Library

REPUBLIC OF THE PHILIPPINES
COURT OF TAX APPEALS
MANILA

Nov. 28, 1959

ALBERTO M. K. JAMIR,
Petitioner,

- versus -

C.T.A. CASE NO. 443

COLLECTOR OF INTERNAL
REVENUE,
Respondent.

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

D E C I S I O N

The petitioner filed his income tax return for the year 1954 showing a gross income of ₱75,858.65 and deductions of ₱58,134.50, and a net taxable income of ₱17,724.15. On the basis of said return he paid income tax in the sum of ₱1,634.00.

After examination of petitioner's 1954 income tax return and his books of accounts and other records, the respondent assessed against petitioner a deficiency income tax and 50% surcharge in the sum of ₱16,395.00, itemized and computed as follows:

Net income as per return ------------		₱17,724.15
Add: Disallowances -		
1. Purchases overstated ----	₱ 1,118.95	
2. Unrecorded income-------	31,274.91	
3. Bank charges ---------	45.67	
4. Car depreciation ------	400.00	
5. Salary of driver ------	720.00	
6. Transportation --------	576.20	
Total adjustments ----------------		34,135.73
Net income as adjusted ----------------		₱51,859.88
Less personal and additional exemptions -		6,000.00
Net taxable income -------------------		₱45,859.88
Income tax due on ₱45,859.88 -----------		₱12,564.00
Less amount previously assessed and paid ------------------------------		1,634.00
Deficiency tax ------------------------		₱10,930.00
50% surcharge -----------------------		5,465.00
Total deficiency tax and surcharge -----		₱16,395.00

(See Exh. 20, pp. 41-42, BII.R. records)

435

Petitioner requested reconsideration of the assessment, except with respect to the overstated purchases in the sum of ₱1,118.95, in his letter to respondent dated July 19, 1957 (Exh. 15). The request for reconsideration was denied, and, in addition, petitioner was required to pay 5% surcharge and 1% monthly interest from December 3, 1956 to the date of payment, pursuant to Section 51(e) of the Revenue Code. He was also asked to pay a "compromise" of ₱50.00 for late payment of the deficiency tax. (See Exh. 16, pp. 57-58, B.I.R. records.) Petitioner has appealed from the decision of respondent.

The disputed items may be classified into three, viz:

1. Unreported income ------------	₱31,274.91
2. Deductions disallowed -	
(a) Bank charges ----------	45.67
(b) Car depreciation --------	400.00
(c) Salary of driver --------	720.00
(d) Transportation expenses -	576.20
3. The 50% fraud penalty --------	5,465.00

The disputed items will be considered in the order hereinabove presented.

<u>The alleged unreported income of ₱31,274.91</u>

The alleged unreported income of ₱31,274.91 has been explained by the income tax examiner in his report of May 31, 1956, as follows:

> "2. Unrecorded income due to cash credits ---------------------- ₱31,274.91
>
> (a) February -------- ₱1,281.24
>
> As per working papers, a cash credit in the amount of ₱3,843.94 can be seen during the month of February, but due to the explanation above regarding the purchases doubly entered in the amount of ₱2,562.70 a net cash credit of ₱1,281.24 resulted.

434

Granting that we accept the explanation of the taxpayer that this amount came from his salaries, the same still remains as an unrecorded income, it appearing that all his salaries from office and school were duly accounted for during the months of October and December, 1954.

(b) May ------------- ₱29,993.67

This amount is explained by the taxpayer in his letter as advances from customers. Notwithstanding this allegation, however, this examiner is of the opinion that this amount is still unrecorded income and not as advances from customers due to the following reasons: (1) The books as reconstituted do not show any account 'Advances from Customers' and the cash received is fully accounted for as either coming from cash sales, withdrawals from banks, or as miscellaneous income; (2) the taxpayer during the first six (6) months did not make any collections on account from anybody, and (3) the taxpayer can not and did not present any record or document to prove that this amount are advances from customers. Such being the case, it is insisted that this amount be included as taxable income." (Exh. 1, pp. 32-33, B.I.R. records.)

