REPUBLIC OF THE PHILIPPINES
COURT OF TAX APPEALS
QUEZON CITY

AYALA HOTELS, INC.,
Petitioner,

- versus -

C.T.A. CASE NO. 6002

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Promulgated:

JAN 1 0 2002

x - x

DECISION

The case at bar seeks the cancellation and termination of alleged Petitioner's deficiency income tax for the year 1993 in the amount of P19,779,385.50.

As represented, Petitioner is a corporation duly organized and existing under the laws of the Republic of the Philippines, with principal business address at the Makati Stock Exchange Building, Ayala Avenue, Makati City. It is registered with the Bureau of Internal Revenue (BIR) with Tax Identification Number (TIN) 000-437-612.

Petitioner entered into two (2) separate contracts of lease with each of the two (2) Lessees, namely, Manila Mandarin Hotel and Manila Peninsula Hotel , covering two (2) parcels of land in Makati (Exhibits F & G; TSN of Mr. Leo D. Abot, July 5, 2000, pp. 28 to 31). Both lease contracts similarly provide:

a) that each of the Lessees, with the consent of Petitioner, will erect a building on the parcels of land, to be used as a hotel;

b) the duration of the contract is twenty-five (25) years starting from the date of actual occupancy of the hotel by the first paying guest (paragraph 1);

c) that the Petitioner represents that the leased property forms an essential part of a commercial center in an integrated and controlled development project, and all buildings and improvements thereon shall be exclusively used and occupied by commercial businesses of a type and quality that will fit into the pattern of development of the surrounding area (paragraph 2);

d) that the Lessees have an option to renew the lease for an additional period of 25 years under the same terms and conditions as those obtaining during the last year of such lease. In the event that the Lessees exercise such option and thereby renew the lease, the Lessees agree to promptly notify the Petitioner in writing within ninety (90) days before the termination of the original term of the lease (paragraph 21); and

e) that the Lessees shall own the hotel building and all the improvements (paragraph 9) (Paragraph 10, Joint Stipulation of Facts and Issues; TSN of Mr. Leo D. Abot, July 5, 2000, pp. 28 to 31).

For the taxable year ending December 31, 1993, Petitioner duly filed on April 15, 1994 (Exhibit D-1) its Corporate Annual Income Tax Return (Exhibit D) with the Respondent's Bureau of Internal Revenue (BIR) (Paragraph 11, Joint Stipulation of Facts; TSN of Mr. Leo D. Abot, July 5, 2000, pp. 17 to 23).

On October 7, 1999 (Exhibit A-1, TSN of Mr. Leo D. Abot, July 5, 2000, p. 13), or 5½ years from the time Petitioner filed its Corporate Annual Income Tax Return, Petitioner received from Respondent a Formal Assessment Notice (FAN) (Exhibit A) dated September 17, 1999, which FAN alleged that Petitioner had deficiency income taxes due to the Government for the taxable year 1993 in the total amount of P19,779,385.50, broken down as follows:

Net income per return		P59,297,967.00
Add: Unreported income for the year 1993 on improvements by Lessees:		
Manila Mandarin Hotel	P 7,546,227.00	
Manila Peninsula Hotel	8,600,210.00	
	16,146,437.00	
Net income per investigation		P75,444,404.00
Income tax due thereon		P26,405,541.00
Less: Income tax already paid		20,754,288.00
Deficiency income tax		5,651,253.00
Add: 50% Surcharge		2,825,626.50
25% Surcharge		1,412,813.25
		9,889,692.75
Add: 20% interest per annum from 4-15-94 to 10-15-99		9,889,692.75
Total Amount Due		P19,779,385.50

(Paragraph 3, Petition for Review, as admitted in Paragraph 2 of the Answer)

The deficiency assessment arose from the finding of the Respondent that the Petitioner should have reported as part of its income for taxable year 1993, the total amount of P16,146,437.00 representing a portion of the total value of the leasehold improvements introduced by the two lessees of the Petitioner, namely, Manila Mandarin Hotel and Manila Peninsula Hotel (Paragraph 4, Petition for Review, admitted in Paragraph 2 of the Answer).

