

WM. H. ANDERSON, PLAINTIFF AND APPELLEE, VS. JUAN POSADAS, JR., COLLECTOR OF INTERNAL REVENUE, DEFENDANT AND APPELLANT.

G.R. No. 44100. September 22, 1938

Ponente: VILLA-REAL, J.

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VILLA-REAL, J.:

This is an appeal taken by Juan Posadas, jr., as Collector of Internal Revenue, from the judgment rendered by the Court of First Instance of Manila, the dispositive part of which is as follows:

"For the foregoing considerations, judgment is rendered:

"4. Approving the deduction of the sum of P42,542.63 representing 100 per cent surcharge on income tax, disapproved in 1921;

"5. Holding that the amount of P155,000, representing the alleged proceeds of the supposed sale of the 'Goodwill Account', is not subject to income tax, and

"6. Holding that the amount of P125,000, representing an allegedly recovered loss, is not subject to income tax.

"It is ordered that a new assessment of said plaintiff's income tax returns, with reference to these six (6) items, be made as above-indicated, and upon the termination of said reassessment, the defendant is ordered to return to the plaintiff any amount in excess of what should be paid under said new assessment, without interest pr costs. It is so ordered."

In support of his appeal, the appellant assigns the following alleged errors as committed by the court a quo in its judgment in question, to wit:

"1. The lower court erred in approving a deduction made in the appellee's income tax return for 1921, in the amount of P42,542.63, paid as 100 per cent surcharge on the income tax due for 1918 and 1919.

"2. The lower court erred in holding that the amount of P125,000, found by the appellant as losses recovered, is not subject to income tax.

"3. The lower court erred in holding that the amount of P155,000, found by the appellant as proceeds from the sale of good will, is not subject to income tax.

"4. The lower court erred in ordering the appellant to make anew income tax assessment against the appellee and to return to him whatever amount he had paid in excess of the amount that he should pay under the new assessment.

"5. The lower court erred in denying the appellant's motion for new trial on the ground that the decision was contrary to law and that the evidence was insufficient to justify the same."

The first question to be decided, which is raised in the first assignment of alleged error, is whether or not the sum of P42,542.63, paid by the appellee Wm. H. Anderson as penalty for fraud committed in his income tax returns corresponding to the years 1918 and 1919, may be deducted from the income tax return made by him for the year 1921.

Section 5 of Act No. 2833 of the Philippine Legislature, commonly known as the Income Tax Law, enumerates the items that may be deducted in computing the net income of a citizen or resident of the Philippines, but the amount paid as penalty for fraud is not mentioned among them. Section 15 of said Act provides, among other things, that "In case a false or fraudulent return or list is willfully made, the Collector of Internal Revenue shall add to the tax one hundred per centum of its amount. The amount so added to any tax shall be collected at the same time and in the same manner and as part of the tax unless the tax has been paid before the discovery of the neglect, falsity, or fraud, in which case the amount so added shall be collected in the same manner as the tax." Pursuant to the authority conferred by the Revised Administrative Code and by Act No. 2833, as amended by Act No. 2926, the Department of Finance, under whose jurisdiction the Bureau of Internal Revenue falls, promulgated, on August 17, 1921, Regulations No. 20, entitled "Income Tax Regulations," section 33 of which, in interpreting the word "taxes," provides, among other things, as follows: "The word 'taxes' means taxes proper and no deductions should be allowed for amounts representing interest or penalties incident to delinquency."

Black, in his book "Income Tax Digest," section 355, page 166, states as follows:

"Fines and Penalties.—Fines paid because of a violation of law are not deductible even if the violation is in connection with a trade or business. Items of this type are deemed not to arise from the ordinary and necessary conduct of business."

It appears, therefore, that in the opinion of the writer Black and of the Department of Finance, fines imposed for violation of law cannot be considered taxes paid to the Government, which should be deducted from income subject to the payment of income tax. The tax under consideration is levied on income, while the fine is paid as penalty for violation of the Internal Revenue Law. The fine, therefore, cannot be considered a tax, inasmuch as it is not levied on income. In providing that the fine should be added to the tax and collected at the same time and as a part thereof, the law had for its purpose merely to facilitate the collection of the fine or surcharge.

