library

REPUBLIC OF THE PHILIPPINES
COURT OF TAX APPEALS
QUEZON CITY

NELLY MAGALLANES LOPEZ,
Petitioner,

- versus - C.T.A. CASE NO. 2607

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

4/21/82

D E C I S I O N

This is an appeal from the decision of the Commissioner of Internal Revenue assessing against and demanding from petitioner Nelly Magallanes Lopez the sum of ₱250,965.94 as deficiency income tax for 1963.

On January 16, 1963, petitioner Nelly Magallanes Lopez and her husband Carlos P. Lopez (now deceased) had entered into a contract, denominated as "Deed of Sale With Assumption of Obligation", with the Macdem Enterprises Co., Inc., hereinafter referred to as MACDEM for short, in which they transferred their properties to the latter, consisting of the following:

SCHEDULE OF ASSETS SOLD TO AND LIABILITIES ASSUMED BY MACDEN ENTERPRISES CO. INC. FROM MR. & MRS. CARLOS T. LOPEZ

| ASSETS | COST | RESERVE FOR DEPRECIATION | BOOK VALUE |
|---|---|---|---|
| Buildings & Laborers Quarters | ₱68,703.09 | ₱22,281.04 | ₱46,422.05 |
| Tractors & Accessories | 71,827.32 | 62,338.64 | 9,488.68 |
| Roads, Bridges & Culverts | 2,772.01 | 2,772.01 | - |
| Delivery Equipments | 30,288.89 | 13,407.51 | 16,881.38 |
| Other Form Equipments | 3,851.37 | 2,166.74 | 1,684.63 |
| Farm Tools & Implements | 3,851.37 | 3,221.43 | 76.84 |
| Office Furniture & Fixtures | 6,294.40 | 5,775.02 | 519.38 |
| Service Car | 30,880.00 | 6,714.00 | 24,166.00 |
| Livestocks | 3,027.00 | - | 3,027.00 |
| TOTAL | ₱220,942.35 | ₱118,676.39 | ₱102,265.96 |
| Agricultural Land - Hda. Los Angeles | | | 240,000.00 |
| Urban Lots | | | 17,152.89 |
| Residential Building | | | 70,570.85 |
| TOTAL ASSETS | | | ₱429,988.85 |

It was stipulated in consideration of the transfer of the above real and personal properties in the said contract -

> That for and in consideration of the sum of FOUR HUNDRED TWENTY NINE THOUSAND NINE HUNDRED EIGHTY EIGHT PESOS AND EIGHTY-FIVE CENTAVOS (₱429,988.85), Philippine Currency, which the VENDEE (MACDEN) shall pay to the VENDORS (Nelly Magallanes Lopez and Carlos P. Lopez) in the manner as hereinafter provided. The VENDORS hereby SELL, CEDE, TRANSFER and CONVEY in favor of the VENDEE, its successors and assigns, the above described parcels of land, together with all buildings and improvements' existing thereon, subject to the following terms and conditions;

> 1. That in view of the fact that the VENDORS have unpaid subscriptions to shares of stock of the VENDEE amounting to One Hundred Twenty Thousand Pesos (₱120,000.00) the said amount shall be deducted from the purchase price aforementioned and the subscription to shares of stocks of the VENDORS herein shall be considered as fully paid. That the VENDEE shall likewise assume the liabilities of the VENDORS as of October 31, 1962 in the total sum of Two Hundred Ninety Seven Thousand One Hundred Fourteen Pesos and Ten Centavos (₱297,114.10), as appearing in the books which includes the accounts with the Philippine National Bank by way of crop loan, time loan and palay loan.
>
> xxx xxx xxx
>
> 4. That the balance of Twelve Thousand Eight Hundred Seventy-Four Pesos and Seventy-Five Centavos (₱12,874.75) shall be paid by the VENDEE to the VENDORS within a period of four (4) years from and after the date of the exemption of this contract. (Exhs. B, B-1, B-2 & B-3)

Petitioner Nelly Magallanes Lopez and her deceased husband have transferred their properties in consideration of, or in exchange for (1) the assumption by MACDEM to pay their liability of ₱297,114.10 with the Philippine National Bank consisting of crop, time and palay loans; (2) the crediting of ₱120,000.00 as payment for the unpaid MACDEM shares subscribed by petitioner and her husband; and (3) the payment of the sum of ₱12,874.75 to petitioner, which is the balance of the consideration of the aforesaid contract of ₱429,988.85 and to be paid by MACDEM.

MACDEN in return for the transfer of the said properties, accordingly, credited the sum of ₱120,000.00, and issued the remaining unpaid shares. It also assumed the liabilities of petitioner Nelly Magallanes Lopez and her late husband Carlos P. Lopez with the Philippine National Bank consisting of P.N.B. crop loan for 1962 to 1963, time and palay loan, and, apparently, including accounts payable, accrued audit fees and SSS premiums, all in the total sum of ₱297,114.10. On the basis of the transfer made by the spouses to MACDEN of their properties, the said agreement was considered by respondent as an exchange of said properties with the shares of stocks and assumed liabilities and monetary consideration by the MACDEN.