Respondent's findings were premised mainly on the application of Section 49 of Revenue Regulations No. 2 (Income Tax Regulations) which provides:

> "**Section 49. Improvements by Lessees.** - When buildings are erected or improvements made by a lessee in pursuance of an agreement with the lessor, and such buildings or improvements are not subject to removal by the lessee, the lessor <u>may at his option report the income therefrom upon either of the following bases</u>:
>
> (a) The lessor may report as income at the time when such buildings or improvements are completed the fair market value of such buildings or improvements subject to the lease.
>
> (b) The lessor may spread over the life of the lease the estimated depreciated value of such buildings or improvements at the termination of the lease and report as income for each year of the lease an aliquot part thereof." (Emphasis supplied)

Specifically, Respondent posits that the improvements introduced by Petitioner's lessees are not subject to removal and hence, must be reported by Petitioner as income based on either of the two rules under Section 49; that is, to report the fair market value of the buildings or improvements as income at the time when such buildings or improvements are completed, or to report as income for each year of the lease an aliquot part of the estimated depreciated value of such buildings or improvements at the termination of the lease (Paragraph 5, Petition for Review, as admitted in Paragraph 2 of the Answer).

Pursuant to the Audit Report sent to the Petitioner by the Respondent through the revenue officers who conducted the examination of the Petitioner's books, the following calculations were made to establish the amounts alleged as "unreported income" subject of the instant deficiency assessment:

	Manila Mandarin Hotel (in Pesos)	Manila Peninsula Hotel (in Pesos)
COST OF IMPROVEMENTS		
Site Improvement	4,084,259.00	314,905,352.00
Building and Building Equipment	398,949,466.00	120,738,873.00
APPRAISAL INCREASE		
Site Improvement	329,005.00	121,320,807.00
Building and Building Equipment	99,719,098.00	16,382,293.00
Total Value (Estimated useful life @ 40 years)(a)	503,081,828.00	573,347,325.00
NET BOOK VALUE AFTER 25 YEARS (b)	188,655,686.00	215,005,247.00
ANNUAL REPORTABLE INCOME FOR 25 YEARS (c)	7,546,227.00	8,600,210.00
TAXABLE INCOME FOR 1993	7,546,227.00	8,600,210.00

The amount of alleged unreported income for 1993 was arrived at by –

(i) taking the total value of the improvements (including the building equipment) in (a) above;

(ii) dividing the same by 40 years representing the estimated useful life to arrive at the annual depreciation over 40 years;

(iii) multiplying the annual depreciation over 40 years by 25 years (representing the original 25-year term of the lease) to arrive at the total depreciation expense to be claimed by the lessee for the first 25-year term of the lease;

(iv) deducting the total depreciation expense for 25 years arrived at in (iii) above from the total value of the improvements in (a) above to arrive at the net depreciated value of the improvements after 25 years in (b) above; and

(v) dividing the net depreciated value after 25 years in (b) above by 25 years to arrive at the aliquot part of the net depreciated value of the improvements at the end of the original 25-year term of the lease which should allegedly be reported as income for each year of the original 25-year term of the lease (Paragraph 12, Joint Stipulation of Facts and Issues).

On November 5, 1999, Petitioner, through its external auditors, filed with the Respondent its protest letter (Exhibit B) dated November 4, 1999, pursuant to Section 228 of the Tax Code, as amended. Said protest letter specified the factual and legal bases of the protest against said alleged deficiency income tax assessment, and further requested that the deficiency tax assessment be withdrawn and cancelled (Paragraph 6, Joint Stipulation of Facts and Issues; TSN of Mr. Leo D. Abot, July 5, 2000, pp. 14 to 16).

On December 27, 1999, Respondent's letter (Exhibit C), dated December 6, 1999, was received by the Petitioner's external auditors, denying the protest filed on November 5, 1999 (Paragraph 7, Joint Stipulation of Facts and Issues; TSN of Mr. Leo D. Abot, July 5, 2000, pp. 15 to 16).

