REPUBLIC OF THE PHILIPPINES
COURT OF TAX APPEALS
QUEZON CITY

GENERAL FOODS, (Philippines), Inc.,
Petitioner,

- versus - C.T.A. Case No. 4386

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

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# DECISION

This is an assessment case for alleged deficiency income tax in the amount of P2,635,141.42 for fiscal year ended February 28, 1985.

Petitioner is a domestic corporation engaged in the manufacture and sale of various consumer products in the Philippines such as "Tang", "Calumet" and "Kool-Aid". By virtue of its having been merged with Kraft Foods, Inc., it is now called Kraft General Foods (Philippines), Inc.

On June 14, 1985, Petitioner filed its Corporate Annual Income Tax Return for fiscal year ended February 28, 1985 and claimed P9,461,246.00 as deduction under "Marketing Expenses", (Media Advertising). Respondent disallowed fifty percent (50%) thereof or P4,730,623.00 on the ground that said expenses are in the nature of capital expenditures which should be amortized for two years. The disallowance resulted to an alleged deficiency income tax of P2,635,141.42 computed as follows:

| | |
|---|---|
| Net income per return .............. | P34,651,089.00 |
| Add: Disallowed media advertising .. | 4,730,623.00 |
| Net income per investigation ....... | P39,381,712.00 |
| Income tax due thereon ............. | 13,773,599.00 |
| Less: Tax already assessed ......... | 12,117,881.00 |
| Deficiency Income Tax .............. | P 1,655,718.00 |
| Add: 20% interest from 6/16/85 to 5/31/88 ........... | 979,423.42 |
| TOTAL AMOUNT DUE AND COLLECTIBLE ... | P 2,635,141.42 |

(Exh. 3, BIR Records, p. 193)

The sole issue in this appeal is whether or not the media advertising expenses paid or incurred by Petitioner constitute ordinary and necessary expenses fully deductible under the Tax Code or should they be considered as capital expenditures since they are expenses paid in order to create goodwill and reputation to the Petitioner and/or its product(s).

The pertinent provision of the Tax Code applicable to the case at bar is Section 30(a)(1)(A) (now Sec. 29 (a)(1)(A) which provides, thus:

> Sec. 30. *Deductions from Gross Income.* - In computing net income, there shall be allowed as deductions -
>
> (a) Expenses. - (1) Business expenses. - (A) In General - All ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other

> compensation for personal services actually rendered; travelling expenses while away from home in the pursuit of trade, profession or business, rentals or other payments required to be made as a condition to the continued use or possession, for the purposes of the trade or business, of property which the taxpayer has not taken or is not taking title or in which he has no equity.

Under the above provision, before an expense is allowed as deduction from gross income, it must satisfy the following requirements:

1) The expense must be both ordinary and necessary;

2) The expense must be paid or incurred within the taxable year; and

3) The expenses must be incurred in carrying on a trade or business.

The term "advertising" is here used in its generally understood meaning, namely, use of the spoken or written word in printed matter, movies, radio and television to acquaint the public with the taxpayer's merchandise or services.

Evidence showed that the questioned advertising expenses were indeed "paid or incurred within the taxable year" and that they were "incurred in carrying on a trade or business". There is no dispute about that. But what is not clear, (and this is where the bone of contention lies), is whether the questioned advertising expenses are indeed "ordinary and necessary".

This Court in the case of **Visayan Cebu Terminal Co., Inc., vs. Col. of Int. Rev.**,(CTA Case No. 128, June 29, 1957) considered an expense as necessary "where the expenditure is appropriate or helpful in the development of the taxpayer's business or that the same is proper for the purpose of realizing a profit or minimizing a loss". It is also considered necessary "if it is appropriate and helpful to the taxpayer's business or occupation. When an expense is called necessary, it is merely distinguished trom personal expenditure or from one not pertinent to the business of the taxpayer". (1955, CCH Fed. Tax Course, par. 403). We do not, therefore, argue against the necessity of advertising expenses as part of modern business for indeed, they are necessary for its survival. The question, however, remains: Were those advertising expenses ordinary? Hence, for an advertising expense to be deductible, it should not only be necessary, but also ordinary. One cannot be separated from the other.

This Court has long recognized that subject, however, to two limitations, expenditures for advertising are deductible in the year when paid or incurred. The first limitation relates to the extent to which the expenditures are actually capital outlays, thus necessitating an inquiry into the nature or purpose of such expenditures. (Mertens, Vol. 4A 25.38 p. 190, citing E.H. Sheldon & Co., 19 TC 481 (1952); Ralph E. Duncan, 30 TC 386 (1958); and Funkhouser Industries, Inc., TC Memo 1957-197). The second limitation, not necessarily entirely exclusive of the first, relates to whether the expenditures are ordinary and necessary, giving rise to the reasonableness of the amount of such expenditures. (see Mertens, infra; emphasis supplied).

Advertising is generally of two kinds, namely: 1) advertising to stimulate the current sale of merchandise or use of services; and 2) advertising designed to stimulate the future sale of merchandize or use of services. The latter type involves expenditures incurred, in whole or in part, to create or maintain some form of good will for the taxpayer's trade or business or for the industry or profession of which the taxpayer is a member. If the expenditures are for advertising of the first kind, then, except as to questions of reasonableness of amount, there is no doubt such expenditures are deductible as business expenses. If, however, the expenditures are for advertising of the second kind, then normally they are to be spread over the reasonable period of time, irrespective of whether the taxpayer is on the cash or accrual basis. The underlying theory is that a capital asset which has a determinable life has been acquired and, therefore, the expenditure should be spread over the life of that asset. (Mertens, supra, citing several American jurisprudence; emphases supplied).

