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VARSITY HILLS, INC.,
Petitioner,

Aug. 30/69

versus

CTA CASES NOS. 1455 & 1731

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

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DECISION

These two cases are appeals from the decisions of respondent assessing petitioner the sums of ₱15,830.88 (CTA Case No. 1455) and ₱10,514.35 (CTA Case No. 1731) as deficiency income taxes for the years 1956 and 1959, respectively. These two cases were jointly tried and submitted to this Court for a joint decision as they involve identical parties and issues.

Petitioner is a domestic corporation organized and existing under and by virtue of the laws of the Philippines. In the years in question (1956 & 1959), it was engaged as a developer of a subdivision in Marikina, Rizal, and selling the subdivided and developed lots by installments to the public. In order to provide water supply to the buyers of its lots, it entered into a contract with the National Waterworks & Sewerage Authority (NAWASA) for the construction of a waterworks system in the subdivision. The agreement stipulated, among others, that petitioner would advance, as in fact it advanced, to the NAWASA the sum of ₱338,796.80 for the installation of the water supply system in the subdivision, to be repaid out of the water fees and water rentals collected from the lot owners until the full amount advanced by petitioner is recovered, the ownership of the water system remaining with the NAWASA. Pursuant to the above agreement NAWASA has already repaid to petitioner the sum of ₱100,843.05, itemized as follows:

Date	Amount
1952	none
1953	none
1954	none
1955	none
1956	₱ 3,284.42
1957	2,604.63
1958	10,203.45
1959	11,910.69
1960	6,256.56
1961	none
1962	36,259.86
1963	4,684.04
1964	6,148.62
1965	9,086.81
1966	10,403.97
1967	none
TOTAL REFUND	₱100,843.05

Respondent, in its letter of August 15, 1963, and received by petitioner on August 29, 1963, assessed petitioner in the sum of ₱15,830.88

representing deficiency income tax for 1956, computed as follows:

Net income per return . . .	₱576,278.46
Add: Unallowable deduction: Cost of Waterworks	47,914.98
Net income per final investigation	₱624,193.44
Tax due thereon	₱166,774.00
Less amount already assessed	153,358.00
B a l a n c e	₱ 13,416.00
Add: ½% monthly interest from 6/20/59 to 6/20/62	2,414.88
Deficiency tax due	₱ 15,830.88

This deficiency assessment was contested by petitioner in CTA Case No. 1455.

Respondent also assessed petitioner a deficiency income tax for 1959 the sum of ₱10,514.35 which arose out of the disallowance of the amounts of ₱28,809.85 representing the alleged overstated cost of sales of lots for 1959, and ₱1,800.00 as the cost of the construction of culverts and rip-rap headwall on the subdivision.

The issues involved in these cases are:

(1) Whether or not the sums of ₱47,914.98 and ₱28,809.85 advanced by petitioner to NAWASA for the installation of a waterworks system in the former's subdivision in 1956 and 1959, are to be considered as part of the cost of the lots offered for sale (capital expenditures) and therefore allowable deductions; and

(2) Whether or not the sum of ₱1,800.00 spent in 1959 for the

> construction of box culverts and rip-rap headwalls in the subdivision of petitioner is an allowable deduction as an ordinary and necessary business expense.

With regard to the first issue, petitioner contends that as a matter of good accounting practice, it treated the amounts of ₱47,914.98 and ₱28,809.85 representing parts of the total amount of ₱338,796.80 advanced by it to NAWASA for the construction of a water supply system in the former's subdivision in 1956 and 1959, respectively, as part of the costs of the lots it sold (chargeable to capital expense) and therefore deductible from its income tax. It further averred that considering the yearly reimbursements made by NAWASA to petitioner from 1952 to the present, there is an indication that the amount of ₱338,796.80 which was advanced by the latter to the former would never be fully refunded within the corporate existence of petitioner. Petitioner stated that every amount received by it from NAWASA has been reported as "other income" in its income tax returns.

