6-70

REPUBLIC OF THE PHILIPPINES
COURT OF TAX APPEALS
QUEZON CITY

J. AMADO ARANETA AND
ESTER ARANETA,
Petitioners,

- versus - C.T.A. CASE No. 1699

COMMISSIONER OF INTERNAL
REVENUE,
Respondent.
x - - - - - - - - - - - x

11/6/70

DECISION

Petitioner sought a review of the decision of respondent Commissioner of Internal Revenue, dated September 17, 1965, assessing the spouses J. Amado Araneta and Ester Araneta the amount of ₱272,648.88, representing deficiency income taxes, surcharges and interests, for 1957, 1958, 1959, 1960 and 1961.

Mr. J. Amado Araneta, the petitioner primarily subject to the tax assessment, is the president and stockholder of several corporations, namely: J. Amado Araneta & Co., Philippine Fiber Processing Co., and the Philippine Financing Corporation of the Philippines. In Negros Occidental, he controls several sugar centrals, such as the Ma-ao Sugar Central, Talisay Bacolod Milling, etc. He owns agricultural land and the Hacienda Bonifacio which was sold in 1958.

From the said corporations and sugar centrals, Mr. Araneta received salaries, bonuses and dividends which are reported in his income tax returns on the "cash receipts basis", and the income from farming on the "accrual basis".

For the years under review (1957-1961), petitioner J. Amado Araneta filed with the Bureau of Internal Revenue his income tax returns, declaring therein income from salaries, bonuses and dividends but omitted therefrom the income from farming and the gain derived from the sale of Hacienda Bonifacio.

On October 30, 1962, after petitioners were informed of Memorandum Order No. 50-62 of the respondent dated September 10, 1962, granting amnesty to all taxpayers who shall voluntarily report until November 30, 1962 their correct income for prior years, they filed with the Bureau of Internal Revenue office the corresponding amended income tax returns for the years 1957 to 1961, declaring therein the undeclared income from farming amounting to ₱30,301.88, ₱63,239.95, ₱18,983.60, ₱13,075.65 and ₱9,746.04, respectively; and the capital gain of ₱34,223.54 from the sale of Hacienda Bonifacio in 1958. In short, petitioners failed to declare in their original income tax returns for prior years the total amount of ₱169,570.66.

On the basis of the amended income tax returns, petitioners paid the additional taxes and interests due from them for 1957, 1958 and 1959. The additional income taxes for 1960 and 1961 were not paid by petitioners because of the overpayment made on their original income tax returns by erroneously declaring therein as personal income the dividends pertaining to J. Amado Araneta & Co.

On February 21, 1963, petitioners received from respondent an assessment demanding payment of ₱1,215,195.52 as deficiency income taxes, surcharges and interests for prior years. Upon protest, the said assessment was reduced to ₱272,648.88, itemized as follows:

ASSESSMENT No. AR-90-1-25453-65/57

| | | |
|---|---|---|
| Net income per return ------------ | | ₱ 96,009.84 |
| Add: Additional income: | | |
| Interest income from J.A.A. & Co. --- | ₱22,993.97 | |
| Underdeclared and additional income from farming --- | 30,301.88 | 53,295.85 |
| Net income per re-investigation ---------------------- | | ₱149,305.69 |
| Tax due on net taxable income of ₱146,305.69 ----------------- | | ₱ 45,702.00 |
| Less: Amount already assessed ---- | | 36,505.00 |
| Balance -------------------------- | | ₱ 9,197.00 |
| Add: 50% surcharge --------------- | | 4,598.50 |
| ½% monthly interest from 6-20-59 to 6-20-62 -------- | | 1,655.46 |
| TOTAL AMOUNT DUE & COLLECTIBLE --- | | ₱ 15,450.96 |

ASSESSMENT No. AR-46-1-416015-65/58

| | | |
|---|---|---|
| Net income per return ------------- | | ₱ 73,783.44 |
| Add: Additional income: | | |
| Undeclared profits, sale of hacienda- | ₱120,162.42 | |
| Interest income from J.A.A. & Co. --- | 22,993.97 | |

| | | |
|---|---|---|
| Interest income - Financing Corp. of the Phil. ----------- | ₱ 3,600.00 | |
| Undeclared export proceeds -------- | 8,130.85 | |
| Interest on sales tax payable ----- | 9,176.24 | |
| Production expenses after sale of hacienda ---------- | 4,312.53 | |
| Undeclared income from farming ---- | 63,239.95 | ₱231,615.96 |
| Net income per reinvestigation --- | | ₱305,399.40 |
| Tax due on net taxable income of ₱302,399.40 ---------------- | | ₱133,284.00 |
| Less: Amount already assessed ---- | | 40,789.00 |
| Balance -------------------------- | | ₱ 72,495.00 |
| Add: 50% surcharge --------------- | | 36,247.50 |
| ½% monthly interest for 3 years ------------------ | | 13,049.10 |
| TOTAL AMOUNT DUE & COLLECTIBLE --- | | ₱121,791.60 |

