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REPUBLIC OF THE PHILIPPINES
COURT OF TAX APPEALS
QUEZON CITY

FERNANDEZ HERMANOS, INC.,
Petitioner,

versus CTA CASE NO. 1389

August 2, 1965

THE COMMISSIONER OF INTERNAL REVENUE,
Respondent.

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D E C I S I O N

This is an appeal from the decision of the respondent Commissioner of Internal Revenue, dated March 26, 1963 (pp. 60-61, BIR rec.) assessing and demanding from petitioner Fernandez Hermanos, Inc., deficiency income tax for the year 1957, in the sum of ₱38,918.76, plus surcharge and interest.

Petitioner, a domestic corporation, filed its income tax return for the year 1957 on April 30, 1958 (Exhs. A & A-1, pp. 6-10, BIR rec.). On August 17, 1962, respondent assessed against the petitioner deficiency income tax in the amount of ₱38,918.76, computed as follows:

"Net income per return	₱29,178.70
Add: Unallowable deductions:	
(1) Net loss claimed on Ha.Dalupiri	89,547.33
(2) Amortization of Contractual Right claimed as an expense under Mines Operations	48,481.62
Net income per investigation	₱167,207.65
Tax due thereon	₱ 38,818.00
Less: Amount already assessed. . . .	5,836.00
B a l a n c e	₱ 32,982.00
Add: ½% monthly interest from 6-20-59 to 6-20-62	5,936.76
TOTAL AMOUNT DUE & COLLECTIBLE. . . .	₱ 38,918.76"

(Exh. G, pp. 25-26, BIR rec.)

On September 17, 1962, petitioner requested for a period of 30 days within which to contest the said assessment (p. 32, BIR rec.). As a condition for the grant thereof, respondent required petitioner to sign a waiver of the defense of prescription (p. 33, BIR rec.). On October 17, 1962, petitioner wrote another letter to the respondent asking that the deficiency income tax assessment be reconsidered and withdrawn (pp. 40-41, BIR rec.). Petitioner, through its Managing Director, on February 14, 1963 signed a waiver of the defense of prescription to expire on December 31, 1963 (pp. 46-47, BIR rec.). On March 26, 1963, respondent rendered his decision denying petitioner's request for reconsideration and reiterated his demand of ₱38,918.76 as deficiency income tax (pp. 60-61, BIR rec.). Petitioner filed the instant petition for review on May 8, 1963, alleging that respondent has no legal or factual basis to assess the deficiency income tax in question and that the right of the Government to collect the same has already prescribed.

Two issues have been raised by the parties, to wit: (1) whether or not the right of the Government to collect the deficiency income tax in question has already prescribed; and in the negative, (2) whether or not the respondent is justified in disallowing the claimed deductions in the total amount of ₱138,028.95.

In its petition for review, petitioner contends that the right of the Government to collect the alleged deficiency income tax has already prescribed. However, in its memorandum, petitioner did not touch the issue of prescription and we conclude that it has abandoned such defense. Nonetheless, we hold that the right of the Government to collect the deficiency income tax has not yet prescribed. The records show that petitioner filed its income tax return for the year 1957 on April 30, 1958 (p. 6, BIR rec.). The deficiency income tax was assessed on August 17, 1962 (pp. 25-26, BIR rec.) which was within the 5-year period from the filing of the return as required by law (Sec. 331, Revenue Code). Under Section 332(c) of the Revenue Code, the Government has another five years from the date of assessment, i.e., from August 17, 1962, within which to collect the said tax. The collection thereof was commenced on May 8, 1963 when the petitioner filed its petition for review which is deemed a "judicial action" for the collection of the deficiency income tax (Manuel P. Sunga v. Comm. of Int. Rev., CTA Case 676, Oct. 25, 1961; Fernandez Hermanos, Inc. v. Comm. of Int. Rev., CTA Case 787, June 10, 1963). Clearly, therefore, the right of the Government to collect the deficiency income tax has not yet prescribed.

We will now proceed to the disputed items. During the year 1957, petitioner claimed an alleged loss in the sum of ₱89,547.33 in the operation of its Hacienda Dalupiri. Respondent disallowed this item on the following grounds: (1) that petitioner did not make any distinction between ordinary and necessary expenses and capital expenses; (2) that the operation of the hacienda is a mere device to siphon off the earnings of the petitioner and to decrease its income tax liability; and (3) that petitioner is not consistent in its method of reporting income.

This Court in a previous case had occasion to pass upon the same issue in regard to losses sustained by petitioner in the operation of Hacienda Dalupiri.