As a consequence of this asserted exchange of assets between Nelly Magallanes Lopez and her late husband, on the one hand, and MACDEN on the other, the appreciation made by respondent of the value of the real and personal properties aforesaid given in exchange, i.e., from their book value (₱429,988.85) to the alleged fair market value (₱964,738.37), constitute the gain realized in the exchange. The amount of ₱429,988.85 above constitutes, therefore, the book value of the assets or properties given in exchange in consideration of the aforesaid liabilities assumed by MACDEN from the Philippine National Bank in the amount of ₱297,114.10, of the credit of ₱120,000.00 in payment of the unpaid MACDEN shares of stocks; and account receivable of ₱12,874.75, payable by MACDEN to petitioner in 4 years from 1963. By deducting from the appraised fair market value of ₱964,738.37 of the properties exchanged by respondent with their net book value of ₱429,988.85, respondent had considered the increase in the value of the assets given in exchange which is ₱542,133.30, 50% of which (or ₱122,755.15) is deducted from ₱542,133.30, the said resulting amount of ₱419,378.15 is, therefore the gain assertedly realized in the exchange. This amount, in the report of Examiner Isabelo Romualdo (Exh. 5, p. 8, BIR rec.), is subject to deficiency income tax for 1963 of ₱250,965.94, inclusive of ½% interest, as was finally computed and determined by respondent. This determination of profit was based upon or anchored on the holding in a Resolution of the Supreme Court in the case of Collector of Internal Revenue vs. Binalbagan Estate, Inc. G.R. L-12752, promulgated on March 21, 1965, that "x x x Such increase in value of the assets should have been taxed as profit realized by Binalbagan from the exchange of assets for the Biscom shares. x x x"

Based on this finding, respondent issued on April 9, 1969 an assessment against petitioner in the amount of ₱250,965.94 inclusive of interest, as deficiency income tax for 1963 (Exh. 1, p. 36, BIR rec; Exh. N-1, Brown Envelope) computed as follows:

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|---|---|
| Net taxable income as per investigation | ₱419,378.15 |
| Less: Personal & additional exemption | 7,000.00 |
| Net income subject to tax | ₱412,378.15 |
| Tax due thereon | ₱212,683.00 |
| Deduct: Amount already paid | None |
| Deficiency tax due | ₱212,683.00 |
| Add: ½% monthly int. fr. 4-16-64 to 4-9-69 (18%) | 38,282.94 |
| TOTAL AMOUNT DUE & COLLECTIBLE | ₱250,965.94 |

Succintly, this assessment was explained to have been arrived at by respondent as follows:

> "The net taxable income amounting to ₱419,378.15 represents the gain you realized from the exchange of your propreties in 1963 with the shares of stocks of MACDEN ENTERPRISES CO., INC., Under Section 35(c)(1) of the National Internal Revenue Code as implemented by Sections 140 & 141 of Revenue Regulations No. 2, the difference between the fair market value of the properties at the time of the exchange and its original cost, is income realized and subject to income tax. Under the Supreme Court

> decision in the case of the Collector of Internal Revenue vs. Binalbagan Estate, Inc. (G.R. No. L-12752, March 21, 1965), it was held that the increase in the value of the assets over its cost should be taxed as profit realized from the exchange of said assets. Considering the fair market value of your assets at the time of exchange as ₱964,738.37 and its cost amounted only to ₱422,605.07, the gain realized amounted to ₱542,133.30. Since some of the assets exchanged are capital assets, only 50% of the gain realized is returnable for income tax in 1963. Subtracting, therefore the amount of ₱122,755.15 representing 50% of the gain realized from the exchange of capital assets from ₱542,133.30, realized from such exchange."

In a memorandum dated April 29, 1969, petitioner contested the assessment of deficiency income tax served against her and assailed, among others, the manner and procedure followed by Examiner Isabelo J. Romualdo in his examination and alleged that the assesment in question is arbitrary and without legal and factual basis. (Exh. 2, pp. 53-69, BIR rec.)

On September 16, 1970, Deputy Commissioner of Internal Revenue, Conrado P. Diaz, wrote a letter to petitioner, calling her representative Francisco E. Maravilla to a conference on September 30, 1970 to enable the latter to present her side of the case. (Exh. 3, p. 74, BIR rec.) During the said conference, petitioner submitted a letter on that day in support of the arguments presented in her original memorandum dated April 29, 1969. (Exh. E, pp. 102-114, CTA rec.) And, on October 15, 1970, petitioner submitted another rejoinder to the memorandum questioning the finality of respondent's assessment. (Exh. 4, pp. 82-87, BIR rec.)

On December 7, 1970, Conrado P. Diaz, Acting Commissioner of Internal Revenue (Exh. 5, p. 93, BIR rec.), acting on the letters of protest of petitioner, denied the same in this wise:

> "In reply thereto, please be informed that after considering the points raised said letters, this Office could not find its way clear to sustain said request. The assessment was seasonably made by the Commissioner, thru his authorized representative, the Regional Director of Revenue Region No. 14, within the period prescribed by law. Furthermore, your contention that the transfer of assets was an exempt transaction finds no basis, for under Section 35(c) of the Tax Code, implemented by Revenue Regulations No. 2, otherwise known as the Income Tax Regulations, the difference between the fair market value and the original cost of properties exchanged for shares of stock is considered either income derived or loss sustained.
>
> "In view thereof, you are hereby requested to pay said amount to the Collection Agent of Bacolod City within ten (10) days from your receipt hereof in order that this case will be closed and terminated."

Again, this denial was protested by petitioner in a memorandum to the Acting Commissioner of Internal Revenue, dated December 21, 1970, alleging that respondent had neither presented any evidence to justify his position nor presented any argument against petitioner's stand. (Exh. 6, pp. 95-113, BIR rec.)