In this appeal, counsel for the Government seek to justify the findings and decision of respondent in regard to the alleged unreported income under the so-called "expenditures method" of determining unreported income. We quote from the memorandum of counsel:

"We now come to the item 'Unrecorded Income' which appears to be the largest amount involved herein. From the testimony of Examiner Vinuya (t.s.n. 96-100) it can be easily gleaned that this particular discrepancy was discovered thru an analysis of the expenditures of the taxpayer, otherwise known as the 'Expenditures Method' of determining income. This method is, in essence, simple proof of expenditures, investments and other outlays of money in excess of the taxpayer's income for the taxable year, giving rise to the inference that such expenditures represent unreported income to the taxpayer during the year or period in which they are made. (Fraud Under Federal Tax Law by Balter, 1953 Ed., CCH.) To this effect it was shown that after a verification of the

> taxpayer's reconstituted records his expenditures were in excess of his declared or available income." (Memorandum for Respondent, August 7, 1959, pp. 4-5.)

Briefly, the position of the Government is that since petitioner's records show that in February and May of 1954 his expenditures exceeded his income during these months, the excess represents unreported income; and a deficiency income tax has been assessed on account of such unreported income on the basis of the "expenditures method". To justify the use of this method, Balter's Fraud Under Federal Tax Law, 1953 ed. has been cited. The meaning and application of the "expenditures method" of determining unreported income have apparently been misunderstood. This method has been explained by Balter as follows:

> "This method is, in essence, simply proof of expenditures, investments and other outlays of money in excess of taxpayer's reported income for the taxable years, giving rise to the inference that such expenditures represent unreported income to the taxpayer during the years in which they were made.
>
> "Since these methods of indirect proof are based upon the same general theory, i.e., that money in the hands of the taxpayer not accounted for by his income tax returns leads to the inference that he failed to report all of his income, it will usually be found that a combination of two or all three of these methods will be used in any particular case.
>
> "The increase in net worth and expenditures methods are for practical purposes complementary of each other and must be considered as one mechanism for the establishment of unreported income. We shall, therefore, generally refer to this combined method as the increase in net worth method.
>
> "In order to establish a prima facie case, the government must prove:
>
> 1. That the taxpayer was engaged in an income producing business.

2. What the taxpayer's assets were at the beginning of the tax year in question, i.e., the 'starting point'.

3. What was the value taken at cost of these assets.

4. What were the taxpayer's assets and their value at the end of the tax period in question.

5. If the process of showing increase in net worth extends over a period of more than one tax year, what is the fair and reasonable allocation of the increase over the years in question.

6. What are the correct and fair adjustments to be made by way of eliminating duplications, return of capital, evaluation of unspecified or contingent obligations, depreciation, gifts, devises, bequests, or nontaxable items.

7. What are fair and equitable adjustments to be made for living expenses, payment of taxes, cost of life insurance, etc." (Balter, Fraud Under Federal Tax Law, 1953 ed., Pars. 227-228, pp. 422-423; emphasis supplied.)

It will be observed that the net worth-expenditures method of determining unreported income is availed of, under the circumstances mentioned by Balter, to establish unreported income for the taxable year or years in question. It has never been used to determine unreported income for periods short of a taxable year. This must be so because the net income of a taxpayer is required to be computed on the basis of his annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer (Sec. 38, Revenue Code). And in determining the net income, it is required that all items of gross income must be included in the gross income for the taxable year in which received by the taxpayer, and all deductions and credits must be taken for the taxable year in which "paid or accrued" or "paid or incurred", dependent upon the method of accounting upon the basis of which the net income is computed (Secs. 39 and 40). Finally, the law requires that an income tax return must be filed for each taxable year (Secs. 45 and 46). A return for a period less than twelve months is permitted under Section 42, but in such cases it is considered as a separate taxable period, and for this reason a separate return is required.[1]

As the income tax may not be computed on the basis of more than the regular annual periods, it is not likewise permissible to determine unreported income on the basis of less than the annual periods prescribed by law.

> "The Sixteenth Amendment was adopted to enable the government to raise revenue by taxation. It is the essence of any system of taxation that it should produce revenue ascertainable, and payable to the government, at regular intervals. Only by such a system is it practicable to produce a regular flow of income and apply methods of accounting, assessment, and collection capable of practical operation. It is not suggested that there has ever been any general scheme for taxing income on any other basis. The computation of income annually as the net result of all transactions within the year was a familiar practice, and taxes upon income so arrived at were not unknown, before the Sixteenth Amendment. See Bowers v. Kerbaugh-Empire Co., supra, p. 174; Pacific Insurance Co. v. Soule, 7 Wall. 433; Pollock v. Farmers' Loan & Trust Co., 158 U.S. 601, 630. It is not to be supposed that the amendment did not contemplate that Congress might make income so ascertained the basis of a scheme of taxation such as had been in actual operation within the United States before its adoption. While, conceivably, a different system might be devised by which the tax could be

---

1 A return for a taxable period of less than twelve months is also required in case of death of the taxpayer, under Section 40, Revenue Code.

