REPUBLIC OF THE PHILIPPINES
COURT OF TAX APPEALS
MANILA

PHILIPPINE AIR LINES, INC.,
Petitioner,

- versus - C.T.A. CASE NO. 45

COLLECTOR OF INTERNAL REVENUE,
Respondent.

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February 8, 1956

D E C I S I O N

This is an appeal from a decision of the respondent Collector of Internal Revenue denying the claim of the petitioner Philippine Air Lines, Inc. for the refund of the sum of ₱1,478,692.95, allegedly representing total excess deposits made by the petitioner to cover the franchise tax of 2% of its gross revenue for the period from July 1, 1946 to December 31, 1952. The said amount was reduced after submission of a stipulation of facts to ₱1,321,584.98, "minus the tax corresponding to the item of labor segregated in the Additional Stipulation of Facts and the items admitted by petitioner as taxable as contained in the Supplemental Stipulation of Facts." The excess deposits were due to the fact that petitioner computed the franchise tax on its gross revenue at the rate of 5% as provided in section 259 of the National Internal Revenue Code, instead of 2% as provided in its franchises.

In his answer to the petition for review, the respondent denied the petitioner's right to the refund of said amount of ₱1,478,692.95 on the ground that upon examination of the books of petitioner there was found a deficiency franchise tax and surcharge in the amount of ₱603,160.70, and accordingly, filed a counterclaim for said amount. The said counterclaim was reduced after submission of the stipulation of facts to ₱594,758.66, "minus the tax corresponding to the items under Schedules I and II admitted as not taxable." The said counterclaim represents deficiency franchise tax, plus surcharge, brought about by the non-inclusion by petitioner of various items in its reports, which items, according to respondent, constitute part of petitioner's taxable gross receipts or gross revenue.

Respondent admits that the rate of franchise tax payable by petitioner, during the period here in question, is only 2% as provided in Acts Nos. 4271 and 4272 and not 5% as provided in section 259 of the National Internal Revenue Code, as amended, in view of the decision of the Supreme Court in Philippine Railway Co. v. Collector of Internal Revenue, G.R. No. L-3859, March 25, 1952. The issue, therefore, boils down to the taxability of the various items considered by respondent as part of the gross receipts or gross revenue of petitioner.

The following are the pertinent facts stipulated and submitted by the parties:

"I. That petitioner is a corporation duly organized and existing under the laws of the Philippines, with its principal office at M.R.S. Building, Manila; that 53.6% of its capital stock is owned by the National Development Company, an instrumentality of the Republic of the Philippines; and that respondent is the duly appointed, qualified and the incumbent Collector of Internal Revenue, with principal office at Manila, Philippines;

"II. That petitioner at all times material to this petition was, and until now is, operating and maintaining an air transport service for the transportation of passengers, mail and property by means of aircraft, pursuant to the provisions of Acts Nos. 4271 and 4272, the franchises originally granted to its predecessors - the Philippine Aerial Taxi Company, Inc. and Iloilo-Negros Air Express Company, Inc.- which franchises including all the conditions, terms, restrictions, and limitations have since been duly transferred to petitioner by legislative authority under Commonwealth Act No. 643 and Republic Act No. 759, respectively, as fully and completely and to the same extent as if the said franchise had been originally granted to petitioner;

"III. That the aforesaid franchises granted to petitioner by Acts Nos. 4271 and 4272 provide for the payment of a percentage tax of two per cent of its gross revenues, together with the tax on its real property in consideration of the franchises, and provide further that the payment of said percentage and real property taxes 'shall be in lieu of all taxes of any kind, nature or description';

"IV. That since the third quarter of 1946 to December 31, 1952, petitioner had been depositing quarterly certain amounts to cover its franchise taxes for the preceding quarters;

"V. That for the period from October 1, 1946 to June 30, 1947, petitioner deposited the total sum of ₱387,081.72 to cover the franchise taxes that may be found due from the said petitioner on its gross revenues at the rate of 5% under section 259 of the National Internal Revenue Code as amended, instead of at the rate of 2% under its franchise in accordance with the decision subsequently promulgated by the Supreme Court in the case entitled "Philippine Railway Company v. Collector of Internal Revenue, G.R. No. L-3859;

"VI. That according to respondent, petitioner is satisfied to a refund of its excess deposit of ₱109,713.77 as franchise taxes for the period from October 1, 1946 to June 30, 1947, as indicated in the computation of the respondent, as follows:

