the taxpayer's method of accounting should be followed generally may also be admitted. But Section 38 is very clear and explicit that where the method employed by a taxpayer does not clearly reflect his income, the Collector of Internal Revenue may employ any other method which in his opinion would clearly reflect the income, or he may make use of "the best evidence obtainable" under Sec. 15. The power or authority of the Collector to choose the method of determining taxable income is quite comprehensive, and the only limitation to the exercise of such power or authority is that the method chosen or adopted must "clearly reflect the income." The government, in the words of the U. S. Supreme Court, "has relied for the collection of income tax largely upon the taxpayer's own disclosures. . . the government must be free to use all legal evidence available to it in determining whether the story told by the taxpayer's books accurately reflects his financial history. " (Holland v. U.S. supra.)

That the net worth method may in some instances be grossly inaccurate and arbitrary, may also be accepted; but the fact that the use of such method may be arbitrary in isolated instances is not a valid defense against its legality. By the very nature of the net worth method, errors or mistakes are apt to be committed in arriving at the net worth of the taxpayer in any given period, specially where the necessary data are withheld by the taxpayer himself, or are simply unavailable because of the absence of adequate records. The validity or efficacy of the net worth method can not, under such circumstances, be made to depend upon the absolute accuracy of the taxable income arrived at by the use of such mehhod, otherwise the Government would be at the mercy of taxpayers. Where it clearly appears, however, that an abuse or injustice has been perpetuated, or where gross inaccuracies are shown to exist in the use of the method, this Court will not hesitate to lend its assistance to every taxpayer who feels himself aggrieved by an unjust or incorrect assessment.

Our opinion, therefore, is that Section 38 of the Revenue Code authorizes the Collector of Internal Revenue to employ the net worth method where a taxpayer keeps no books or records or where such books or records do not clearly reflect his income. On this point, we reiterate the views expressed on our decision in Perez v. Araneta, supra.

> "The consensus of opinion among well-known authorities on Federal income taxation in the United States is that the power of the Commissioner of Internal Revenue to use the net worth method springs or is derived mainly from Section 41 of the Internal Revenue Code of 1939 (Section 446 of the 1954 Code). Samuel Byer, a New York attorney and formerly Agent, Conferee, Technical Advisor in Appellate Division, U. S. Internal Revenue Service, in an article 'The Net Worth Technique for Determining Income,' (Proc. NYU 13th Ann. Inst. on Fed. Taxation 1055 (1955), while expressing the opinion that Section 41 'does not represent the authority for use of the net worth or any other indirect method' because he believes that it proceeds from the broad general investigatory provisions of the Code, has this to

say: 'The proposition that the Commissioner's authority to use the net worth method or any other indirect method in determining income, is rooted in or stems from Section 41 of the Internal Revenue Code of 1939 has been supported by the Courts so frequently that the mere mention of the indirect technique for determining income calls forth a recitation of the provisions of that section. Support for the proposition is not lacking in discussion by able tax men.'

x x x

"It appears to us to be well established that the prevailing view in the United States is that the use of the neto worth or any indirect method of proving ureported income is permitted under Section 41 of the U. S. Internal Revenue Code of 1939 (Section 446 of the 1954 Code). Section 38 of our Revenue Code having been patterned after Section 41 of the U.S. Code, the construction placed upon that section by the U. S. courts has a strong persuasive force in this jurisdiction. We have no doubt, therefore, that Section 38 of our Revenue Code as it is worded permits the use of the net worth method by the Collector of Internal Revenue where direct proof of under-declaration of income is not available by any other means. x x x "

It is argued, however, that assuming that the net worth method is permitted under the law, it is not applicable to the case of herein petitioner as the requisites for its use are not present. The following conditions, according to counsel for petitioner, are indispensable requisites for the proper use of the net worth method:

"(1) The taxpayer does not keep books, or his books are so inadequate that they do not reflect his correct income.

> "(2) There must be an opening net worth, established with reasonable certainty, to serve as a starting point from which to calculate future increases in the taxpayer's assets. The importance of accuracy in this figure is immediately apparent, as the correctness of the result depends entirely upon the inclusion in this sum of all assets on hand at the outset.
>
> "(3) The Government must track down all relevant leads furnished by the taxpayer reasonably susceptible of being checked.
>
> "(4) There is ample evidence of source of income of the taxpayer, which accounts for the increase in networth. The government must do more than show an increase in networth; it must prove in some way that the source of the increase was taxable income.
>
> "(5) Proper adjustment must be made for personal and other non-deductible expenditures as well as for non-taxable receipts and for depreciation." (p. 104.)

