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ENRIQUE AVELINO,
Petitioner,

- versus -

C.T.A.
CASE NO. 88

Nov. 29, 1958

THE COLLECTOR OF INTERNAL REVENUE,
Respondent.

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D E C I S I O N

The petitioner has appealed to this Court from the decision of respondent requiring him to pay the sum of ₱22,123.55 (due as of February 15, 1955), representing alleged deficiency income tax for 1947, including surcharge, interest and "compromise" penalties, which tax has been assessed allegedly by means of the net worth method. The assessment is based solely on an investment in the sum of ₱60,000 made by petitioner in the National Livestock Produce Corporation which was organized sometime in June, 1947. As petitioner did not file any income tax return for the year 1947, the said amount of ₱60,000.00 was considered by respondent as unreported income of the former in that year. However, petitioner claims that he never earned that amount; he obtained it as a loan from one Severino Sayque, a naturalized Filipino, who returned to China in 1948 or 1949.

The only issue presented for our consideration is whether or not the said sum of ₱60,000.00 was income earned by petitioner in 1947. If it was income earned by petitioner in 1947, he is liable for the income tax assessed against him; if it was obtained as a loan, the assessment has no legal basis and the decision appealed from must be set aside.

The evidence for petitioner tends to show that prior to the organization of the National Livestock Produce Corporation in June, 1947, he was merely a "rancher" in his father's ranch; that he had no salary as such "rancher"; that he was merely provided with a "house to live in and other expenses"; that his only additional means of livelihood was the salary of his wife who was employed in the former PRATRA (later PRISCO) with a salary of about ₱400.00 per month; that he, with seven others, organized in June, 1947 the National Livestock Produce Corporation for the purpose of importing cattle from Australia; that at the time of its organization, he had no money; that in order that his services could be availed of as president or manager of the corporation, he was given a loan of ₱60,000.00 by one Severino Sayque, another organizer of the corporation; that the loan was evidenced by a promissory note, a copy of which was presented in evidence; that the loan was guaranteed by Dr. Fernando M. Chan, also an organizer of the corporation, who was presented as witness and who admitted that he guaranteed the loan; that the corporation was a total failure and had to be dissolved after the death of President Roxas; that at the time of its dissolution the corporation had absolutely no funds or assets; and that the loan that he secured from Sayque has not yet been paid, the creditor not having returned from China until now, and even if the creditor were to demand payment of the loan, he can not pay the same because he has no money or property of any kind with which to discharge his obligation.

Respondent, on the other hand, refuses to believe that petitioner obtained a loan from Sayque and insists that the sum of ₱60,000.00 which petitioner invested in the National Livestock Produce Corporation was income earned by petitioner in 1947. The decision of respondent is apparently based upon the findings and recommendation of the Conference Staff of the Bureau of Internal Revenue which refused to believe the alleged loan on the following grounds: (1) that respondent failed to present the promissory note when he was interviewed by revenue agents in connection with said investment; (2) that Sayque, the alleged creditor, was not in a financial position to extend the loan; (3) that it is incredible that Sayque should give a loan of ₱60,000.00 without "requiring a solid security to guarantee its return and payment;" (4) that no attempt has been made by the creditor or his family to demand payment of the loan; (5) that petitioner did not know Dr. Fernando M. Chan well enough "to persuade the latter to guarantee an obligation amounting to ₱60,000.00;" and (6) that "because of Dr. Chan's professional and social standing and family relations and in view of his apparent closeness to the herein taxpayer, he (Dr. Chan) was in a better and more secure position than Mr. Sayque to extend the loan to Mr. Avelino; and it was "therefore exceedingly strange and unusual that the latter should choose, if at all, to secure the loan not from Dr. Chan but from Mr. Sayque who, to him, was practically a stranger." (Pp. 3-7, Exh. 7; pp. 216-220, BIR records.) Let us inquire into the validity of these arguments.

The evidence shows that when petitioner was interviewed by revenue agents, he admitted that he invested ₱60,000.00 in the National Livestock Produce Corporation but that it was given to him as a loan. It does not appear that he was asked to produce the document evidencing the loan. He had, therefore, a right to expect that his allegation was given credence and that there was no necessity of showing the document. Accordingly, the fact that petitioner did not produce the promissory note when he was first interviewed on the matter does not disprove the existence of such loan.

To prove that Sayque was not in a financial position to give a loan of ₱60,000.00 and to invest at the same time ₱40,000.00 in the National Livestock Produce Corporation, respondent introduced in evidence the income tax returns of Sayque for the years 1946 and 1947. For 1946, Sayque reported a net income of ₱27,905.10, and for 1947, ₱9,255.79. To our mind, this does not prove the incapacity of Sayque to give the loan and to make the investment in question. A person may not have earned a centavo during a period of years, but it does not mean that he is not worth anything.

