BDB Law wts
DU-BALADAD AND ASSOCIATES

Fulvio D. Dawilan
TAX LAW FOR BUSINESS

BDB Law's "Tax Law for Business" *appears in the opinion section of* ***Business Mirror*** *every Thursday.*

The net worth method

In a previous article in this column, we discussed the usual practice by revenue examiners of comparing the information reported by taxpayers in their books/tax returns with other reports of the same taxpayer or with information from third parties. The revenue officers usually treat the excess of sales/revenues reported by the suppliers over the costs/expenses reported by their customers as income of the customer, and accordingly impose the corresponding tax. As we have commented, this is improper because this is supposedly an additional cost/expense to the customer and not an income.

The usual justification for this approach as found in most assessment notices is the old case of *Perez* vs *CTA and CIR, L-9193, May 29, 1957/Perez* v. *CTA and CIR, L-10507, May 30, 1958* (the Perez Case). A review of the Perez Case would, however, show that an income-tax assessment was made on the basis of the net-worth method of assessment. As described by the Court in that case, "the method is based upon the general theory that money and other assets in excess of liabilities of a taxpayer [after an accurate and proper adjustment of nondeductible items] not accounted for by his income-tax returns, leads to the inference that part of his income has not been reported." This is definitely different from the mere differences in the amounts reported by transacting parties.

As amplified in Revenue Memorandum Circular 43-74, the net worth method is an extension of the accounting principle: Assets minus liabilities equals net worth. The taxpayer's net worth is determined both at the beginning and at the end of the same taxable year. The general theory underlying this method is that the taxpayer's money and other assets in excess of liabilities after accurate and proper adjustment of nondeductible and nontaxable items not accounted for in his tax return is deemed to be his unreported income. Clearly, the basic concept of this net worth method of determining income is that any increase in taxpayer's net worth, after making some adjustments, constitutes taxable income.

Indeed, there is basis for resorting to the net worth method in determining possible unreported taxable income. There is a provision in the Tax Code which states that when a report required by law as a basis for the assessment of any national internal revenue tax shall not be forthcoming within the time fixed by laws or rules and regulations or when there is reason to believe that any such report is false, incomplete or erroneous, the Commissioner shall assess the tax on the best evidence obtainable.

Thus, if the taxpayer does not maintain books of account or the books of account do not clearly reflect the income and there is evidence of a possible source or sources of income to account for the increases in net worth, the net worth method may be used. Hence, there has to be a beginning and ending net worth. If there is no definite starting point or opening net worth, as well as ending net worth, the net worth method of determining unreported income cannot be used.

More often, we hear from the news reports about significant or unexplained increases in the net worth of some personalities. If these are legally earned but not subjected to tax, then the tax authority may rightfully assess for the rightful share of the government. On the other hand, if these are illegally acquired, without a doubt, these are not subjected to taxes. "Illegally earned income is subject to income tax", the US Supreme Court declared in 1927 in one case that eventually became the basis for the US IRS to investigate Al Capone, prosecute him and put him behind bars. In this jurisdiction, illegally sourced income is also subject to tax. The presumed income and the corresponding taxes due can be determined through the use of the net worth method.

To reiterate, the net worth method mirrors the basic accounting concept that assets minus liabilities equals net worth. If there is an increase in net worth, the presumption, if not explained, is that the increase constitutes income, whether the presumed income is acquired legally or illegally. But this contemplates a situation where there are beginning/opening and ending net worth. Certainly, the method does not apply when there is merely difference in the amounts recorded by the transacting parties.

****

The author is a senior partner of Du-Baladad and Associates Law Offices (BDB Law), a member-firm of WTS Global.

The article is for general information only and is not intended, nor should be construed as a substitute for tax, legal or financial advice on any specific matter. Applicability of this article to any actual or particular tax or legal issue should be supported, therefore, by a professional study or advice. If you have any comments or questions concerning the article, you may e-mail the author at fulvio.dawilan@bdblaw.com.ph *or call 403-2001 local 310.*