The question has been asked: Do these conditions obtain, or have they been complied with, in the case at bar? To which counsel for petitioner replied: "Our answer is emphatically in the negative. This is especially true with respect to Conditions Nos. 2, 3 and 4, which, needless to state, are amongt the most important ones."

Apparently, Condition No. 1- that the books of the petitioner are so inadequate that they do not reflect his correct income - has been met, counsel for petitioner not having bothered to prove the adequacy of their client's books and records. That the books and records of petitioner do not reflect his correct income is clearly shown in our discussion of the first issue (referring to the correctness of the increases in net worth of petitioner), and also in Annex"A" attached to the memorandum for petitioner dated Feb. 27, 1956. In said Annex "A", it is admitted that petitioner incurred income tax deficiencies during the years 1947, 1948 and 1950, even without considering the items disputed by respondent.

Condition No. 5, referring to adjustment for personal and other non-deductible expenditures as well as for non-taxable receipts and for depreciation, is also admitted as having been complied with. This was made possible largely by agreement of the parties.

Condition No. 2, relating to the opening net worth, which must be established with reasonable certainty, is alleged not to have been clearly established. While it is true that the opening net worth of petitioner as of Jan. 1, 1946, which was used by respondent in determining petitioner's yearly increases in net worth from 1946 to 1950, has been shown to be erroneous, yet upon the evidence submitted by the parties, the opening net worth has been established with reasonable certainty. (See page 40, supra.) It may be stated in favor of petitioner and his counsel that they cooperated willingly during the trial of this case in bringing to light petitioner's opening net worth, which happily facilitated the early termination of the trial and helped the Court in great measure in the proper determination of the issue.

Condition No. 3, which requires, according to counsel for petitioner, that the "Government must track down all relevant leads furnished by the taxpayer reasonably susceptible of being checked," has been in our opinion, adequately met. Leads furnished by petitioner in regard to his assets and liabilities were investigated and checked, and, where found to have been clearly established, were admitted by respondent. The same is true with petitioner's non-taxable receipts and income. It may be true that there were certain flaws in the findings of respondent, but the flaws that we have observed operated more to the advantage of petitioner than of the Government. Note, for instance, the subject of non-deductible expenditures, among which are the personal, living and family expenses of the taxpayer (Sec. 31, Revenue Code), which expenditures are required to be added to his increase in net worth to arrive at his gross income. Respondent, without considering "relavant leads", simply estimated petitioner's personal expenses asthe equivalent of his personal exemptions deductible under Section 23 of the Revenue Code. In effect, respondent did not find any non-deductible expenditure of petitioner for personal, living & family expenses during all the years under review. We do not believe that petitioner would assail the propriety of the net worth method as applied to his case merely because of the failure of respondent to appraise reasonably his non-deductible expenditures for personal, living and family expenses.

Condition No. 4, requiring evidence of income of the taxpayer, which accounts for the increase in his net worth, has likewise been complied with. The evidence of record shows that petitioner has, or had during the period under review, a flourishing business in optical goods, office equipment, and haberdashery. He maintained expensive race horses of which he kept no records. He had considerable real estate transactions, which were also not recorded, the only record ~~of~~ which is what appears in the income tax returns. He alleges to have contracted personal loans, no record of which was also kept, which personal loans do not appear to have been spent for personal, living and family expenses and must presumably have been invested in income-producing ventures. He is also the president of the Philippine Racing Club. Considering the admittedly inadequate records of petitioner, we find no difficulty in expressing the opinion that these are some of the probable sources of petitioner's undeclared income.

It is not required in net worth cases

that the Government prove with absolute certainty the sources from which petitioner derived his unreported income. It is sufficient if evidence is adduced of the likely source or sources of such income. In this case, there is ample evidence of the probable sources from which petitioner could have derived his undeclared income "in quantity sufficient to account for the net worth increases". (Holland v. U. S. supra.)

The third issue refers to the propriety of the imposition of the 50% fraud penalty provided in Section 72 of the Revenue Code. The pertinent portion of said section relating to the fraud penalty reads:

> " x x x In case of willful neglect to file the return or list within the time prescribed by law, or in case a false or fraudulent return or list is willfully made, the Collector of Internal Revenue shall add to the tax or to the deficiency tax, in case any payment has been made on the basis of such return before the discovery of the falsity or fraud, a surcharge of fifty per centum of the amount of such tax or deficiency tax."