4th Quarter, 1946 - - - - - - - - - - - - - - - -	₱4,315,690.48
1st Quarter, 1947 - - - - - - - - - - - - - - - -	4,181,404.09
2nd Quarter, 1947 - - - - - - - - - - - - - - - -	5,371,134.65
Total Gross Receipts per Government audit- - - - - - - - - - - - - -	₱13,868,229.37
Less Sales of motor fuels to employees at cost, p. 5, Audit Report, held not subject to franchise tax, per decision Philippine Long Distance Tel. C. Case - - - - - - - - - - -	14,733.01
Gross revenues per final government audit	₱13,853,496.36
Tax due thereon at 2% - - - - - - - - - - - -	₱ 277,059.93
Less amount deposited - - - - - - - - - - -	387,081.72
Amount over deposited - - - - - - - - - - -	₱ 110,011.79
Less deficiency tax for previous period	298.02
Net amount overdeposited- - - - - - - - - -	₱ 109,713.77

"VII. That according to petitioner, it is entitled to a refund of the sum of ₱244,563.13 as excess deposit, instead of the sum of ₱109,713.77 for the said period from October 1, 1946 to June 30, 1947, as indicated below:

Total gross revenues, as per government audit		₱13,868,229.37
Less: Sales of motor fuels to employees at cost (p. 5 of Audit Report-Ruling on Phil. Long Dist. Tel. Co.) - - - - - - - - - -		14,733.01
Gross Revenues per final government audit -		₱13,853,496.36
Less: Revenues not subject to franchise tax -		
Incoming-International -	₱3,863,504.98	
Outgoing-International -	1,645,318.25	
Passenger Passes- International (See Exhibit A of Gov't Audit Report)	36,876.00	
Passenger Passes- Domestic (See Exh. A of Gov't Audit Report)	81,889.17	
Premium on Capital Stock (p. 5 of Audit Report	1,050,166.67	
Cost of materials & supplies sold and/or used for other Airlines, etc. (p. 5 of Gov't Audit Report - - - - - - - - -	64,712.98	6,742,468.05
Total gross revenues subject to franchise tax		₱ 7,111,028.31
2% Franchise tax due thereon - - - - - - - - -		₱ 142,220.57
Plus deficiency tax for previous period - - -		298.02
Total franchise taxes - - - - - - - - - - - -		₱ 142,518.59
Less amount deposited - - - - - - - - - - - -		387,081.72
Total excess deposit - - - - - - - - - - - - -		(₱ 244,563.13)

"VIII. That the nature of the various items constituting the discrepancy of ₱6,742,468.05 is described in paragraph XXI of this Stipulation of Facts;

"IX. That for the period from July 1, 1947 to December 31, 1948, petitioner deposited the sum of ₱556,884.84 to cover the franchise tax that may be found due from the said petitioner at the rate of 5% under section 259 of the National Internal Revenue Code as amended, instead of the rate of 2% under its franchise, in accordance with the decision subsequently promulgated by the Supreme Court in the case entitled "Philippine Railway Company v. Collector of Internal Revenue, G.R. No. L-3859;

"X. That according to respondent, the petitioner is indebted to the government in the sum of ₱151,228.92 as deficiency franchise tax for the period from July 1, 1947 to December 31, 1948, but that in view of the overdeposit made by the petitioner mentioned in paragraph VI hereof in the amount of ₱109,713.77, for the period from October 1, 1946 to June 30, 1947, there is due from the petitioner only the sum of ₱51,893.94 as deficiency franchise taxes and 25% surcharge, as indicated below:

Total gross revenues per government audit		₱35,431,945.36
Less: Sales of materials and services to employees at cost held not subject to franchise tax, per decision, Phil. Long Dist. Tel. Co. case		26,257.53
Gross revenue per final government audit		₱35,405,687.83
Tax due thereon at 2%		708,113.76
Less: Amount deposited	₱556,884.84	
Plus overdeposit for Oct.1, 1946 to June 30, 1947 under par.VI hereof	109,713.77	666,598.61
Amount of tax still due		₱ 41,515.15
25% surcharge		10,378.79
Total franchise tax and surcharge still due		₱ 51,893.94

XI. That according to petitioner, it is entitled to the refund of the sum of ₱201,384.69 as excess deposit of the franchise taxes for the period from July 1, 1947 to December 31, 1948, as indicated in the computation of the petitioner, as follows:

Total gross revenues per government audit -	₱35,431,945.36
Less: Cost of materials & services rendered to employees (Ruling re Phil. Long Dist. Tel. Co.)	26,257.53
Gross revenues per final government audit -	₱35,405,687.83
Less: Revenues not subject to franchise tax:	
Incoming -International -	₱10,316,723.13
Outgoing - International	5,457,328.84

