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REPUBLIC OF THE PHILIPPINES
COURT OF TAX APPEALS
MANILA

FERNANDEZ HERMANOS, INC.,
Petitioner,

- versus -

June 10, 1963

C.T.A.
CASE NO. 787

THE COMMISSIONER OF INTERNAL
REVENUE,
Respondent.

x - - - - - - - - - - - - - - x

D E C I S I O N

The respondent assessed against the petitioner the sums of ₱13,414.00, ₱119,613.00, ₱11,698.00, ₱6,887.00 and ₱14,451.00, as alleged deficiency income tax for the years 1950, 1951, 1952, 1953 and 1954, respectively. These income tax deficiencies were the result of alleged discrepancies found in the income tax returns of petitioners for said years, which are summarized below:

1. Losses -

a. Losses in Mati Lumber Co. (1950) ----------	₱ 8,050.00
b. Losses in or bad debts of Palawan Manganese Mines, Inc. (1951) ---	383,134.25
c. Losses in Balamban Coal Mines - 1950 ----	8,989.76
1951 ----------------	27,732.66
d. Losses in Hacienda Dalupiri -	
1950 ----------------	17,418.95
1951 ----------------	29,125.82
1952 ----------------	26,744.81
1953 ----------------	21,932.62
1954 ----------------	42,938.56
e. Losses in Hacienda Samal-	
1951 ----------------	8,380.25
1952 ----------------	7,621.73

2. Excessive depreciation of houses -

1950 ----------------	₱ 8,180.40
1951 ----------------	8,768.11
1952 ----------------	18,002.16
1953 ----------------	13,655.25
1954 ----------------	29,314.98

3. Taxable increase in net worth -

1950 ----------------	30,050.00
1951 ----------------	1,382.85

4. Gain realized from sale of real property in 1950 --- 11,147.26

In this appeal, two main issues have been raised by the parties, viz.: (1) the correctness of respondent's determination with respect to the disputed items described above, and (2) whether or not the right of the Government to collect the deficiency income tax in question has already prescribed.

We will first consider the second issue.

Section 332 of the National Internal Revenue Code provides that where the assessment of an internal revenue tax has been made within the time prescribed by law, such tax may be collected by judicial action within 5 years from the date of assessment. In the case of a disputed assessment appealed by the taxpayer to this Court, the "judicial action" is deemed to have been commenced on the date of the filing of the appeal, and not on the date of the filing of respondent's answer.

> "It is but logical to conclude that the judicial action for collection of an internal revenue tax is deemed commenced with the filing of the taxpayer's appeal with this Court, for the purpose of reckoning the prescriptive period for collection under Sections 316 and 332 of the Revenue Code, for the following reasons. In the first place, when the taxpayer appeals from the decision of the Commissioner of Inter-

> nal Revenue, the latter is precluded from instituting an action for collection in the ordinary courts. (See Ledesma v. C.T.A., G. R. No. L-11343, Jan. 29, 1958.) If the appeal is filed on the last day of the fifth year after assessment, and the answer of the Commissioner is filed after fifteen days, is it just that the Government be declared barred from collecting the tax because the answer was filed fifteen days after the five-year period for collection, when it was prohibited from instituting judicial action upon the filing of the taxpayer's appeal? In the second place, if the Commissioner, through oversight, negligence or otherwise of his counsel, should fail to file answer and he is declared in default, as has actually happened in some cases, is it reasonable to conclude that no judicial action has been commenced despite the pendency of the appeal and the authority of this Court to pronounce judgment as to the taxpayer's liability? If such be the case, the running of the prescriptive period would continue to run notwithstanding the pendency of the appeal, which is admittedly unreasonable and unjust on the part of the Government, and contrary to the doctrine laid down by the Supreme Court in the cases of the Alhambra Cigar &Cigarette Mfg. Co.,[1] Bohol Land Transp. Co.[2] and Gancayco,[3] supra." (Manuel P. Sunga v. Commissioner of Int. Rev., C.T.A. No. 676, Oct. 25, 1961.)