The denial of the Respondent of the Petitioner's protest, as clearly specified in the Respondent's letter, dated December 6, 1999, and received by the Petitioner on December 27, 1999, is based on the following grounds:

(i) the Petitioner's failure to report alleged rental income in the amount of P16,146,437.00 can be legally considered a fraudulent act with intent to evade tax; hence, the ten-year, and not the three-year, prescriptive period should apply;

(ii) even granting that there was no willful intent on the part of the Petitioner to understate its rental income for purpose of evading its corporate income tax, the Supreme Court has held in the case of Aznar vs. Commissioner of Internal Revenue that the filing of a false tax return, even without any intent to evade tax, is likewise embraced under the 10-year statute of limitations;

(iii) that Section 49 of Revenue Regulations No. 2, upon which the assessment issued against the Petitioner is based, is legal and has the force and effect of law;

(iv) that the 50% surcharge is being imposed in the assessment against the Petitioner by reason of the finding of the Respondent that the Petitioner failed to report its income from the leasehold improvements introduced by the Lessees which amounts were considered substantial; and

(v) that the imposition of the 25% surcharge in addition to the 50% surcharge is justified considering that, since the assessment against the Petitioner pertains to calendar year 1993, the provisions of the old National Internal Revenue Code should apply, and not those of the Tax Reform Act of 1997 and Revenue Regulations No. 12-99 (Paragraph 13, Joint Stipulation of Facts and Issues).

On January 26, 2000, Petitioner filed with this Court, the instant Petition for Review, which prayed for the cancellation and termination of the alleged deficiency income tax assessment against the Petitioner for taxable year 1993 in the amount of P19,779,385.50.

After presentation of its testimonial and documentary evidence, Petitioner filed its Formal Offer of Evidence describing in detail the evidence presented as well as their respective purposes. This Court, in its Resolution dated October 25, 2000, resolved to admit all the exhibits formally offered in evidence by the Petitioner.

Based on the Parties' Joint Stipulation of Facts and Issues approved by this Court, the specific issues in the instant case are the following:

1. Whether or not the BIR's right to assess has prescribed under Section 203 of the Tax Code;
2. Whether or not Petitioner should have reported as part of its income for taxable year 1993 the total amount of P16,146,437.00 representing a portion of the total value of the leasehold improvements introduced by its Lessees, namely Manila Mandarin Hotel and Manila Peninsula Hotel.
3. Whether or not Petitioner is liable for the amount of P19,779,385.50 representing alleged deficiency income tax for the taxable year 1993; and
4. Whether or not there is basis for the imposition of both the 25% and 50% surcharges in the assessment against the Petitioner.

It is the principal submission of Petitioner that it is not liable for the alleged deficiency income tax assessment issued by Respondent against it, as the same is without legal and factual bases on the following grounds:

(1) Section 49 of Revenue Regulations (RR) No. 2 was not intended to, and cannot replace, the general rule provided in Section 44 of the Tax Code on the period for recognition of income, because implementing rules like RR No. 2 cannot go beyond the law which it seeks to implement, but was rather intended, by the very language of Section 49 of RR No. 2

itself, to give the taxpayer-lessor like Petitioner the option as to when to report income from leasehold improvements;

(2) The leasehold improvements introduced by the lessees of Petitioner, who is an accrual basis taxpayer, should be reported in the year it is earned. Thus, prior to its taking actual possession and ownership of the leasehold improvements when the term of the lease is finally terminated, it has not yet earned the value of the leasehold improvements, or even an aliquot portion thereof, and as such, there is no basis to the Respondent's assessment that Petitioner had unreported income equal to the value of leasehold improvements or a portion thereof;

(3) The provisions of the United States (US) income tax rules on leasehold improvements, which was copied verbatim as our Section 49 of RR No. 2, have already been invalidated by US Revenue Act of 1942, which excludes from gross income all income, other than rent, derived by a lessor of real property upon termination of the lease, attributable to buildings erected or other improvements made by the lessee;

(4) Section 49 of RR No. 2 should be applied together with Section 44 of the Tax Code, for to do otherwise, inequity and unfairness would result to the Petitioner who would be required to report income and pay a tax on the value of the leasehold improvements prior to actual or constructive receipt of any property or even any benefit therefrom; and

(5) The method used by the BIR in computing for the alleged "unreported income" is inequitable, unjust and impractical.