Passenger Passes- International (p. 3 of Audit Report)	₱398,356.80	
Passenger Passes - Domestic (p. 2 of Audit Report)	241,695.12	
Cost of materials & Services rendered to PAF per contract (Exh. A, Sch. 1. p. 2 of Audit Report)	266,103.25	
Cost of materials & Services rendered to other Airlines, etc. (Exh. A, Sch. 1, p. 2 Audit Report	89,375.88	
Cost of motor fuels sold to CAA, etc. (Exh. A, Sch. 1, p. 2 of Audit Report)	1,395.46	
Premium on capital stock (p. S. Audit Report) domestic	724,736.42	
Earned Surplus, as detailed in Sch.1 . p. 3)	134,965.38	₱17,630,680.28
Gross revenues subject to franchise tax		₱17,775,007.55
2% Franchise tax due thereon		₱ 355,500.15
Less: Amount deposited.		556,884.84
Total Excess Deposit		(₱ 201,384.69)

"XII. That the nature of the total discrepancies of ₱17,630,680.28 is described in paragraph XXI of this Stipulation of Facts;

"XIII. That for the period from January 1, 1949 to December 31, 1950, petitioner deposited the sum of ₱780,645.68 to cover the franchise tax that may be found due from the said petitioner at the rate of 5% under section 259 of the National Internal Revenue Code, as amended, instead of the rate of 2% under its franchise in accordance with the decision subsequently promulgated by the Supreme Court in the case entitled 'Philippine Railway Company v. Collector of Internal Revenue, G. R. No. L-3859

"XIV. That according to respondent, the petitioner is still indebted to the Government in the sum of ₱422,896.64 as alleged deficiency franchise taxes and 25% surcharges for the period from January 1, 1949 to December 31, 1950, as indicated in the computation of the respondent as follows:

Gross revenues as per original government audit -		₱56,130,629.05
Less; Rental of aircraft for domestic use for use in international service subsequently held not subject to tax	₱105,244.99	

Cost of materials & Services to employees at cost held not subject to franchise tax, per decision Phil. Long Distance Telephone Co., case . . .	₱ 77,134.54	₱182,479.53
Gross revenues per final government audit		₱55,948,149.52
Tax due thereon at 2%		1,118,962.99
Less amount deposited		780,645.68
Amount still due		₱ 338,317.31
25% surcharge		84,579.33
Total deficiency franchise tax and surcharge		₱ 422,896.64

XV. That according to petitioner, it is entitled to the refund of the sum of ₱283,535.82 as excess deposit of the franchise taxes for the period from January 1, 1949 to December 31, 1950, as indicated in the computation of the petitioner, as follows:

Gross revenues as per original government audit		₱56,130,629.05
Less:		
Rental of aircrafts for domestic use for use in international service subsequently held not subject to tax	₱105,344.99	
Cost of materials & services rendered to employees (Ruling on Phil. Long Dist. Tel. Co.)	77,134.54	182,479.53
Gross revenues per final government audit		₱55,948,149.52
Less: Revenues not subject to franchise tax-		
Incoming-International -	₱19,392,414.02	
Outgoing-International -	10,043,430.05	
Passenger Passes- International (p.4 of Audit Report)	962,413.73	
Passenger Passes- Domestic (p. 2 of Audit Report).	304,065.39	
Premium on capital stock (p. 4 of Audit Report) .	25,073.50	
Cost of materials & services rendered to other airlines, etc. (Sch. 2. p. 1 & 2 of Audit Report) . .	103,448.90	
Cost of materials & services rendered to PAF per contract (Sch.2, p.1 & 2 of Audit Report)	256,604.87	

Earned surplus as listed in attached Schedule II (Sch. 2 p. 1 & 2 of Audit Report)	₱ 5,205.84	₱31,092,656.30
Gross revenues subject to franchise tax		₱24,855,493.22
2% Franchise tax thereon		497,109.86
Less: Amount deposited		780,645.68
Excess amount deposited		(₱ 283,535.82)

"XVI. That the nature of the various items constituting the discrepancy of ₱31,092,656.30 is described in paragraph XXI of this Stipulation of Facts;

"XVII. That for the period from January 1, 1951 to December 31, 1952, petitioner deposited the sum of ₱1,382,767.28 to cover the franchise tax that may be found due from the said petitioner at the rate of 5% under section 259 of the National Internal Revenue Code, as amended, instead of the rate of 2% under its franchise in accordance with the decision subsequently promulgated by the Supreme Court in the case entitled 'Philippine Railway Co. v Collector of Internal Revenue, G.R. No. L-3859', and that of this amount, the sum of ₱138,000.00 was subsequently refunded by the respondent, thereby leaving only the sum of ₱1,244,767.28 as net deposit for said period.