It is incredible, according to respondent, that Sayque should give a loan of ₱60,000.00 without "requiring a solid security to guarantee its return and payment." It appears, however, that Sayque took the necessary precaution by seeing to it that the amount was immediately turned over to the treasurer of the National Livestock Produce Corporation immediately after the money was delivered to petitioner, a fact which could have set his mind at rest as to the wisdom of giving the loan. Besides, the loan was not without security, as alleged. The promissory note carried the personal guaranty of Dr. Chan, admittedly a solvent guarantor. And then there is that "solid security" which the creditor must have found in the name of the debtor, who is the son of the then President of the Senate. It is admitted that Sayque and the other organizers of the corporation knew at the time that petitioner was without money or property, but nonetheless he was made president and manager of said corporation obviously for the only reason that he was the son of the President of the Senate.

The fact that no attempt has been made to demand payment for the loan by the creditor or by his family is admittedly a strong argument against the existence of the loan. But upon careful scrutiny of the records, we find that the failure to demand payment for the loan is not without sufficient justification. In the first place, the creditor has not been heard from. He returned to China sometime in 1948 or 1949, and from all indications, he is either dead or he has been prevented from returning to the Philippines for reasons beyond his control. In the second place, the creditor knew when he extended the loan that petitioner was without money or property, and for this reason the promissory note provides that the loan "is payable within two years or as soon (as) my business prospers and makes profits without interest." In other words, the creditor was well aware of the risk and decided to take it. We realize the weakness of this stand, but taken in connection with the other facts of the case, we are satisfied that the possibility of the existence of the loan may not be lightly disregarded.

The last two arguments that petitioner did not know Dr. Chan well enough to persuade the latter to guarantee the loan, and that considering the social and financial position of Dr. Chan, the loan should have been obtained from him instead of from Sayque, do not, in our opinion, prove that the loan was not in fact given by Sayque. As already stated elsewhere, the other organizers of the corporation had faith and confidence in petitioner because he was the son of the President of the Senate at the time. This was sufficient inducement, at least in the case of the organizers of the National Livestock Produce Corporation, to trust petitioner. That the loan was given by Sayque instead of by Dr. Chan is of little or no consequence.

Even granting that the facts of record do not justify the conclusion that the sum of ₱60,000.00 invested by petitioner in the National Livestock Produce Corporation was secured from Sayque by way of loan, are we justified in holding that it was income earned by petitioner in 1947 and therefore taxable to him? Let us scrutinize carefully the facts.

As already stated above, the evidence shows that petitioner was merely a "rancher" in his father's ranch. He was not paid any salary, but he was provided with a "house to live in and other expenses." His only additional means of livelihood was the salary of his wife who was employed in the former PRATRA (later PRISCO) at a salary of about ₱400.00 per month. When petitioner became president and manager of the National Livestock Produce Corporation, he received no salary. He had no property of his own nor any investment. These facts are not denied but are impliedly admitted by respondent as shown by the fact that the only asset attributed to petitioner by respondent in 1947 is the investment of ₱60,000.00 in the National Livestock Produce Corporation made in June, 1947. Considering these facts, how could it be possibly assumed that petitioner could have earned a taxable income of ₱60,000.00 from January 1 to June, 1947, a period of only about six months? If the said amount was not received by him as a loan, it must have been earned by him from a source or sources between January 1 to June, 1947, in order to be taxable to him. But there is no evidence in this case of a likely source from which petitioner could have derived the income. If the said sum of ₱60,000.00 was in fact taxable income, it must have been income earned by someone other than petitioner, and the Government is obviously barking at the wrong tree.

The assessment against petitioner was made allegedly by means of the net worth method. One of the essential elements in order to establish the validity of an assessment by this method is that there must be evidence of a likely source or sources from which the supposed undeclared income was derived. It is not necessary that the Government prove with absolute certainty the source or sources from which the taxpayer derived his unreported income. It is enough if there is evidence of a likely source or sources from which the increase in net worth was derived "in quantity sufficient to account for the net worth increases."

In four net worth cases appealed to this Court, we sustained the assessments of respondent, although modified in most cases, because there was evidence in each case of the likely source or sources from which the unreported incomes of the taxpayers could have been derived. (See Perez v. Araneta, B.TA. No. 189, Feb. 13, 1956, affd. in G. R. No. L-9193, May 29, 1957; Reyes v. Coll. of Int. Rev., C.T.A. No. 42, July 26, 1956, affd. in G. R. No. L-11534, Nov. 25, 1958; Li Yao v. Coll. of Int. Rev., C.T.A. No. 30, July 31, 1956; Buenaventura v. Coll. of Int. Rev., C.T.A. No. 139, June 24, 1957.) In this case, there is absolutely no evidence of a likely source from which petitioner could have derived the sum of ₱60,000.00 as income taxable under the Income Tax Law. Accordingly, we find no legal basis to sustain the assessment against petitioner.

