REPUBLIC OF THE PHILIPPINES
COURT OF TAX APPEALS
MANILA

JOSE YULO,
Petitioner,

- versus - C.T.A. CASE NO. 84

J. ANTONIO ARANETA, as
Collector of Internal
Revenue,
Respondent.

x - - - - - - - - - - - - x July 8, 1958

D E C I S I O N

The respondent assessed against the petitioner the sum of ₱2,138,913.50 as deficiency income tax for the years 1946, 1948, 1950, 1951 and 1952. It is not clear from the decision of respondent how the deficiency assessment for each year was arrived at. However, from an examination of the entire records it appears that the deficiency assessment was brought about by (a) the alleged failure of petitioner to report as part of his gross income in 1948 the sum of ₱2,452,546.00, which represents, according to respondent, the fair market value of 2,452,546 shares of stock of the Financing Corporation of the Philippines received as dividend by petitioner from the Talisay-Silay Milling Company, Inc.; (b) the imposition of the fraud penalty (50% surcharge) for failure of petitioner to include in his income tax return for 1948 the alleged dividend income of ₱2,452,546.00; and (c) the disallowance by respondent of various deductions from

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gross income claimed by petitioner in his returns for 1946, 1948, 1950, 1951 and 1952.

Having failed to secure a reconsideration of the decision of respondent, petitioner appealed to this Court. At the same time, petitioner sought to enjoin respondent from collecting the deficiency assessment pending final determination of the case. By a resolution of this Court dated February 26, 1955, respondent was enjoined from enforcing collection of the assessment by the summary administrative remedies upon the filing and approval by this Court of a surety bond for the amount of ₱2,150,000.00. A surety bond for said amount was duly filed on February 26, 1955 by petitioner, as principal, and the Philippine Phoenix Surety & Insurance, Inc., as surety, which was approved by this Court on the same date.

There are three principal questions involved in this case, to wit: (1) whether or not petitioner received a taxable dividend in 1948 in the sum of ₱2,452,546.00; (2) the legality of the imposition of the fraud penalty in connection with petitioner's 1948 income tax return; and (3) the legality of various deductions from gross income claimed by petitioner.

With respect to the first question, it appears that in 1948 petitioner was a stockholder of the Talisay-Silay Milling Co., Inc., hereinafter referred to as "Talisay-Silay". Among the assets of Talisay-Silay in 1948 were 6,000,000 shares of stock of the

Financing Corporation of the Philippines, hereinafter referred to as "Financing", with an acquisition cost of ₱1.00 per share. It also owned 21,988.5 shares of the Central Azucarera del Danao.

Sometime in February, 1948, the Board of Directors of Talisay-Silay, pursuant to a prior resolution of its stockholders, authorized the distribution of its Financing and Danao shares. The pertinent portion of the said resolution states:

> "La Junta acordo distribuir entre los accionistas de esta Compania en proporcion al numero de acciones que cada uno posee, tal como aparece en los libros de la Compania el dia 15 del mes de Enero de 1948, las 6,000,000 de acciones de la Financing Corporation of the Philippines y las 21,988-½ acciones de la Central Azucarera del Danao y que pertenecen en propiedad a esta Compania, debiendo hacerse dicha distribucion tal pronto como sea posible." (Exh. P of petitioner and Exh. 21 of respondent; page 351, CTA records.)

As registered owner of 178,269 shares of Talisay-Silay, petitioner received in March, 1948 2,452,546 Financing shares which were duly recorded in the books of the latter. The distribution of the Danao shares did not materialize as they had been previously pledged by Talisay-Silay and the resolution mentioned above was accordingly repealed in regard to the Danao shares.

When petitioner filed his 1948 income tax return on February 29, 1952, he reported a gross income of ₱142,164.52 and deductions amounting to ₱165,966.34, resulting in a loss of ₱23,801.82.

The value of the 2,452.546 Financing shares was not included as part of his income in that year. When the return was first examined and audited, the following deductions were disallowed:

1. Entertainment expenses ----	₱ 6,000.00
2. Club dues ----------------	1,044.65
3. Guard's salaries ----------	4,702.35
Total ----	₱11,747.00

resulting in the reduction of petitioner's loss in that year from ₱23,801.82 to ₱12,054.82, but nonetheless exempt from income tax. However, he was asked to pay ₱20.00 as compromise in extrajudicial settlement of his penal liability for failure to file his return within the period prescribed by law.

After re-examination and re-audit of petitioner's 1948 income tax return occasioned by the discovery of the receipt by petitioner of 2,452,546 Financing shares, respondent assessed against petitioner a deficiency income tax and surcharge for 1948 amounting to ₱1,911.562.06, computed as follows:

Net loss per first investigation ----------------------	₱ 12,054.82
Add: Dividends received from Talisay-Silay Milling Co., Inc. in the form of Financing Corporation of the Philippines shares-------	2,452,546.00
Net income per reinvestigation ----------------------	₱2,440,491.18
Deduct: Personal and additional exemption ----	3,500.00
Net income subject to tax ----	₱2,436,991.18
Tax due thereon -------------	₱1,274,374.71
50% surcharge ---------------	637,187.35
Total tax and surcharge ------	₱1,911,562.06

As shown in the foregoing computation, respondent appraised the fair market value of Financing shares at ₱1.00 per share.

Petitioner assails the legality of the assessment of ₱1,911,562.06 for the year 1948 not only because of the inclusion of the fair market value of Financing shares as part of his income in that year but also because of the disallowance of his claim for deduction of entertainment expenses, club dues and guard's salaries, previously mentioned, in the total amount of ₱11,747.00. The propriety of the said deductions will be considered later. We are concerned for the present solely with the taxability of petitioner with respect to the Financing shares received by him.

It is the view of petitioner that it is not proper to consider the value of the Financing shares as part of his income in 1948 because (a) said shares were not received by him as dividend but as a loan; (b) Talisay-Silay was not in a position to declare a dividend in 1948 as it had no earned surplus; (c) assuming that the distribution by Talisay-Silay of the Financing shares was a dividend distribution, his tax liability is limited to the fair market value of the Financing shares corresponding to one-half of 150,288 Talisay-Silay shares, or 75,144 shares, actually owned by him, the rest being owned by his brother-in-law, J. Amado Araneta; and (d) the fair market value of Financing shares in 1948 at the time of the distribution was ₱.50 and not ₱1.00 as appraised by respondent. On the other hand, respondent claims that the distribution by Talisay-Silay of its

Financing shares was a dividend distribution and not a loan; that Talisay-Silay had adequate earned surplus at the time of the distribution; that petitioner was the sole and exclusive owner of the 178,269 Talisay-Silay shares and the dividend corresponding to said shares was taxable to him alone; and that the fair market value of the Financing shares was correctly appraised at ₱1.00 per share.

Section 29 of the National Internal Revenue Code defines "gross income" as including "gains, profits, and income derived . . . . from interests, rents, dividends, securities, or the transactions of any business carried on for gain or profit, or gains, profits, and income derived from any source whatever." And a dividend, according to Section 83, "means any distribution made by a corporation to its shareholders out of its earnings or profits accrued since March first, nineteen hundred and thirteen, and payable to its shareholders, whether in money or in other property." A dividend may be paid in the form of stock of another corporation, in which case the dividend constitutes income to the recipients to the amount of the full market value of such stock when received by individual stockholders. (Sec. 251, Rev. Regs. No. 2, 39 O.G. 325.)

What is the nature of the distribution made by the Talisay-Silay of its shares of stock of Financing Corporation? Was it a dividend, a return of capital, or a loan? To petitioner, it was a loan; to respondent, it was a dividend distribution.