"XVIII. That according to respondent, the petitioner is still indebted to the Government in the amount of ₱120,038.68 as deficiency franchise taxes and surcharges for the period from January 1, 1951 to December 31, 1952, as indicated in the computation of the respondent as follows:

Gross revenues as per original government audit		₱67,164,599.41
Less: Cost of motor fuels, materials & services rendered to employees, held not subject to franchise tax per decision in Philippine Long Distance Telephone Co. case...		126,688.58
Gross revenues as per final government audit.....		₱67,039,910.83
Tax due thereon at 2%		₱ 1,340,798.22
Less: Amount deposited		1,244,767.28
Amount still due		₱ 96,030.94
25% surcharge.		24,007.74
Total tax and surcharge		₱ 120,038.68

"XIX. That according to petitioner, it is entitled to the refund of the sum of ₱701,815.11 as excess deposit of the franchise taxes for the period from January 1, 1951 to December 31, 1952, as indicated in the computation of the petitioner, as follows:

Gross revenue per government audit		₱64,164,599.41
Less: Cost of motor fuels, materials & services rendered to employees (Ruling of Phil. Long Distance Telephone Co.) ...		124,688.58
Gross revenues per final government audit		₱67,039,910.83
Less: Revenues not subject to franchise tax-		
Incoming-International	₱26,990,961.33	
Outgoing-International.....	12,243,999.32	
Passenger Passes-International (p.6 of Audit Report plus items in Sch. 3, p.2, 3 & 4 of Audit Report)	33,960.20	
Passenger Passes-Domestic (p. 2 of Audit Report - Domestic	178,264.53	
Premium on capital stock (Sch. 2, p. 1 of Audit Report)	10.00	
Cost of materials & services rendered to other airlines, etc. (Sch. 1, p. 1 of Audit Report)	216,370.71	
Cost of materials & services rendered to PAF per contract (Sch. 1 p. 1. of Audit Report)	227,022.24	
Earned surplus (Sch. 2, p. 1 of Audit Report)	1,713.61	₱39,892,302.54
Gross revenues subject to franchise tax		₱27,147,608.29
2% Franchise tax due thereon		₱ 542,952.17
Less: Amount deposited		₱ 1,244,767.28
Excess amount of deposit		(₱ 701,815.11)

"XX. That the nature of the various items constituting the discrepancy of ₱39,892,302.54 is described in paragraph XXI of this Stipulation of Facts;

"XXI. That the nature of the various items constituting the discrepancy specified in paragraphs VII, XI, XV, and XIX hereof is described as follows:

1. Gross revenues from international service.- The revenues from international service are divided into two parts, namely, outgoing, meaning gross revenues derived by PAL as passenger fares and freight and other revenues for flight from Manila to foreign

countries, and incoming, meaning gross revenues derived by PAL in its foreign stations outside the Philippines as passenger fares and freight and other revenues for flight from a foreign country to another foreign country or from a foreign country to Manila. Included in the incoming are the following items which have no classification whether incoming or outgoing international revenues:

(a) Earned surplus:

2nd qr., 1947 to 4th qr., 1948 - - - -	₱77,529.13
1st qr., 1949 to 4th qr., 1950	323,343.74
1st qr., 1951 to 4th qr., 1952	(39,937.75)
Total	₱391,026.12

(b) Non-operating revenues by years:

1947	42.46
1948	77,799.62
1949	762.18
1950	317,934.19
1951	1,262,346.32
1952	59,304.05
Total	₱2,213,188.82

Foreign airlines calling in the Philippines pay franchise taxes for their outgoing revenues only.

2. Premium on capital stock - In the course of the various increases of its capital stock, PAL had sold additional stock to its stockholders of records only at over and above par. The excess over par, called premium which PAL received from its stockholders of records only for its stock is considered by respondent as forming part of its gross revenues and subject to the franchise tax. Petitioner, however, believes that the excess or premium on capital stock represents capital transaction or contribution by the stockholders to the corporation and credited to capital and not to earned surplus account and not subject to franchise tax.

3. Passes.- As a consequence of being a government-controlled corporation, passenger passes are issued by PAL to government officials and other airline officials by virtue of which holders of passes are allowed to book passage free of charge including their baggage, subject to availability of space. Respondent holds that the money value of the passenger passes forms part of the gross revenues of the PAL subject to the franchise tax. Petitioner, however, believes that inasmuch as PAL received nothing from these passes, no tax should be imposed thereon.