Among the circumstances generally recognized as justifying the imposition of the fraud penalty are: (1) intentional understatement of income, substantial in amount per se or substantial in relation to the total reported income; (2) intentional overstatement of deductions, substantial in amount per se or substantial in relation to the total reported income; and (3) recurrence of the understatement of income or overstatement of deductions for more than one tax year. (Balter, Fraud Under Federal Tax Law, 2nd ed. [1953], p. 226, cited in Perez v. Araneta, *supra.*)

In the case at bar, the understatements of petitioner's income are "substantial in amount *per se* or substantial in relation to the total reported income." Such substantial understatements of income have been clearly established in 1946, which recurred in the following years up to 1950, except in 1949. In fact, petitioner admits that understatements were made in his returns, although in amounts less than those established during the trial, as shown in Annex "A" attached to the memorandum for petitioner dated February 27, 1956. The following is a comparative statement of the net incomes declared in his returns and the net incomes established by the net worth method, together with the under-declarations:

	Net Income Declared	Net Income Established	Net Income Undeclared
1946	₱51,380.26	₱105,779.30	₱ 54,399.04
1947	12,660.98	149,277.79	136,616.81
1948	13,615.87	49,098.62	35,482.75
1950	14,395.07	161,583.70	147,177.63

The net income undeclared in 1946 is more than 100% of the net income declared. In 1947, the undeclared net income is more than 1,079% of the net income declared. In 1948, the undeclared net income is more than 260% of the net income declared. In 1950, the undeclared net income is more than 1,000% of the declare d net income. We have no hesitancy in expressing the opinion that, under the cirscumstances, such huge underdeclarations could not have been the result of honest mistakes. In Spies v. U.S. 317 U. S. 492, it was held that affirmative willful attempt may be inferred from "any conduct, the likely effect of which would be to mislead or to conceal."

Having arrived at the conclusion that the fraud penalty has been properly imposed in this case, the last issue as regards the statute of limitations upon assessment and collection properly applicable to the case is easy of solution. The same question was fully discussed by us in Perez v. Araneta, *supra* from which we quote:

> "Under Section 331, the Collector of Internal Revenue has 5 years after the return was filed within which to assess an internal revenue tax, and no proceeding in court without assessment can be begun after expiration of said period. However, under Section 332 (a), it is provided that in the case of a false or fraudulent return with intent to evade tax or of a 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 falsity, fraud, or omission. In connection with the issue as to the legality of the imposition of the fraud penalty, we expressed the opinion that the fraud penalty is applicable. Accordingly, it is also our opinion that the 10-year period provided in Section 332 (a) within which a deficiency income tax may be assessed applies.

> There is no question that the assessments in this case were all made within 10 years from the date of discovery of the fraud. It follows that said assessments were validly made. And since under the law, the Collector of Internal Revenue has 5 years after assessment within which to collect the tax, it is obvious that the right of the Government to collect the deficiency income tax assessed against petitioner for the years 1947 to 1950 has not prescribed."

In this case, the assessment was made within 10 years from the discovery of the fraud. Consequently, the right of the Government to assess the deficiency income tax in question has not prescribed. The right to collect by judicial action has not also prescribed, judicial proceedings having been instituted by petitioner himself within 5 years after the assessment. Of course, we still maintain the view that after the lapse of three years after the returns were due, or were filed, the Collector of Internal Revenue is not authorized to collect any deficiency income tax by warrant of distraint and levy.

For the foregoing considerations, we are of the opinion that -

(1) The undeclared taxable incomes of petitioner for the years 1946, 1947, 1948 and 1950 have been clearly established by the use of the net worth method;

(2) The use of the net worth method, or any other method, to prove unreported income is clearly authorized under Sections 15 and 38 of the Revenue Code;

(3) The 50% surcharge prescribed in Section 72 of the Revenue Code has been properly imposed; and

(4) The right of the Government to assess the deficiency income tax against petitioner for the years 1946, 1947, 1948 and 1950 and the right to collect such deficiency tax by judicial action have not prescribed.

Accordingly, the decision appealed from is hereby modified, and petitioner is hereby ordered to pay the aggregate amount of ₱210,758.20, representing deficiency income tax and 50% surcharge corresponding to taxable years 1946, 1947, 1948 and 1950, computed and itemized on pages 40-44 of this decision, such payment to be made within a reasonable period to be fixed by respondent. With costs against petitioner.

SO ORDERED.

Manila, July 26, 1956.

ROMAN M. UMALI
Associate Judge

We Concur:

MARIANO NABLE
Presiding Judge

AUGUSTO M. LUCIANO
Associate Judge