<u>ASSESSMENT No. AR-90-1-315395-65/59</u>

| | | |
|---|---|---|
| Net income per return | | ₱ 91,092.54 |
| Add: Additional income: | | |
| Interest income from J.A.A. & Co. --- | ₱22,993.97 | |
| Interest income from Financing Corp. of the Phil. ------ | 1,800.00 | |
| Income from J.A.A. & Co. ---------- | 66,803.98 | |
| Income from Phil. Fiber Processing Company -------- | 29,196.02 | |
| 2½% additional planters share from M.S.C. --------- | 5,770.11 | |
| Undeclared income from farming --- | 18,983.60 | 145,547.68 |
| Net income per re-investigation -- | | ₱236,640.22 |
| Tax due on net taxable income of ₱233,640.22 -------------- | | ₱109,718.00 |
| Less: Amount already assessed | | 40,760.00 |
| Balance ------------------------- | | ₱ 68,958.00 |

| | | |
|---|---|---|
| Add: 50% surcharge --------------- | | ₱ 34,479.00 |
| ½% monthly interest for 3 years ------------------- | | 12,412.44 |
| TOTAL AMOUNT DUE & COLLECTIBLE --- | | ₱115,849.44 |

ASSESSMENT No. AR-46-1-41233-65/60

| | | |
|---|---|---|
| Net income per return ------------ | | ₱ 88,994.72 |
| Add: Additional income: | | |
| Interest income from J.A.A. & Co. ---- | ₱22,993.97 | |
| Interest income from Financing Corp. of the Phil. ------ | 1,817.31 | |
| Underdeclared income from farming ---- | 13,075.65 | |
| | ₱37,886.93 | |
| Less: Dividend income belonging to J.A.A. & Co. declared as personal income - | (15,869.00) | 22,017.93 |
| Net income per re-investigation -- | | ₱111,012.65 |

| | |
|---|---|
| Tax due on net taxable income of ₱108,012.65 ---------------- | ₱ 41,247.65 |
| Less: Amount already assessed ---- | 30,157.00 |
| Balance -------------------------- | ₱ 11,090.00 |
| Add: 50% surcharge ------------- | 5,545.00 |
| ½% monthly interest for 3 years ------------------ | 1,996.20 |
| TOTAL AMOUNT DUE & COLLECTIBLE --- | ₱ 18,631.20 |

ASSESSMENT No. AR-46-1-412617-65/61

| | | |
|---|---|---|
| Net income per return ----------- | | ₱173,306.36 |
| Add: Additional income: | | |
| Interest income from J.A.A. & Co. ---- | ₱22,993.97 | |
| Underdeclared income from farming ---- | 9,746.04 | |
| | ₱32,740.01 | |
| Less: Dividend income belonging to J.A.A. & Co. declared as personal income - | 31,738.00 | 1,002.01 |
| Net income per re-investigation -- | | ₱174,308.37 |

| | |
|---|---|
| Tax due on net taxable income of ₱171,308.37 ------------- | ₱ 75,099.00 |
| Less: Amount already assessed -- | 74,548.00 |
| Balance ------------------------- | ₱ 551.00 |
| Add: 50% surcharge -------------- | 275.50 |
| ½% monthly interest for 3 years ------------------ | 99.18 |
| TOTAL AMOUNT DUE & COLLECTIBLE -- | ₱ 925.68 |

Petitioners admitted that they do not dispute the items of "Undeclared export proceeds" (1958), "Interest on sales tax payable" (1958) and the "2½% additional planters share from Ma-ao Sugar Central" (1959) involving ₱8,130.85, ₱9,176.24 and ₱5,770.11, respectively. However, petitioners assailed and disputed the correctness of the following items, namely:

1. Interest income of ₱22,993.97 from J. Amado Araneta & Co. (1957 to 1961);

2. Interest income of ₱3,600.00, ₱1,800.00 and ₱1,817.31 from Financing Corporation of the Philippines, for 1958, 1959 and 1960, respectively;

3. Income of ₱66,803.98 from J. Amado Araneta & Co. for 1959;

4. Income of ₱29,196.02 from Philippine Fiber Processing Co. for 1959;

5. Undeclared profit of ₱120,162.42 from the sale of Hacienda Bonifacio for 1958;

6. Production expenses of ₱4,312.53 incurred after the sale of Hacienda Bonifacio for 1958; and

7. 50% surcharges as fraud penalty.

