REPUBLIC OF THE PHILIPPINES
COURT OF TAX APPEALS
MANILA

SANTIAGO GANCAYCO,
Petitioner,

- versus -   C.T.A. CASE NO. 287

COLLECTOR OF INTERNAL REVENUE,
Respondent.

x- - - - - - - - - - - - - -x   Nov. 14, 1957

DECISION

This is a petition for review of the decision of the respondent holding the petitioner liable for the payment of ₱16,860.31, as deficiency income tax for the year 1949. Two preliminary questions were raised before the hearing on the merits. Petitioner sought the cancellation of the sale at public auction of certain real properties levied upon by respondent, and the latter sought to have the appeal dismissed on the ground that the appeal was filed beyond the thirty-day period prescribed in Section 11 of Republic Act No. 1125. These questions were resolved in our resolutions of August 27, 1956 and October 27, 1956. The case is now before us for consideration on the merits.

The issues raised are: (1) whether the sums of ₱27,459.00, as alleged farming expenses, and ₱8,893.45, as alleged entertainment and representation expenses, are deductible from the gross income of petitioner for 1949, and (2) whether or not the right of respondent to collect the deficiency tax of ₱16,860.31 has prescribed.

In all the pleadings and memoranda submitted by the parties it does not appear how the deficiency income tax of ₱16,860.31 was arrived at. Since the parties have designated it as merely the deficiency income tax for 1949, we will assume that it is the deficiency income tax proper, exclusive of any surcharge and interest, and that assuming that the disallowance of the sums of ₱27,459.00 and ₱8,893.45 by respondent is proper, the deficiency tax of ₱16,860.31 has been correctly computed.

The first item disallowed is the sum of ₱27,459.00, designated by the parties as "farming expenses". In the income tax return of petitioner, it is identified as expenses for "Labor, milling, etc." This amount was disallowed on the ground that it was spent in clearing and developing the Hacienda San Miguel of petitioner necessary to bring the hacienda into a productive state, the said hacienda having been acquired only in the same year (1949). Petitioner admits that said amount was spent "in the development and cultivation of (his) property at San Miguel, Tabaco, Albay." (Exhibit M.)

Section 30 (a) (1) of the National Internal Revenue Code allows the deduction from gross income of all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on a trade or business. In the case of farmers, the regulations enumerate the items which are generally allowed as deductions and those which are not deductible but may be capitalized. Section 75 of Revenue Regulations No. 2, 39 O. G. 325, provides:

"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 live stock 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 expenses. If a farm 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 deductions."

No evidence has been presented as to the nature of the said "farming expenses" other than the bare statement of petitioner that they were spent for the "development and cultivation of (his) property." No specification has been made as to the actual amount spent for purchase of tools, equipment or materials, or the amount spent for improvements. Respondent claims that the entire amount was spent exclusively for clearing and developing the farm which were necessary to place it in a productive state. It is not, therefore, an ordinary expense but a capital expenditure. Accordingly, it is not deductible but it may be amortized, in accordance with Section 75 of Revenue Regulations No. 2, cited above. See also Section 31 of the Revenue Code which provides that in computing net income, no deduction shall in any case be allowed in respect of any amount paid out for new buildings or for permanent improvements, or betterments made to increase the value of any property or estate.

In order that an item of expenditure may be deductible, it is required that each year's return, so far as practicable, both as to gross income and deductions therefrom, should be complete in itself, and taxpayers are expected to make every reasonable effort to ascertain the facts necessary to make a correct return. (Sec. 76, Rev. Regulations No. 2.) Petitioner having failed to comply with this requirement, we agree with respondent that the claimed deduction must be disallowed.

The second item of ₱8,893.31 represents alleged entertainment and representation expenses. Counsel for petitioner has apparently confused this amount with the amount of ₱31,121.77 which was claimed as entertainment and representation expenses of S. Gancayco, Inc. Of the said amount of ₱31,121.77, 50% was allowed by respondent. (See Exh. H-1.) The income tax case of S. Gancayco, Inc. is not in issue here.

The sum of ₱8,893.31 claimed as entertainment and representation expenses by petitioner in his individual capacity was disallowed by respondent on the ground that the expenses were personal and not deductible under Section 31 (a) (1) of the Revenue Code. No evidence has also been presented as to when the amount was spent, whether on one occasion or on several occasions; the person or persons entertained; the relation of such person or persons with petitioner; the amount spent in each occasion; and whether or not the business of petitioner was directly or indirectly benefited by such expenses. In order to qualify for deduction, it must be clearly shown that the amount claimed to have been spent for entertainment and representation must have been both ordinary and necessary expenses for the promotion of the business. Petitioner failed to adduce any evidence to prove the deductibility of said amount.