4. Earned surplus, domestic.- This item represents various credits to the surplus account listed in Schedule L, Schedule II, and Schedule III, all attached to this Stipulation and made integral parts hereof, describing the nature of the items constituting the earned surplus and which are the subject

of controversy. The petitioner believes that the items listed in Schedules I, II and III do not form part of the gross receipts or gross revenues of the petitioner subject to franchise tax while the respondent, on the other hand, believes that they are subject to said tax. Some of the items listed in Schedules I, II and III are mere adjusting entries which do not affect the income accounts, while the rest of the items such as FEATI's valuation reserve for plane P.I. C-4, MIATCHI & Cali net surplus absorbed by PAL, and the item of ₱16,350.00 which is the estimated cost of the Samar Shop Equipment at Guiuan transferred from FEATI in 1946, are not taxable.

5. Cost of materials and services.- These items consist of the following:

(a) Materials and services furnished PAF.- Under the maintenance and Overhaul COntract between the PAL and the Philippine Air Forces, a copy of which is attached, marked Exhibit "A", and made an integral part of this Stipulation, the PAF reimburses the PAL for the cost of materials used and labor involved in the repairs, plus 10% and 25% thereof, respectively. PAL declares the total amount received at premium of 10% and 20% on the materials and labor, respectively. Respondent, however, believes that both the cost of materials and labor plus the 10% and 20% should be subject to the franchise tax.

(b) Cost of materials and services furnished other airlines.- PAL also repairs the planes of other airlines. PAL declares the gross profit on the labor and on the materials furnished. Respondent, however, believes that with respect to repairs to other airlines, both the cost of the labor and materials plus the profit should be subject to the franchise tax.

(c) Materials and services furnished CAA.- PAL sometimes sells to the Civil Aeronautics Administration motor fuel at cost. PAL does not declare the amount received from the CAA because according to PAL, it derives no gross revenues from the sale of such motor fuel. Respondent, however, believes that with respect to such motor fuels, the total amount received from the CAA by the PAL should be declared for franchise tax purposes."

For convenience, Schedules Nos. 1, II and III, attached to the above quoted Stipulation of Facts by the parties, are as follows:

"SCHEDULE I

EARNED SURPLUS (Domestic)

Reversion of Accounts Payable to Surplus par. JV-9-4, San Miguel Brewery, August, 1946 ..... ₱1,429.30

A. Soriano y Cia., July 1946 for rental of house Nos. 1, 3 and 4 at Cuneta	₱ 616.67	₱ 2,045.97
Service rendered by Supply and Procurement Section from May to April, 1947, per adjustment entry # 30, JV-10-14	₱4,000.00	
Medical Services rendered to MIAiCI from October to January, 1947 per adjustment # 29, JV-10-14.....	375.00	4 375.00
Issued by PAL in Sept. 1946 to MIAICI of:		
1- Caterpillar Road Grader (Cost)	₱4,000.00	
1- Callion Road Roller (Cost)	3,500.00	7,500.00
Estimated Cost of Samar Shop Equipment at Guiuan transferred from FEATI in 1946 per adj. # 7 JV-12-108		16,350.00

Uncashed checks which were reverted back to the credit of the PAL account with the Hongkong and Shanghai Banking Corporation per JV-48-3-68 as follows:

PAYER	CHECK NO.	AMOUNT	
S. Fabregas	F-01774	₱ 8.00	
Sto. Tomas Univ.	F-08474	40.00	
H. B. Andrews	F-48228	193.33	
B. Racaza	F-67421	150.00	
Dr.J.S. Sta Cruz	F-79542	38.00	
R. C. Rils	F-88320	39.42	
Felix Boncan	F-524	5.00	490.97

Reversion of Accrued Salaries & wages unclaimed per JV-48-4-53 as follows:

A.L. Espinosa	₱29.85	
D. Villaluna	25.00	
N. Rojales	12.50	
F. Samaniego	12.50	
M. Bassinger	120.80	
C. Dhindion	47.20	
R. Schultz	29.05	276.91

FEATI's valuation Reserve for plane P.I. C-4 which was sold in December 1947. The reserve was not taken up when said plane was dropped from the books per JV 48-4-51, JV 12-169 and JV 28 and 37	29,166.64
MIAICI's Net Surplus up to June 30, 1948 absorbed by PAL	41,989.56

Earned Surplus re-acquisition of CALI properties for which PAL paid 37727 shares of capital stock per list attached to JV-12-101	₱32,770.33
T O T A L	₱134,765.38

