REPUBLIC OF THE PHILIPPINES
COURT OF TAX APPEALS
QUEZON CITY

MARIETTA KALAW, INC.,
Petitioner,

- versus - C.T.A. CASE NO. 2275

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

5/26/81

D E C I S I O N

This suit is brought by petitioner Marietta Kalaw, Inc. for recovery of the amount of ₱30,462.00 as alleged overpaid income tax for 1968. Respondent, however, denied the claim for refund and interposed as counterclaim deficiency assessment for income and personal holding company taxes in the amounts of ₱14,185.96 and ₱74,304.17, respectively, both for 1968.

As borne out by the pleadings submitted by the parties and records of the Bureau of Internal Revenue pertaining to this case, it appears that petitioner is a duly registered domestic corporation engaged in real estate business with offices located at 1200 A. Bocobo St., Ermita, Manila.

On April 14, 1969, petitioner filed its income tax return for the taxable year 1968 declaring therein a net taxable income of ₱154,066.20 and paid income tax as reflected thereon in the sum of ₱41,072.00. (Exh. A, Petitioner's Envelope; Exh. 9, p. 140, BIR rec., Folder 1) as follows:

| O.R. | Date | Amount |
|---|---|---|
| A-0519577 | 4/14/69 | ₱20,536.00 |
| A-0519629 | 7/15/69 | 20,536.00 |
| T O T A L | - | ₱41,072.00 |

(Exhs. E & E-1, Petitioner's Envelope.)

Sometime on February 2, 1970, respondent directed an examiner to conduct an investigation of petitioner's tax liabilities. (Exh. 1, p. 141, BIR rec.) As a consequence thereof, respondent in a letter dated September 30, 1970, informed petitioner about a proposed assessment to wit:

| | |
|---|---|
| Deficiency Income Tax Under Sec. 24 of the Tax Code - - - - - - - - - | ₱12,022.00 |
| Additional Tax on Personal Holding Company Under Sec. 63 of the Tax Code - - - - - - - | 74,206.44 |
| T O T A L - - - - - - - - - | ₱86,228.44 |

with an advise that an informal conference within the next ten (10) days may be requested should there be any objection to the proposed assessment. (Exh. 8, p. 150, BIR rec., Folder 1.) This was followed by a notice dated January 29, 1971 informing petitioner that nothing definite was arrived at in the discussion of the proposed assessment with respondent's examiner. Petitioner was again advised to request for an informal conference within the next ten (10) days if there is any serious objection to the proposed assessment, otherwise, the same would be finalized. (Exh. 10, p. 151, BIR rec., Folder 1.)

On February 8, 1971, counsel for petitioner asked that the conference be deferred to February 15, 1971. (p. 152, BIR rec., Folder 1.) Instead of having an informal conference on the date it requested, petitioner, on February 16, 1971 filed an amended income tax return for 1968 reflecting thereon the amount of ₱45,150.50 as its net income, resulting in a reduced tax liability of ₱10,610.00 and showing an overpayment of ₱30,462.00. (Exhs. C & 12, pp. 168-179, BIR rec., Folder 1.)

On April 15, 1971, petitioner filed with respondent a claim for refund of the amount of ₱30,462.00 which represents the difference between the tax previously paid of ₱41,072.00 and the tax liability of ₱10,610.00 on the ground that it reported as capital gains the amount of ₱221,134.68 instead of ₱89,624.68 actually received in 1968. It alleged that the original income tax return was prepared based on the realization of the full income while it has been adopting a cash basis. (Exh. F, p. 40, BIR rec., Folder II.) On the same date petitioner instituted the instant appeal with this Court. (p. 1-4, CTA rec.)

On January 18, 1972, Revenue Examiner Pastor Oscaya had already investigated and verified the claim of petitioner and recommended to the Chief, Financing, Real Estate & Transfer Taxes (Audit) Division, that the amount of ₱29,785.00 representing overpayment of income tax in 1968 be refunded. (Exhs. B-3, B-3-A, pp. 47-48, BIR rec., Folder II.) Before complete resolution of the claim, however, the instant case was schedule for hearing by this Court, and during the trial thereof, the parties presented their evidence oral and documentary. It appears, that on December 27, 1973, respondent assessed and demanded from petitioner the payment of deficiency income tax for 1968 in the amount of ₱14,185.96, details of which are as follows:

ACR-36-4-800594-73/68

| | | |
|---|---|---|
| Net income per return . . . . . . . . . . . | | ₱154,066.20 |
| Add: Unallowable deductions: | | |
| 1. Interest expense . . . . | ₱22,594.30 | |
| 2. Loss on sale of fixed assets | 14,408.35 | 37,002.65 |
| Net income per investigation. . . . . . . | | ₱191,068.85 |
| Tax due thereon . . . . . . . . . . | | 53,094.00 |
| Less: Amount already assessed . . . . . | | 41,072.00 |
| B a l a n c e . . . . . . . . . . | | ₱ 12,022.00 |
| Add: ½% mo. int. fr. 4-16-69 to 4-16-72 . | | 2,163.96 |
| TOTAL AMOUNT DUE & COLLECTIBLE . . . . . | | ₱ 14,185.96 |

and personal holding company tax for the same year in the amount of ₱74,304.17, to wit:

| | |
|---|---|
| Total amount subject to tax . . . . . . | ₱139,932.55 |
| 45% personal holding company tax due thereon . . . . . . . . . . . . | ₱ 62,969.64 |
| Add: ½% mo. int. fr. 4-16-69 to 4-16-72 | 11,334.53 |
| TOTAL AMOUNT DUE & COLLECTIBLE . . . . . | ₱ 74,304.17 |

(Exh. 14, pp. 309-310, BIR rec., Folder 1.)