Clearly, under the law, if the distribution was made out of the earnings or profits of Talisay-Silay accumulated since March 1, 1913, it is a dividend, and therefore taxable to the recipients; otherwise, it would be a mere return of capital or a loan, depending upon the circumstances.

Let us inquire whether or not at the time of the distribution in 1948 Talisay-Silay had earnings or profits accumulated since March 1, 1913.

The Surplus Section of the March 31, 1947 Balance Sheet of Talisay-Silay (Exh. AA) shows the following:

Surplus	
Per Books ------------------	₱3,042,383.01
Arising from physical appraisal of the fixed assets-	4,347,977.42
Total ----------------------	7,390,360.43

Both parties admit that the surplus "Per Books" of ₱3,042.383.01 was the accumulated earnings or profits of Talisay-Silay as of March 31, 1947. However, said amount was reduced to ₱2,395.250.50 as of December 31, 1947 by charges to earned surplus. (Respondent's Analysis of Earned Surplus Account, Exh. 26.) The December 31, 1947 statement of account was the only one available just before February, 1948 when the Financing shares were distributed, so that the balance of ₱2,395,250.50 appearing in said statement was the earned surplus at the time of the distribution, there being no charges or adjustments effected between the two dates.

With regard to the sum of ₱4,347,977.42, it appears that the same consisted of two items. viz:

Appraisal surplus---------	₱2,926,530.91
War damage compensation receivable ------------	1,421,446.51
Total ------------------	₱4,347,977.42

The appraisal surplus of ₱2,926,530.91 was surplus arising from the appraisal of salvaged fixed assets. In accordance with generally accepted accounting principles, such an appreciation is recorded by taking up the excess of the appraised value over the book value of the assets. Although the books of Talisay-Silay erroneously showed the appraisal as an adjustment of the total accumulated depreciation, still it cannot be interpreted, as urged upon us by respondent, as an adjustment of overdepreciation in prior years. It has not been shown that the rates of depreciation used by Talisay-Silay were excessive. Therefore, the increase in value of the salvaged assets cannot be claimed as a reduction of overdepreciation, but an actual increase in sound value as per appraisal. The surplus arising from such appraisal of depreciated assets is not considered part of the "earnings or profits" out of which a dividend distribution could be made. It is well settled that "in the absence of a distribution unrealized appreciation, even if reflected on the books by reappraisal, is not added to earnings and profits." (Mintz & Plumb, Dividends in Kind - The Thunderbolts and the New Look, 10 Tax Law Rev., 41 (Nov., 1954), citing La Belle Iron Works v. U. S., 256 U. S. 377; Chapman v. Anderson, 11 F. Supp. 913.)

The second item relating to war damage compensation receivable in the sum of ₱1,421,446.51 is alleged to be the difference between the total value of the assets of Talisay-Silay damaged or lost during the last war and the contingent reserve set up for war losses. Since the war damage claims were adjudicated only in 1949, it cannot be taken into account as part of the surplus of Talisay-Silay on December 31, 1947 or at the time of the distribution of the Financing shares in February, 1948.

It is clear, therefore, that as of December 31, 1947, the earnings or profits of Talisay-Silay available for distribution as dividend was ₱2,395,250.50. Petitioner contends, however, that Talisay-Silay had actually no surplus profits at the time because the said amount was wiped out by the decline in value of about 50% of the Financing shares and by the contingent tax liability in the sum of ₱558,645.34.

It is alleged that the Financing shares, at the time of the distribution, had declined in value to about 50% of the cost to Talisay-Silay which acquired the shares at ₱1.00 per share. Accordingly, it was necessary to set up a reserve of ₱3,000,000.00 against surplus which would completely wipe out the earned surplus of ₱2,395,250.50. There is no justification for establishing such a reserve where the depreciated property is to be distributed. Upon distribution, the depreciated property will carry with it the probable loss so that there is no purpose in setting up the reserve. The rule in such cases is that the loss represented by the difference between the cost and the fair market value of the deprecia-ted asset given away is not deductible in computing earnings or profits available for dividends. (First Savings Bank of Ogden v. Burnet, 53 F (2d) 919, cited in Hubbard, Recent Developments in Dividends in Kind of Appreciated and Depreciated Property, 12 NYU Insti-tute on Federal Taxation, 311.)

As to the contingent tax liability of ₱558,645.34, it appears that sometime in 1940 the Bureau of Inter-nal Revenue assessed against the Talisay-Silay the said amount as income tax on unreasonable accumula-tion of profits. The said assessment was still pend-ing redetermination by the Bureau in 1948 at the time of the distribution of the Financing shares. It is alleged that there was also a need for establishing a reserve for such contingent tax liability, and the opinions of well known practicing accountants have been cited in support of this view. We find, how-ever, that no such reserve had actually been estab-lished in the books of Talisay-Silay. It was set up in 1949 only as a balance sheet footnote by the auditors, A. Tulio and Associates. No book entry was made for this pending assessment, the same having been finally dropped sometime in 1953. We agree with the opinion of the accounting firm, Stewart, Cunanan & Company, that

> "x x x . As these assessments had not been made final, however, and as good reasons may have existed for believ-ing the assessments could be success-fully contested, we would not have con-sidered it essential to provide a re-

> serve, so long as the assessments were clearly shown on the balance sheet as contingent liabilities." (Exh. PP; pp. 44-45, Memorandum for Petitioner, July 27, 1956.)

On the question, therefore, whether or not Talisay-Silay had earnings or profits available for distribution as dividend in February, 1948, we are of the opinion that it had the amount of ₱2,395.250.50 available for dividend distribution. It is, however, alleged that there was actually no dividend distribution; that the resolution of the Board of Directors of Talisay-Silay deliberately used the term "distribute" and omitted the use of the term "dividend" because its president, J. Amado Araneta, already entertained grave doubt whether Talisay-Silay could declare a dividend considering that the corporation had no surplus, or that, if it had, the surplus was not adequate to cover the distribution of the 6,000,000 Financing shares; that a "balance sheet audit" had to be ordered sometime in September or October of 1949 to determine the legality of making a dividend distribution; that after such audit by the accounting firm of Tulio & Associates, it was established that Talisay-Silay could not legally distribute as dividend the 6,000,000 Financing shares; and that upon recommendation of the auditors, adjustments were made in the books of Talisay-Silay so as to make it appear that the distribution was a loan to the stockholders. Under these facts, it is urged that the distribution of the Financing shares was not a dividend distribution but a loan. In support of this view, the expert opinions of five accounting firms were offered in evidence to prove the impropriety of distributing the 6,000,000 Financing shares as dividend.

The fact remains that the 6,000,000 Financing shares were actually distributed pro rata to the stockholders of Talisay-Silay in February, 1948 before the opinions of experts were sought. If, as alleged, the president of Talisay-Silay already doubted the validity of making a dividend distribution even before the resolution authorizing the distribution was passed, the books of the corporation should have been ordered audited before and not after the distribution. The subsequent attempt to transform the distribution into a loan to the stockholders is not worthy of consideration. Our attention has been particularly drawn to the resolution of the Board of Directors of Talisay-Silay dated November 29, 1950, which reads:

> "Whereupon, upon motion duly made and seconded, it was resolved that said Resolution No. 8 approved by the Board of Directors at its meeting held on February 20, 1948, be as the same is hereby amended and revoked in so far as the 21,988.5 shares owned by the Company in the Central Azucarera del Danao are concerned." (Exh. R.)