> "Expenses which are described as being ordinary and necessary generally contemplate expenses which are directly connected with and proximately resulting from carrying on the business and must be shown to be appropriate and helpful in the development of the taxpayer's business for the acquisition or

pursuit of income or profit (Deputy vs. Du Pont, 308 U.S. 488, 84 L. Ed. 416; Welch vs. Helvering, 290 U.S. 111, 78 L. Ed. 212). In connection with this case, it may be stated in passing, that it has become a business, and to a certain extent a professional practice to entertain actual or prospective customers or clients. Since expenses of this nature generally consist of a mixture of personal and business purposes, whether or not such expenditures will be allowed, will depend upon the factor of the necessity of such expenses to earn the income, or that direct business benefits would be derived from such expenditures, or whether the expenses have some definite reasonable purpose connected with the business in hand and reasonably calculated to accomplish the end sought (see 4 Mertens, Law of Federal Income Taxation, 467-468). In this instance, the burden of proof is on the taxpayer to show that such expenditures were primarily business rather than personal expenses." (John T. Hicks vs. Collector of Int. Rev., C.T.A. Case No. 38, October 19, 1955, 52 Off. Gaz. No. 6, pp. 3157, 3159.)

We are, however, asked to apply the rule laid down in the case of Cohan v. Commissioner, 39 F (2d) 540, 8 AFTR 10552, where it was held that in case of the impossibility of determining the precise amount spent for entertainment and representation, it is the duty of the court to make a detemmination, even if the result be merely an approximation. XXY, In that case it was held:

"In the production of his plays Cohan was obliged to be free-handed in entertaining actors, employees, and, as he naively adds, dramatic critics. He had also to travel much, at times with his attorney. These expenses amounted to substantial sums, but he kept no account and probably could not have done so. At the trial before the Board he estimated

> that he had spent eleven thousand dollars in this fashion during the first six months of 1921, twenty-two thousand dollars, between July first, 1921, and June thirtieth, 1922, and as much for his following fiscal year, fifty-five thousand dollars in all. The Board refused to allow him any part of this, on the ground that it was impossible to tell how much he had in fact spent, in the absence of any items or details. The question is how far this refusal is justified, in view of the finding that he had spent much and that the sums were allowable expenses. Absolute certainty in such matters is usually impossible and is not necessary; the Board should make as close an approximation as it can, bearing heavily if it chooses upon the taxpayer whose inexactitude is of his own making. But to allow nothing at all appears to us inconsistent with saying that something was spent. True, we do not know how many trips Cohan made, nor how large his entertainments were; yet there was obviously some basis for computations, if necessary by drawing upon the Board's personal estimates of the minimum of such expenses. The amount may be trivial and unsatisfactory, but there was basis for some allowance, and it was wrong to refuse any, even though it were the traveling expenses of a single trip. It is not fatal that the result will inevitably be speculative; many important decisions must be such. We think that the Board was in error as to this and must reconsider the evidence."

There is no parity between the Cohan case and this case. In the former, there was evidence of the amount of the expenses, the persons entertained, and the necessity of entertaining such persons. In this case, there is no such evidence. It is merely claimed that the amount of ₱8,893.31 was spent for entertainment and representation. No account or any detail has been given upon which to base an estimate of the amount which may be allowed as a deduction.

We had occasion recently to apply the rule laid down in the Cohan case. In Visayan Cebu Terminal Co., Inc. v. Collector of Internal Revenue, C.T.A. Case No. 128, June 29, 1957, the sum of ₱75,855.88 was claimed as a deduction for representation expenses. The entire amount was disallowed by the Collector on the ground that the disbursements partook of dividend distributions. Evidence was presented to the effect that at least part of the amount was spent to entertain customers and for payment of hotel and accommodation charges of the officers of the corporation while traveling for the business of the corporation. In deciding to allow the deduction of a part of the amount claimed, this Court stated:

> "As to how the amounts claimed by the officers and members of the Board were spent, Casco testified that, with respect to the manager, they were spent for 'hotel and accommodation charges and entertainment expenses while in Manila; entertainment of the agents of the ship and other officers and also importers when he comes to Manila on official business for the Company.' As regards the members of the Board, he testified that 'they used to present chits covering their expenses forthe entertainments of friends who came from other places to see Cebu to get indentions of their imports. The members of the Board of Directors or the liason officers entertained them, in which case these liason officers submitted hotel and accommodation expenses and also transportation expenses.' x x x
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> "From the evidence adduced by appellant, there were two sets of representation expenses. One covers expenses supported by appropriate vouchers and chits; the other covers expenses without supporting papers. It is alleged that the records were destroyed when the house of Buenaventura M. Veloso, treasurer of appellant, where the records were kept was burned. We may, therefore, accept as correct the fact that at least a portionof the amount of ₱75,855.88

> was spent for representation expenses of appellant corporation, while the portion thereof not covered by supporting papers was spent for purposes not clearly established. The first qualifies for the deduction, the other does not. It is up to us to determine from all available data the amount properly deductible as representation expenses. It would seem unjust to disallow the deduction of the entire amount for lack of documentary evidence to establish the precise amount beyond a reasonable doubt."

There is also no parity between the case of the Visayan Cebu Terminal and this case. The sole allegation that an amount was spent for entertainment and representation does not supply any reasonable basis for estimating the amount deductible under the law. We are, therefore, constrained to affirm the disallowance made by respondent of the entire amount.

We now come to the second issue whether or not the right of respondent to collect the deficiency income tax for 1949 has prescribed.