"SCHEDULE II

EARNED SURPLUS (Domestic)

From 1949 to 1950

DATE	FOLIO	PARTICULARS	AMOUNT
1949			
May 31	J3-42	To take up cancellation of various checks drawn against H. S. B. C (not cashed)	₱ 349.66
June 30	J6-42CI	To reverse entry made per JV 43-1-73 in connection with Invoice 6283 which was already paid in Oct. 1947 per G/R 12?30	₱1,673.48
July 31	C/R 414	Refund of freight by NCB, C/R 45566	5.00
Sept. 30	J9-424	To record cancellation of various checks	60.50
Oct. 31	J10-420	Taking up S.F. Invoice # 99 dated July 5, 1947 which was paid by Soriano y Cia	65.50
Nov. 30	311-428	To charge the account of Phil. Senate for Invoice #16331 dated August 31, 1948	200.00
Nov. 30	J11-42A	To adjust amount charged to A/C 1241 by JV 49-1-42	.89
Dec. 31	J12-68	To write off "out of Date" checks, shown as outstanding per PAL's Bank Reconciliation	486.38
1950			
Feb. 28	J2-43	To record cancellation of checks	2,285.73

March 31	J3-42	To eliminate credit of Manila Engineer's District account for unused FEATI ticket No. 12914-4/25/47 ...	₱ 78.70
		T O T A L	₱ 5,203.84

"SCHEDULE III

DOMESTIC EARNED SURPLUS

1951 - 1952

JV-12-76-51 to write off and/or cancel the following liabilities:

Evening News	₱ 30.00
New Society Bakery	15.80
Balcoff & Pobledor	150.00
Carmelo & Bauerman	320.00
Uy Tit & Co.....	22.60
Paul Bros.	11.00
Go Soc & Sons	1,164.25
T O T A L	₱1,713.65

In order to clarify ambiguous items contained in Sechedules I, II and III of the Stipulation of Facts and other items appearing in the aforesaid Stipulation of Facts, the parties were required to clarify those items and to submit evidence relative thereto. A supplemental stipulation of facts was thereafter submitted dated November 11, 1955, which is reproduced below en toto:

"I. ADDITIONAL STIPULATION REGARDING SCHEDULE I, ATTACHED TO THE ORIGINAL STIPULATION OF FACTS DATED MAY 19, 1955

"After a consideration of further particulars on the following items, both parties admit that these are not taxable:

Reversion of Accounts Payable to Surplus per JV-9-4, San Miguel Brewery, August, 1946	₱1,429.30	
A. Soriano y Cia., July 1946 for rental of houses Nos. 1. S & 4 at Cuneta ...	616.67	₱ 2,045.97
Issued by PAL in Sept. 1946 to MIAICI of:		
1-Caterpillar Road Grader (Cost)	₱ 4,000.00	
1-Callion Road Roller(Cost)	3,500.00	7,500.00

Estimated cost of Samar Shop Equipment at Guiuan transferred from FEATI in 1946 per adj. # 7 JV 12-108		₱16,350.00
Reversion of Accrued Salaries & wages unclaimed per JV-48-4-53:		
A.L. Espinosa	₱ 29.85	
D. Villaluna	25.00	
N. Rojales	12.50	
F. Samaniego	12.50	
M. Bassinger	120.80	
C. Chindian	47.21	
R. Schultz	29.05	276.91
Medical services rendered to MIATCI from Oct. to Jan. 1947 per adjustment # 29, JV-10-14		375.00
T O T A L		₱26,547.88

"The parties also upon further consideration of its nature agree that the item of ₱29,166.64 captioned 'Valuation Reserve' is taxable.

"In connection with the item of ₱4,000.00 captioned as 'Service rendered by Supply and Procurement Section from May to April, 1947, per adjusting Entry No. 30, JV-10-14', part of ₱4,375.00, the following stipulations as to the nature of these items are submitted by the parties: The Manila International Air Terminal Co., Inc., otherwise known as MIATCI was a subsidiary corporation of the Philippine Air Lines, Inc., whose management was handled by the PAL. In connection with such management, services were rendered by the Supply and Procurement Section of the PAL to the MIATCI and such services were charged against the MIATCI.

"In connection with the 5th item of Schedule I, amount of ₱490.97 composed of 7 sub-items, the parties agree that these 7 sub-items represent claims against the PAL by various creditors which were paid by PAL by means of checks, the numbers of which are enumerated in Schedule I but due to the fact that the creditors did not cash the said checks, they were subsequently cancelled by PAL and the corresponding adjusting entries made in its books. The adjusting entries were made in its books. The adjusting entries were made by crediting the amounts of those checks to PAL's surplus accounts.