Furthermore, in the case of *Molina vs. Rafferty* (38 Phil., 167), this court has laid down the doctrine, cited with approval in the case of *People vs. Hernandez* (59 Phil., 272), that "Long continued administrative interpretation of a tax law, while not conclusive, should be followed unless clearly erroneous." (See also 59 Corpus Juris, 1025, sec. 609.)

Regulations No. 20, issued by the Department of Finance, were promulgated on August 17, 1921, and published in volume XX, No. 18, page 323, of the Official Gazette, on February 11, 1922, that is, more than 16 years ago. The Bureau of Internal Revenue has constantly been enforcing them and no question as to their validity has ever been raised by anybody. Neither have they been amended by the Legislature which had enacted the law whose provisions relative to deductions for tax purposes are interpreted by said regulations No. 20. Such silence, under the rule on interpretation of laws, signifies acquiescence in such construction (59 Corpus Juris, 1037, sec. 613). While it is true that the above-cited doctrine of this court establishes the exception that the interpretation be not clearly erroneous, yet it does not appear, for the foregoing reasons, that the interpretation given by the Department of Finance to the case under consideration is erroneous.

This court, therefore, finds the first assignment of alleged error to be well founded.

With respect to the second assignment of alleged error, it is contended that the court a quo erred in holding that the amount of P125,000, found by the appellant as losses recovered, is not subject to the payment of income tax.

William H. Anderson had purchased the business of Erlanger & Galinger. In 1915, he incorporated said partnership under the firm name of Erlanger & Galinger, Inc., with an authorized capital of P600,000, divided into 1,200 shares at the par value of P500 each. All of said shares were subscribed by the incorporator Anderson, who paid in cash, on different dates, the total amount of P70,000. The unpaid balance of P530,000 was entered in an intermediary account, called underwriting account, which was opened in the corporation in Anderson's name, in place of his personal account.

On January 1, 1918, there was opened in Anderson's name a good will account, upon the debit side of which was entered the sum of P300,000. On the same date, the sum of P300,000 was entered upon the credit side of Anderson's underwriting account, thereby reducing the balance thereof from P530,000 to P230,000.

On said date, January 1, 1918, Anderson sold to Simon Feldstein 200 shares at the rate of 2 to 1, receiving in payment thereof the sum of P50,000 with a loss of P50,000.

On January 2d of the same year, Anderson sold 300 more shares to Feldstein at the rate of 3 to 1, and received in payment thereof the sum of P50,000, having lost P100,000 in the transaction.

In view of said losses, Anderson deducted the sum of P50,000 from the taxable income stated by him in his return for the year 1918, and the sum of P75,000 from his return for the year 1919, or a total amount of P125,000. Said deductions were approved by the Bureau of Internal Revenue.

As the Collector of Internal Revenue attempted to collect a tax on the P300,000 at which Anderson assessed the good will of the business, the latter, on December 29, 1923, agreed with the former to eliminate said good will, which in effect was so done by him by debiting said sum in his capital account and crediting it in the good will account. With said elimination, Anderson's debt of P530,000 was restored. To Feldstein's account was debited the sum of P125,007 which, together with the P100,000 paid by him for the 500 shares which he had bought of Anderson, to the latter's loss, amounts to P225,007. Said sum of P125,007 was the proportional part of the P300,000 which corresponded to Feldstein, for the above-stated 500 shares, at the rate of 7/12 for Anderson and 5/12 for Feldstein.

On January 2, 1924, the sum of P134,169 was debited in Anderson's personal account and that of P95,831 in Feldstein's capital account, in the same proportion of 7/12 for the former and 5/12 for the latter, that is, the amount of P230,000, thereby eliminating the underwriting account in said amount.