It will be noted that Resolution No. 8 was amended and revoked only with respect to the Danao shares, so that it is obvious that the distribution of the Financing shares was ratified and confirmed.

Of course, we have not the least doubt as to the soundness of the opinions of the accounting experts presented by petitioner with respect to the impropriety of Talisay-Silay declaring a dividend distribution of the 6,000,000 Financing shares. They are unanimous in their opinion that, as there was no adequate surplus, Talisay-Silay should not have declared a dividend distribution. This is sound accounting principle and is in accordance with the Corporation Law. Unfortunately, taxation is concerned solely with what was done, not with what should have been done. After a transaction has been effected and completed, its taxability is determined by what has been done and the circumstances surrounding the transaction. Any attempt to modify the effects of the transaction on the alleged ground that they were not intended by the parties would be unavailing.

That the Corporation Law prohibits the distribution by a corporation of any of its assets which may impair its capital, except under the conditions specified in the law, may be admitted. However, as long as the distribution remains, as in the case at bar, the same not having been invalidated in any proceeding for the enforcement of the Corporation Law, for tax purposes, the effects of such distribution must be considered solely in the light of the applicable taxing statute. Under the Income Tax Law, gains, profits, and income derived from any source whatever are taxable (Sec. 29, Revenue Code), except those that are expressly exempted by law. This means that even incomes derived from illegal sources are taxable. It is, therefore, no defense to the taxability of the stockholders of Talisay-Silay that the distribution made by it of the Financing shares was in violation of the Corporation Law.]

Assuming that the distribution by Talisay-Silay of its Financing shares resulted in the receipt by the stockholders of a taxable dividend, according to petitioner his liability is limited to the tax on the value of 1,033.799.05 Financing shares corresponding to 75,144 shares of Talisay-Silay which he actually owned. Of the 178,269 shares of Talisay-Silay registered in the name of petitioner, it is alleged that 103,125 shares were owned by J. Amado Araneta.

The evidence for petitioner tends to show that J. Amado Araneta owned 27,981 Talisay-Silay shares. Later, he acquired an option to purchase from Cesar Ledesma, Inc. no less than 80,000 nor more than 150,000 Talisay-Silay shares. 150,288 Talisay-Silay shares were actually purchased under an agreement between Araneta and petitioner whereby the latter would help the former secure the necessary funds with which to purchase said shares. It was the understanding between the two that the purchase of said shares was to be made as a "joint venture" between the two. To prove that there was a joint venture with respect to the 150,288 shares, evidence was presented to the effect that Araneta paid the interest corresponding to his share of the loan secured from the Hongkong and Shanghai Banking Corporation.

While the evidence presented by petitioner in regard to the joint ownership of the 150,288 Talisay-Silay shares is quite strong, yet upon a careful consideration of all the evidence we agree with respondent that the shares in question were wholly owned by petitioner. They were assigned to and registered in his name; they were pledged by him not only with the Hongkong and Shanghai Banking Corporation but also with the Philippine National Bank; and the Financing shares distributed by Talisay-Silay corresponding to the entire 178,269 shares were issued in the name of petitioner. That they were allegedly registered in the name alone of petitioner solely to facilitate the granting of the loan from the Hongkong and Shanghai Banking Corporation does not sound convincing.

There is another circumstance that militates against the existence of a "joint venture." If a joint venture was formed, then a corporation was established, for income tax purposes, subject to tax apart from the individuals forming the joint venture. Section 84 (b) of the Revenue Code defines "corporation" as including partnerships, no matter how created or organized, joint-stock companies, joint accounts (cuentas en participacion), associations or insurance companies, but does not include duly registered general copartnerships (compañias colectivas). Under this statutory definition, two persons purchasing a sweepstake ticket are considered to have established a partnership.[1] (Gatchalian v. Collector of Internal Revenue, 39 O.G. 1370.) Persons contributing to a common fund for the purchase of real estate for rent thereby formed a partnership within the meaning of Sec. 84 (b) which is subject to the corporate income tax under Section 24. (Evangelista v. Collector of Internal Revenue, G. R. No. L-9996, Oct. 15, 1957.) It does not appear that the joint venture of petitioner and his brother-in-law filed any income tax return nor paid income tax.

Then again, upon examination of the records, we find that petitioner deducted from his gross incomes in 1947, 1948, 1949 and 1950 the following interest payments made by him on account of loans secured from various banks (pp. 140, 189, BIR records), viz:

Name of Bank	Interest Deducted			
	1947	1948	1949	1950
1. Phil. Nat. Bank —	₱10,745.46	₱71,539.61	₱122,241.50	₱47,033.01
2. Bank of Communications —	—	34,967.00	37,844.61	40,760.10
3. Hongkong & Shang. Bank. Corp. —	154,218.03	19,299.33	—	—
4. Bank of Commerce —	10,058.60	2,018.71	10,717.65	12,066.35
5. Bank of P.I. —	—	—	690.41	953.45
Totals —	₱175,022.09	127,824.65	171,494.17	100,812.91

The interest claimed as deduction by petitioner in his income tax returns for 1947, 1948, 1949 and 1950 are approximately those which he paid on a credit

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[1] Sweepstakes winnings are now exempt from income tax.

line of about ₱2,000,000 at 6% per annum to the Hongkong and Shanghai Banking Corporation and later to the Philippine National Bank. It follows that the amounts allegedly paid, if they were paid at all, by J. Amado Araneta as his share of the interests on the loan of the alleged joint venture were claimed as deduction from gross income not by Araneta but by petitioner alone, it appearing from the income tax returns of Araneta that he never claimed any deduction for interest during the years 1948 to 1950. (Exhs. 52 to 52-C.) This circumstance is obviously not in keeping with the theory of joint ownership of the shares of stock of Talisay-Silay advanced by petitioner.

We will now consider the value of the Financing shares received by petitioner to determine the correctness of respondent's deficiency assessment. Petitioner claims that the fair market value of said shares at the time of the distribution was ₱.50 per share, while respondent claims it was ₱1.00. The sole basis of the opinion of respondent that the Financing shares had a fair market value of ₱1.00 was a report submitted by Manuel J. Marquez to the Board of Directors of the Philippine National Bank in connection with an application of petitioner for the transfer of his credit line from the Hongkong and Shanghai Banking Corporation to the Philippine National Bank. The report states:

> "In regard to the present value of Financing Corp. shares we would like to report that these had a book value

> on Dec. 31, 1947 at about ₱0.63 each. In February of this year, when Mr. Yulo applied for the loan of ₱2,050,000.00, the market value of Financing Corp. shares was placed at ₱1.00 each in view of of the market price then of Atok-Big Wedge shares which was ₱1.25. As stated in our memorandum of February 25, 1948 which became the basis of Res. 592 of the same date, the Financing Corp. of the Philippines holds a large block of Atok-Big Wedge shares 4,286,271 to be exact, which at the prevailing market price last February of ₱1.25 for Atok-Big Wedge, considerably enhanced the value of shares of the holding company, that is the Financing Corp. of the Philippines which we then placed at its par value of ₱1.00 each." (Exh. 42-A.)

On the side of petitioner, only Artemio Tulio expressed the opinion that the fair market value of Financing shares was ₱.50 per share. Evidence was also presented to show that 75,000 Financing shares were sold on December 5, 1947 over the counter of the Manila Stock Exchange at ₱.50 per share. (Exhs. SS and TT.)