> assessed, wholly or in part, on the basis of the finally ascertained results of particular transactions, Congress is not required by the amendment to adopt such a system in preference to the more familiar method, even if it were practicable. It would not necessarily obviate the kind of inequalities of which respondent complains. If losses from particular transactions were to be set off against gains in others, there would still be the practical necessity of computing the tax on the basis of annual or other fixed taxable periods, which might result in the taxpayer being required to pay a tax on income in one period exceeded by net losses in another." (Burnet v. Sanford & Brooks Co., 282 U.S. 359)

/In this case, petitioner filed his income tax return for the calendar year 1954. No separate return was filed for each of the months of February and May of that year, and no such return could have been validly filed for said months. Therefore, it is error for respondent to determine an alleged unreported income of petitioner for the months of February and May apart from the rest of the taxable year on the basis of the net worth-expenditures method. Obviously, upon the evidence of record, the net worth-expenditures method cannot be applied to the case of herein petitioner for the taxable period in question because his reported gross income (₱75,858.65) far exceeded the deductions claimed (₱58,134.50), even if all the deductions disallowed by respondent are considered against petitioner. (See page 1, supra.)

To show the impropriety of the application of the net worth-expenditures method to the instant case, we need but refer to the alleged unreported income of ₱1,281.24, the excess of petitioner's expenditures in February, 1954, over his supposed income during the same month. The evidence for petitioner, which is not controverted by respondent, shows that he received salaries from the Recto Law Office, the MLQ School of Law and the Philippine Law School during that month. They were, however, recorded in the books of petitioner for the months of October and December of the same year. (See Exh. 1, pp. 32-33, B.I.R. records.)

Taking into account said salaries, petitioner's income during the month of February exceeded his expenditures during that month. Does the fact that income actually received in February but recorded or "accounted for" in the books of the taxpayer for the month of October or December of the same year represent unreported income within the meaning of the Income Tax Law? Apparently, the position of respondent is that it is unreported income. Unquestionably, it is unreported income for the month of February, but it is income admittedly recorded for the month of October or December of the same year and actually reported in the taxpayer's income tax return for that year. The unreasonableness of respondent's determination is too obvious to need further comment.

With respect to the alleged unreported income of ₱29,993.67 for the month of May, 1954, we are satisfied from the evidence adduced by petitioner that he received advances from certain customers which, added to his salaries as professor of law and as an assistant in the Recto Law Office and the income from his business, more than offset the alleged excess of his expenditures over his recorded income for said month.

We now come to the deductions disallowed by respondent. The first item refers to -

Bank charges - ₱45.67

This item represents, according to petitioner, (a) the cost of check books or booklets obtained by him; (b) service charges in case the number of checks issued in one month exceeded the maximum allowed by the bank; (c) service charges in case the deposit fell below ₱500.00 at any one time; and (d) cost of telegrams in case of deposits made of checks drawn against banks located outside of Manila. (See page 7, Memorandum for Petitioner, March 16, 1959; pp. 51-53, t.s.n.)

Petitioner admitted in his testimony that he could not state in detail the breakdown of said amount. Added to this is the fact that petitioner failed to prove that the entire amount represents business expenses. It is possible that a portion of said amount is attributable to banking transactions unconnected with his business or that of his wife and therefore not deductible. For these reasons, the disallowance of the deduction of said bank charges must have to be sustained.

Car depreciation - ₱400.00; salary of driver - ₱720.00

The deductions for car depreciation and salary of driver being of similar nature, they will be considered together.

Petitioner claimed a depreciation deduction for his car in the sum of ₱800.00. Respondent disallowed one-half as personal expense, it appearing that the car was used both for personal and business purposes. From the evidence, it appears that the car of petitioner was used more for business than for personal purposes. He was, and is until now, a law practitioner, a law professor in two law schools and was, during the year in question, engaged in business as importer. He had only one car at the time. Consequently, three-fourths of the value of the depreciation of the car in the sum of ₱600.00 may be considered as a reasonable allowance in connection with his business, while one-fourth in the amount of ₱200.00 represents non-deductible personal expense.