In this case, petitioner contends that the assessment was made on December 27, 1955. On the other hand, respondent contends that the assessment was made on February 24 and 27, 1956. Whichever date is correct is immaterial as the herein appeal was filed on May 4, 1960, which is less than five years from December 27, 1955. Therefore, the right to collect the tax in question has not yet prescribed.

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[1] G. R. Nos. L-12026 & L-12131, May 29, 1959.
[2] G. R. Nos. L-13099 & L-13462, April 29, 1960.
[3] G. R. No. L-13325, April 20, 1961.

We now come to the disputed items. The first of these items is the sum of ₱8,050.00, the value of the shares of stock of Mati Lumber Co. acquired by petitioner on January 1, 1948. These shares of stock were determined by petitioner to be worthless in 1950. Consequently, the sum of ₱8,050.00, representing the cost of said shares, was written off in its books in said year and was claimed as a loss deduction in its income tax return for said year. Respondent disallowed the deduction solely on the ground that the worthlessness of said shares of stock was not clearly established in 1950.

The evidence shows that sometime in 1950 petitioner became aware that Mati Lumber Co. ceased to operate in 1949. For this reason, investigation was made as to the financial status of said company. The report submitted to petitioner was to the effect that the company ceased operations in 1949 when its manager and owner, a certain Mr. Rocamora, left for Spain where he subsequently died. When the company ceased to operate, it had no assets, in other words, completely insolvent. This information as to the insolvency of the company having reached petitioner in 1950, it took immediate steps to write off the investment as worthless and consequently claimed the loss as a deduction in its income tax return for 1950. These facts are supported by the evidence. We, therefore, find and hold that said investment has been proven to be worthless; that it was ascertained to be worthless in 1950; and that it was properly claimed as a loss deduction in said year, pursuant to Section 30(d)(4)(B) or Section 30(e)(3).]

Petitioner deducted in 1951 the sum of ₱353,134.25, representing alleged losses in or bad debts of Palawan Manganese Mines, Inc. Respondent claims that the deduction is not allowable either as losses or as bad debts.

Sometime in 1945, Palawan Manganese Mines, Inc., the controlling stockholders of which are also the controlling stockholders of petitioner corporation, requested financial help from petitioner to enable it to resume its mining operations in Coron, Palawan. The request for financial assistance was readily and unanimously approved by the Board of Directors of petitioner, and thereafter a memorandum agreement was executed on August 12, 1945, embodying the terms and conditions under which the financial assistance was to be extended, the pertinent provisions of which are as follows:

> "WHEREAS, the FIRST PARTY, by virtue of its resolution adopted on August 10, 1945, has agreed to extend to the SECOND PARTY the requested financial help by way of accommodation advances and for this purpose has authorized its President, Mr. RAMON J. FERNANDEZ to cause the release of funds to the SECOND PARTY;
>
> "WHEREAS, to compensate the FIRST PARTY for the advances that it has agreed to extend to the SECOND PARTY, the latter has agreed to pay to the former fifteen per centum (15%) of its net profits.
>
> "NOW THEREFORE, for and in consideration of the above premises, the parties hereto have agreed and covenanted that in consideration of the financial help to be extended by the FIRST PARTY to the SECOND PARTY to enable the latter to resume its mining operations in Coron, Palawan, the

> SECOND PARTY has agreed and undertaken as it hereby agrees and undertakes to pay to the FIRST PARTY fifteen per centum (15%) of its net profits." (Exh. H-2.)