After examination of the records of Talisay-Silay and Financing, and after a consideration of the factors mentioned in the Marquez report, Enrique Caguiat expressed the view that the fair market value was ₱.62 plus; Sycip, Gorres, Velayo & Co., ₱.62458; Stewart, Cunanan & Co., about ₱.63; and Fleming & Williamson, ₱.6245. The market value as found by these experts was approximately the book value of the shares. The opinions of these experts were presented in evidence by petitioner himself.

We cannot close our eyes to the preponderant opinion of experts. Marquez himself, whose report has been relied upon by respondent, admitted that the book value of Financing shares on December 31, 1947 was about ₱.63. That he appraised the fair market value of said shares at ₱1.00 was probably due more to his desire to facilitate the grant of the huge loan of the applicant than to reflect the correct and impartial valuation of said shares. It is of common knowledge that financial institutions do not treat their clients equally. The Philippine National Bank is no exception. Accordingly, the findings of an investigator in regard to the market value of an asset for purposes of determining its sufficiency as security for a loan, although admissible in evidence, is not conclusive in the determination of its value for tax purposes. We are, therefore, of the opinion, considering the foregoing circumstances and in the absence of actual sales of said shares in the free market, that the book value of said shares was approximately the fair market value thereof on the date of the distribution in February, 1948, which we place at ₱.62.

Since the fair market value of each Financing share on the date of distribution was ₱.62, the total fair market value of the 6,000,000 shares was ₱3,720,000. We have found that Talisay-Silay had earnings or profits of ₱2,395,250.50 available for dividend distribution. We have here a case where the value of the property distributed is in excess of the distributing corporation's earnings or profits. The rule in such cases is that the distribution is a taxable dividend if it does not exceed the sum of its earnings or profits available for distribution. Distributions in excess of that amount are capital distributions which reduce the basis of the stockholder's stock. (Vol. I, P-H Federal Taxes (1955), par. 9183.) Therefore, of the ₱3,720,000 worth of Financing shares distributed, ₱2,395,250.50 represents dividend taxable to the stockholders, while ₱1,324,745.50 represents a partial return of their capital.

Petitioner received 2,452,546 Financing shares which (multiplied by ₱.62 per share) had a market value of ₱1,520,578.52. As it appears that he owned 40.8757% of the total shares of stock of Talisay-Silay, he is deemed to have received a taxable dividend of ₱979,075.41 (₱2,395,250.50 x 40.8757%), and ₱541,503.11 (₱1,520,578.52 - ₱979,075.41) as a partial return of capital which accordingly reduced the cost basis of his Talisay-Silay shares. Therefore, the taxable dividend which must be considered in the computation of the deficiency income tax of petitioner for 1948 is ₱979,075.41 and not ₱2,452,546.00 as determined by respondent. The sum of ₱541,503.11, being a partial return of capital, must be considered in determining the income tax liability of petitioner for 1951 when he sold a portion of his Talisay-Silay stockholding to May, Inc. (See pp.43-45, infra)

The next question is whether or not the imposition of the fraud penalty against petitioner for allegedly filing a fraudulent income tax return for 1948 is proper.

Section 72 of the Revenue Code provides that in case a false or fraudulent return is willfully made, the Collector of Internal Revenue (now Commissioner) shall add to the tax a surcharge of 50% of the amount of such tax. The rule is well settled that in order that the fraud penalty may be imposed it is essential that a false or fraudulent return be willfully filed, that is, with intent to evade tax. Did petitioner willfully file a false or fraudulent return for 1948 with intent to evade tax?

The decision of respondent on this point reads:

> "The imposition of the 50% fraud penalty is in accordance with law. There is in this case an element of fraud when he deliberately failed to report as income the dividends received by him in 1948 and of deducting items not allowed by law." (Decision of respondent dated Sept. 23, 1954, pp. 5-6; Exh. 1 for respondent; Exh. G for petitioner.)

Respondent justifies the imposition of the fraud penalty on two grounds, viz: first, petitioner deliberately failed to report as income the dividend received by him in 1948, referring to the Financcing shares; and second, petitioner deducted from his income in 1948 items not allowed by law.

As to the first ground, the only allegation is that petitioner deliberately failed to report as income the Financing shares received by him as dividend. No allegation has been made that the failure to report such income was due to any intention to evade payment of the tax. The fraud penalty provided in Section 72 of the Revenue Code can not therefore be imposed solely on the ground that petitioner deliberately failed to report the value of the Financing shares received by him as dividend. While it may be true that a finding of fraud by the Commissioner of Internal Revenue is presumptively correct, yet when the taxpayer has shown, as in this case, that the failure to report an income is due to an honest belief that it is not taxable, it is incumbent upon respondent to prove the existence of fraud. As aptly stated by the Supreme Court:

> "Fraud cannot be presumed: it must be alleged and proved, at least satisfactorily, if not conclusively by one who alleges its existence. (De Roda v. Lalk, 48 Phil. 38; Arroyo v. Granada and Centeno, 18 Phil. 484.) The rule is founded on public policy to guard against the speculative tendencies of the human mind and its readiness to accept as fact theories that appeal to the imagination." (Hilado v. Assad, G. R. No. L-6397, Aug. 31, 1955.)

Petitioner has shown that his failure to report the value of the Financing shares received by him was due to his belief that it was not taxable. He has stoutly maintained this view from the time that the deficiency assessment was made. And this view of petitioner is supported by the advice and opinions of five of the foremost accounting firms of the country, namely, Tulio & Associates; Enrique Caguiat & Associates; Sycip, Gorres, Velayo & Associates; Stewart, Cunanan & Co.; and Fleming & Williamson. These accounting firms may have been mistaken in their views, but it has not been shown that their views and opinions were sought by and given to petitioner in aid of an intention to evade payment of the tax. This Court has held that where the taxpayer failed to report an item of income because of an honest belief that such income is not taxable, the imposition of the fraud penalty is not proper. (Gutierrez v. Collector of Internal Revenue, C.T.A. No. 65, Aug. 31, 1955, aff'd in G. R. Nos. L-9738 and L-9771, May 31, 1957.) And in another case where the taxpayer failed to include certain items in its tax returns upon advice of its accountant, it was held:

> "As has been already held, 'where the taxpayer's belief is founded on the advice of eminent counsel' (Adams v. Shields, 17 Ohio Cir. Ct. 129, 9 Ohio Cir. Dec. 558) or where the mistake is 'one involving some matter of doubt or difficulty of such serious nature as to reasonably require judicial interference' (State v. Chicago & Northwestern Ry. Co., 108 N. W. 594, 128 Wis. 449, 515) no penalty can be imposed because the false statement is due to honest mistake of law or fact (See footnotes to 61 C.J. p. 1488). This principle has now found positive expression in two new provisions of our New Civil Code: Art. 2215, par. (3) prescribing that the court may equitably mitigate exemplary damages where the defendant had acted upon the advice of counsel; and Art. 526, par. 3, to the effect that 'mistakes upon a doubtful or difficult question of law may be the basis of good faith.' Consequently, we believe and so hold that plaintiff-appellee should be refunded the 100% surcharge imposed on it by the appellant Collector under the first, second, third, fourth, and sixth causes of action of the complaint." (Insular Lumber Co. v. Collector of Int. Rev., G. R. No. L-7190, April 28, 1956.)