> "From the evidence, we are convinced that the Hacienda Dalupiri was operated by petitioner for business and not for pleasure. It was mainly a cattle farm, although a few race horses were also raised. It does not appear that the farm was used by petitioner for entertainment, social activities, or other non-business purposes. Therefore, it is entitled to deduct expenses and losses in connection with the operation of said farm. (See 1955 PH Fed. Taxes, Par. 13, 663, citing G. C. M. 21103, CB 1939-1, p. 184.)
>
> "Section 100 of Revenue Regulations No. 2, otherwise known as the Income Tax Regulations, authorizes farmers to determine their gross income on the basis of inventories. Said regulations provides:

> 'If gross income is ascertained by inventories, no deduction can be made for livestock or products lost during the year, whether purchased for resale, produced on the farm, as such losses will be reflected in the inventory by reducing the amount of livestock or products on hand at the close of the year.'

"Evidently, petitioner determined its income or losses in the operation of said farm on the basis of inventories. We quote from the memorandum of counsel for petitioner:

> 'The Taxpayer deducted from its income tax returns for the years from 1950 to 1954 inclusive, the corresponding yearly losses sustained in the operation of Hacienda Dalupiri, which losses represent the excess of its yearly expenditures over the receipts; that is, the losses represent the difference between the sales of livestock and the actual cash disbursements or expenses. (Pages 21-22, Memorandum for Petitioner.)'

"As the Hacienda Dalupiri was operated by petitioner for business and since it sustained losses in its operation, which losses were determined by means of inventories authorized under Section 100 of Revenue Regulations No. 2, it was error for respondent to have disallowed the deduction of said losses. x x x" (Fernandez Hermanos, Inc. v. The Comm. of Int. Rev., CTA Case 787, June 10, 1963.)

It is true that petitioner followed the cash basis method of reporting income and expenses in the operation of the Hacienda Dalupiri and used the accrual method with respect to its mine operations. This method of accounting, otherwise known as the hybrid method, followed by petitioner is not without justification.

> "x x x A taxpayer may not, ordinarily, combine the cash and accrual bases. The 1954 Code provisions permit, however, the use of a hybrid method of accounting, combining a cash and accrual method, under circumstances and requirements to be set out in Regulations to be issued. Also, if a taxpayer is engaged in more than one trade or business he may use a different method of accounting for each trade or business. And a taxpayer may report income from a business on accrual basis and his personal income on the cash basis." (See Mertens, Law of Federal Income Taxation, Zimet & Stanley Revision, Vol. 2, Sec. 12.08, p. 26.)

The last disputed item refers to the disallowance of the sum of ₱48,481.62 which allegedly represented 1/5 of the cost of the "contractual right" over certain mines which petitioner had acquired.

It appears that the Palawan Manganese Mines, Inc., during a special meeting of its Board of Directors on January 19, 1956, approved a resolution, the pertinent portions of which read as follows:

> "RESOLVED, as it is hereby resolved, that the corporation's current assets composed of ores, fuel and oil, materials and supplies, spare parts and canteen supplies appearing in the inventory and balance sheet of the Corporation as of December 31, 1955, with an aggregate value of ₱97,636.98, contractual rights for the operation of various mining claims in Palawan with a value of ₱100,000.00, its title on various mining claims in Palawan with a value of ₱142,408.10 or a total value of ₱340,045.08 be, as they hereby are ceded and transferred to Fernandez Hermanos, Inc., as partial settlement of the indebtedness of the corporation to said Fernandez Hermanos, Inc., in the amount of ₱ 442,885.23." (Exh. E, p. 17, CTA rec.)

On March 29, 1956, petitioner's corporation accepted the above-offer of transfer, thus:

> "Whereas, the Palawan Manganese Mines, Inc., due to its yearly substantial losses has decided to cease operation on January 1, 1956 and in order to satisfy at least a part of its indebtedness to the Corporation, it has proposed to transfer its current assets in the amount of NINETY SEVEN THOUSAND SIX HUNDRED THIRTY SIX PESOS & 98/100 (₱97,636.98) as per its balance sheet as of December 31, 1955, its contractual rights valued at ONE HUNDRED THOUSAND PESOS (₱100,000.00) and its title over various mining claims valued at ONE HUNDRED FORTY TWO THOUSAND FOUR HUNDRED EIGHT PESOS & 10/100 (₱142,408.10) or a total valuation of THREE HUNDRED FORTY THOUSAND FORTY FIVE PESOS & 08/100 (₱340,045.08) which shall be applied in partial settlement of its obligation to the Corporation in the amount of FOUR HUNDRED FORTY TWO THOUSAND EIGHT HUNDRED EIGHTY FIVE PESOS & 23/100 (₱442,885.23);" (Exh. E-1, p. 18, CTA rec.)

