Library

ALFREDO Y. DE VERA,
Petitioner,

- versus -

C.T.A.
CASE NO. 167

March 23, 1959

COLLECTOR OF INTERNAL REVENUE,
Respondent.

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

D E C I S I O N

This is an appeal by the petitioner from the decision of the respondent holding the former liable for the payment of the sum of ₱56,424.00, as deficiency income tax for the year 1950, computed as follows:

Net income as per return -------	₱59,739.81
Add: Undeclared share in the profit of Philippine Tobacco Trading -----------	79,315.97
Total net income ---------------	₱139,055.78
Less: Personal & additional exemptions -------------	7,200.00
Net taxable income -------------	₱131,855.78
Income tax due on ₱131,855.00 ---	₱ 53,903.00
Less: Amount previously assessed and paid ---------	15,287.00
Deficiency income tax -----------	₱ 37,616.00
50% surcharge ------------------	18,808.00
Deficiency income tax and surcharge --------------------	₱ 56,424.00

When petitioner filed his income tax return for 1950, one of the items of income reported by him was the sum of ₱37,552.13, representing his share in the net profit (₱39,528.56) of the Philippine Tobacco Trading, a registered general copartnership 95% (or 19/20) of the capital of which was owned by him, the other 5% (or 1/20) being owned by one Crispulo Lansangan.

46

Upon investigation of the income tax return of the Philippine Tobacco Trading, the examiner of the Bureau of Internal Revenue who investigated the case found an underdeclaration in the net profit of the partnership in the sum of ₱84,742.98, which was finally reduced to ₱79,315.97, consequently resulting in the underdeclaration of petitioner's income in his income tax return.[1] The said underdeclaration of the net profit of the partnership was brought about by the following discrepancies:

1. Unreported sales of cigarettes --		₱39,355.00
2. Understated inventory ----------		31,929.15
3. Overdepreciation of delivery equipment -------------------		362.18
4. Samples already recorded as purchases ------------------		811.95
5. Unallowable expenses claimed:		
(a) Leasehold improvement ...	₱ 537.00	
(b) Christmas expenses	1,306.00	
(c) Miscellaneous expenses	7,875.00	
(d) Transportation expenses	1,314.20	11,032.20
Total ---------------		₱79,315.97

Item No. 3, overdepreciation of delivery equipment, and Item No. 4, samples already recorded as purchases, involving the sums of ₱362.18 and ₱811.95, respectively, are not disputed. The sole issue involved in this appeal relates to the correctness of the decision of respondent in regard to the alleged unreported sales of cigarettes, understatement of inventory and the expenses claimed by the partnership

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[1] Section 26 of the Revenue Code provides that persons carrying on business in general copartnership duly registered shall be liable for income tax only in their individual capacity, and the share of the profits of the partnership to which any taxable partner would be entitled, whether divided or otherwise, shall be returned for taxation and the tax paid accordingly.

and disallowed by respondent.

The book inventory of the partnership shows that it had on hand as of December 31, 1950, 872 cases of Eagle, Wings, Ritz and Raleigh cigarettes. On the other hand, according to the actual physical inventory, it had 694 cases of said cigarettes. The difference of 178 cases, itemized below, with a total value of ₱39,355.00, was not accounted for.

BRAND	NO. OF CASES ON HAND PER BOOK	NO. OF CASES PER PHYSICAL INVENTORY	DIFFERENCE	SALES VALUE
Eagle	3		3	₱ 630.00
Wings	391	310	81	18,225.00
Ritz	267	211	56	11,760.00
Raleigh	211	173	38	8,740.00
Totals	872	694	178	₱39,355.00

In view of the failure of petitioner or of the partnership to account for the 178 cases of cigarettes, respondent concluded that they were sold. Petitioner, however, claims that there is no discrepancy with respect to the Eagle cigarettes; and as regards the Wings, Ritz and Raleigh cigarettes, they "were either destroyed and/or burned and given away as complimentary and samples."

It is contended on behalf of petitioner that -

> "There was really no difference in the Eagle cigarettes as both physical and book inventory of Eagle cigarettes as of December 31, 1950 should have no balance on hand. It was overlooked by the examiner in computing the total Eagle cigarette cases sold." (Page 2, Memorandum for the Petitioner.)

It appears that in 1950 the partnership handled 410 cases of Eagle cigarettes. The allegation that "both physical and book inventory of Eagle cigarettes as of

December 31, 1950 should have no balance on hand" is an admission that all the 410 cases were sold. However, the records show that only 407 cases were sold, and the book inventory shows a balance on hand (unsold) of 3 cases. We agree with respondent that there was an underdeclaration of sales of 3 cases of Eagle cigarettes.