We shall discuss the contested items in the order of their presentation.

1. Interest income of ₱22,993.97 from J. Amado Araneta & Co. for each of the years under review.

For each of the years of 1957 to 1961, petitioner J. Amado Araneta, president and controlling stockholder of J. Amado Araneta & Co. was credited in the books of the company the sum of ₱22,993.97 as yearly interest of 5% on the amount of ₱459,879.33 advanced by him to the Philippine National Bank in 1957 in payment of the account of said company. The said yearly interest of ₱22,993.97 was neither paid in cash nor collected by petitioner J. Amado Araneta. The company, however, deducted the said interests from gross income in its corporate income tax returns. The aforesaid interests, however, were treated by respondent as yearly income of petitioners from 1957 to 1961.

The said interest income was denied by petitioners and alleged as defenses that: (1) the interests were neither paid in cash nor collected by petitioner J. Amado Araneta; (2) said petitioner had no knowledge that the said interests were credited to him upon instruction of Mr. Gregorio Noriega, manager of the company; and (3) the interests credited to Mr. J. Amado Araneta was erroneously made because said petitioner was indebted to the company in amounts exceeding ₱459,879.33 paid by him to the Philippine National Bank.

There are two ways of returning the taxable income of taxpayers, namely: (1) cash receipts and disbursements basis; or (2) the accrual basis. The doctrine of constructive receipt, relied upon by respondent in assessing petitioners, is designed to prevent the exclusion from taxable income of items, the actual receipt of which could, at the option of a taxpayer on the cash basis, be deferred or indefinitely postponed. (Montgomery's Taxes, Vol. 1, 1946-47, p. 1007.)

Income is constructively received, if duly credited on the books of the payor. On this point, our Income Tax Regulations, which were promulgated pursuant to Section 338 of the Revenue Code, provide:

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

There is constructive receipt of an income by a taxpayer if (1) the income is available to him; (2) the debtor is able and ready to pay him; (3) his right to receive is not restricted; and (4) his failure to receive is the result of the exercise of his own choice. (C. E. Gullet, 31 B.T.A. 1067; William Parris, 20 B.T.A. 320.)

Mr. J. Amado Araneta's right to receive the interest income is recorded in the books of J. Amado Araneta & Co.; the said company is financially capable and ready to pay him; his right to receive the interest income is without restriction as to the time and manner of payment; his failure to receive the interest income was of his own choice.

Income is said to accrue when the right to receive it becomes fixed (Spring City Foundry Co. vs. Commissioner, 292 U.S. 182). Mr. J. Amado Araneta, however, claimed, thru his accountant, that the right to receive the said interest income is not known to him because it was Mr. Gregorio Noriega, resident manager of the company, who instructed the company accountant that the accrued interest in question be recorded in the books of the company in favor of Mr. Araneta. This pretense is not tenable. Mr. Araneta is not only the president of the company bearing his name but he also owns and controls the interest thereof. The acts of his resident manager involving the substantial interest income is presumed to be known by Mr. Araneta because the same was recorded in the company's books for a period of five (5) years. Moreover, the deduction of the said substantial interest expense from the gross income of the company for 1957 to 1961, inclusive, can not be said to have been made without the knowledge of Mr. Araneta as president and controlling stockholder of the company.

Petitioner insisted and claimed that, since Mr. J. Amado Araneta was indebted to J. Araneta & Co. from 1957 to 1961 in amounts exceeding ₱459,879.33 which was advanced and paid by him to the Philippine National Bank, no interest income accrued to Mr. Araneta because compensation or set-off takes effect by operation of law.

Compensation is a mode of extinguishing to the concurrent amount the obligation of the persons who in their own right are reciprocally debtors and creditors of each other. While compensation resembles in many respects the common law set-off or counterclaim provided in certain provisions of the Rules of Court, it differs from the latter in that a set-off or counterclaim must be pleaded to be effectual; whereas compensation takes place by operation of law, and extinguishes reciprocally the two debts as soon as they exist simultaneously, to the amount of their concurrent sums. (Yap Unki vs. Chua Jamco, 14 Phil. 602.)