The question therefore of whether petitioner is legally entitled to the refund of overpaid income tax for 1968 is interlaced with the following issues, to wit:

1. Whether or not petitioner has changed its method of reporting income and expenses in 1968;

2. Whether or not the sale of the cars to Messrs. Edgardo T. Kalaw and Mariano T. Kalaw is a bonafide transaction, the loss of which on the part of petitioner is a deductible expenses; and

3. Whether or not petitioner is a personal holding company pursuant to Section 63 in relation to Sections 64 and 65 of the Revenue Code.

Before going into the merits of the case, we will first thresh out the preliminary question of prescription raised by respondent. In opposing petitioner's appeal, respondent contends that the instant petition was filed with this Court beyond the two year period provided in Section 306 (now Sec. 292) of the Revenue Code. Apparently, respondent assumed that the counting of the two year period prescribed by law should be reckoned from April 14, 1969 when petitioner filed its return.

Therefore, this Court has no jurisdiction, the instant petition having been filed only on April 15, 1971.

Respondent misses the point. While petitioner did file its income tax return for the taxable year 1968 on April 14, 1969, it paid the tax due thereon in two equal installments, the final payment thereof appears to have been made on July 15, 1969. (See Exhs. A & 9, supra.) A similar situation had already been considered by the Supreme Court which held that when the tax is paid in installments, the prescriptive period provided in Section 306 of the Revenue Code should be counted from the date of the final payment. (Coll. v. Prieto, et al., No. 11976, April 21, 1961, 2 SCRA 1007.) Inasmuch as the instant petition was filed on April 15, 1971, it is obvious that the same was filed within the time prescribed by law. Hence, this Court has jurisdiction.

We will now discuss the issue of whether or not petitioner has changed its method of reporting income and expenses in 1968.

Petitioner contends that it has been regularly reporting on cash basis, however, in the preparation of the 1968 return, the entire amount of ₱221,134.68 representing gains on capital asset was reported instead of ₱89,624.68 actually received in that year. It therefore caused the amendment of its return on February 16, 1971 to reflect its true net income. In support thereof petitioner submitted as Exh. "A-6" the amendment to its 1969 return which reflected the capital gains actually realized for that year.

On the other hand, respondent submits that petitioner who had been adopting the cash basis of reporting income and expenses, had without previous permission changed its method of accounting in 1968 in violation of Section 168 of Revenue Regulations No. 2. This is based on the fact that for the said year, petitioner returned the entire (accrued) amount of capital gains instead of the amount actually received in the same year, had it been reporting on cash basis. Respondent also argues that due to petitioner's change of its method of accounting, the disallowance of the amount of ₱22,594.30, as interest expense which correspond to the year 1969, is proper.

The contention of respondent that petitioner changed its method of accounting in violation of Section 168 of Revenue Regulations No. 2, is without merit.

It will be noted, as indicated earlier that petitioner filed its income tax return for 1968 on April 14, 1969 declaring therein a net taxable income of ₱154,066.20 on the basis of which it paid the corresponding tax due thereon amounting to ₱41,072.00. This return was however, amended on February 16, 1971. And, while it appears in the original return that petitioner shifted from cash basis to accrual basis, we noted that corresponding adjustment was made in the amended return.

We likewise find the argument of respondent that due to petitioner's change in its method of accounting, the amount of ₱22,594.30 as interest expense which correspond to the year 1969 is proper, without merit.

As shown by the records, there was a readjustment of the interest expense. Thus, the amount of ₱126,862.17 declared in the original return was reported in the amended return in the amount of ₱104,267.87, thereby deleting the amount of ₱22,594.30. This readjustment render further discussion of the interest expense, unnecessary.

The issue on the disallowance of the loss of petitioner on the sale of cars to the Kalaw brother, now comes in.

Petitioner contends that the sale of the cars to Messrs. Edgardo T. Kalaw and Maximo T. Kalaw, Jr.

was at "arms lenght transaction", hence, the loss thereof on its part is an allowable deduction under Section 30(d) of the Revenue Code. Respondent contends otherwise.