On February 26, 1974, respondent, in a letter referring to the above memorandum (Exh. 7, p. 153, BIR rec.), denied petitioner's protest stating in the ultimate paragraph thereof, as follows:

> "In view thereof, you are hereby requested to urge your client Mrs. Nelly Magallanes Lopez to pay the amount of ₱250,965.94 representing deficiency income tax and interest for the year 1963 within ten days from receipt hereof otherwise this Office will be constrained to enforce collection thereof through the remedies prescribed by law."

This denial was admittedly received by petitioner on March 13, 1974. (Exh. 9, par. XXVI, p. 9, CTA rec.) And on the same date, respondent filed a complaint for the collection of deficiency income tax against petitioner with the Court of First Instance of Manila in Civil Case No. 93652. (Exh. K, pp. 147-149, CTA rec.) A copy of the complaint was then received by petitioner Nelly Magallanes Lopez on May 3, 1974. (See Exh. 9, *supra*, par. XXVIII, p. 10, CTA rec.)

On May 11, 1974, petitioner's counsel interposed the present appeal in behalf of petitioner.

On July 19, 1974, respondent, in his answer to the petition for review, alleged among others, that the appeal was filed beyond the thirty-day period prescribed in Section 11 of Republic Act No. 1125, and, hence, this Court has no jurisdiction over the case. However, from the facts disclosed during the preliminary hearing, the alleged lack of jurisdiction did not appear indubitable. Hence, this Court, in the interest of justice and expediency, preferred the jurisdictional issue to be considered together with the merits of the case.

The issues, therefore, brought for determination in this appeal are as follows:

1. Whether or not this Court has jurisdiction to take cognizance of the case;

2. Whether or not the right of respondent to assess petitioner for the 1963 income tax has already prescribed; and

3. Whether or not the transfer of petitioner's properties in 1963 to MACDEN in consideration of the issuance of 1,600 shares of stocks and assumption of the former's liabilities or obligations gave rise to a taxable income.

With respect to the first issue, respondent maintains that petitioner's appeal was filed beyond the thirty-day period prescribed in Section 11 of Republic Act No. 1125 and, therefore, the same cannot be taken cognizance by this Court for lack of jurisdiction. Respondent claims that the final decision appealable to this Court was the letter-decision dated February 26, 1974. He further asserts that petitioner's letter of March 14, 1974, being merely pro-forma since it raises new grounds, did not stop the running of the thirty-day period counted from receipt of the decision within which to appeal to this Court.

Petitioner admitted that the final and definitive assessment was made in the letter dated February 26, 1974. (See Memorandum in Opposition to Respondent BIR Commissioner's Verbal Motion To Dismiss, pp. 176-185, CTA rec.) However, she cannot accept the view that the request for reconsideration filed by her on March 14, 1974 did not have the effect of suspending the running of the thirty-day period for appeal because it is pro-forma.

It must be noted that the said letter of March 14, 1974 of petitioner was actually the first request for reconsideration of the decision on the disputed assessment rendered by respondent. (See Noblejas vs. Commissioner of Internal Revenue, CTA Case No. 1923, Resolution, October 4, 1968.) That being so, it had the effect of suspending the running of the period of appeal. Being the first request for reconsideration, it cannot be seriously said that such request is <u>pro-forma</u> even though the defenses contained therein may be the same as those asserted in the previous communications of petitioner to respondent.

The period to appeal started to run only on May 4, 1974, a day after receipt of notice of the complaint for collection filed by respondent in the Court of First Instance of Manila, which complaint is tantamount to a denial of petitioner's request for reconsideration. (Republic vs. Lim Tiang Teng, G.R. L-21731, March 31, 1966; SCRA 584.) From May 4, 1974, when notice of the complaint was received, to May 11, 1974, when the present appeal in this Court was filed, only eight (8) days had elapsed. Consequently, this Court has jurisdiction over this appeal.

Coming now to the second issue, petitioner contested the right of respondent to assess the deficiency income tax against her claiming that the proposed assessment of April 9, 1969, in the amount of ₱250,965.94, did not become final for the reason that the assessment was signed only by the Regional Director and his power to make final assessment does not include those that exceeds ₱10,000.00. She contends that respondent rendered his final assessment only on February 26, 1974, or beyond the prescriptive period of five years, invoking the provisions of Section 331 of the Tax Code. It must be noted, however, that respondent communicated the discovery of petitioner's omission to file her income tax return for 1963 on March 31, 1969. There being a failure to file a return, an assessment can be made and the tax imposed thereon collected within a period of 10 years from the date of the discovery of the omission. (Republic vs. Tan, 28 SCRA 325.)

In the present appeal, petitioner made no allegation nor presented any evidence to show that her income tax return for 1963 had been filed. Therefore, the five-year period within which to assess, prescribed in Section 331 of the Tax Code, is not applicable as said period refers to cases where returns are filed. The only period petitioner can invoke is the ten-year period provided in Section 332 of the same Code within which to assess the tax. The five-year period within which to assess the tax by respondent applies only when a return is filed pursuant to Section 331 of the Tax Code, and the prescriptive period of ten years within which to assess applies only whenever an income tax return is not filed, pursuant to Section 332(a) of the Tax Code. (Tan Guan vs. Nable, No. L-18598, July 23, 1968; 24 SCRA 93.) Counting, therefore, from March 31, 1969, when the discovery of omission or failure to file return was discovered, to April 9, 1969, the date of the assessment, it is clear that respondent assessed the taxpayer within a period of ten years from the discovery of the omission to file a return. Petitioner's plea of prescription cannot, therefore, be sustained.