In this appeal, however, respondent has made the allegation for the first time that -

> "x x x petitioner devised a way of reducing the tax consequences arising from his receipt of the said shares by organizing May, Inc. in 1950; transfering the said shares to the corporation in the same year; causing in 1951 the formal declaration as dividends of the Financing shares already distributed; causing the payment of the income tax on the financing shares received by him in 1948 by May, Inc. and thus creating a favorable background for the exclusion of the said Financing shares in his own income tax return for 1948 which he filed in 1952." (Page 129, Memorandum for respondent, Aug. 25, 1956.)

and has asked this Court to disregard the corporate existence of May, Inc. The organization of May, Inc., according to respondent, having been effected by petitioner to reduce his taxes, it is evidence of an intention to evade tax which justifies the imposition of the fraud penalty.

We cannot accept the soundness of this proposition. We find respondent has taken an inconsistent stand on this matter. The practice that has generally been followed by the Bureau of Internal Revenue in cases where a corporation or entity is considered merely as an <u>alter ego</u> of another is to apply the tax payments made by the sham corporation or entity to the deficiency assessment against the taxpayer, it being understood that the payments made by the sham corporation or entity was in fact and in law made by the taxpayer himself. (See Liddell & Co., Inc. v. Collector of Internal Revenue, BTA No. 186, Aug. 11, 1955; Yutivo Sons Hardware Co. v. Collector of Int. Rev., C.T.A. No. 64, April 27, 1957.) In this case the tax paid by May, Inc. has not been applied to the deficiency assessment against petitioner, an indication that respondent recognizes the separate corporate existence of said corporation.]

We may also add that the law recognizes the right of taxpayers to reduce their taxes as long as the method used or availed of does not go beyond the bounds of law. One of the methods recognized by law whereby taxpayers reduce their taxes is the organization of personal holding companies. (See Secs. 63-71, Revenue Code.) Therefore, that a taxpayer has endeavored to reduce his taxes is in itself, standing alone, not an indication of fraud.

The other ground relied upon by respondent in imposing the fraud penalty is that petitioner deducted from his income in 1948 items not allowed by law. Respondent has not imposed the fraud penalty except with respect to petitioner's income tax return for 1948. The deductions claimed by petitioner from his income in 1948 are similar to the deductions claimed by him in his income tax returns for 1950, 1951 and 1952, and yet respondent has not imposed the fraud penalty except, as already stated, in connection with petitioner's return for 1948. If petitioner did not commit fraud in filing his returns for 1950, 1951 and 1952, wherein deductions similar to those claimed in 1948 were claimed, we see no reason for considering the 1948 return fraudulent on that ground. The imposition of the fraud penalty should not be made to rest on flimsy grounds.

Fraud, not having been established by respondent, we are of the opinion that the imposition of the fraud penalty in this case cannot be validly sustained.

We now come to the third question - the legality of the deductions claimed by petitioner in his income tax returns for 1948, 1950, 1951 and 1952. For convenience, the deductions in question may be classified as follows:

I. Business expenses.

1. General administrative expenses	
(a) Management fee, 1950 ----	₱ 8,119.78
(b) Share in general administrative expenses, 1950-1952 --------	336,292.63
2. Salaries and wages	
(a) Salaries of guards, 1948 & 1952 -----------	14,956.10
(b) Salary of driver, 1951 -----------------	2,400.00
3. Traveling and entertainment expenses-	
(a) Traveling expenses in going to U.S. in 1951 --	31,000.00
(b) Entertainment expenses, 1948, 1950-52 ----------	24,571.35
(c) Club dues, 1948 --------	1,044.65
4. Office Supplies, etc.	
(a) Stationery, 1952 --------	522.30
(b) Postage, telephone & telegraph, 1952 ------	1,606.40

II. Taxes

1. Penalty on real estate tax, 1951 ----------------------	2,475.59

III. Losses

1. War damage losses, 1950 -------	255,737.30

IV. Bad debts

1. Tenants' pre-war accounts, 1946 ---------------------	55,000.00

Expenses are deductible in computing net income. The expenses which are deductible are -

> "All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; traveling expenses while away from home in the pursuit of a trade or business; and rentals or other payments required to be made as a condition to the continued use or possession, for the purposes of the trade or business, or property to which the taxpayer has not taken or is not taking title or in which he has no equity." (Sec. 30 (a) (1), Revenue Code.)

Under the law, in order that an expense may be deductible, three conditions must be satisfied, to wit: (1) the expense must be both "ordinary and necessary"; (2) it must be paid or incurred during the taxable year; and (3) it must be incurred in carrying on any trade or business. (Collector of Int. Rev. v. Philippine Education Co., Inc., G. R. No. L-8505, May 30, 1956; 4 Mertens, Law of Federal Income taxation, Sec. 25.03, p. 307.) Bearing these requisites in mind, we now proceed to consider the deductions claimed by petitioner under the heading "business expenses."

The first item is the sum of ₱8,119.78. It appears that petitioner is the owner of Hacienda Canlubang and Hacienda Pabanlag, the former situated in Laguna and the latter in Pampanga. He entered into a contract with the Canlubang Sugar Estate, Inc., also wholly owned by petitioner, for the management of the two haciendas. Under the contract, Canlubang

Sugar Estate, Inc. was to receive as management fee 7.5% of the gross receipts of the two haciendas. However, in 1950, petitioner paid to Canlubang Sugar Estate, Inc. 15% of the gross receipts of the Hacienda Pabanlag in the amount of ₱16,239.56. But in the following year an adjustment was made reducing the percentage to the original 7.5% and the difference was credited to the capital account of petitioner. (Exh. YY.) Respondent disallowed the deduction of one-half of ₱16,239.56, or ₱8,119.78, in accordance with the contract of management. In other words, one-half of ₱16,239.56 was disallowed because it was excessive and therefore not "ordinary and necessary." The disallowance is also sought to be justified under Section 44 of the Revenue Code which provides:

> "SEC. 44. Allocation of income and deductions.-In any case of two or more organizations, trades, or businesses (whether or not incorporated and whether or not organized in the Philippines) owned or controlled directly or indirectly by the same interests, the Collector of Internal Revenue is authorized to distribute, apportion, or allocate gross income or deductions between or among such organizations, trades, or business, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or business."

The scope, purpose and application of Section 44 of the Revenue Code are explained in Section 179 of Revenue Regulations No. 2, which we quote:

"SEC. 179. Determination of the taxable net income of a controlled taxpayer. -

x x x x

"(b) Scope and purpose.— The purpose of section 44 is to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer, by determining, according to the standard of an uncontrolled taxpayer, the true net income from the property and business of a controlled taxpayer. The interests controlling a group of controlled taxpayers are assumed to have complete power to cause each controlled taxpayer so to conduct its affairs that its transactions and accounting records truly reflect the net income from the property and business of each of the controlled taxpayers. If, however, this has not been done, and the taxable net incomes are thereby understated, the statute contemplates that the Collector of Internal Revenue shall intervene, and, by making such distributions, apportionments, or allocations as he may deem necessary of gross income or deductions, or of any item or element affecting net income, between or among the controlled taxpayers constituting the group, shall determine the true net income of each controlled taxpayer. The standard to be applied in every case is that of an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer. Section 44 grants no right to a controlled taxpayer to apply its provisions at will, nor does it grant any right to compel the Collector of Internal Revenue to apply such provisions.

"(c) Application. —Transactions between one controlled taxpayer and another will be subjected to special scrutiny to ascertain whether the common control is being used to reduce, avoid, or escape taxes. In determining the true net income of a controlled taxpayer, the Collector of Internal Revenue is not restricted to the case of improper accounting, to the case of a fraudulent, colorable, or sham transaction, or to the case of a device designed to reduce or avoid tax by shifting or distorting income or deductions. The authority to determine true net income extends to any case in which either by inadvertence or design the taxable net

> income, in whole or in part, of a controlled taxpayer, is other than it would have been had the taxpayer in the conduct of his affairs been an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer."