In order that legal compensation may take place, it is indispensable that all the requisites prescribed by law are present (Art. 1290, Civil Code of the Philippines). The same Code provides:

> Art. 1279. In order that compensation may be proper, it is necessary:
> (1) That each of the obligors be bound principally and that he be in the same time a principal creditor of the other;
> (2) That both debts consist in a sum of money, xx xx xx.
> (3) That the two debts be due;
> (4) That they be liquidated and demandable.

It is doubtful whether Mr. J. Amado Araneta is a creditor of J. Amado Araneta & Co. The only evidence submitted to this Court was the testimony of the company accountant who presented the entries in the ledger showing the balances allegedly due from Mr. Araneta at the end of the years 1957 to 1961. The journal entries evidencing the nature of the transaction between the individual and the company were not submitted to the Court for evaluation. The said yearly balances may even represent the personal drawing account of Mr. Araneta as president of the company bearing his name. If the said balances represent legitimate indebtedness of the company, they were not proven to be due and demandable. Neither were they liquidated in the books of the company, thereby allowing said company to deduct the interest expense from it s gross income from 1957 to 1961 and at the same time granted Mr. Araneta the unristricted option of not declaring his interest income for an indefinite period by claiming that his income were reported on the cash receipts and disbursements method of accounting. Under the facts and circumstances of the case, we are constrained to hold that the interest income of Mr. J. Amado Araneta from the company were constructively received by him from 1957 to 1961 and the same should have been reported in his individual income tax returns.

2. <u>Interest income of ₱3,600.00, ₱1,800.00 and ₱1,817.31 from Financing Corporation of the Philippines for 1958, 1959 and 1960.</u>

The books of accounts of Financing Corporation of the Philippines show that Mr. J. Amado Araneta was credited the amounts of ₱3,600.00, ₱1,800.00 and ₱1,817.31 as accrued interest for 1958, 1959 and 1960, respectively. Respondent considered that the said amounts were constructively received by Mr. Araneta but the latter claimed that he was not liable therefor because his income were declared on the cash-receipts basis.

Mr. Araneta is also the president and stockholder of the said corporation. In the light of our extensive discussion in the preceding contested items of undeclared interest income, we hold that the interests here in dispute, which were also deducted as interest expense from the corporation's gross income, were constructively received by Mr. Araneta and, therefore, includible in his gross income during the years in question; otherwise, a contrary ruling would open the door to tax avoidance or possible tax evasion. A recognized authority on income tax commenting on the theory of constructive receipt said:

> There was an obvious necessity to implement the doctrine of actual receipt with the theory of constructive receipt as a test of realization of income. Such a measure of tax liability is not unreasonable in principle. A taxpayer may not deliberately turn his back on income and thus select the year in which he will report it. A failure to recognize constructive receipt of income as income realized would open the door to avoidance and possible evasion. A taxpayer should not have the right to select the year in which to reduce income to possession. It is now well settled that income which is subject to a taxpayer's unfettered command and which he is free to enjoy at his own option is taxed to him as his income whether he sees fit to enjoy or not. (Mertens, Law of Federal Income Taxation, Sec. 10.01, Vol. 2, 1953 ed.)

3. Undeclared income of ₱66,803.98 from J. Amado Araneta & Co. for 1959; and

4. <u>Undeclared income of ₱29,196.02 from Philippine Fiber Processing Co. for 1959.</u>

The items of ₱66,803.98 and ₱29,196.02, or a total of ₱96,000.00, being interrelated, we will discuss them jointly.

In the books of the Philippine Fiber Processing Company, particularly page 19 of Journal No. 76 dated April 30, 1959 (Exh. U, p. 42, C.T.A. rec.) the following entries were recorded, to wit:

Surplus Adjustment ----- ₱96,000.00

| | |
|---|---|
| J. Amado Araneta & Co. --------- | ₱66,803.98 |
| Associated Sugar, Inc. --------- | 29,196.02 |

To provide discretionary and entertainment <u>expenses of the president</u> from Jan. 1955 to Dec. 1958 at ₱2,000.00 per month per Board Resolution of Feb. 1955:

| | |
|---|---|
| 1955 ------------------ | ₱24,000.00 |
| 1956 ------------------ | 24,000.00 |
| 1957 ------------------ | 24,000.00 |
| 1958 ------------------ | 24,000.00 |

(Exh. U-1, p. 42, C.T.A. rec.)