Pursuant to the agreement mentioned above, petitioner gave to Palawan Manganese Mines, Inc. yearly advances starting from 1945, which advances amounted to ₱587,308.07 by the end of 1951. Despite these advances and the resumption of operations by Palawan Manganese Mines, Inc., it continued to suffer losses. By 1951, petitioner became convinced that those advances could no longer be recovered. While it continued to give advances, it decided to write off as worthless the sum of ₱353,134.25. This amount "was arrived at on the basis of the total of advances made from 1945 to 1949 in the sum of ₱438,981.39, from which amount the sum of ₱85,847.14 had to be deducted, the latter sum representing its pre-war assets (t.s.n. pp. 136-139, Id)." (Page 4, Memorandum for Petitioner.) Petitioner decided to maintain the advances given in 1950 and 1951 in the hope that it might be able to recover the same, as in fact it continued to give advances up to 1952. From these facts, and as admitted by petitioner itself, Palawan Manganese Mines, Inc. was still in operation when the advances corresponding to the years 1945 to 1949 were written off the books of petitioner. Under the circumstances, was the sum of ₱353,134.25 properly claimed by petitioner as deduction in its income tax return for 1951, either as losses or bad debts?

✓It will be noted that in giving advances to Palawan Manganese Mines, Inc. petitioner did not expect to be repaid. It is true that some testimonial evidence was presented to show that there was some agreement that the advances would be repaid, but no documentary evidence was presented to this effect. The memorandum agreement signed by the parties appears to be very clear that the consideration for the advances made by petitioner was 15% of the net profits of Palawan Manganese Mines, Inc. In other words, if there were no earnings or profits, there was no obligation to repay those advances. It has been held that voluntary advances made without expectation of repayment do not result in deductible losses. 1955 PH Fed. Taxes, Par. 13,329, citing W. F. Young, Inc. v. Comm., 120 F. 2d 159, 27 AFTR 395; George B. Markle, 17 T.C. 1593.

Is the said amount deductible as a bad debt? As already stated, petitioner gave advances to Palawan Manganese Mines, Inc. without expectation of repayment. Petitioner could not sue for recovery under the memorandum agreement because the obligation of Palawan Manganese Mines, Inc. was to pay petitioner 15% of its net profits, not the advances. No bad debt could arise where there is no valid and subsisting debt.

Again, assuming that in this case there was a valid and subsisting debt and that the debtor was incapable of paying the debt in 1951, when petitioner wrote off the advances and deducted the amount in its return for said year, yet the debt is not deductible in 1951 as a worthless debt. It appears that the debtor was still in operation in 1951 and 1952, as petitioner continued to give advances in those years. It has been held that if the debtor corporation, although losing money or insolvent, was still operating at the end of the taxable year, the debt is not considered worthless and therefore not deductible. 1955 PH Fed. Taxes, Par. 13, 867, citing Equinox Co., 2 B.T.A. 466; Baumann Rubber Co., 4 B.T.A. 671; John Lutz, 9 B.TA. 23; Peabody Coal Co., 18 B.T.A. 1081, affd. in 55 F. 2d 7, 10 AFTR 1025; Clifford Yewdall, Par. 54,087 P-H Memo TC.

Petitioner spent for the operation of its Balamban Coal Mines in Cebu ₱8,989.76 in 1950 and ₱27,732.66 in 1951. These amounts were deducted by petitioner as losses in its returns for said years. The deduction was disallowed by respondent on the ground that the expenditures should have been capitalized, or if they are deductible losses, the losses are deductible in 1952, not in 1950 and 1951.

The disbursements consisted of engineer's and men's payrolls, supplies, tools, taxes and other extraction costs. As there was no road or outlet through which coal products could be transported from the mines to the provincial road, it became necessary to abandon the mines, and they were actually abandoned in 1952. Considered as losses, we agree with respondent that they are deductible in 1952, when the mines were abandoned, and not in 1950 and 1951 when they were still in operation.

"Running through this chapter as a constantly basic proposition is the thought that losses must always be established by

> some identifiable event. The event may be a sale; it may be the destruction of, or injury to property; or it may be the abandonment of property. But in all cases, some definite event must fix the time when the loss is sustained." (Merten's Law of Federal Income Taxation. Vol. 5, Sec. 28.04. pp. 8-9, cited with approval in the Memorandum for Petitioner, p. 20; underscoring supplied.)