The purpose of Section 44 of the Revenue Code is to give the Collector of Internal Revenue (now Commissioner) adequate authority to prevent evasion of taxes by arbitrary shifting of profits, fictitious sales, excess expenses, etc., when two or more businesses are owned or controlled by the same interests. The Commissioner can make his own allocation of such income or deductions or other items affecting income between the two to arrive at their true liability. (Vol. I, P-H Federal Taxes, Par. 6900.)

It is not denied that Hacienda Pabanlag paid to Canlubang Sugar Estate, Inc. in 1950 the sum of ₱16,239.56, as management fee, but in the subsequent year, one-half thereof, or ₱8,119.78, was credited by the Canlubang Sugar Estate, Inc. to the capital account of petitioner, owner of both Hacienda Pabanlag and the Canlubang Sugar Estate, Inc. Respondent has obviously not abused the power conferred upon him by Section 44 of the Revenue Code.

The allegation has been made that since the total amount of ₱16,239.56 was reported as income by the Canlubang Sugar Estate, Inc. in its return for 1950, Hacienda Pabanlag should be allowed to deduct from its income in the same year the full amount of

₱16,239.56. It is enough to state here that deductions may not be utilized to shift taxable income from one taxpayer to another.

The next item - share in the general administrative expenses in the aggregate amount of ₱336,292.63 - refers to the yearly payments made by Hacienda Pabanlag and Hacienda Canlubang to the Canlubang Sugar Estate, Inc. as their shares in the general administrative expenses of the latter. For the year 1950, the contribution was ₱72,694.21; for the year 1951, ₱85,586.16; and for the year 1952, Pabanlag contributed ₱61,938.36, and Canlubang, ₱116,073.90. Examiners Paz B. Suarez and Felicidad S. Lopez submitted a comprehensive and enlightening report on this item. We quote:

> "In addition to the above-mentioned management fees, the plantations share in the general and administrative expenses of Canlubang Sugar Estate in proportion to the gross receipts of each plantation. Included among the expenses shared by the plantations are executive salaries, accounting staff, athletic promotion, cine's operation, civil engineering, repairs and maintenance of buildings, police, Canlubang church, hospital, Casa de Nipa, Manila office and other expenses.
>
> "It is the opinion of the undersigned examiners that executive salaries and the accounting staff expenses should not be included among the items of expenses to be shared by the plantations. The taxpayer's representative explained that all of the executive and the members of the accounting staff devote some of their time in working for the plantations and that they do not receive any compensation from the haciendas. It is to be remembered, however, that the plantations pay a specific amount as management fee to Canlubang Sugar Estate. It is believed that in accepting the responsibility

> of managing the plantations for a certain fee, the management of these plantations become part of the ordinary functions of that corporation, and that any work performed on the plantation by the executives and the accounting staff is part of the performance of their official duty. The executives' salary and the accounting staff expenses are incurred by the corporation in the exercise of its function as manager of the plantations for which function it is paid its management fee. The other items which are shared by the plantations are expenses for the social upliftment and the betterment of the living conditions of the workers of Canlubang Sugar Estate. Because of the fact that the facilities on which these expenses are incurred are also enjoyed by the workers on the plantations, it is but proper that the haciendas share in these expenses.
>
> "Hacienda Pabanlag, one of the plantations managed by Canlubang Sugar Estate is located in Floridablanca, Pampanga. Records show that the salary of the overseer residing in Pabanlag is borne by the plantation. Traveling and other expenses incurred by him or by the other employees of Hacienda Pabanlag in making reports to Canlubang are charged directly to the haciendas. The traveling expenses of the general overseer of all plantations managed by Canlubang Sugar Estate incurred in inspection trips to Pabanlag are also borne by the hacienda. The sale of the share of the plantation in the sugar produced is taken care of by Pampanga Sugar Mills. The facilities at Canlubang are not availed of by the workers of Pabanlag. There is therefore no reason for Hacienda Pabanlag's sharing in the general and administrative expenses of Canlubang Sugar Estate. It is to be noted, too, that Hacienda Pabanlag shared in these expenses only in 1952." (Exh. YY, p. 217, BIR records.)

We do not see any necessity for Haciendas Pabanlag and Canlubang sharing in the general administrative expenses of Canlubang Sugar Estate, Inc. in addition to the management fees under the contract of management. The sum of ₱336,292.63 cannot, therefore, be considered as "ordinary and necessary expenses" of said haciendas and are not deductible from their gross incomes. And in view of the power vested in respondent by Section 44 of the Revenue Code, he has properly disallowed the claimed deduction to prevent arbitrary shifting of incomes and expenses of organizations owned or controlled by the taxpayer.

Respondent also disallowed the deduction of guards' salaries in the sums of ₱4,702.35 and ₱10,253.75 for the years 1948 and 1952, respectively, and the salary of a driver for 1951 in the sum of ₱2,400.00. The reason given for the disallowance of guards' salaries is not quite clear. The decision of respondent of September 23, 1954, states:

> "The amounts of ₱4,702.35 and ₱10,253.75 representing salaries of guards in 1948 and 1952, respectively, for his personal security are not deductible, the same being personal in nature and are, therefore, included in his personal exemption. Police protection is already afforded to his haciendas by the Canlubang Sugar Estate, Inc. for which your client shared in the general administrative expenses thereof." (Exh. 1, p. 338, CTA records.)

If the reason for the disallowance of guards' salaries is as stated by respondent in his decision, he is being unkind to petitioner. He has disallowed the deduction on the ground that police protection is already afforded to petitioner's haciendas by the Canlubang Sugar Estate, Inc. whose general administrative expenses were shared by petitioner, and yet he has disallowed at the same time the contributions of petitioner to the Canlubang Sugar Estate, Inc. as his share in its general administrative expenses. Since the disallowance of petitioner's share in the general administrative expenses of Canlubang Sugar Estate, Inc. has been sustained, no reason exists to justify the disallowance of the guards' salaries.

The decision of respondent of September 23, 1954 does not make any reference to the disallowance of the salary of petitioner's driver for the year 1951 in the sum of ₱2,400.00. It is claimed on behalf of petitioner that his car was used by him in carrying on the management and operation of his different business interests. We may accept the fact that said car was used in the operation and management of his business interests, but it cannot be denied that said car was also used by him and his family for purely personal purposes. /This is a case where a car is used both for personal and for business purposes. Considering petitioner's vast business interests, we believe that two-thirds of his expenses for the maintenance of the car may be considered business expenses and are deductible, while one-third is non-deductible personal expense. (See Cohan v. Commissioner, 39 F (2d) 540, 8 AFTR 10552.) Therefore of the sum of ₱2,400, ₱1,600 may be allowed as a business expense and ₱800.00 disallowed as a personal expense.