Respondent's examiners treated the said entries amounting to ₱96,000.00 as undeclared income of Mr. J. Amado Araneta in 1959 because the surplus adjustment took place in that year and the said taxpayer is likewise the president and controlling stockholder of the Philippine Fiber Processing Company.

From the evidence adduced, we gathered that the sums of ₱66,803.98 and ₱29,196.02 were previously advanced by J. Amado Araneta & Co. and Associated Sugar, Inc., respectively, to their affiliate - Philippine Fiber Processing Company - for discretionary and entertainment expenses of Mr. J. Amado Araneta. In 1959, the said advances amounting to ₱96,000.00 were paid by the Philippine Fiber Processing Company to its affiliates. (Exhs. U and U-1.)

Mr. Jose Sanchez testified that from January, 1955 to December, 1958, Mr. Araneta was provided with discretionary funds for entertainment and representation expenses at the rate of ₱2,000.00 a month as president of the Philippine Fiber Processing Company pursuant to its board resolution of February, 1955. Mr. Araneta, therefore, received only ₱24,000.00 per annum as representation expenses for the years 1955 to 1958, or a total of ₱96,000.00. The latter figure cannot be said to have been constructively received by Mr. Araneta in 1959 because the same was spent by him for prior years. The said expenditures were supported by receipts and vouchers which were shown to the investigating revenue examiners as confirmed by them. (See BIR records, p. 298.) However, the receipts and vouchers as well as the corresponding book entries for 1955 and 1956 were not made available to the said examiners because the preservation thereof after five (5) years was not required by Section 337 of the Tax Code aside from the fact that the years 1955 and 1956 were not covered by the investigation of respondent's examiners.

Accordingly, we hold that the sum of ₱96,000.00 does not form part of Mr. Araneta's income in 1959 and should be excluded in computing his taxable income for the said year.

5. Undeclared profit of ₱120,160.42 from the sale of Hacienda Bonifacio in 1958.

In 1947, Mr. J. Amado Araneta purchased Hacienda Bonifacio for ₱23,560.00. On October 31, 1958, the said land together with improvements valued at ₱111,300.00 and the buildings thereon with a book value of ₱20,252.92 were sold for ₱200,000.00, thereby realizing a profit of ₱68,447.08. In the 1958 amended income tax return of Mr. Araneta, he declared that the capital gain derived from the sale of the said property was ₱34,223.54. Respondent, however, considered the said property as ordinary asset and the profit realized from the sale thereof amounting to ₱120,162.42 as ordinary gain.

Under Section 34(a)(1) of the National Internal Revenue Code, all classes of property are capital assets except the following:

> 1. Stock in trade . . . . or other property of a kind which would properly be included in the inventory of the taxpayer

if on hand at the close of the taxable year;

2. Property held by the taxpayer primarily for sale to its customers in the ordinary course of his trade or business;

3. Property used in the trade or business which is subject to allowance for depreciation provided in subsection (f) of Section 30 of the Revenue Code; and

4. Real property used in the trade or business of a taxpayer.

In determining whether the gain derived from the sale of real property is entitled to capital gains treatment, the critical issue is whether it is used or held for sale by the seller "in the ordinary course of his trade or business." In resolving the question at issue, the U. S. Tax Court in the case of Curtis Co. v. Commissioner of Internal Revenue (23 T. C. 752) held as follows:

> It has frequently been stated that, in determing whether the gain derived from the sale of real property is entitled to capital gains treatment under section 117(j), the test which deserves greatest weight is the purpose for which the property was held during the period in question. Walter R. Crabtree, supra. This holding period does not terminate upon the decision to sell but extends until the project is actually sold. Naturally, once a decision has been made to sell investment property, such property is thereafter held for sale. However, this does not preclude the application of section 117(j) since the critical issue is whether it is held for sale by the seller "in the

> ordinary course of his trade or business." To obtain capital gains treatment under section 117(j), a taxpayer may choose the most advantageous method of liquidating his investment in properties originally acquired and held for investment purposes, so long as such method of disposal does not constitute his entrance into the trade or business of selling such properties. It may be more expeditious to enter such business in order to dispose of investment properties; but once this is done, the benefits of section 117(j) are lost.