In connection with the other brands of cigarettes (Wings, Ritz and Raleigh), petitioner admits the discrepancies between the book inventory and the actual physical inventory, but he maintains that the discrepancies represent cigarettes "destroyed and/or burned and given away as complimentary and samples." Petitioner sought to prove this allegation by presenting in evidence supposed stock cards and the testimony of his bookkeeper, Jose Ocleana, and another employee, Feliciano Borlagon. We have carefully scanned the records and are quite convinced that the cigarettes in question were not burned or destroyed or given away, as alleged. The books and invoices, from which the entries in the supposed stock cards were taken, were not submitted in evidence. And the testimony of the witness of petitioner, including that of petitioner himself, is so vague and inconsistent to merit serious consideration.

There is another circumstance which to our mind negates the contention that the said cigarettes were burned or destroyed or given away. If, as alleged, the greater portion of said cigarettes were burned or destroyed, the total value thereof should have been entered in the books as loss. The same is true with the cigarettes allegedly given away to customers or as advertisement; they should have been entered in the books as expenses. No such entry appears in the books and records of the partnership contrary to the vigorous assertion of petitioner that "corresponding entries on said books of accounts and records were made in the course of ordinary business operation." If the said cigarettes were really burned or destroyed or given away, and appropriate entries were made in the books and records of the partnership, the net profit of ₱39,528.56 reported by the partnership in its 1950 income tax return would have been almost wiped out. As a result, petitioner would appear to have overdeclared, instead of underdeclared, his share in the profit of the partnership; instead of incurring a deficiency, he would have made an overpayment; and, as a matter of simple justice, he should be entitled to a refund. There is no showing that the failure to claim deduction for the alleged losses and expenses was due to the desire of petitioner to pay more tax than what was legally due. Neither does it appear that the failure to claim such deduction was due to simple oversight. The amount involved, ₱39,355.00, is not insignificant as to have been overlooked. If the losses were actually sustained and the expenses actually incurred, the profit of the partnership would have been practically reduced to nil, and the taxable income of petitioner, the controlling stockholder and managing partner of the partnership, would have been greatly reduced, a circumstance that cannot be lightly disregarded.

We find no justification in overruling the decision of respondent as regards the unreported sales of cigarettes.

Respondent also found that the partnership undervalued its inventory of goods in stock by ₱31,929.15. He valued the cigarettes at cost because, according to him, the cost was lower than the market price. On the other hand, petitioner valued the cigarettes at market price because he claims it was lower than cost.

Section 36 of the Revenue Code provides:

> "Sec. 36. Inventories. - Whenever in the judgment of the Collector of Internal Revenue, the use of inventories is necessary in order to determine clearly the income of any taxpayer, inventories shall be taken by such taxpayer upon such basis as the Secretary of Finance may, by regulations, prescribe, as conforming as nearly as may be to the best accounting practice in the trade or business and as most clearly reflecting the income."

Section 145 of Revenue Regulations No. 2 provides in part:

> "The bases of valuation most commonly used by business concerns and which meet the requirements of the Income Tax Law are (a) cost price or (b) cost or market price, whichever is the lower. Any goods in an inventory which are unsalable at normal prices or unusable in the normal way because of damage, imperfections, shop wear, changes of style, odd or broken lots, or other similar causes, including second hand goods taken in exchange, should be valued at '*bona fide*' selling prices whether basis (a) or (b) is used, or if such goods consist of raw materials or partly finished goods held for use or consumption, they should be valued upon a reasonable basis, taking into consideration the usability and the condition of the goods,

> but in no case shall such value be less than the scrap value. '*Bona fide*' selling price means actual offerings of goods during a period ending not later than thirty days after inventory date. The burden of proof will rest upon the taxpayer to show that such exceptional goods as are valued upon such selling basis come within the classifications indicated above, and he shall maintain such records of the disposition of the goods as will enable a verification of the inventory to be made."

The regulations require that goods be valued in the inventory at cost or at cost or market price, whichever is lower. The goods in question were valued in the inventory at supposed market prices, lower than cost, it being alleged that the cigarettes were moldy and in bad order. But, although it is admitted that some of the cigarettes were still good, a uniform inventory price was given for each brand of cigarettes, irrespective of whether the cigarettes were moldy, damaged, or still good. On the other hand, respondent valued the goods at cost, it appearing from the books of the partnership that such cigarettes were sold in January and February, 1951, at prices higher than cost. That the said cigarettes were sold in January and February, 1951 at prices higher than cost is not controverted. Therefore, the decision of respondent that the goods should be valued at cost, which has been shown to be lower than market price, is in order.