The next item of business expenses disallowed by respondent refers to the traveling and entertainment expenses. The first amount involves the sum of ₱31,000.00. The facts surrounding this expenditure are stated by counsel for petitioner in their memorandum which we quote:

> "This amount represents the expenses incurred and paid by Mr. Yulo on and/or his trip to the United States in the performance of his duties as Chairman of the Philippine Council for United States Aid (PHILCUSA). In August, 1951, Mr. Yulo went to the United States, in company with His Excellency, President Elpidio Quirino, in the interest of the Philippine Government. During his stay in the United States, as Chairman of the Philippine Council for United States Aid (PHILCUSA), he was actively engaged in his work concerning the rehabilitation of the Philippine economy. He was constantly in the offices of high officials of the United States Government in Washington discussing matters of great importance relative to the rehabilitation of the Philippine economy. He was on continuous move from one office to another in Washington and from one city to another. He stayed in high-class hotels which cost him considerable sums of money and he incurred expenses for transportation. He was often entertained by high Government officials in Washington and he entertained them in return. The taxpayer paid for his trip to the United States, stay in hotels, meals, transportation and entertainments with his own funds. The Government of the Republic did not pay the taxpayer for his services nor did it reimburse him for his expenses. The amount of ₱31,000.00 was, therefore, spent by the taxpayer in the performance of his work as Chairman of the Philippine Counsel for United States Aid in the United States. The expense was incurred in prosecution of an official duty and not for any reason or purpose. It was such expense which the Government of the Republic should have defrayed but which the taxpayer assumed in a spirit of patriotic service. It was an important business of the Government of the Philippines that the taxpayer per-

> formed or undertook in the United States. In performing or undertaking such business the taxpayer incurred an expenditure of ₱31,000.00 which could not have been avoided." (Pp. 130-130 A, Memorandum for petitioner.)

The expenses were disallowed on the ground that "the trip being personal in nature, said amount cannot be allowed as deduction in 1951." Respondent claims that petitioner "did not undertake the trip abroad for business purposes but on the invitation of former President Quirino."

We agree with petitioner that the trip was official in character, having been undertaken in connection with his employment as Chairman of the PHILCUSA. However, in such cases, the traveling expenses are deductible only to the extent of the income derived from such employment; or where traveling expenses were authorized to be reimbursed, to the extent of the amount received as reimbursement. Such expenses may not be deducted from income derived from other sources. In this case, it is admitted that petitioner did not receive any compensation as Chairman of the PHILCUSA nor any reimbursement for his traveling expenses. Accordingly, the deduction of said expenses was properly disallowed. The authorities cited by counsel for petitioner are not in point. In the cases cited, the expenses of the claimant-employees were allowed as deduction from the income derived from their employment in connettion with which the expenses were incurred. (See B.I.R. General Circular Nó. 479, January 27, 1941, which explains the treatment of traveling expenses and per diems of government employees for income tax purposes.)

Petitioner deducted from his gross income in 1948 the sum of ₱6,000.00 as entertainment expenses; in 1950, ₱6,000.00; in 1951, ₱6,000.00; and in 1952, ₱6,571.35. These deductions were disallowed on the following grounds:

> "Regarding entertainment expenses for the years 1948, 1949, 1950, 1951 and 1952, it appears from his income tax returns for said years that he deducted same under schedule 'A'. However, under said schedule his reported income for said years consisted of salaries and bonus from Elizalde & Company and legal fees from various corporations. If he had incurred expenses for entertainment, they were not incurred in connection with the operation of his haciendas, but more or less for civil and social engagements which were personal in natufe and, therefore, not deductible under the law. To constitute allowable deductions of entertainment expenses, they must be incurred on a purpose reasonably connected with the business. Furthermore, we entertain some doubt as to the amount actually spent for alleged entertainment. We are inclined to believe that the amounts are mere calculations because it is inconceivable to have spent a uniform amount of ₱6,000.00 a year from 1947 through 1951 for entertainment." (Exh. 1, p. 337, CTA records.)

That the amounts claimed as entertainment expenses are mere "calculations" does not justify disallowance of the entire claim, provided there is evidence that some amounts were actually spent, the persons entertained, and the necessity of entertaining such persons for the promotion or enhancement of the business of the taxpayer. Where it is impossible to determine the precise amount, it is the duty of this Court to make a determination, even if the result be merely an approximation.] (Visayan Cebu Terminal Co., Inc.,v. Collector of Internal Revenue, C.T.A. No.128, June 29, 1957, citing Cohan v. Commissioner, 39 F (2d) 540, 8 AFTR 10552.) In this case, no evidence has been presented to justify deductibility of the claimed entertainment expenses. Counsel for petitioner merely made a general statement as to the extent of petitioner's business activities and his "social and civic engagements."

> "It would only be natural for the petitioner to entertain customers, businessmen and executives of business firms in the conduct of his different businesses as well as in his numerous civil and social engagements. He is on the market to sell the produce of his farms - sugar, coconut and other farm products. He looks for customers who can buy his products at the best price obtainable. Luncheon parties and other entertainments that he tenders to customers and businessmen are necessary in carrying on his businesses and/or in undertaking his various business activities, let alone his social and civic engagements, for all of which he spends more than ₱6,000.00 annually. It may not be amiss to mention that the petitioner is a person of high standing and reputation in business and in society that the amount of ₱6,000.00 for entertainment expenses claimed in his income tax returns for each year is altogether inadequate. Certainly, under the above-stated circumstances, the amount of ₱6,000.00 for entertainment expenses paid or incurred by the taxpayer may be considered ordinary and necessary expenses in carrying on business within the purview of section 30 (a) (1) of the National Internal Revenue Code as amended." (Pp. 108-109, Memorandum for petitioner.)

No account or any detail has been given upon which we may base an estimate of the amount which may be allowed as a deduction. The disallowance of the entire amount is, therefore, in order. (Santiago Gancayco v. Collector of Internal Revenue, C.T.A. Nol 287, Nov. 14, 1957.)

The sum of ₱1,044.65 is claimed by petitioner as deduction from his income in 1948. This amount allegedly represents club dues paid to the Baguio Golf Club and other clubs. As in the case of entertainment expenses, no evidence was presented to prove the necessity of incurring such expenses to promote petitioner's various businesses. "Since in most instances there is large personal element in a club membership, substantial evidence is a prerequisite to the allowance of club dues as a deductible expense." (Vol. 4, Mertens Law of Federal Income Taxation, Sec. 25.79.) The club dues here in question have been properly disallowed.

The last item of business expenses claimed as deduction by petitioner consists of the sum of ₱522.30, representing expenses for stationery in 1952, and the sum of ₱1,606.40 for postage, telephone and telegraph also in 1952.

The sum of ₱522.30 has been disallowed on the ground that the said amount is already "included in (petitioner's) share of the general administrative expenses." (Exh. 1, p. 338, CTA records.) In view of our opinion in the case of the guards' salaries which were also disallowed by respondent on the same ground, we are of the opinion that petitioner is entitled to this deduction.

With respect to the sum of ₱1,606.40 allegedly spent for postage, telephone and telegraph in 1952, there is nothing in the decision of respondent of September 23, 1954 making reference to this amount. We take it that these expenses were disallowed on the same ground as the expenses for stationery. Therefore, we hold that petitioner is entitled to this deduction.

The sum of ₱2,475.59 claimed by petitioner as deduction in his income tax return for 1951 is denominated as "penalty on real estate tax." Counsel for petitioner admit that "the same was included as a deduction in the income tax return of petitioner for the calendar year 1951 thru error or inadvertence and without bad faith."

Petitioner deducted the amount of ₱255,737.30 for war losses in his income tax return for 1950 pursuant to Section 30(d) of the Revenue Code which allows deduction of "losses actually sustained during the taxable year and not compensated for by insurance or otherwise." The question in regard to the deductibility of war losses has already been finally settled by the Supreme Court in two cases. It has been held that a loss sustained in 1945 as a result of military operations by the United States for the liberation of the Philippines was not "compensated for by insurance or otherwise", within the meaning of Section 30 (d) of the Revenue Code, and, therefore, such loss is deductible only in the year sustained, not in 1950 when the taxpayer was definitely advised that the United States would not pay the amount claimed. (Cu Unjieng v. B.T.A., G.R.No. L-6296, Sept. 29, 1956; Hilado v. Collector of Int. Rev., G.R. No. L-9408, Oct. 31, 1956.)