On the other hand, respondent claims that the amount advanced by petitioner to NAWASA for the construction of the waterworks system is not a capital expenditure as contemplated under Section 120 of the Income Tax Regulations (Revenue Regulations No. 2), the pertinent portion of which is quoted hereunder:

> "Section 120. CAPITAL EXPENDITURES.—No deduction from gross income may be made for any amounts paid out for new buildings or for permanent improvements or betterments made to increase the value of the taxpayer's property, or for any amount expended in restoring property or in making good the exhaustion thereof for which an allowance for depreciation or depletion or other allowance is or has been made. Amounts expended for securing a copyright and plates, which remain the property of the person making the payments, are investments of capital. . ."

It points out that the phrase "paid out" in the above-cited regulation implies that the expenses for the betterment or improvements on the property should be borne out by the taxpayer, which is not the situation in the case at bar, NAWASA being the owner of the waterworks system. Such expenses, therefore, could not be considered as a capital expenditure of petitioner. It also stresses that the amounts claimed are not ordinary and necessary business expenses because the same are merely loans to the NAWASA by the petitioner to be reimbursed from water fees and water meter rental collections.

We believe petitioner's stand to be well taken. Although there is no jurisprudence yet on this question in our jurisdiction as this case is of first impression here, we find that the Tax Court and District Court of the United States have already settled this issue in analogous cases. The settled doctrines in that jurisdiction on this point can very well be adopted here since Section 120 of our Income Tax Regulations cited by respondent was lifted from cognate provisions of the Federal Income Tax Regulation which we quote hereunder:

> "§ 1.263(a) Statutory provisions; capital expenditures; general rule. /Sec. 263(a) IRC/
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> x x x x x
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> "(a) Except as otherwise provided in chapter 1 of the Code no deduction shall be allowed for-
>
> "(1) Any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate, or
>
> "(2) Any amount expended in restoring property or in making good the exhaustion thereof for which an allowance is or has been made in the form of a deduction for depreciation, amortization, or depletion.
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> x x x x x
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> "§ 1.263(a)-2 (T.D. 6313, filed 9-16-58; republished in T.D. 6500, filed 11-25-60.) Examples of capital expenditures.
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> "The following paragraphs of this section include examples of capital expenditures:

> "(a) The cost of acquisition, construction, or erection of buildings, machinery and equipment, furniture and fixtures, and similar property having a useful life substantially beyond the taxable year.
>
> "(b) Amounts expended for securing a copyright and plates, which remain the property of the person making the payments. . ." (Federal Regulations, Prentice-Hall, Inc. Aug. 1, 1962.)

The cases of Albert Gersten, et al. v. Comm. of Internal Revenue (28 TC 756), The Colony Inc. v. Comm. of Internal Revenue (26 TC 30) and the Divine v. US (10 AFTR 2d 5403) are in point.

In the case of The Colony, Inc. v. Comm. of Internal Revenue, petitioner is a corporation organized to acquire, subdivide and sell real estate. In 1948 and 1949, petitioner made payments to the Utilities Company for the extension of gas and electricity service to The Colony subdivision and included this amount in the cost of its Colony lots. The contracts between petitioner and the companies provided that all or a part of the payments might be refunded to petitioner. Respondent takes the position that the petitioner is not entitled to add any part of the payments to the costs of the lots it sold during the taxable years, because there existed a possibility that all or a part of the payments might be refunded to petitioner at some time after the taxable years. The Tax Court ruled:

> ". . . The determinative factor is that the petitioner made unconditional payments to the two companies in order to obtain utility service for The Colony, and thereby to attract customers for The Colony lots. The payments were thus closely related to the sale of the lots, and petitioner's income from the sale of lots will be more clearly reflected if a pro rata portion of the payments in question are included in its basis for gain or loss in each lot which was sold. . . . The question of the taxability of the refunds which petitioner may receive from the utility companies is not before us. It is noted, however, that the petitioner concedes, on brief, that such refunds would, if made, constitute taxable income. See Chevy Chase Land Co., 34 B.T.A. 150."