Further, Petitioner asseverated that considering that the assessment was issued beyond the three-year period, as prescribed under Section 203 of the Tax Code, the assessment becomes null and void, for the right to assessment has been barred by prescription. It said that there is no "willful intention" to evade tax on the part of Petitioner and it did not file a "false return", thus, there is no justification to impose the ten-year prescriptive period. And finally, it asserted that there is no basis for the imposition of both the 50% and 25% surcharges, hence, it prayed that the alleged deficiency tax assessments for the year 1993 be cancelled and terminated.

On the other hand, Respondent argued that Petitioner is liable to the subject assessment on the following grounds:

(1) Petitioner's failure to report in its 1993 corporate income tax return its rental income, from improvements introduced by its lessees, is a fraudulent act with intent to evade tax hence the applicable provision is Section 223(a) of the Tax Code, thus, the tax assessment against petitioner is not barred by prescription since the same had been issued within ten (10) years after the discovery of falsity, fraud or omission;

(2) Section 49 of RR No. 2 is legal due to herein reasons: (a) Revenue Regulations have the force and effect of law, (b) Despite the numerous amendments to the Income Tax Law, no issue has been raised against the validity of Section 49 of RR No. 2, and (c) Section 49 is clear and leaves no room for interpretation;

(3) Since Section 49 of RR No. 2 is clear, the duty of the Commissioner is to enforce and implement rather than to question its validity, thus, considering that RR No. 2 was promulgated by the Secretary of Finance, the same may both be legally modified or revoked by the Commissioner for lack of jurisdiction; and

(4) The imposition of the 50% and 25% surcharges is with legal bases, hence, he prayed for the dismissal of the case for lack of merit.

After a circumspect study of the first issue, the Court resolves to uphold herein Petitioner's stance that Respondent's right to assess against Petitioner has already prescribed for having been issued beyond the three-year prescriptive period and that there is no basis to apply the extended ten-year prescriptive period.

Section 203 of the Tax Code, as amended, provides for the rule on the period within which assessments must be made, viz:

Section 203. ***Period of limitation upon assessment and collection.*** **-** Except as provided in the succeeding section, internal revenue taxes shall be assessed within three years after the last day prescribed by law for the filing of the return, and no proceeding in court without assessment for the collection of

> such taxes shall be begun after the expiration of such period: Provided, That in case where the return is filed beyond the period prescribed by law, the three year prescriptive period shall be counted from the day the return was filed. For the purposes of this section, a return filed before the last day prescribed by law for the filing thereof shall be considered as filed on such last day.

Petitioner filed its 1993 income tax return on April 15, 1994. Thus, under the statutory 3-year period of limitation, the tax assessment for taxable year 1993 should have been issued by the Respondent on or before April 15, 1997. Since the Respondent received the FAN only on September 17, 1999, or more than five (5) years from April 15, 1994 when Petitioner filed its 1993 income tax return, the subject deficiency assessment is considered null and void, as the same was issued beyond the three (3) year period to assess as provided for in Section 203 of the Tax Code.

Respondent does not contest the allegation that the assessment was issued beyond the three-year prescriptive period and has, thus, prescribed based on Section 203 of the Tax Code, as amended. In fact, Respondent's position is that the applicable prescriptive period for the assessment in question is that provided under Section 222 of the Tax Code, as amended, which states:

> "In case of a false or fraudulent return with intent to evade tax or of failure to file a return, the tax may be assessed, or a proceeding in court for the collection of such tax may be filed without assessment, at anytime within ten (10) years after the discovery of the falsity, fraud, or omission x x x."

The application of Section 222 by the Respondent is premised on the theory that (1) Petitioner's failure to report as income the amount of the improvements introduced by its lessees, "can be legally considered as a fraudulent act with intent to evade tax"; and

(2) assuming the lack of willful intent on the part of the Petitioner to understate its rental income, that "the filing of a 'false return', even without any intent to evade tax, is likewise embraced under the aforementioned 10-year statute of limitation.

The Court finds that there is no basis for the application of the ten-year prescriptive period based on the ground that there is no "willful intention to evade tax" on the part of the Petitioner.