The last disputed item is the sum of ₱55,000.00 claimed as a bad debt deduction in 1946. Section 30 (e) (1) of the Revenue Code permits the deduction of "debts due to the taxpayer actually ascertained to be worthless and charged off within the taxable year." In order that a bad debt deduction may be validly claimed, it is essential (1) that there be a valid and subsisting debt, and (2) that the debt be actually ascertained to be worthless and charged off within the taxable year.

In this case, it is not disputed that certain tenants of petitioner had pre-war accounts with the latter. These accounts were ascertained to be worthless in 1945. In fact, petitioner deducted the sum of ₱55,000.00 from his net worth as of February 26, 1945 in filing his war profits tax return, and respondent agreed to the deduction. But the accounts were actually charged off in the books of petitioner only in 1946. It is contended that the bad debts are deductible in the year 1946 when the accounts were charged off in the books of petitioner. We do not agree with petitioner. Since the accounts were actually ascertained to be worthless in 1945 the same should have been charged off in that year, as he did when he filed his war profits tax return, and claimed as a deduction in his income tax return for that year. A taxpayer may not defer deduction to a later year of a bad debt the worthlessness of which has been ascertained in a prior year. The law does not permit the charging off and the deduction of a bad debt in a year other than in the year it is ascertained to be worthless.]

In resumé, we are of the opinion that -

(1) The distribution of Talisay-Silay of its 6,000,000 Financing shares resulted in a dividend distribution, taxable to the stockholders to the extent of its earnings or profits, and a partial distribution of capital to the extent that the distribution exceeds such earnings or profits;

(2) Fraud not having been established by respondent with respect to petitioner's 1948 income tax return, the imposition of the fraud penalty is not in order; and

(3) The disallowance by respondent of the deductions claimed by petitioner in his income returns for 1946, 1948, 1950, 1951 and 1952 is in accordance with law, except with respect to (a) guards' salaries in the sums of ₱4,702.35 for 1948 and ₱10,253.75 for 1952; (b) two-thirds of the salary of petitioner's driver for 1951 in the sum of ₱1,600.00; and (c) expenses for stationery, postage, telephone and telegraph in 1952 in the sums of ₱522.30 and ₱1,606.40.

In line with the foregoing opinion, we find the petitioner liable for the payment of the sum of ₱720,948.92 as deficiency income tax for the years 1946, 1948, 1950, 1951 and 1952, itemized and computed below, instead of ₱2,138,913.80 as determined by respondent.

1946

Net income per prior BIR audit -------		₱21,802.60
Add: Tenants' pre-war accounts disallowed ----------------------		55,000.00
Net income --------------------------		₱76,802.60
Deduct: Personal exemption ------------		4,000.00
Net taxable income -------------------		₱72,802.60
Tax due ------------------------------		₱17,332.88
Less: Amount previously paid ----------		2,206.44
Deficiency tax due -------------------		₱15,126.44

1948

Net loss per prior BIR audit ----------		(₱12,054.82)
Add: Dividend in the form of Financing shares	₱979,075.41	
Deduct: Guards' salaries -	4,702.35	974,373.06
Net income --------------------------		₱962,318.24
Less: Personal exemption -------------		3,500.00
Net taxable income -------------------		₱958,818.24
Tax due ------------------------------		₱440,765.48

1950

Net loss per prior BIR audit ----------		₱215,054.31
Add: Disallowances:		
War losses ---------	₱255,737.30	
Management fee -----	8,119.78	
Share in general administrative expenses of Canlubang Sugar Estate ------------	72,694.21	₱336,551.29
Net income --------------------------		₱121,496.98
Less: Personal exemption -------------		3,600.00
Net taxable income -------------------		₱117,896.98
Tax due ------------------------------		₱ 46,526.00

1951

Net income per prior BIR audit -------		₱196,637.38
Add: Disallowances:		
Miscellaneous wages (driver's salary) --	₱ 800.00	
Travelling expenses U.S. & Europe ------	31,000.00	
Entertainment expenses ------------	6,000.00	
Penalty on real estate taxes --------------	2,475.59	
Shows in gen. adm. expenses --------------	85,586.16	125,861.75
Gain from sale of Talisay-Silay Shows: 50% of ₱456,508.82--	₱228,254.41	
Less: Loss on Financing shares 50% of ₱248,111.64 -------	124,055.82	₱104,198.59

Net Income	₱426,697.72
Deduct: Personal exemption . .	3,600.00
Net taxable income	₱423,097.72
Tax due	₱219,148.00
Less: Amount previously paid	87,190.00
Deficiency tax due	₱131,958.00

1952

Net income per prior BIR audit		₱ 20,245.76
Add: Disallowances:		
Share in gen. adm. expenses (Pabanlag) . .	₱ 61,938.36	
Share in gen. adm. expenses (Canlubang)	116,073.90	
Entertainment expenses (personal)	6,571.35	
Total	₱184,583.61	
Less: Disallowed Contributions	4,535.52	180,048.09
Net income		₱200,293.85
Deduct: Personal exemption . .		3,000.00
Net taxable income		₱197,293.85
Tax due		₱ 89,532.00
Less: Amount previously paid ..		2,959.00
Deficiency tax due		₱ 86,573.00

RESUME

1946	₱ 15,126.44
1948	440,765.48
1950	46,526.00
1951	131,958.00
1952	86,573.00
T o t a l. . .	₱ 720,948.92

In connection with the income tax liability of petitioner for 1951, it is to be noted that in the foregoing computation the determination made by respondent has been revised upward. This is due to the inclusion in petitioner's income in said year of his capital gain derived from the sale or exchange of his 150,288 Talisay-Silay shares less the capital loss sustained in the sale or exchange of his Financing shares.

The 150,288 Talisay-Silay shares were acquired by petitioner at a cost of ₱14 per share, or a total cost of ₱2,104,032.00. He received a partial return of capital arising from his receipt of ₱2,452,546.00 Financing shares in the sum of ₱541,503.11, so that the return of capital corresponding to the 150,288 Talisay-Silay shares was ₱456,508.82 (150,288 ÷ 178,269 x ₱541,503.11). The Talisay-Silay shares were assigned to May, Inc. in 1951 for ₱14.00 per share, the original cost, thereby resulting in a capital gain of ₱456,508.82. (See page 20, supra.) In the case of the Financing shares, of the 2,452,546 shares received by petitioner from Talisay-Silay in 1948, 2,067,597 were assigned to May, Inc. at ₱.50 per share. The original cost to petitioner of these shares was ₱.62 per share, thereby resulting in a capital loss of ₱.12 per share, or ₱248,111.64. Therefore, the net taxable capital gain of petitioner derived from the assignment to May, Inc. of the 150,288 Talisay-Silay shares and 2,067,597 Financing shares is ₱104,194.08 (50% of ₱456,508.82 less 50% ₱ 248,111.64).

For the foregoing considerations, the decision of respondent is hereby modified, and petitioner is hereby required to pay the sum of ₱720,948.92 as deficiency income tax for the years 1946, 1948, 1950, 1951 and 1952. With costs against petitioner.

SO ORDERED.

Manila, July 8, 1956.) 18) 9

ROMAN M. UMALI
Associate Judge

WE CONCUR:

MARIANO NABLE
Presiding Judge

AUGUSTO M. LUCIANO
Associate Judge

Appealed - No decision yet of S.C.

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