In the case of Albert Gersten, et al. v. Comm. of Internal Revenue, the Tax Court reiterated its doctrine applied in the Colony case (supra). In this case, four corporations in which certain of the petitioners were stockholders were engaged in the business of subdividing tracts of land into lots and constructing and selling houses thereon. To procure the waterlines necessary to supply water for the houses so built and sold, the corporations, under contracts with the water company, paid the cost of the extension of the water company's lines into the various properties. For a period of 10 years from the date of completion of the waterlines the water company agreed to make payments to the corporation based on a percentage of the gross revenue it would derive from the sale of water to the occupants of the houses sold, but in an amount not to exceed the cost to the corporation for the running of the waterlines. The corporation did not hold title to the facilities. All of the houses were completed and sold. In reporting their gain upon the sales of the houses the four corporations treated the cost to them of the waterline as part of the cost of the houses sold, which treatment was disallowed by the respondent in the determination of the income. The Tax Court, in deciding the case in favor of petitioners, held that the payments made by the corporations to the water company for the construction of waterlines were properly included by the corporation as part of the cost of houses sold. The Tax Court said:

> "The first issue raised in the proceedings is whether the payments which the 4 corporations, Richard, Whittier, Rex, and Lawrence, made to San Gabriel were properly included by such corporations in computing the cost of the houses which they constructed and sold. The respondent determined that the amounts paid to San Gabriel were not properly includible by the corporations in computing their cost of goods sold because all such payments were

repayable. Petitioners, on the other hand, argue that the liability of each of the corporations to pay for the installation of the water facilities was fixed and absolute; and that despite whatever possibility there was of a repayment of part or all of the amounts paid, the payments were nonetheless properly includible in computing the cost of the houses sold.

"In Colony, Inc., 26 T. C. 30, we had much the same question as here. There the corporate taxpayer, which was engaged in the business of subdividing tracts of land and selling lots, made payments to utility companies for the installation of gas and electric service under contracts which called for the repayment of the amounts paid, such repayments to be made by payment of a specified amount for each new customer who purchased service from the gas company's mains or connected to the electric company's lines. The repayments were to be made only for a period of either 5 or 10 years from the date of the contract. The Commissioner took the position that the taxpayer was not entitled to include any part of the payments so made to the utility companies as a part of the cost of the lots which it sold during the taxable years, because of the possibility that all or a part of such payments might be repaid. We concluded that the determining factor was that the taxpayer had made unconditional payments to the utility companies in order to obtain service from them for the purchasers of its lots. We held that the payments were thus closely related to the sale of the lots and that the taxpayer's income from such sales would be more clearly reflected if a pro rata portion of the payments which it made to the utility companies was included in its basis for determining the gain or loss on each lot sold.

> "We see no distinguishing difference in that case and the one before us here. It is true that there the repayments were measured by a fixed sum to be paid for each new customer who purchased service from the utility companies, while here the payments depended upon the amount of water sold by San Gabriel in the various subdivisions. But in both cases the controlling facts were that the corporations made unconditional payments to provide utility service for the subdivisions, and such payments were directly related to the property sold. We therefore conclude that the payments which the 4 corporations here made were a proper item to be included in computing the cost of the property which they sold."

Another case which we think is four-square to the case at bar is the case of Divine v. U.S. (10 AFTR 2d 5403), wherein the taxpayer made deposits with public utilities to provide services, had added these deposits to the cost of lots sold, for the purpose of determining gain or loss on sales of real estate lots and later, when the utilities paid him back, included these repayments as income, the District Court held that petitioner's accounting treatment is correct. The District Court ruled as follows:

> "On the question of the deposits of the public utilities— with the public utilities, the taxpayer was, of course, required to make deposits with the public utilities in order to get the utilities to the subdivisions. The taxpayer followed the practice, apparently, of adding those deposits to the cost of the lot, which reduced the profit

and then later, when the public utility paid the taxpayer back, the taxpayer would include that in income. The Government contends that it should not have done that, that it should have set up a prepaid asset and then charged it off when they got the money back. The Government pretty well concedes that its own Internal Revenue Code, Section 1011, and the Bulletin at page 285, is on the taxpayer's side on that issue, as well as the case of Gersten versus Commissioner, 28 Tax Court, at page 756. So the Court holds that the way the taxpayer handled the public utility deposit was correct."