The law prescribes two remedies for the collection of internal revenue taxes, viz.; "(a) by distraint of goods, chattels, or effects, and other personal property of whatever character, including stocks and other securities, debts, credits, bank accounts, and interest in and rights to personal property, and by levy upon real property and interest in or rights to real property; and (b) by judicial action. Either of these remedies or both simultaneously may be pursued in the discretion of the authorities charged with the collection of such taxes." (Sec. 316, Revenue Code.) Collection of internal revenue taxes in general by distraint of levy and by judicial action may be pursued by the Collector of Internal Revenue within the periods of limitation provided in Sections 331 and 332 of the Revenue Code. However, with respect to income taxes, collection by distraint or levy may be effected only within three years after the return was filed, or, in case of a failure to file a return, from the date the same was due. (Sec. 51 (d), id.) After the three-year period, the collection of income tax by distraint and levy is illegal and void. (Collector of Int. Rev. v. Avelino, G.R. No. L-9202, Nov. 19, 1956; Collector of Int. Rev. v. Reyes, G.R. No. L-8685, Jan. 31, 1957; Collector of Int. Rev. v. Zulueta, G.R. No. L-8840, Feb. 8, 1957; Sambreno v. Court of Tax Appeals, G.R. No. L-8652, March 30, 1957.) In such case, collection may be effected only by judicial action within the periods of limitation prescribed in Sections 331 and 332. This has been the consistent opinion of this Court which has been followed and observed in a long line of decisions.

> 1. After three years from the filing of an income tax return, the Government cannot collect income tax by distraint and levy; but it may do so by judicial action within five years from the date the return was filed, if there was no assessment, or within five years from the date of assessment. (Intestate Estate of N. T. Hashim, Manila Civil Case No. 71131, June 11, 1956; Adriano Chua Joy v. Collector of Int. Rev., C.T.A. No. 245, May 25, 1956; Republic of the Phil. v. Canlas, Manila C. C. No. 22366, June 16, 1956; Suyoc Consoli-

dated Mining Co. v. Collector of Int. Rev., C.T.A. No. 189, Sept. 27, 1956; Solano v. Collector of Int. Rev., C.T.A. No. 208, Oct. 5, 1956; Jose Ng Suy v. Collector of Int. Rev., C.T.A. No. 321, July 1, 1957; Bohol Land Transp. Co. v. Collector of Int. Rev., C.T.A. No. 261, Sept. 26, 1957.)

2. Where the taxpayer failed to file his income tax return, the Collector of Internal Revenue may aseess the tax within ten years from the date of discovery of the omission, and may collect the tax without assessment by judicial action within the same period. (Eufemia Evangelista v. Collector of Int. Rev., C.T.A. No. 53, Nov. 23, 1955, affirmed by the Supreme Court in G.R. No. L-9996, Oct. 15, 1957.)

3. In case of fraud, income tax may be collected without assessment by judicial action within ten years from the date of discovery of the fraud, or within five years from the date of assessment, if an assessment has been made. (Reyes v. Collector of Int. Rev., C.T.A. No. 42, Jan. 8, 1955, affirmed in G.R. No. L-8685, Jan. 31, 1957; Perez v. Araneta, B.T.A. No. 189, Feb. 13, 1956; William Li Yao v. Collector of Int. Rev., C.T.A. No. 30, July 31, 1956; Elvira Buenaventura v. Collector of Int. Rev., C.T.A. No. 139, June 24, 1957.)

In this case, petitioner filed his 1949 income tax return on May 10, 1950. After three years from that date, or from May 11, 1953, any warrant of distraint and levy issued by respondent to enforce collection of the deficiency income tax assessed against petitioner for the year 1949 is illegal and void. However, since the deficiency tax was assessed on April 8, 1953, collection thereof may be enforced by judicial action within five years from said date. The five-year period is to be counted from April 8, 1953, and not from May 14, 1951, the date of the original assessment, because the latter assessment was superseded by the one issued on April 8, 1953, which reduced the original assessment. (Suyoc Consolidated Mining Co. v. Collector of Int. Rev., C.T.A. No. 189, Sept. 27, 1956.) Judicial action having been instituted by petitioner himself when he appealed to this Court on June 14, 1956, the right of the government to collect the said deficiency income tax has not prescribed. (Alhambra Cigar & Cigarette Mfg. Co. v. Collector of Int. Rev., C.T.A. No. 143, Jan. 31, 1957; Jose Ng Suy v. Collector of Int. Rev., C.T.A. No. 321, July 1, 1957; Bohol Land Transportation Co. v. Collector of Int. Rev., C.T.A. No. 261, Sept. 25, 1957.)

FOR THE FOREGOING CONSIDERATIONS, the decision appealed is hereby affirmed. Petitioner is hereby required to pay the sum of ₱16,860.31, plus the corresponding surcharge and interest from the date of delinquency. With costs against petitioner.

SO ORDERED.

Manila, November 14, 1957.

R. M. Umali
ROMAN M. UMALI
Associate Judge

WE CONCUR:

MARIANO NABLE
Presiding Judge

AUGUSTO M. LUCIANO
Associate Judge