In this case, the event which definitely fixed the time when the loss was sustained was the abandonment of the mines in 1952. The expenditures in 1950 and 1951 could not have been considered losses prior to the abandonment of the mines. The disallowance of the deduction has to be sustained.

Petitioner deducted losses in the operation of its Hacienda Dalupiri the sums of ₱17,418.95 in 1950, ₱29,125.82 in 1951, ₱26,744.81 in 1952, ₱21,932.62 in 1953, and ₱42,938.56 in 1954. These deductions were disallowed by respondent on the ground that the farm was operated solely for pleasure or as a hobby and not for profit. This conclusion is based on the fact that the farm was operated continuously at a loss.

From the evidence, we are convinced that the Hacienda Dalupiri was operated by petitioner for business and not for pleasure. It was mainly a cattle farm, although a few race horses were also raised. It does not appear that the farm was used by petitioner for entertainment, social activities, or other non-business purposes. Therefore, it is entitled to deduct expenses and losses in connection with the operation of said farm. (See 1955 PH Fed. Taxes, Par. 13,663, citing

G. C. M. 21103, CB 1939-1, p. 164.)

Section 100 of Revenue Regulations No. 2, otherwise known as the Income Tax Regulations, authorizes farmers to determine their gross income on the basis of inventories. Said regulations provides:

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

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

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

As the Hacienda Dalupiri was operated by petitioner for business and since it sustained losses in its operation, which losses were determined by means of inventories authorized under Section 100 of Revenue Regulations No. 2, it was error for respondent to have disallowed the deduction of said losses. The same is true with respect to losses sustained in the operation of the Hacienda Samal for the years 1951 and 1952.

During the years 1950 to 1954, petitioner claimed a depreciation allowance for its buildings at the rate of 10%. Respondent claims that the reasonable allowance for depreciation is only 3%. Accordingly, the amount claimed as depreciation allowance in excess of 3% was disallowed as excessive. Petitioner has not submitted adequate proof of the correctness of its determination that the depreciable assets in question had a useful life of only 10 years. We are, therefore, constrained to sustain the disallowance made by respondent.

For the year 1950, respondent determined that petitioner had an increase in net worth in the sum of ₱30,050.00, and for the year 1951, the sum of ₱1,282.85. These amounts were treated by respondent as taxable income of petitioner for said years.

It appears that petitioner had an account with the Manila Insurance Company, the records bearing on which were lost. When its records were reconstituted, the amount of ₱349,800.00 was set up as its liability to the Manila Insurance Company. It was discovered later that the correct liability was only ₱319,750.00, or a difference of ₱30,050.00, so that the records were adjusted so as to show the correct liability. The correction or adjustment was made in 1950. Respondent contends that the reduction of petitioner's liability to Manila Insurance Company resulted in the increase of petitioner's net worth to the extent of ₱30,050.00 which is taxable. This is erroneous. The principle underlying the taxability of an increase in the net worth of a taxpayer rests on the theory that such an increase in net worth, if unreported and not explained by the taxpayer, comes from income derived from a taxable source. (See Perez v. Araneta, G. R. No. L-9193, May 29, 1957; Coll. v. Reyes, G. R. Nos. L-11534 & L-11558, Nov. 25, 1958.) In this case, the increase in the net worth of petitioner for 1950 to the extent of ₱30,050.00 was not the result of the receipt by it of taxable income. It was merely the outcome of the correction of an error in the entry in its books relating to its indebtedness to the Manila Insurance Company. The Income Tax Law imposes a tax on income; it does not tax any or every increase in net worth whether or not derived from income. Surely, the said sum of ₱30,050.00 was not income to petitioner, and it was error for respondent to assess a deficiency income tax on said amount.