Coming now to the third issue, petitioner contends that the transfer of their (petitioner and her deceased husband) properties to MACDEN is a sale and, therefore, there is no taxable exchange. It is contended that the assets of petitioner, and that of her late husband, with a cost or net book value of ₱429,988.85, having been sold for the same amount as its cost or net book value, which consist of ₱297,114.10 representing assumed liabilities with the PNB and others; the credit of the sum of ₱120,000.00 to satisfy the unpaid subscription of the MACDEN shares of stock; and the accounts payable of ₱12,874.75, to be satisfied or paid by MACDEN within a period of four years from the date of contract, there is no taxable gain as contemplated in Section 35(c)(1) of the Tax Code. She contends, in the alternative, that assuming this transaction as an exchange, a position taken by respondent, and assuming that the fair market value of the assets of petitioner was at the time of the alleged exchange ₱964,738.35 as arrived at by Examiner Romualdo, and the fair market value of the 1,600 shares of stock received in exchange as determined by the same Examiner to be either ₱422,605.07 (Exh. 11, p. 37, BIR rec.) or ₱654,749.52 (Exh. 3, pp. 12-14,BIR rec.) there would be a loss to petitioner, instead of a taxable gain. This was shown in the foregoing computations by petitioner. (pp. 20 & 21, Memorandum of Petitioner.)

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|---|---|
| Total fair market value of real properties as arbitrarily fixed by BIR Examiner Isabelo J. Romualdo . . . . . . . . . . . . . . | ₱964,738.37 |
| Less: Fair market value (Cost of 1,600 shares of Macden Enterprises Co., Inc. per Exhibit II) . . . . . . . | 422,605.07 |
| Net loss to petitioner . . . . . . . | (₱542,133.30) |

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| Fair market value of properties arbitrarily given by BIR Examiner Isabelo J. Romualdo . . . . . . . . . | ₱964,738.37 |
| Less: Fair market value (cost of 1,600 shares of MACDEN per Exhibit 3) . . . . . . . | 654,749.52 |
| Net loss to petitioner . . . . . . . | (₱309,988.85) |

She concluded that there being a loss, there was no income realized from the exchange or received by petitioner which is taxable pursuant to Section 35(c)(1) of the Tax Code. Finally, she contends that the ruling in the case of Collector of Internal Revenue vs. Binalbagan Estate, Inc., G.R. L-12752, promulgated on January 30, 1965 is not applicable to the instant case.

On the other hand, respondent insists that the deed of transfer between petitioner Nelly Magallanes Lopez and MACDEN is not a deed of sale under precise legal contemplation, and that the transaction is actually an exchange where the valuable considerations received under the transfer are the relief from all her obligations of ₱297,114.40 with the Philippine National Bank, etc., the release of the 1,600 shares of stock upon the application of the sum of ₱120,000.00, which is the consideration to the unpaid subscription; and the accounts receivable from MACDEN of ₱12,874.75. It is asserted that since there was an exchange of property for assets, the increase from the book value or costs of the petitioner's properties of ₱422,605.07 (should be ₱429,988.85) to its fair market value as found by respondent in the sum of ₱964,738.37, the difference in the amount of ₱542,133.30, which is an appreciation or increase of the value of the assets, is under the asserted ruling of the Supreme Court in the case of Collector of Internal Revenue vs. Binalbagan Estate Inc., G.R. L-12752, January 30, 1965, taxed as profit realized in the exchange of said assets. Respondent concludes that since some of the assets exchanged are capital assets, only 50% of such gain in the sum of ₱122,755.15 realized in 1963 should be deducted from the gain of ₱542,133.30 realized in the exchange, and the balance of ₱419,378.15, being the net gain realized from such exchange (Exh.1, p. 36, BIR rec.) is, therefore, subject to a deficiency income tax for 1963.

In the proper disposition of the third issue, i.e., whether or not the transfer of petitioner's properties or assets to the MACDEN, in consideration of the latter's issuance of its 1,600 shares of stocks and assumption of the former's liabilities, is a taxable gain on the sale, or on the exchange of property, it is best to cite and restate the applicable provisions of law, which is Section 35(c)(1) of the National Internal Revenue Code, as amended by Republic Act No. 1921, approved on June 22, 1957. Said Section 35(c)(1), as amended, provides as follows:

> Sec. 35. <u>Determination of gain or loss from the sale or other disposition of property</u>. - The gain derived or loss sustained from the sale or other disposition of property, real, personal, or mixed, shall be determined in accordance with the following schedule:
>
> (a) In the case of property acquired on or before March first, nineteen hundred and thirteen, the fair market price or value of such property as of March first, nineteen hundred and thirteen.
>
> (b) In the case of property acquired on or after March first, nineteen hundred and thirteen, the cost thereof if such property was acquired by purchase or the fair market price or value as of the date of the acquisition if the same was acquired by gratuitous title.
>
> (c) Exchange of property -
> (1) <u>General rule</u>. Except as herein provided, upon the sale or exchange of property, the entire amount of the gain or loss, as the case may be, shall be recognized.