An indispensable ingredient that must be proven to exist for the 10-year prescriptive period to apply is that there must be, apart from the element of mistake, <u>a clear, unequivocal and willful intention to evade tax.</u>

In the case of **B.F. Goodrich Philippines, Inc. vs. Commissioner of Internal Revenue, CA G.R. SP No. 25100, dated January 14, 1992,** the Court of Appeals laid down the rule in ascertaining the existence of fraud, viz:

> "Obviously, there could have been no fraud, for fraud – at the least – implies and connotes an active and deliberate intent as deceit, which is surely absent in this case. As the Supreme Court puts it in **Aznar vs. Court of Tax Appeals, et al., 58 SCRA 519,** fraud is "actual and constructive," in this wise:
>
> > "The lower court's conclusion regarding the existence of fraudulent intent to evade payment of taxes was based merely on a presumption and not on evidence establishing a willful filing of false and fraudulent returns so as to warrant the imposition of fraud penalty. The fraud contemplated by law is actual and not constructive. It must be intentional fraud, consisting of deception willfully and deliberately done or resorted to in order to induce another to give up some legal right. Negligence, whether slight or gross is not equivalent to the fraud with intent to evade the tax contemplated by the law. It must amount to intentional wrongdoing with the sole object of avoiding the tax. It necessarily follows that a mere mistake cannot be considered as fraudulent intent, and if both Petitioner and

> Respondent Commissioner of Internal Revenue committed mistakes in making entries in the returns and in the assessment, respectively, under the inventory method of determining tax liability, it would be unfair to treat the mistakes of the Petitioner as tainted with fraud and those of the Respondent as made in good faith."

The aforesaid decision was affirmed by the Supreme Court in **Commissioner eof Internal Revenue vs. B.F. Goodrich Philippines Inc., et. al., G.R. No. 104171, February 24, 1999,** thus:

> "Since the BIR failed to demonstrate clearly that private respondent had filed a fraudulent return with the intent to evade tax, or that it had failed to file a return at all, the period for assessments has obviously prescribed. Such instances of negligence or oversight on the part of the BIR cannot prejudice taxpayers, considering that the prescriptive period was precisely intended to give them peace of mind."

In the case of **Santiago S. Ong, et al. vs. Commissioner of Internal Revenue (CTA Case No. 4648, July 20, 1994),** this Court held:

> "Finally, with regard to the last issue, we hold that the respondent had failed to substantiate his claim that the petitioners had fraudulently attempted to evade their tax liabilities. Fraud is never presumed. Courts never sustain findings of fraud upon circumstances which create only suspicions and even the understatement of a tax is not by itself proof of fraud for purposes of tax evasion (Commissioner of Internal Revenue vs. Javier, Jr., 199 SCRA 824). We are therefore inclined to adopt the admission and explanation of the petitioners that their liability for deficiency income taxes arose from mere oversight and inadvertence."

Further, it was held in the case of **Yulo vs. Araneta (CTA Case No. 84, dated July 8, 1958)** that:

> "As to the first ground, the only allegation is that petitioner deliberately failed to report as income the financing shares received by him as dividends. No allegation has been made that the failure to report such income was due to any intention to evade payment of the tax. The fraud penalty provided under (then) Section 72 of the Revenue Code cannot therefore be imposed solely on the ground that petitioner deliberately failed to report the value of the financing shares received by him as dividends. While it may be true that a finding of fraud by the Commissioner of Internal Revenue is presumptively correct, yet when the taxpayer has shown, as in this case, that the failure to report an income is due to an honest belief that it is not taxable, it is incumbent upon respondent to prove the existence of fraud."

Thus, considering that (1) the Respondent did not present any evidence supporting his allegation of the existence of fraud; (2) existing rules and jurisprudence proved that the existence of fraud can never be presumed; and (3) the Petitioner, through the testimony of its Chief Financial Officer, Mr. Leo D. Abot, has sufficiently shown that the non-reporting of the income representing a portion of the value of the leasehold improvements was based on its reliance on several provisions, rulings and accepted principles of taxation and may thus be considered, at the very least, an "honest belief", viz:

> "ATTY. MONTERO:
>
> Q. Mr. Witness, you stated that the Gross Income of Petitioner Ayala Hotels, Inc. reported P67,422,388.00 as Gross Income from rental payments which is cross referred as Schedule No. 4 as Rental Income, did this amount include a portion of the total value of the leasehold improvements introduced by the two (2) Lessees of the Petitioner?
>
> MR. ABOT:
>
> A. No, the amount did not include the value of the leasehold improvements introduced by the Lessee, Sir.