"With respect to the item captioned as 'MIATCI's' net surplus up to June 30, 1948 absorbed by 'PAL' the parties hereby stipulate as follows:

"The Manila International Air Terminal Co., Inc., otherwise known as MIATCI, was a subsidiary corporation of PAL which was engaged in the business of operating the Makati Air Field up to June 30, 1948. When the Manila International Air Terminal Co., Inc. was opened, the Makati Air Field was abandoned and MIATCI went out of business. On the said date all the assets and liabilities of MIATCI were taken over by PAL, including its net surplus of ₱41,977.56 plus another item of ₱12.00 as deposits on work orders, or a total of ₱41,989.56, which is the item the parties are now describing. A copy of the balance sheet of MIATCI as of June 30, 1948 is attached hereto as Annex 'A' from which the aforesaid items of ₱41,977.56 and ₱12.00, or a total of ₱41,989.56 may be seen marked with an asterisk.

"The government auditors considered this amount taxable, as the book value of the net assets taken over by the petitioner were in excess by ₱41,989.56 over the price therefor, and MIATCI is a distinct and separate corporation. Petitioner claims that the said surplus is not taxable, as this represents the accumulated net profit of its subsidiary, which has already paid income tax thereon.

"In connection with the item of ₱32,770.33 captioned as 'Earned surplus re-acquisition of CALI properties x x x,' the parties hereby stipulate as follows:

"The Commercial Air Lines, Inc., otherwise known as CALI, was a corporation formerly engaged in the international airlines business in the Philippines. On August 31, 1948, all of the aircraft, spare engines, furniture, fixtures and other equipment, and other assets of CALI were acquired by PAL for the stated amount of ₱1,052,931.80. This amount was paid for in the following manner:

PAL acquired from CALI the following properties:

11 Aircraft (Type C-47)... JV-48-8-57	₱446,720.00	
2 Air craft (Type C-64) .... JV 48-6-57	16,411.54	
Additional cost to flyable aircraft JV 48-12-101	7,074.46	₱470,206.00
Spare engines, furniture fixture, and other equipment JV-48-12-52	₱138,240.00	
Spare parts (R & R items) JV 48-12-101	372,735.51	
Materials & supplies JV 48-12-101	70,250.29	

Jolo Waiting Station JV-48-12-101	₱ 500.00	
Junk Piles (sold to Maidamer) JV-48-12-101 ...	500.00	
Junk Piles (sold to CALI) JV-48-12-101	500.00	₱582,725.80
Total value of acquired properties		₱1,052,931.80

Above properties were paid in the following manner:

In cash		₱ 250,000.00
In PAL stock as follows:		
69,669 shares at ₱10.00 per share	₱696,690.00	
69,669 shares at ₱1.00 premium	69,669.00	
69,669 shares at a total price of ₱11.00 per share		₱ 766,359.00
By application of MIATCI Receivable owing by CALI		32,770.33
By application of PAL Receivable owing by CALI		3,791.93
		₱1,052,921.26
Difference between value of acquired properties and payments made as detailed above absorbed into our Account 7187 as income (non-operating)		10.54
T O T A L		₱1,052,931.80

"The item the parties are now describing may be identified in the above statement as application of MIATCI's receivables owing by CALI in the amount of ₱32,770.33. This amount represents receivables of MIATCI payable by CALI for the use of Makati Air Field during the time it was in operation. In view of the fact that the MIATCI was a subsidiary of the PAL, these MIATCI receivables were included in the purchase price of all the property and equipment of CALI acquired by PAL.

"The government auditors contend that this amount is taxable inasmuch as this amount pertains to the MIATCI and not to the PAL, so that the profit on the sale is computed as follows:

Total assets acquired by PAL		₱1,052,931.30
Total payment, as listed above	₱1,052,921.26	
Less MIATCI receivables	32,770.33	
Net amount paid by PAL		1,020,150.93
Total profit, per government auditors		₱ 32,780.87
Less profit declared		10.54
Additional profit to be declared .		₱ 32,770.33

"On the other hand, PAL contends that the sum of ₱32,770.33 cannot be considered as profit by the PAL because as shown in the above-indicated statement, PAL acquired from CALI properties worth ₱1,052,931.80 for the sum of ₱1,032,921.26, which amount includes the sum of ₱32,770.33, or at a discount of ₱10.54, and that until PAL has disposed of these properties acquired from CALI for an amount over and above the sum of ₱1,052,921.26, no profit can be considered as having been derived by PAL from this transaction. In other words, there can be no profit from a purchase transaction by the purchaser until the latter has resold the property purchased.