Respondent aduced no evidence that the land and buildings here in question were used or held for sale by Mr. Araneta in the ordinary course of his trade or business. On the other hand, the said property was used and held by the taxpayer for investment purposes by utilizing the land for farming. The buildings constructed on the said agricultural land were, however, depreciated by the accountant of Mr. Araneta. Will the depreciation of the buildings convert Hacienda Bonifacio into an ordinary asset? The answer is no because the test which deserves the greatest weight is the purpose for which the buildings were held, that is, whether they were used or held by the taxpayer "in the ordinary course of his trade or business." This test is justified by Section 30(f) of the Revenue Code which provides as follows:

(f) Depreciation:

(1) <u>In general</u>.- A reasonable allowance

> for deterioration of property arising out of its <u>use or employment in the trade or business, or out of its not being used</u>:
> xx xx xx.

We find that Section 34(a)(1) of our Revenue Code is patterned after Section 117(a)(1) of the U. S. Revenue Code of 1939. [26 USCA, Section 117(a)(1) and (j).] In interpreting and applying Section 117(j) of the U. S. Revenue Code which is similar to our law, the Court ruled that houses which were not used or held for sale in the trade or business of a taxpayer are capital assets. Thus, in the case of D. L. Phillips v. Commissioner of Internal Revenue (24 T. C. 451), the U. S. Tax Court held as follows:

> Our holding above that the vacant lots in Overbrook were held by petitioner primarily for sale is not inconsistent with our contrary view with respect to the houses. As stated above, vacant lots in general were a large part of petitioner's stock in trade as a real estate dealer. In the absence of evidence to the contrary, the sales of vacant lots in Overbrook at a profit during the years 1946 through 1951 are persuasive evidence that they were held primarily for that purpose at all times. The Overbrook <u>houses</u>, on the other hand, had been held by petitioner for rental purposes for a number of years prior to their sale, and a proper analysis of the circumstances surrounding their sale leads to a result differing materially from that relating to sales of vacant land which was not held for investment purposes.

After holding that the farm and building of Hacienda Bonifacio are capital assets, we also hold that the permanent improvements made by Mr. Araneta in the farm consisting of roads, railways, irrigation systems, etc., in order to make it productive and suitable as a sugar plantation are capital expenditures. (Sec. 120, Revenue Regulations No. 2.) The said expenditures should, therefore, be added to the acquisition cost of the land in determining the capital gain derived from the sale of Hacienda Bonifacio. Consequently, the ordinary gain of ₱120,162.40 allegedly realized by petitioners from the sale of Hacienda Bonifacio has no factual and legal basis.

6. Production expense of ₱4,312.53 of Hacienda Bonifacio in 1958.

Respondent's examiners disallowed the production expense of ₱4,312.53 on the theory that after the sale of Hacienda Bonifacio on October 31, 1958, petitioners were no longer the owners of said property. The theory of respondent on this score is untenable. In the first place, petitioners' 1958 amended income tax return shows that their income from farming during the said year amounted to ₱63,239.95. It is, therefore, inconceivable that the meager production expense of ₱4,312.53 were not incurred by petitioners. In the second place, even if Hacienda Bonifacio was disposed of by petitioners on October 31, 1958, the said expense in the cultivation and harvesting of the standing crops still owned by them are justified and reasonable. As the said expenses were deductible from petitioners' 1958 gross income, the same should not be considered as additional income of petitioners during the said year.

7. <u>50% surcharges as fraud penalty from 1957 to 1961</u>.

Respondent imposed the 50% surcharges on the deficiency income taxes due petitioners from 1957 to 1961 based on their undeclared income of ₱169,570.66 from farming and the profit realized from the sale of Hacienda Bonifacio in 1958. The said undeclared income were, however, reported in petitioners' amended income tax returns for said years, and the deficiency income taxes due thereon were paid by them pursuant to the offer of compromise contained in respondent's Memorandum Order No. 50-62 dated September 10, 1962.

Section 72 of the Revenue Code imposes the 50% surcharge as a fraud penalty in case a false or fraudulent return is willfully made by the taxpayers. In the instant case, the filing of the amended income tax returns for the years 1957 to 1961, inclusive, belies the fraudulent intent of the petitioners to deprive the Government of its lawful taxes. Moreover, fraud is a serious charge and, to be sustained, it must be supported by clear and convincing proof. (Republic v. Ker & Co., Ltd., G. R. No. L-21609, Sept. 29, 1966.) Consequently, as no evidence whatsoever was adduced by respondent to justify the fraud penalty, the 50% surcharge imposed on petitioners' deficiency income taxes is baseless and unjustified.