This provision is implemented by Section 136 of the Revenue Regulation No. 2, known as Income Tax Regulation, as follows;

> Sec. 136. <u>Basis for determining gain or loss from sale of property</u>. - For the purpose of ascertaining the gain or loss from the sale or exchange of property, the basis is the cost of such property, or in the case of property which should be included in the inventory, its latest inventory value. But in the case of property, acquired before March 1, 1913, when its fair market value as of that date is in excess of its cost, the gain to be included in gross income is the excess of the amount realized therefor over such fair market value. (See Illustration I,

> section 137 of these regulations) Also in the case of property acquired before March 1, 1913 when its fair market value as of that date is lower than its cost, the deductible loss is the excess of such fair market value over the amount realized therefor. (See Illustration II, Id.) No gain or loss is recognized in the case of property sold or exchanged (a) at more than cost but at less than its fair market value as of March 1, 1913. (See Illustration III, Id., (Id.), or (b) at less than cost but at more than its fair market value as of March 1, 1913. (See Illustration IV, Id., Id.) In any case, proper adjustment must be made in computing gain or loss from the exchange or sale of property for any depreciation or depletion sustained and allowable as a deduction in computing net income; the amount of depreciation previously charged off by the taxpayer shall be deemed to be the true depreciation sustained unless shown by clear and convincing evidence to be incorrect. x x x ."

This provision of law is substantially provided for in Sections 1001 and 1002 of the US Revenue Code of 1954, which equally provides the determination of the amount of gain or loss arising from the sale or other disposition of property and reproduced in Sections 111 and 112(a) of the US Internal Revenue Code of 1939. (Jacob Mertens, <u>Law of Federal Income Taxation</u>, 1954-58 Code, 1959 Ed., p. LXX.) Other US Internal Revenue Code provisions, such as Sections 1011 and 1012, entitled Adjusted Basis for Determining Gain or Loss and Basis of Property-Cost, are provisions from which our law (Section 35(c)(1) of the National Internal

Revenue Code) has been equally taken. Sections 1001, 1002, 1011, 1012 and 1016 of the US Internal Revenue Code of 1954, to the extent here pertinent, are quoted as follows:

> SEC. 1001. <u>DETERMINATION OF AMOUNT OF AND RECOGNITION OF GAIN OR LOSS</u>.
>
> (a) <u>Computation of Gain or Loss</u>.- The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in Section 1011 for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.
>
> (b) <u>Amount Realized</u>.- The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received. In determining the amount realized -
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> xxx xxx xxx
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> xxx xxx xxx
>
> (c) <u>Recognition of Gain or Loss</u>.- In the case of a sale or exchange of property, the extent to which the gain or loss determined under this section shall be recognized for purposes of this subtitle shall be determined under section 1002.
>
> SEC. 1002. <u>RECOGNITION OF GAIN OR LOSS</u>
>
> Except as otherwise provided in this subtitle, on the sale or exchange of property the entire amount of the gain or loss determined under Section 1001, shall be recognized.

SEC. 1011. <u>ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.</u>

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SEC. 1012. <u>BASIS OF PROPERTY-COST.</u>

> The basis of property shall be the cost of such property except as otherwise provided in this subchapter and subchapters C (relating to corporate distributions and adjustments), K (relating to partners and partnerships), and P (relating to capital gains or losses). The cost of real property shall not include any amount in respect of real property taxes which are treated under Section 164(d) as imposed on the taxpayer."

A running commentary of these provisions which parallel our present law (Section 35(c)(1) of the National Internal Revenue Code) show that, under said Section 1001 of the aforesaid 1954 US Internal Revenue Code, in the determination of the amount of gain or loss arising from the sale or other disposition of property, it was the obvious intention of the US Congress to maintain the same rules that have been laid down under prior laws, as there is identity of the sentence structures of these provisions with the old ones. (Mertens, <u>Law of Federal Income Taxation</u>, Code Commentary, Section 1001:1 Vol II, Ch. 1, Subch. C-Page 6.)

That being the rule observed, the gain or loss from the sale or disposition of property is determined by the difference between the "amount realized" and the "adjusted (cost) basis" of the property. So that an excess of the "amount realized" over the adjusted cost basis results in gain, and an excess of the adjusted cost basis over the "amount realized" results in a loss. This method of computing gain or loss contemplates that, from the amount realized, there shall be withdrawn (or deducted) a sum sufficient to restore the adjusted cost basis, and the amount (if any) which thereafter remains constitutes the gain. The "amount realized" may be in cash or in other form, such as a benefit to the seller, or an obligation of the seller is assumed or satisfied, or other property other than cash is transferred to or for the benefit of the seller. (Mertens, Ibid., Sec. 1001:3, Vol. II, Ch. 1, Subch. O-Page 8; underlining ours.)

The "amount realized" from the disposition of property is the sum of any money plus the fair market value of property (other than money) received. (Sec. 1011:2, Mertens, Ibid., Code Commentary, Vol. II, Ch. 1, Subch. O-Page 7.)

Under the aforesaid Section 1002, it provides the general rule for requiring the recognition of the entire amount of gain or loss upon the sale or exchange of property (Mertens, Ibid., Vol. II, Ch. L.

Sub. O-Page 11) and that the basis of property shall be its "cost." (Sec. 1012:1, Ibid., Page 13.) In order to determine the gain or loss in sales or exchanges of property, one must first know the cost basis of the property given in exchange, which must first be recovered or eliminated from the cost of the property received in exchange, so as to isolate the profit or gain which is to be taxed. The cost ordinarily is not only the price paid for the property, but includes expenses involved in its acquisition, and capital expenses incurred on the property made thereafter. (Section 1012:2, Mertens, Ibid., Vol. II, Ch. 1, Subch. O-Page 14.) The purchase price of property includes any indebtedness to which it is acquired. (Ibid.)