In the same vein as the foregoing rulings are the doctrines in the cases of Mount Vernon Gardens, Inc. v. Commissioner of Internal Revenue (9 AFTR 2d 671), Willow Terrace Development Co., Inc. v. Commissioner of Internal Revenue (40 TC 689) and Kauai Terminal, Ltd. (47 BTA 623). We see no valid reason to deviate from this interpretation uniformly and consistently pursued in the source of the regulation in question. As we have stated above, the regulation in question is almost a verbatim copy of the regulation which is the subject of interpretation in the herein cited cases. Consequently, we hold that the disallowance of the deductions of the amounts of ₱47,914.98 and ₱28,809.85 representing cost of construction of waterworks system in 1956 and 1958 respectively, is unjustified.

Anent the second issue of whether or not the sum of ₱1,800.00 spent in 1959 by petitioner is an allowable deduction as an ordinary and necessary expense, we agree with respondent that such amount should be disallowed. Petitioner did not present evidence as to the nature of said expense, but merely stated that to follow respondent's contention that such expense is a capital expenditure would entail much work of recomputation and amendment of its income tax returns, which is not commensurate with the amount of ₱540.00 income tax payable, at 30% on the ₱1,800.00. Considering that the determination of the Commissioner of Internal Revenue is presumed correct and it behooves the taxpayer to rebut such presumption (Tan Guan v. C.T.A., et al., L-23676, April 27, 1967) his failure to do so is fatal to him claim. It is hardly necessary to say that deductions are a matter of legislative grace and does not turn on general equitable considerations. (Deputy v. Du Pont, 308 US 488.)

Moreover, the record shows that the amount of ₱1,800.00 was ascertained by respondent's examiners to have been spent for the construction of 300 meters' extension of the box culverts and of rip-rap headwall on petitioner's subdivision. The expense is therefore a capital expenditure as it increased the value of the subdivision lots and enhanced its saleability.)

> "The above cause is affirmed for the reasons given in the memorandum opinion of the Tax Court. The drainage system there involved we think was a capital improvement. There is substantial evidence that it added to the value of the petitioner's land for the use to which it had been put; that it is immaterial that that increase in value was not by evidence measured in dollars, and that the inferences of the Tax Court could be and were drawn from the physical configuration of the land and what it had been necessary to do to establish thereon the Drive-In Theatre which the petitioner erected thereon." (Mt. Morris Drive-In Theatre Co., v. Comm. of Internal Revenue, 50 AFTR 669-670.)

In CTA Case No. 1731, respondent disallowed the deduction of the sum of ₱28,809.85 which petitioner advanced to the NAWASA; this sum is an allowable deduction. The sum of ₱1,800 spent for culverts, on the other hand, is not deductible. A recomputation of the deficiency tax of petitioner would thus result as follows:

1959

Net income per return . . .	₱ 407,877.75
Add: Unallowable deduction: Contruction of culverts and rip-rap headwall	1,800.00
Net income per investigation	₱ 409,677.75
Tax due thereon	₱ 114,903.00
Less amount already assessed	114,363.00
B a l a n c e	₱ 540.00
Add ½% monthly interest from 4/17/60 to 4/17/63	97.20
Deficiency tax due.	₱ 637.20

IN VIEW OF THE FOREGOING, the decision of respondent in CTA Case No. 1455 is hereby reversed. With regard to CTA Case No. 1731, the decision appealed from is hereby modified, ordering the petitioner to pay a deficiency income tax of ₱637.20. If the said amount is not paid within thirty (30) days from the date this decision becomes final and executory, petitioner shall pay a surcharge of 5% of the unpaid income tax plus a delinquency interest of 1% a month on the unpaid deficiency income tax until fully paid provided that the maximum amount that may be collected as 1% interest per month shall not exceed a period of three (3) years, or 36%. Without pronouncement as to costs.

SO ORDERED.

Quezon City, August 30, 1969.

RAMON L. AVANCEÑA
Associate Judge

I CONCUR:

ESTANISLAO R. ALVAREZ
Associate Judge

Presiding Judge UMALI took no part.