We disagree with petitioner. The pertinent provision is Section 31(b)(2) of the Revenue Code which provides:

> SEC. 31. <u>Items not deductible</u>. - In computing net income no deduction shall in any case be allowed in respect of -
>
> x x x x x x x x x x
>
> (b) <u>Losses from sales or exchanges of property</u>.- In computing net income no deduction shall in any case be allowed in respect of losses from sales or exchanges of property, directly or indirectly;
>
> x x x x x x x x x x
>
> (2) Except in the case of distributions in liquidation, between an individual and a corporation more then fifty <u>per</u> <u>centum</u> in value of the outstanding stock of which is owned, directly or indirectly, by or for such individual;
>
> x x x x x x x x x x

It will be noted that the losses here involved is not a consequence of a distribution in liquidation and Messrs. Edgardo T. Kalaw and Maximo T. Kalaw, Jr. are brothers who among other relatives owned directly or indirectly the outstanding stock of petitioner. Hence, losses on the sale of the cars by petitioner to them is not an allowable deduction.

We now come to the issue of whether or not petitioner is a personal holding company subject to the additional tax on undistributed net income under the law.

There is no quarrel between the parties that for purposes of the income tax law pertinent to this case, "personal holding company" is any corporation other than, firm or association exempt from taxation under Section 27 of the Revenue Code, a bank duly license to do business as such in the Philippines, a life insurance company, or a foreign personal holding company as defined in Section 67 of the same code, if (1) at least 80% of its gross income for the taxable year is a personal holding company income as defined in Section 65 thereof; and (2) at any time during the last half of the taxable year more than 50% in value of its outstanding stock is owned, directly or indirectly, by any or for not more than 5 individuals. (See Sec. 64(a) and (b) of the Revenue Code.)

The income tax regulations define "personal holding company" as any corporation which for the taxable year meets (a) the gross income requirement, and (b) the stock ownership requirement. Both requirements must be satisfied and both must be met with respect to each taxable year. (Sec. 219, Rev. Regs. No. 2.)

The conflict however, arose when on the basis of the original return, respondent determined that petitioner has a gross income of P469,966.73 and a personal holding company income of P421,544.00 as shown in the worksheet of the Revenue Examiner. In other words, respondent contends that at least 80% of petitioner's gross income is personal holding company income. Respondent also contends that petitioner is 100% owned by related family, so that both the gross income and stock ownership requirements of the law have been met; therefore, petitioner is a personal holding company.

We disagree with respondent. We have found earlier that petitioner has amended its return for 1968 on February 16, 1971. The figures indicated therein should therefore be the basis of determining whether the statutory conditions with respect to the gross income requirement had been satisfied.

As shown in the amended return, the gross income of petitioner is P311,518.38, broken down as follows:

Gains or Losses from Sales or Exchange of Property other than Capital Assets . . . . . . . . . (P13,783.08)

| | |
|---|---|
| Gains or Losses from Sales or Exchange of Capital Assets . . . | ₱ 89,624.68 |
| Rentals & Royalties . . . . . . . | 164,491.55 |
| Dividends . . . . . . . . . . | 8,979.45 |
| Other Sources . . . . . . . . . . | 62,205.78 |
| TOTAL GROSS INCOME . . . | ₱311,518.38 |

(Exhs. C & 12, supra.)

Even a cursory examination of the above figures, with the disallowance of the amount of ₱13,783.08 claimed as losses from sale or exchange of property other than capital assets, immediately reveals that the rentals amounting to ₱164,491.55 constitute more than 50% of the gross income of petitioner. And, because of the provision of Section 65(h) of the Revenue Code in relation to Section 64 of the same Code, said amount of ₱164,491.55 inspite of being rentals can not be considered as personal holding company income.

Moreover, assuming arguendo, that all the items other than rents are considered personal holding company income, the sum total thereof would only amount to ₱174,592.99 which is less than 80% of the total gross income of ₱339,184.54. Clearly therefore, the gross income requirement of Section 64(a)(1) of the Revenue Code has not been satisfied. With this conclusion, we need not discuss the argument of respondent with respect to the stock ownership requirement.

For all the foregoing, the computation of the amount refundable to petitioner for the year 1968 is as follows:

| | |
|---|---|
| Net income per amended return . . . | ₱45,159.50 |
| Add: Unallowable deduction: | |
| Gains from sale of property other than capital assets . | 13,783.08 |
| Net taxable income . . . . . . . . . | ₱58,942.58 |
| Tax due thereon . . . . . . . . . | 14,745.00 |
| Amount already paid . . . . . . . . | 41,072.00 |
| BALANCE REFUNDABLE . . . | ₱26,237.00 |

Accordingly, respondent Commissioner of Internal Revenue is hereby ordered to refund to or grant a tax credit in favor of petitioner Marietta Kalaw, Inc. the amount of ₱26,237.00 as overpaid income tax for 1968.

WHEREFORE, the decision assessing petitioner for deficiency income tax is hereby modified as indicated in the above opinion of the Court and the assessment for personal holding company income declared null and void. Without pronouncement as to costs.

SO ORDERED.

Quezon City, May 26, 1981.

CONSTANTE C. ROAQUIN
Associate Judge

WE CONCUR:

AMANTE FILLER
Presiding Judge

ALEX Z. REYES
Associate Judge