Petitioner determined the cost of the mines at ₱242,408.10 by adding the value of the contractual rights (₱100,000.00) and the value of its mining claims (₱142,408.10). Respondent disallowed the deduction on the following grounds: (1) that the Palawan Manganese Mines, Inc. could not transfer ₱242,408.10 worth of assets to petitioner because the balance sheet of the said corporation for 1955 shows that it had only current assets worth ₱97,636.96; and (2) that the alleged amortization of "contractual rights" is not allowed by the Revenue Code.

The law in point is Section 30(g)(1)(B) of the Revenue Code, before its amendment by Republic Act No. 2698, which provided in part:

"(g) Depletion of oil and gas wells and mines:

"(1) In general.— x x x (B) in the case of mines, a reasonable allowance for depletion thereof not to exceed the market value in the mine of the product thereof, which has been mined and sold during the year for which the return and computation are made. The allowances shall be made under rules and regulations to be prescribed by the Secretary of Finance: Provided, That when the allowances shall equal the capital invested, x x x no further allowance shall be made."

Assuming, arguendo, that the Palawan Manganese Mines, Inc. had assets worth ₱242,408.10 which it actually transferred to the petitioner in 1956, the latter cannot just deduct one-fifth (1/5) of said amount from its gross income for the year 1957 because such deduction in the form of depletion charge was not sanctioned by Section 30(g)(1)(B) of the Revenue Code, as above-quoted.

The depletion formula applicable to petitioner in computing the unit depletion charge or the rate of depletion per unit, i.e., ton, feet, etc., is as follows:

$$\frac{\text{Cost of Mine Property}}{\text{Estimated Ore Deposit}} = \text{Rate of Depletion per Unit of Product mined and sold.}$$

(Consolidated Mines, Inc. v. Comm. of Int. Rev., CTA Case Nos. 565 & 578, May 6, 1961.)

The sole basis of petitioner in claiming the amount of ₱48,481.62 as a deduction was the memorandum of its mining engineer (Exh. I, pp. 31-32, CTA rec.), who stated that the ore reserves of the Busuanga Mines (Mines transferred by the Palawan Manganese Mines, Inc. to the petitioner) would be exhausted in five (5) years, hence, the claim for ₱48,481.62 or one-fifth (1/5) of the alleged cost of the mines corresponding to the year 1957 and every year thereafter for a period of 5 years. The said memorandum merely showed the estimated ore reserves of the mines and its probable selling price. No evidence whatsoever was presented to show the product mined and for how much they were sold during the year for which the return and computation were made. This is necessary in order to determine the amount of depletion that can be legally deducted from petitioner's gross income. The method employed by petitioner in making an outright deduction of 1/5 of the cost of the mines is not authorized under Section 30(g)(1)(B) of the Revenue Code. Respondent's disallowance of the alleged "contractual rights" amounting to ₱48,481.62 must therefore be sustained.

In view thereof, we find petitioner liable for deficiency income tax for the year 1957 in the amount of ₱9,696.00, computed as follows:

Net income per return		₱ 29,178.70
Add: Unallowable deductions:		
(1) Amortization of "Contractual Rights"	₱48,481.62	
Total adjustment		48,481.62
Net income		₱ 77,660.32

Net Income	₱77,660.32
Income tax due thereon	₱ 15,532.00
Less: Amount already assessed .	5,836.00
DEFICIENCY TAX DUE.	₱ 9,696.00

WHEREFORE, the assessment appealed from is hereby modified. Petitioner is hereby ordered to pay to respondent the amount of ₱9,696.00 as deficiency income tax for the year 1957, plus the corresponding interest provided in Section 51 of the Revenue Code. If the deficiency tax is not paid in full within thirty (30) days from the date this decision becomes final and executory, petitioner shall pay a surcharge of five per cent (5%) of the unpaid amount, plus interest at the rate of one per cent (1%) a month, computed from the date this decision becomes final until paid, provided that the maximum amount that may be collected as interest shall not exceed the amount corresponding to a period of three (3) years. Without pronouncement as to costs.

SO ORDERED.

Quezon City, August 2, 1965.

ROMAN M. UMALI
Associate Judge

I CONCUR:

TEOFILO D. REYES, SR.
Presiding Judge

Judge Afurong did not take part.