There is another point which to our mind is decisive against the position taken by respondent. The assessment in this case was supposedly made by means of the net worth method. This is an indirect method of proving unreported income and has been sanctioned by the courts. In sustaining this method of proving unreported income, courts have been careful to lay down rules for the guidance of tax collectors. And in Holland v. U.S., 348 U.S. 121, the United States Supreme Court issued the warning that the method "is so fraught with danger for the innocent that the courts must closely scrutinize its use." In Reyes v. Collector of Int. Rev., supra, we defined our stand, and we reiterate it now, that if it should appear "that an abuse or injustice has been perpetrated, or where gross inaccuracies are shown to exist in the use of the method, this Court will not hesitate to lend its assistance to every taxpayer who feels himself aggrieved by an unjust or incorrect assessment." Has the net worth method been correctly and justly applied in this case?

The net worth method of proving unreported income has been described by the U. S. Supreme Court as follows:

> "In a typical net worth prosecution the Government, having concluded that the taxpayer's records are inadequate as a basis for determining income tax liability, attempts to establish an 'opening net worth' or total net value of the taxpayer's assets at the beginning of a given year. It then proves increases in the taxpayer's net worth for each succeeding year during the period under examination and calculates the difference between the adjusted net values of the taxpayer's assets at the beginning and end of each of the years involved. The taxpayer's non-deductible expenditures, including living expenses, are added to these increases, and if the resulting figure for any year is substantially greater than the taxable income reported by the taxpayer for that year, the Government claims the excess represents unreported taxable income. In addition, it asks the jury to infer willfulness from this understatement, when taken in connection with direct evidence of 'conduct, the likely result of which would be to mislead or conceal.' Spies v. United States, 317 US 492, 499, 87 L. ed. 418, 423, 63 S. Ct. 364." (Holland v. U.S., 348 U.S. 121, cited in Perez v. Araneta, supra; Reyes v. Collector of Int. Rev., supra.)

In proving unreported income by the net worth method, the Government must first establish an "opening net worth" or the total net value of the taxpayer's assets at the beginning of a given year and also the "closing net worth" or the net value of the taxpayer's assets at the close of the taxable year. This is essential to determine the increase in net worth of the taxpayer in any given year.] In this case, the increase in net worth allegedly unreported by petitioner was arrived at as follows:

Net income per investigation (Networth Method):

Investment in the National Livestock Produce Corporation	P60,000.00
Personal & Living expenses	4,500.00
Total	64,500.00
Less: Personal exemption	4,500.00
Taxable income	P60,000.00

We have scanned the records thoroughly to ascertain whether respondent has duly established the "opening net worth" and the "closing net worth" of the taxpayer in 1947. Neither "opening net worth" nor "closing net worth" has been established by respondent. All that appears of record is the addition of the words "Net Worth Method" in parenthesis after "Net income per investigation" both in the original report of the examiners and in the assessment made by respondent. The addition in parenthesis of the words "Net Worth Method" after "Net income per investigation" does not prove that an "opening net worth" and a "closing net worth" have been established. And if no "opening net worth" or "closing net worth" has been established, it is impossible to determine an increase in the net worth of a taxpayer in any given year.

The opening net worth of petitioner could not have been zero at the beginning of 1947, and neither could the sum of ₱60,000.00 be his closing net worth at the end of said year, because it appears that the wife of petitioner, whose income must be combined with that of the husband to arrive at the taxable income of the spouses, was an employee in that year with a salary of ₱400.00 per month, or ₱4,800.00 per annum. This fact is not also disputed by respondent. And if the evidence for petitioner is to be believed, which has been sufficiently established, petitioner had a liability of ₱60,000.00 in 1947 to offset his investment of an equal amount. The assessment is, therefore, fatally defective.

It is argued that respondent's assessment is presumptively correct. There can be no argument as to the soundness of the proposition that an assessment regularly made by the Commissioner of Internal Revenue in the performance of official duty is entitled to that presumption. But where an assessment is on its face fatally defective, the presumption does not apply.

The decision appealed from is hereby reversed, without pronouncement as to costs.

SO ORDERED.

Manila, November 29, 1958.

ROMAN M. UMALI
Associate Judge

WE CONCUR:

MARIANO NABLE
Presiding Judge

AUGUSTO M. LUCIANO
Associate Judge

Reversed - G.R. L-14847, Sept. 19, 1961.