After resolving the factual and legal issues, there are still due and collectible from petitioners the following deficiency income taxes and interests, to wit:

1957

| | |
|---|---|
| Net income per return ------------------ | ₱ 96,009.84 |
| Add: Additional income: | |
| Interest income from J. Amado Araneta & Co. ------------- | 22,993.97 |
| Net income per decision ---------------- | ₱119,003.81 |
| Tax due on net taxable income of ₱116,003.81 -------------------------- | ₱ 33,582.00 |
| Less: Amount already assessed* --------- | 24,523.00 |
| Balance --------------------------------- | ₱ 9,059.00 |
| Add: ½% monthly interest for 3 years --- | 1,630.62 |
| TOTAL AMOUNT DUE & COLLECTIBLE --------- | ₱ 10,689.62 |

(*As to amount already assessed, see p. 84, BIR rec.)

1958

| | | |
|---|---|---|
| Net income per return ----------------- | | ₱ 73,783.44 |
| Add: Additional income: | | |
| Interest income from J. Amado Araneta & Co. ---------------- | ₱22,993.97 | |
| Interest income from Financing Corp. of the Philippines -------- | 3,600.00 | |
| Undeclared export proceeds --------------- | 8,130.85 | |
| Interest on sales tax payable ------------ | 9,176.24 | 43,901.06 |
| Net income per decision --------------- | | ₱ 117,684.50 |
| Tax due on net taxable income of ₱114,684.50 ------------------------- | | ₱ 33,054.00 |
| Less: Amount already assessed* -------- | | 16,646.00 |
| Balance -------------------------------- | | ₱ 16,408.00 |
| Add: ½% monthly interest for 3 years -- | | 2,953.44 |
| TOTAL AMOUNT DUE & COLLECTIBLE -------- | | ₱ 19,361.44 |

(*As to amount already assessed, see p. 95, BIR rec.)

1959

| | | |
|---|---|---|
| Net income per return ----------------- | | ₱ 91,092.54 |
| Add: Additional income: | | |
| Interest income from J. Amado Araneta & Co. ---------------- | ₱22,993.97 | |

| | | |
|---|---|---|
| Interest income from Financing Corp. of the Philippines | 1,600.00 | |
| 2½% additional planters share from M.S. Central | 5,770.11 | 30,564.08 |
| Net income per decision ------------------ | | ₱121,656.62 |

| | |
|---|---|
| Tax due on net taxable income of ₱118,656.62 ------------------------------ | ₱ 46,781.00 |
| Less: Amount already assessed ------------ | 40,760.00 |
| Balance ------------------------------------ | ₱ 6,021.00 |
| Add: ½% monthly interest for 3 years ------ | 1,083.78 |
| TOTAL AMOUNT DUE & COLLECTIBLE ----------- | ₱ 7,104.78 |

1960

| | | |
|---|---|---|
| Net income per return -------------------- | | ₱ 88,994.72 |
| Add: Additional income: | | |
| Interest income from J. Amado Araneta & Co. -- | ₱22,993.97 | |
| Interest income from Financing Corp. of the Philippines ---------- | 1,817.31 | |
| | ₱24,811.28 | |
| Less: Dividend income belonging to J. Amado Araneta & Co. declared as personal income -------- | (15,869.00) | 8,942.28 |
| Net income per decision --------------- | | ₱ 97,937.00 |

| | |
|---|---|
| Tax due on net taxable income of ₱94,937.00 ---------------------------- | ₱ 34,549.00 |
| Less: Amount already assessed ---------- | 30,157.00 |
| Balance ------------------------------ | ₱ 4,392.00 |
| Add: ½% monthly interest for 3 years --- | 790.56 |
| TOTAL AMOUNT DUE & COLLECTIBLE --------- | ₱ 5,182.56 |

No deficiency income tax is due from petitioners for 1961 because the undeclared interest income of ₱22,993.97 from J. Amado Araneta & Co. is very much less than the dividend income of ₱31,738.00 declared in the original individual income tax return of Mr. J. Amado Araneta although the said amount pertains to the corporate income of J. Amado Araneta & Co.