The general scheme adopted by the law in determining gain or loss is to first fix the cost of the property given at a generic "unadjusted" basis, except only in such instances where cost could not be the legal basis such as when the property was acquired before March 1, 1913, in which case the fair market value as of that date is taken as basis (Mertens, Law of Federal Income Taxation, Sec. 21.01, Vol. 3, 1942 Ed., pp. 356-357; Sec. 35(a) National Internal Revenue Code, as amended.) or the fair market value at the time of acquisition, if the said property was acquired after March 1, 1913 by gratuitous title, i.e., by inheritance, donation or gift. But this unadjusted cost basis must always have to be adjusted, if any, by the increase or decrease due to expenditures, repayments, depreciation, obsolescence, amortization and depletion; receipts; losses, or other items. (Mertens, Law of Federal Income Taxation, 1954-58 Code) 1959 Ed., pp. 420-421; Ibid., Vol. 3, 1942 Ed., p. 360.) Ordinarily, the original cost of property is readily determinable and usually is the price paid for it (in cash or other property), plus the cost of acquiring it, with appropriate adjustments as aforesaid for capital expenditures, repayments, or other equivalents. (Ibid., Vol. 3, 1942 Ed., p. 360.)

That being the law, it is first important to know whether the properties that were transferred by the petitioner Nelly Magallanes Lopez and her late husband to MACDEN were properly costed.

The properties transferred by petitioner to MACDEN had a total net book value, after allowing depreciation of the same, of ₱429,988.85. These were the properties that were exchanged with securities and other intangible assets such as shares of stocks with a value of ₱120,000.00; assumption by MACDEN of the outstanding financial obligations and liabilities of petitioner in the total amount of ₱297,114.10; and the receipt from MACDEN of the sum of ₱12,874.74 which is the remaining balance of the consideration of the transfer of said properties in the amount of ₱429,988.85. Under the Deed of Sale with Assumption of Obligations, the exchange was consummated on January 16, 1963. The properties transferred consisted of four (4) parcels of land, with the buildings and improvements together with tractors, delivery and farm equipments, tools and implements, livestocks, service cars and other improvements thereon (Exh. 1, pp. 2-4, BIR rec.), in consideration of the aforesaid application of ₱120,000.00 in payment of the unpaid subscriptions of petitioner to shares of stock of MACDEN; the assumption by MACDEN of the liabilities of petitioner in the total sum of ₱297,114.10 appearing in petitioner's books, which includes accounts with the Philippine National Bank by way of crop loan, time and palay loans; and that the balance of ₱12,874.75 which shall be payable by MACDEN.

As per books of petitioner, the schedule of assets and their costs sold to MACDEN Enterprise Co., Inc. less depreciations, for emphasis, is shown below:

SCHEDULE OF ASSETS SOLD TO AND LIABILITIES ASSUMED BY MACDEN ENTERPRISES CO., INC. FROM MR. & MRS. CARLOS T. LOPEZ

| A S S E T S | C O S T | RESERVE FOR DEPRECIATION | BOOK VALUE |
|---|---|---|---|
| Buildings & Laborers Quarters | ₱68,703.09 | ₱22,281.04 | ₱46,422.05 |
| Tractors & Accessories | 71,827.32 | 62,338.64 | 9,488.68 |
| Roads, Bridges & Culverts | 2,772.01 | 2,772.01 | - |
| Delivery Equipments | 30,288.89 | 13,407.51 | 16,881.38 |
| Other Form Equipments | 3,851.37 | 2,166.74 | 1,684.63 |
| Farm Tools & Implements | 3,851.37 | 3,221.43 | 76.84 |
| Office Furniture & Fixtures | 6,294.40 | 5,775.02 | 519.38 |
| Service Car | 30,880.00 | 6,714.00 | 24,166.00 |
| Livestocks | 3,027.00 | - | 3,027.00 |
| T O T A L | ₱220,942.35 | ₱118,676.39 | ₱102,265.96 |
| Agricultural Land - Hda. Los Angeles | | | 240,000.00 |
| Urban Lots | | | 17,152.89 |
| Residential Building | | | 70,570.85 |
| T O T A L  A S S E T S | | | ₱429,988.85 |

In this instant case, there is no gain that has resulted in the exchange. What respondent did, however, which gave rise to the gain subjected to tax was to appreciate the market value of the assets of petitioner, which has a book value of ₱429,988.85 as shown above, and gave it a value at fair market at ₱964,738.37, apparently based on the report of Examiner Isabelo J. Romualdo (Exh. 3, pp. 12-14, BIR rec.) after his investigation, as follows:

| Kind of Property | Fair Market Value |
|---|---|
| 1. Residential Lots - - - - - - - - | ₱ 62,475.00 |
| 2. Agricultural Lots - - - - - - - - | 471,553.00 |
| 3. Sugar Quota - - - - - - - - | 229,779.30 |
| 4. 1962-1963 Standing Crop - - - - | 149,561.07 |
| 5. Improvement in the Hacienda - - | 51,370.00 |
| T O T A L - - - - - - - - | ₱964,738.37 |

By this appreciation of the value of the properties sold to, or otherwise disposed of by exchange with MACDEN, from their costs or net book values to their fair market values, or from ₱429,988.85 to ₱964,738.37, the difference resulting from the appreciation of the value of the assets is considered as the taxable gain. This approach used by respondent to determine the gain for tax purposes is due to the application of the case of Binalbagan Estate Inc. (G.R. No. L-12752, March 21, 1965), wherein it was stated that the increase in values of the assets over their costs should be taxed as profit realized from the exchange.