The same holds true in the case of the alleged increase in net worth of petitioner for the year 1951 in the sum of ₱1,382.85. It appears that certain items (all amounting to ₱1,382.85) remained in petitioner's books as outstanding liabilities of trade creditors. These accounts were discovered in 1951 as having been paid in prior years, so that the necessary adjustments were made to correct the errors. If there was an increase in net worth of the petitioner, the increase in net worth was not the result of receipt by petitioner of taxable income.

The last disputed item relates to the discrepancy in the basis of a certain real property which was sold in 1950. The evidence shows that this property was acquired in 1926 for ₱11,852.74 and was sold in

1950 for ₱60,000.00, apparently resulting in a gain of ₱48,127.26. Petitioner reported in its return a gain of ₱37,000.00, or a discrepancy of ₱11,852.74. It was sufficiently proved during the hearing that, after acquiring the property, petitioner made improvements the value of which have been duly recorded. The total value of these improvements was ₱11,852.74, so that the gain derived by petitioner from the sale of said property was correctly reported. The decision of respondent on this point must have to be reversed.

In line with the foregoing opinion, the deficiency income tax due from petitioner for the years under review amounts to ₱123,436.00, itemized and computed as follows:

1950

Net income per respondent -----		₱ 230,739.45
Deduct:		
1. Losses in Mati Lumber Co. ----	₱ 8,050.00	
2. Increase in net worth arising from correction of error--	30,050.00	
3. Losses in Hacienda Dalupiri-	17,418.95	
4. Gain from sale of real property offset by value of improvements-	11,147.26	66,666.21
Net taxable income -------------		₱164,073.00
Tax @ 16% ----------------------		26,252.00
Less amount previously paid ----		23,504.00
Deficiency income tax ----------		₱ 2,748.00

1951

Net income per respondent ------		₱523,855.14
Deduct:		
1. Increase in net worth resulting from correction of erroneous book		

entries - ₱	1,382.85	
2. Loss in Hacienda Dalupiri-	29,125.82	
3. Losses in Hacienda Samal ---	8,380.25	38,888.92
Net taxable income -------		₱484,966.00
Tax @ 20% - 28% ----------		₱127,790.00
Less amount previously paid		19,066.00
Deficiency income tax -----		₱108,724.00

1952

Net income per respondent -		₱115,316.86
Deduct:		
1. Losses in Hacienda Dalupiri -	₱26,744.81	
2. Losses in Hacienda Samal ----	7,621.73	34,366.54
Net taxable income -------		₱80,950.00
Tax @ 20% ---------------		16,190.00
Less amount previously paid		12,590.00
Deficiency income tax ----		₱ 3,600.00

1953

Net income per respondent -	₱34,436.58
Deduct:	
1. Losses in Hacienda Dalupiri ----	21,932.62
Net taxable income --------	12,503.00
Tax @ 20% ---------------	2,501.00
Less amount previously paid	- -
Deficiency income tax -----	₱ 2,501.00

1954

Net income per respondent -	₱72,625.17
Deduct:	
1. Losses in Hacienda Dalupiri ---------	42,938.56
Net taxable income --------	29,686.00
Tax @ 20% ---------------	5,937.00
Less amount previously paid	74.00
Deficiency income tax -----	₱ 5,863.00

RESUMÉ

1950	---------------	₱ 2,748.00
1951	---------------	108,724.00
1952	---------------	3,600.00
1953	---------------	2,501.00
1954	---------------	5,863.00
	Total -----	₱123,436.00

WHEREFORE, the decision appealed from is hereby modified, and petitioner is ordered to pay the sum of ₱123,436.00 within 30 days from the date this decision becomes final. If the said amount, or any part thereof, is not paid within said period, there shall be added to the unpaid amount a surcharge of 5%, plus interest as provided in Section 51 of the National Internal Revenue Code, as amended. With costs against petitioner.

SO ORDERED.

Manila, June 10, 1963.

ROMAN M. UMALI
Associate Judge

I CONCUR:

AUGUSTO M. LUCIANO
Associate Judge