ATTY. MONTERO:

Q. Why were these amounts not included, Mr. Witness, in short, what is the basis of the company in not reporting as part of its Gross Income, the value of the leasehold improvements?

MR. ABOT:

A. Well, the company did not include in its Gross Income the value of the leasehold improvements introduce(d) by the Lessees because this leasehold improvement is not one among the items as part of the Gross Income as defined in the Tax Code. So, this is not one of the items which have been included in the Gross Income as defined in the Tax Code, Sir.

ATTY. MONTERO:

Q. Any other reason, Mr. Witness?

MR. ABOT:

A. The company based this treatment on the 1975 Ruling by the BIR which ruled categorically that:

"The Income on the Value of lease(hold) of (sic) improvement introduced by the Lessees should be recognized by Lessor upon the termination of the Lease.";

And we have also the treatment for non-inclusion of these items is also based on the General Accepted Test on Income Recognition because the value of lease(hold) of (sic) improvements does not pass the Generally Accepted Test of Recognition of Income such as the All Events Test and Economic Benefit Test and Constructive Receipt Test, Sir." (TSN of Mr. Leo D. Abot, July 5, 2000, pp. 23 to 25)

From the above discussion, We can conclude that there is no basis to hold Petitioner's act as being "legally considered as a fraudulent act with intent to evade tax."

The Petitioner did not file a "false return" to justify imposition of the ten-year prescriptive period. Respondent's letter dated December 6, 1999 cites the 1974 Supreme Court case of **Aznar vs. Court of Tax Appeals, 58 SCRA 518** in arriving at the conclusion that the filing of a false return even without intent to evade tax is sufficient to justify application of the ten-year prescriptive period.

The Court agrees with Petitioner that the pronouncements in the *Aznar* case should not be applied to the instant deficiency tax assessment.

In the case of **Packaging Products Corporation vs. Commissioner of Internal Revenue, CTA Case No. 4464, dated January 11, 1995,** it was made clear that reliance on the *Aznar* case must not be an exercise of unbridled discretion, to wit:

> "To further bolster her contention, respondent quoted portions of the decisions handed down by the Supreme Court in the case of **Aznar vs. CTA and Collector, 58 SCRA 519.**
>
> "x x x x x
>
> Moreover, the fact that the respondent and the petitioner differ in the interpretation of the law with regard to the availment of tax credit on sales taxes does not necessarily make the date contained in the return made by a taxpayer a "false return", within the meaning of the original and amended section 2781 Rev. St., there must appear, if not a design to mislead or deceive on the part of the taxpayer at least culpable negligence. A mistake, not culpable in respect of its value would not constitute such false return (Words and Phrases, Volume 16, page 173).
>
> We find that there is no clear showing that the return filed by petitioner is false. Therefore, the ten-year period to assess deficiency taxes is not applicable to the case at bar. Hence, the questioned assessment is null and void having been filed beyond the three-year period prescribed by law. We are inclined to believe that the defense of falsity of return was a mere afterthought conjured by respondent to rationalize the late assessment."

Thus, under the view which we have taken of in the first issue raised by the parties in this appeal, we deem it unnecessary to resolve the other issues presented. We therefore hold that Petitioner is not liable to pay the alleged deficiency tax assessment for the year 1993 in the amount of P19,779,385.50, on the ground of prescription.

IN THE LIGHT OF ALL THE FOREGOING, the instant Petition for Review is hereby **GRANTED.** Accordingly, the subject assessment issued by the Respondent against Petitioner for the year 1993 is hereby **ORDERED CANCELLED AND WITHDRAWN.**

SO ORDERED.

ERNESTO D. ACOSTA
Presiding Judge

WE CONCUR:

AMANCIO Q. SAGA
Associate Judge

JUANITO C. CASTAÑEDA, JR.
Associate Judge

CERTIFICATION

I hereby certify that the above decision was reached after due consultation with the members of the Court of Tax Appeals in accordance with Section 13, Article VIII of the Constitution.

ERNESTO D. ACOSTA
Presiding Judge