It is to be noted, however, that with the increase in the value of the assets of petitioner to ₱964,738.37, and if these fair market values shall be reckoned as their costs in the course of an exchange, as in this case, and the properties received from such exchange represented by the payment of unpaid subscribed shares of stock of MACDEN of ₱120,000.00; the satisfaction of the obligations in the value of ₱297,114.10; and the balance of ₱12,874.74 to be paid by MACDEN in installments, or in a total sum of ₱429,988.85, which is much less in value than the alleged cost represented by the fair market value of ₱964,738.37, there is clearly a resultant loss rather than a taxable gain or profit that was realized, to which conclusion we agree with petitioner.

But this is not so in this case since what was transferred or exchanged by petitioners were assets with costs or net books value of ₱429,988.85 at the time of exchange, in consideration of or in return for the receipt of intangible property received with fair market value equal to the cost of the tangible and intangible properties and obligations given in exchange in the amount of ₱429,988.85. (See Exh. 1, pp. 2-4, BIR rec.) This being the case, the value of the properties <u>given</u> and the things <u>received</u> in exchange being the same, there is no gain or loss resulting from the exchange.

Even granting that there was in fact appreciation of the value of the properties of petitioner given in exchange to ₱964,738.37, the appreciation of the values of properties given in exchange by itself will not give rise or bring about any gain or profit. (BIR Ruling No. 595, Series of 1959, Nov. 24, 1959; Scanlon vs. Comm., 42 BTA 997, cited in Jose Arañas, National Internal Revenue Code, Vol. 3, p. 341.) In other words, the mere increase in value from their origianl net book value of ₱429,988.85 to their asserted fair market value of ₱964,738.77, or an increase of ₱542,833.30, is not income but merely unrealized increase in value through the conversion of property which is not fundamentally taxable. (Mertens, Law of Federal Income Taxation, Vol. I, Par. 5.05; Fisher vs. Trinidad, 43 Phil. 943; Coll. of Int. Rev. vs. Adm. of the Estate of Exharri, 67 Phil. 502.)

In the instant case, however, respondent, plucking out a statement in the aforesaid resolution of the Supreme Court in the Binalbagan case, asserted that the properties of petitioner Nelly Magallanes Lopez which had an acquisition costs or net book value of ₱429,988.85, and which had been exchanged with the tangible and intangible personal properties, had appreciably increased to the fair market value of ₱964,738.37 at the time of exchange, and, hence, the difference arising from this appreciation of the value of the properties from their net book values of ₱429,988.85 to their alleged fair market value of ₱964,738.37 is the profit realized in the exchange.

This approach cannot, to our mind, be legally

acceptable inasmuch as in the disposition made by petitioner, thru the aforesaid Deed of Sale with Assumption of Obligation of her properties, respondent took into account the fair market value of the properties and not their costs, because this deed of sale is not, by its terms and contents substantially a sale. The transaction between petitioner and her husband, and MACDEN, to our mind is more in the nature of an exchange of property with unpaid shares, etc. rather than as sale of property. (See T. B. Noble, 12 BTA 1432, 1433; Burge, 14 BTA 733; Weiss vs. Stearn, 265 US 242.)
And in the exchanges of property, the "cost" of the property given is taken into account, and in the case of the property received, therefrom, in exchange, its fair market value is considered to determine whether in the transaction, there is gain or loss realized in the exchange. Under American and local authorities, the fair market value of property is not the same as the "cost" of the properties given in exchange, or in consideration for the satisfaction of obligations, the payment of the unpaid subscription and issuance of the corresponding shares of stocks, which are to be valued at "fair market value" in order to determine whether there will be a gain realized in the

exchange. The cost is not only the price paid for such property but include other costs, less or decreased by depreciation, absolescence, amortization and others. The fair market value is used only to value property received in the case of the exchanges of property. In other words, "fair market value" is never used as value of the property given in an exchange, except only where the property was acquired before March 1, 1913, or where the properties were acquired by gratuitous title, in which case the fair market value is the basis. As against the books of petitioner, respondent not having shown that the properties of petitioner and her late husband exchanged were acquired by gratuitous title after March 1, 1913, or acquired prior thereto, the cost as shown in the books of accounts of petitioner prevails. Much more, as aforesaid, the mere appreciation or increase in value of the property in the exchange thereof is legally and fundamentally not income for tax purposes and is only an unrealized increase in its value. (Mertens, Law of Federal Income Taxation, Vol. I, par. 5.05; Fisher vs. Trinidad, 43 Phil. 943; Coll. of Int. Rev. vs. Adm. of Estate of Exharri, 67 Phil. 502; Jose Arañas, National Internal Revenue Code, Vol. I, 1969 Ed., p. 341.) In this instant case, the value of the consideration received as a result of the exchange of the properties given by petitioner, i.e., the credit of ₱120,000.00 in return for the issuance of the unpaid MACDEN shares; the amount of ₱297,114.10 assumed by MACDEN of the petitioner's PNB obligations; and the account receivable in the sum of ₱12,874.75, or the total of ₱429,988.85, should properly be considered as their fair market value.