The same is true as regards the salary of petitioner's driver in the sum of ₱1,440.00 which was claimed as a deduction in his return. Three-fourths of said amount, or ₱1,080.00, may be allowed as a business expense, and one-fourth, or ₱360.00, disallowed as a personal expense.

Transportation expenses - ₱576.20

In his return, petitioner claimed a deduction for transportation expenses "from office to M.L.Q. & Phil. Law School" in the sum of ₱1,325.00. Of this amount, respondent allowed the deduction of ₱748.80, the amount estimated to represent what petitioner would have reasonably spent for taxicab hire, and disallowed the balance of ₱576.20 as overclaimed deduction. In this appeal, however, petitioner claims that the said amount represents "the transportation for the delivery of merchandise to our customers, the transportation of my wife or that of my employees in coming to Manila for the purpose of attending to certain matters such as going to the bank, going to the customers as well as the transporation of goods from the pier after they are released by the customs authorities up to our warehouse at Binakayan, Kawit, Cavite." No documentary evidence has been presented to prove that such expenses were actually incurred in connection with his business, in addition to the expenses in the operation and maintenance of his car. We find no justification to modify respondent's determination.

The fraud penalty of 50% surcharge - P5,465.00

Included in the assessment against petitioner is the 50% surcharge provided in Section 72 of the Revenue Code, which is imposed in case of willful neglect to file an income tax return within the time prescribed by law, or in case a false or fraudulent return is willfully made. We have scanned the records of the case for the reason or reasons relied upon by respondent to justify the imposition of the fraud penalty and we have found none. The report of the internal revenue examiner does not contain any statement in regard to this penalty. The letter of respondent to petitioner dated November 9, 1956 (Exh. 20, pp. 41-42, B.I.R. records) does not state any reason for the imposition of said penalty. From the start, petitioner questioned the propriety of the imposition. (Exh. 13, pp. 45-47, B.I.R. records.) However, even the final decision of respondent (Exh. 16, pp. 57-58, BIR records) is silent in regard to the fraud penalty, although it is also included in the computation of the deficiency assessment. We cannot look with favor upon arbitrary impositions of the fraud penalty.

The question in regard to the fraud penalty was first touched upon in the answer of the Government to the petition for review filed by petitioner. The answer contains the following allegations:

"3. That petitioner's income tax return for the year 1954 is false and fraudulent, the falsity consisting in his willful failure to report in his return the aforesaid sum of ₱34,135.73 as additional income for 1954, more particularly the 'unrecorded income' of ₱31,274.-91 mentioned in paragraph 4 hereof;

"4. That by reason of the falsity of the 1954 income tax return filed by petitioner as stated in the next preceding paragraph, the addition of 50% surcharge to the tax due is warranted under section 72 of the National Internal Revenue Code, which expressly directs the imposition thereof;"

If the sole reason for the imposition of the fraud penalty in this case is the alleged failure of petitioner to include in his income tax return the alleged "unrecorded income" in the sum of ₱31,274.91, there is no longer any justification for the imposition thereof since, as already stated, we have found neither legal nor factual basis to support respondent's finding as regards the alleged "unrecorded income".

FOR THE FOREGOING CONSIDERATIONS, we find petitioner liable for the deficiency income tax for the year 1954 in the sum of ₱552.00, computed as follows:

Net income per return --------------		₱17,724.15
Add: Disallowances -		
1. Overstated purchases-	₱1,118.95	
2. Bank charges --------	45.67	
3. Car depreciation (½)-	200.00	
4. Salary of driver (½)-	360.00	
5. Transportation expenses ---------	576.20	2,300.82
Net income as adjusted -----------		₱20,024.97
Less personal and additional exemptions -------------------		6,000.00
Net taxable income ---------------		₱14,024.97
Income tax due on ₱14,024.97 ------		₱ 2,186.00
Less amount previously assessed and paid ----------------------		1,634.00
Deficiency income tax ------------		₱ 552.00

Accordingly, the decision appealed from is hereby modified, and petitioner is ordered to pay the sum of ₱552.00 within thirty days from the date this decision becomes final. If the said amount, or any portion thereof, is not paid within said period, the surcharge of 5% and a monthly interest at the rate of 1% shall be added to the unpaid amount from the date of delinquency to the date of payment. No pronouncement as to costs.

SO ORDERED.

Manila, November 28, 1959.

ROMAN M. UMALI
Associate Judge

WE CONCUR:

MARIANO NABLE
Presiding Judge

AUGUSTO M. LUCIANO
Associate Judge