It appears, therefore, that with the P100,000 paid by Feldstein on account of the 500 shares bought by him of Anderson, plus the sum of P125,007 debited to Feldstein's account, which is equivalent to 5/12 of the good will of P300,000, which corresponds to Feldstein for his participation in the share of the corporation, and the above-stated sum of P95,831, the total amount debited in Simon Feldstein's account is P320,838. This amount exceeds the sum of P250,000, which represents the value, at the rate of P500 each, of the 500 shares sold to Feldstein by Anderson. Therefore, as the total value of the 500 shares, at the par value of P500 each, has been debited in Feldstein's account, the loss of P125,000 suffered by Anderson at the beginning, by reason of the sale of said 500 shares, has been recovered, and it is but just that the sum of P125,000, deducted from the profits by reason of losses suffered temporarily out of the capital, be restored thereto.

It is not attempted to consider the sum of P125,000 as profit obtained from the sale of the 500 shares to Feldstein by Anderson, but as the restoration of a temporary loss in the same amount, which was deducted from the income corresponding to the years 1918 and 1919.

The second assignment of alleged error is likewise well founded.

The ruling of the lower court that the amount of P155,000, found by the appellant as proceeds from the sale of good will, is not subject to income tax, is assigned as third alleged error.

According to Reynolds, a witness for the plaintiff, the good will account of P155,000 was created "because the conditions of the business deserved the establishment of this item." The phrase "good will" is defined in 28 Corpus Juris, 729, section 1, as follows:

"Good will may be defined to be the advantage or benefit which is acquired by an establishment, beyond the mere value of the capital stock, funds, or property employed therein in consequence of the general public patronage and encouragement which it receives from constant or habitual customers on account of its local position or common celebrity or reputation for skill, affluence, punctuality, or from other accidental circumstances or necessities, or even from ancient partialities or prejudices. * * *"

According to the above-quoted definition, good will is the reputation or good name of an establishment. If the good will, that is, the good reputation of the business is acquired in the course of its management and operation, it does not form part of the capital with which it was established. It is an intangible moral profit, susceptible of valuation in money, acquired by the business by reason of the confidence reposed in it by the public, due to the efficiency and honesty shown by the manager and personnel thereof in conducting the same and on account of the courtesy accorded its customers, which moral profit, once it is evaluated and used, becomes a part of the assets. The good will of P155,000 created by Anderson has been beneficial not only to him but also to Feldstein in the proportion of 7/12 for Anderson and 5/12 for Feldstein, which is the proportion of the participation of each in the shares of the corporation Erlanger & Galinger, Inc., that is, P90,412 for Anderson and P64,588 for Feldstein, inasmuch as Anderson's personal debt for the balance of the unpaid shares was diminished by said sum of P90,412 and Feldstein's capital account increased by P64,588.

The benefit received by Anderson does not consist merely in the sum of P90,412. He also realized a gain of P70,838 from the sale of 500 shares to Feldstein. Said benefits, added together, make a total of P161,250, that is, P6,250 more than the sum of P155,000 on which the defendant and appellant Collector of Internal Revenue is attempting to collect tax from him.

In view of the foregoing considerations, this court is of the opinion and so holds: (1) That the fines paid as penalty by a taxpayer cannot be deducted from the amount subject to the payment of income tax; (2) that the amount deducted from the income by reason of temporary partial loss from the capital should, upon the recovery of said loss, be restored to the profits and pay the corresponding tax, and (3) that the good will created by an incorporator in the course of the business of a corporation and appraised to pay the unpaid price of shares subscribed to by said incorporator, is a profit and is subject to the payment of income tax.

Wherefore, the appealed judgment is reversed in so far as it (1) approves the deduction of the amount of P42,542.63, which represents 100 per cent surcharge on income tax; (2) holds that the amount of P125,000, deducted from the income as loss which was recovered later, is not subject to income tax, and (3) holds that the amount of P155,000, representing the proceeds of the sale of good will, is not subject to income tax, and the defendant is absolved from the complaint, with the costs to the plaintiff. So ordered.

Avanceña, C. J., Abad Santos, Imperial, Diaz, Laurel, and Concepcion, JJ., concur.

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