The respondent did not quite understood the significance of the resolution in the case of Binalbagan Estate Inc. case, which we think is inapplicable to this instant case. The reason for the inapplicability of the Binalbagan Estate Inc. case, contrary to what has been asserted by respondent, is that the appreciation of value from the original cost, which is ₱429,988.85 or an appreciable increase in value from said amount to its fair market value of ₱964,738.37, in the amount of ₱542,133.30, does not constitute the taxable gain realized from the exchange aforesaid because the mere increase in value of the properties in question did not bring about a realized gain in the exchange.

In the decision in the case of Binalbagan Estate, Inc., it is actually in the sell of the BISCOM shares of stock, acquired thru exchange by Binalbagan Estate, Inc., to the Philippine Planters Corporation, that has brought about the gain on that transaction. Prior thereto, the exchange of the properties and sugar quota of Binalbagan Estate, Inc. with the BISCOM shares was consumated with the said properties and sugar quota costed at fair market value of ₱4,023,763.97, instead of the book value of ₱824,559.91, excepted in the latter case, the sugar quota, which the Supreme Court did not clearly believe to be the real acquisition cost, and, hence, held that the acquisition cost of the 216,000 stocks are of the same fair market value, or ₱4,023,763.97. So that when the non-par value BISCOM shares of stock were later sold at ₱6,192,935.00, there resulted a taxable gain. This was the factual situation in the Binalbagan Estate, Inc. case which is not the same as in the case at bar, or even analogous to it.

In this instant case, the properties and assets of petitioner were exchanged with the stocks of MACDEN, and the assumption by the latter of petitioner's obligations. It is in the subsequent sale of the MACDEN non-par value shares of stocks, at their fair market value, which shall be the basis of the determination of the gain or loss. There is no subsequent sale made of the MACDEN stocks received by petitioner Nelly Magallanes Lopez so as to come within the holding in the case of the Binalbagan Estate, Inc. The basis for determining gain or loss in exchanges of property will be the difference in the acquisition cost or the latest inventory value of property given in exchange, and the fair market value of the property received in exchange. (Coll. of Int. Rev. vs. Binalbagan Estate, Inc., G.R. No. L-12752, Jan. 30, 1965, citing Sec. 35(c) of the Nat. Int. Rev. Code, and Sec. 136, Rev. Reg. No. 2, Income Tax Regulation.) Considering that the asserted fair market value of the assets and properties (₱964,738.37) which were given by petitioner in exchange of the tangible and intangible benefits received is higher in value than the properties received in exchange (₱422,625.07), there was no gain but instead there may be even a resultant loss to petitioner.

It has been apparently asserted and wrongly by respondent that the properties of petitioner, with a fair market value of ₱964,738.37, were exchanged only with the 1,600 shares of stocks of MACDEN. We think this is an error since what were really exchanged for the transfer of the properties of petitioner to MACDEN were not only the unpaid MACDEN shares of stocks, but also the assumption of the obligation of petitioner with the PNB by MACDEN in the sum of ₱297,114.10; and the amount of ₱12,674.75, which is the balance of the consideration of the transfer of petitioner's properties payable by MACDEN from date of execution of the deed of sale with assumption of obligation, with a total fair market value of ₱429,988.85.

The entering into a sale with assumption of obligation between petitioner and MACDEN, we believe is substantially more in the nature of an exchange rather than a sale. (Jacob Mertens, Law of Federal Income Taxation, Vol. 3A, Par. 22.92, citing Conrad Hilton, 13 TC 623; Sidney Weisner, TC MEMO 1961-234, etc.; Weiss vs. Loni Stearn, 265 US 241, 242, 68 ed., 1001.) A sale of property generally occurs where there is a disposition of property for cash, its equivalent, or the recipient's promise to pay. (Tauling v. US, 61-1, USTC, Par. 918.), cited in Mertens, Law of Federal Income Taxation, Vol. 3B par. 22-92), and an exchange of property ordinarily implies reciprocal transfers of assets other than cash, its equivalent, or the recipient's promise to pay (Ibid., citing Helvering vs. Autlian Flaccus Oak Leather Co., 313 US 247, 85 Led. 1310.) An exchange is both a disposition of property transferred by a taxpayer and an acquisition of property received in return. (Ibid., citing Miller vs. U.S., 331 F2d 854.)

When a property is exchanged for another property, the property received in exchange shall, for the purpose of determining gain or loss, be treated as equivalent to cash, or the amount of its fair market value, if any. (Section 204(b) of the U.S. Rev. Act of 1918, cited in A.V. Siegel et al., 14 US 186, 187.) Consequently, with the properties of petitioner that were exchanged being with a net book value or cost of ₱429,988.85 and fair market value of ₱964,738.37, with tangible and intangible assets (overpaid shares of stocks of MACDEN and assumed obligations), with a fair market value of ₱429,988.85, no gain resulted from such exchange therefor.

IN VIEW OF THE FOREGOING, we are of the opinion and so hold that, there being no gain resulting from the exchange thru the Deed of Sale with Assumption of Obligation entered into by and between petitioner

Nelly Magallanes Lopez and MACDEN, petitioner is not liable for deficiency income tax assessment in the amount of ₱250,965.94 for 1963. The assessment issued against petitioner is, therefore, hereby set aside.

No pronouncement as to costs.

SO ORDERED.

Quezon City, April 21, 1982.

CONSTANTE C. ROAQUIN
Associate Judge

WE CONCUR:

AMANTE FILLER
Presiding Judge

ALEX Z. REYES
Associate Judge