The sum of ₱537.00 was spent by the partnership in 1950 for the construction or erection of partitions in an office room in Uy Ket Building at Dasmariñas, Manila, which it rented and occupied from 1949 to February, 1951, when the premises were abandoned together with the improvements. The said amount was claimed as an ordinary and necessary expense and was deductdd from the gross income of the partnership in 1950. Respondent claims that the said amount was a capital expenditure and should have been amortized, hence the deduction thereof as an ordinary and necessary expense was disallowed.

There is no dispute that the amount spent for partitions in the office room of the partnership in Uy Yet Building was a capital expenditure. The rule is that a tenant's expenditure for additions or betterments to property he has leased represents an investment of capital, rather than an upkeep or maintenance expense. Such expenditure is required to be capitalized under Section 30 (f) of the Revenue Code. (See 1955 PH Federal Taxes, par. 12,095.) And Section 31 of the Revenue Code expressly 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. Accordingly, the disallowance of the claimed deduction is proper.

The alleged Christmas expenses, ₱1,306.00; miscellaneous expenses, ₱7,875.00; and transportation expenses, ₱1,314.20, were disallowed by respondent on the ground that such expenses are not supported by invoices, receipts or other pertinent documents. Where deduction for expenses is disallowed by the Commissioner, it is incumbent upon the taxpayer to prove that they are allowable under the law. The taxpayer must show that the amounts allegedly spent were actually spent and that they are ordinary and necessary expenses in carrying on the trade or business of the taxpayer.

The deduction of said expenses is sought to be justified in the following language:

> "The above-named expenses were disallowed on the mere ground that they were all unsupported. However, the disbursements of which were duly recorded and entered in the books of original entry in the regular course of business operation (t.s.n. Page 50-51). For each and every entry in its books of accounts, the same is supported by voucher prepared by the petitioners employees duly signed and approved and in most cases supported by invoices, chits and statements. Respondent claimed that vouchers prepared by the petitioner alone were not sufficient to support the expenditures. It is must be noted that the expenses, operating expenses more particularly those which were disallowed by the respondent, were necessary, reasonable and ordinary in the course of the petitioner's business operation." (Page 3, Memorandum for the Petitioner.)

Petitioner claims that the expenses were "necessary, reasonable and ordinary in the course of the petitioner's business operation," without presenting evidence to show why they are ordinary and necessary. The bare statement of the taxpayer or of his counsel that an item of expense is ordinary and necessary, unaccompanied by adequate evidence, has no weight with the Commissioner or with this Court. The said expenses have been properly disallowed.

The fraud penalty of 50% surcharge has been imposed upon petitioner. Respondent justifies the penalty on the following grounds:

> "(1) That petitioner, manager and controlling partner of the Philippine Tobacco Trading, underdeclared the latter's sales in 1950 by ₱39,355.00; (2) that he underdeclared the value of the inventory of the partnership by ₱31,929.15; (3) that he claimed deductions which are not allowable, the total of which amounted to ₱12,206.33; (4) that as a result, he was able to conceal part of his share in the income of the partnership, his undeclared share being ₱79,315.97; and (5) that by concealing part of his income, he was able to evade payment of the amount of ₱37,616.00, representing the deficiency income tax due on his undeclared income. We have also shown that petitioner fabricated evidence to explain the discrepancies in the inventory of the cigarettes in question and gave false testimony on the alleged burning of the cigarettes." (Page 14, Memorandum for Respondent.)

While the petition for review raised the issue as regards the legality of the imposition of the fraud penalty, no evidence was presented to prove the claim that petitioner did not file a false or fraudulent return with intent to evade tax. In fact, the memorandum of counsel for petitioner is absolutely silent on this point. The imposition of the fraud penalty has to be sustained.

FOR THE FOREGOING CONSIDERATIONS, the decision appealed from is hereby affirmed. As prayed for, petitioner is hereby ordered to pay the sum ₱56,424.00, plus 5% surcharge and 1% monthly interest from February 28, 1955 to the date of payment, pursuant to Section 51 (e) of the Revenue

Code. With costs against petitioner.

SO ORDERED.

Manila, March 23, 1959.

R. M. Umali
ROMAN M. UMALI
Associate Judge

WE CONCUR:

M. Nable
MARIANO NABLE
Presiding Judge

Augusto M. Luciano
AUGUSTO M. LUCIANO
Associate Judge