In the case at bar, the Petitioner failed in the two limitations set by American jurisprudence. The first is the test on the "reasonableness" of the amount incurred, and hence, not ordinary. The second is the test on whether or not the questioned advertising expenses are actually capital outlays to create "goodwill" to the product and/or Petitioner's business, and hence, considered as capital expenditure to be spread over the life of the asset.

We hold that expenses, although highly necessary, cannot be deducted unless they are also ordinary. An expense to be considered ordinary must be reasonable in amount (1988 CCH Fed. Tax Course, par. 403). There is, however, no criterion as to what is ordinary expense because there is no hard and fast rule as to what is reasonable amount for it to be considered ordinary. We do not attempt to draw the dividing line. We only say it depends in each case on the particular facts and the nature of the expenditure itself, which in turn depends on the extent and permanency of the word accomplished by the expenditure (see **Atlas Consolidated Mining and Development Corporation, vs. Commissioner of Internal Revenue**, No. L-26911, Jan. 27, 1981, 102 SCRA 246).

In the present case, Petitioner claimed as deductible media Advertising expense in the amount of P9,461,246 which is almost one-half (½) of Petitioner's claim for "Marketing Expenses". Such amount does not include the amount of P2,678,328 which is claimed under "Other advertising and promotions" expense. The amount of P9,461,246 for Media Advertising expense is almost twice over General and Administrative Expenses. For clearer understanding, Petitioner's Schedule I- General Expenses for the Fiscal Year ended February 28, 1985 is hereby quoted thus:

GENERAL FOODS PHILIPPINES, INC.

SCHEDULE I - GENERAL EXPENSES
FOR THE FISCAL YEAR ENDED FEBRUARY 28, 1985

GENERAL AND ADMINISTRATIVE EXPENSES

| | |
|---|---|
| Salaries and wages | P 1,796,706 |
| Employee benefits and allowances | 701,285 |
| Stationery and general operating supplies | 157,726 |
| Repairs and maintenance | 418,139 |
| Freight, storage and cartage | 41,528 |
| Rent | 15,689 |
| Postage, telephone and telegraph | 234,307 |
| Employee procurement expenses | 101,175 |

| | |
|---|---|
| Travelling expenses | 173,432 |
| Motor vehicle operating expenses | 113,519 |
| Representation and entertainment | 125,230 |
| Professional and legal fees | 446,646 |
| Publications and association membership dues | 61,633 |
| Bank charges | 135,999 |
| Miscellaneous | 117,624 |
| | 4,640,636 |
| **MARKETING EXPENSES** | |
| Media advertising | 9,461,246 |
| Consumer promotion | 1,548,014 |
| Other advertising and promotions | 2,678,328 |
| Sales field expense | 1,098,055 |
| Transportation | 656,694 |
| Market research | 939,326 |
| administrative and production management | 1,289,080 |
| Royalty expense | 1,294,831 |
| | 18,965,614 |
| TOTAL | P23,606,250 |

(BIR Records, p. 143)

With such a gargantuan expense for the advertisement of a singular product, which even excludes "other advertising and promotions" expenses, We are not prepared to accept that such amount is reasonable "to stimulate the current sale of merchandise" regardless of Petitioner's explanation that such expense "does not connote unreasonableness considering the grave economic situation taking place after the Aquino assassination characterized by capital flight, strong deterioration of the purchasing power of the Philippine peso and the slackening demand for consumer products" (Petitioner's Memorandum, CTA Records p. 273) We are not convinced with such an explanation. The staggering expense led us to believe that such expenditure was incurred "to create or maintain some form of good will for the taxpayer's trade or business or for the industry or profession of which the taxpayer is a member." The term "good will" can hardly be said to have any precise signification; it is generally used to denote the benefit arising from connection and reputation. (Words and Phrases, Vol. 18 p. 556 citing **Douhart vs. Laogan**, 86 Ill. App. 294). As held in the case of **Welch vs. Helvering,** efforts to establish reputation are akin to acquisition of capital assets and, therefore, expenses related thereto are not business expense but capital expenditures. (Atlas Mining and Development Corp., vs. Commissioner of Internal Revenue, supra). For sure such expenditure was meant not only to generate present sales but more for future and prospective benefits. Hence, "abnormally large expenditures for advertising are <u>usually</u> to be spread over the period of years during which the benefits of the expenditures are received" (Mertens, supra, citing Colonial Ice Cream Co., 7 BTA 154).

**WHEREFORE**, in all the foregoing, and finding no error in the case appealed from, We hereby **RESOLVE** to **DISMISS** the instant petition for lack of merit and **ORDER**

the Petitioner to pay the respondent Commissioner the assessed amount of P2,635,141.42 representing its deficiency income tax liability for the fiscal year ended February 28, 1985.

SO ORDERED.

Quezon City, Metro Manila, February 8, 1994.

MANUEL K. GRUBA
Associate Judge

WE CONCUR:

Dissenting
ERNESTO D. ACOSTA
Presiding Judge

RAMON O. DE VEYRA
Associate Judge

*CERTIFICATION*

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

ERNESTO D. ACOSTA
Presiding Judge
Court of Tax Appeals