The deficiency income taxes and interests due from the spouses J. Amado Araneta and Ester Araneta are itemized as follows:

| Year Involved | Total Amount Due |
|---|---|
| 1957 ---------- | ₱10,689.62 |
| 1958 ---------- | 19,361.44 |
| 1959 ---------- | 7,104.78 |
| 1960 ---------- | 5,182.56 |
| TOTAL ------------ | ₱42,338.40 |

WHEREFORE, the decision of respondent Commissioner of Internal Revenue is modified. Petitioners are hereby ordered to pay respondent Commissioner of Internal Revenue or his duly authorized collection agent the amount of ₱42,338.40 as deficiency income taxes and interests for 1957 to 1960, inclusive. If the said amount is not paid within thirty (30) days from the date the decision becomes final and executory, petitioners are hereby ordered further to pay to respondent the additional delinquency interest of 1% a month until the amount due is fully paid, but said interest of 1% is limited to three (3) years or a maximum of 36%.

SO ORDERED.

Quezon City, November 6, 1970

(Sgd.) ESTANISLAO R. ALVAREZ
Associate Judge

I CONCUR:

(Sgd.) RAMON L. AVANCEÑA
Associate Judge

Presiding Judge ROMAN M. UMALI concurs and dissents in a separate opinion.

CONCURRING AND DISSENTING OPINION OF PRESIDING JUDGE ROMAN M. UMALI

C.T.A. CASE No. 1699

I concur in the opinion of my colleagues that the assessment against petitioners should be modified, but I dissent with respect to the portion which holds that farm buildings for which depreciation deduction was claimed are capital assets which are subject to the capital gain and loss provisions of the Income Tax Law.

The term "capital assets" is defined in Section 34 of the National Internal Revenue Code as follows:

> Sec. 34. Capital gains and losses.- (a) Definitions.- As used in this Title -
>
> (1) Capital assets. - The term "capital assets" means property held by the taxpayer (whether or not connected with his trade or business), but does not include stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business, or property, used in the trade or business, of a character which is subject to the allowance for depreciation provided in subsection (f) of section thirty; or real property used in the trade or business of the taxpayer.

Under this statutory definition of capital assets, "property used in the trade or business, of a character which is subject to the allowance for depreciation x x x x or real property used in the trade or business of the taxpayer" is not considered capital asset. For purposes of the deduction from gross income provided in Section 30 of the Revenue Code, farming is considered a business. It is for this reason that farmers are allowed to claim deduction for ordinary and necessary expenses incurred in their farming business under paragraph (a) and depreciation deduction for property used in the farm having a useful life of more than one year under paragraph (f) of said Section 30 of the Revenue Code. For convenience, Section 75 of Revenue Regularions No. 2 (Income Tax Regulations) is reproduced in full below:

> Sec. 75. EXPENSES OF FARMERS.- A farmer who operates a farm for profit is entitled to deduct from gross income as necessary expenses all amounts actually expended in the carrying on of the business of farming. The cost of ordinary tools of short life or small cost, such as hand tools, including shovels, rakes, etc., may be included. The cost of feeding and raising livestock may be treated as an expense deduction, in so far as such cost represents actual outlay, but not including the value of farm produce grown upon the farm or the labor of the taxpayer. Where a farmer is engaged in producing crops which take more than a year from the time of planting to the process of gathering and disposal, expenses deducted may be determined upon the crop basis, and such deductions must be taken in the year in which the gross income from the crop has been realized. The cost of farm machinery, equipment, and farm buildings represents a capital investment and is not an allowable deduction as an item of expense. Amounts expended in the development of farms, orchards, and ranches, prior to the time when the productive state is reached may be regarded as investments of capital. Amounts expended in purchasing work, breeding or dairy animals are regarded as investments of capital,

> and may be depreciated unless such animals are included in an inventory in accordance with section 149 of these regulations. The purchase price of transportation equipment even when wholly used in carrying on farm operations, is not deductible but is regarded as an investment of capital. The cost of gasoline or fuel, repairs, and upkeep of the transportation equipment if used wholly in the business of farming is deductible as an expense; if used partly for business purposes and partly for the pleasure or convenience of the taxpayer or his family, such cost may be apportioned according to the extent of the use for purposes of business and pleasure or convenience, and only the proportion of such cost justly attributable to business purposes is deductible as a necessary expense. If a far is operated for recreation or pleasure and not on a commercial basis, and if the expenses incurred in connection with the farm are in excess of the receipt therefrom, the entire receipts from the sale of products may be ignored in rendering a return of income, and the expenses incurred, being regarded as personal expenses, will not constitute allowable deduction.

It does not seem proper, therefore, to treat the gain derived from the sale of property used in the farm of petitioners, for which depreciation deduction was claim as a capital gain entitled to the capital gain treatment under Section 34 of the Revenue Code. The same should be treated as an ordinary gain taxable in full.

(Sgd.) ROMAN M. UMALI
Presiding Judge