"II. ADDITIONAL STIPULATION REGARDING SCHEDULE II, ATTACHED TO THE ORIGINAL STIPULATION OF FACTS DATED MAY 19, 1955.

"With respect to Schedule II, the parties after further study have agreed that the following items are taxable:

DATE	FOLIO	PARTICULARS	AMOUNT
1949			
July 31	C/R 414	Refund of freight by MCE, O/R 45566	₱ 5.00
Nov. 30	J11-42A	To adjust amount charged to A/G 2141 by JV 49-1-42	.89
Nov. 30	J11-428	To charge the account of Phil. Senate for Invoice #16331 dated August 31, 1948	200.00
1950			
Mar. 31	J3-42	To eliminate credit of Manila Engineer's District account for unused Feati Ticket No. 12914-4/25/47	78.70
		T O T A L	₱ 284.59

"The parties also agreed, considering additional data relative thereto, that the following items are not taxable:

DATE	FOLIO	Particulars	Amount
1949			
Oct. 31	J10-420	Taking up S.P. Invoice #99 dated July 5,1947 which was paid by Soriano y Cia	₱ 65.50

Dec. 31	J12-68	To write off "Cut of data' checks, shown as outstanding per PAL's Bank reconciliation	₱ 426.38
Feb. 28	J2-43	To record cancellation of checks	₱2,285.73
		T O T A L	₱2,837.61

"With respect to the following items:

DATE	FOLIO	PARTICULARS	AMOUNT
1949			
May 31	J13-42	To take up cancellation of various checks drawn against HSEC (not cashed)	₱ 349.66
Sept 30	J9-42A	To record cancellation of various checks ...	60.50

the parties hereby agree that these represent the total amount of cancelled checks which were paid by PAL to various creditors but which were not actually cashed by the corresponding payees, and therefore adjusting entries were made debiting Bank Account and crediting Surplus.

"With respect to the item of ₱1,673.48, the parties hereby agree that this represents the amount of passenger fare from Oakland to Manila which was actually received by PAL here in Manila but erroneously credited to Earned Surplus, Domestic, which should properly be included in the Earned Surplus, Incoming International. If this Honorable Court will finally rule that the revenue from incoming international service will be subject to the franchise tax, then this item should be included in the gross revenue from incoming international service.

"III. ADDITIONAL STIPULATION REGARDING SCHEDULE III, ATTACHED TO THE ORIGINAL STIPULATION OF FACTS DATED MAY 15, 1953.

"With respect to Schedule III attached to the original Stipulation of Facts, dated May 19, 1955, the parties hereby stipulates that all the items enumerated in said Schedule III represent balances payable to various creditors representing expenses for materials and services which were written off to Surplus as they were long outstanding in the books.

"IV. ADDITIONAL STIPULATION WITH RESPECT TO THE ITEMS UNDER THE CAPTION COST OF MATERIALS AND SERVICES FURNISHED TO PAL AND COST OF MATERIALS AND SERVICES FURNISHED OTHER AIRLINES.

"The parties further stipulate that the following are the segregation of the value of labor from the value of materials in connection with the above-captioned items, for the four periods involved in this case.

SUMMARY OF BREAKDOWN OF MATERIALS AND SUPPLIES SOLD AND SERVICES RENDERED FROM OCTOBER 1, 1946 to DECEMBER 31, 1952

		Sales to PAL		Other Sales	
	Total	Labor	Materials	Labor	Materials
Oct. 1, 1946 to June 30, 1947					
Cost of materials and supplies sold and/or used for other airlines, etc. (p. 5 of Gov't Audit Report)	₱ 54,712.98				
July 1, 1947 to Dec. 13, 1948					
Cost of materials and services rendered to PAL per contract (Exh. A Sch. 1 p. 2 of Audit Report)	226,103.25	₱120,500.85	₱145,503.40		
Cost of materials and services rendered to other airlines, etc. (Exh. A, Sch. I, p. 2 Audit Report)	89,375.88				₱89,375.88
Cost of motor fuels sold to CAA, etc. (Exh. A. Sch. 1 p 2 Audit Report)	1,395.46				1,395.46
1949 and 1950					
Cost of materials and services rendered to other airlines, etc. (Sc.A,pp 1 & 2 Audit Report	₱103,443.90			10,601.64	92,847.16

Cost of materials and services rendered to PAF per contract.(Sch. 2, pp. 1 & 2 of Audit Report)	₱256,604.87	94,921.13	161,683.74		
1951 and 1952					
Cost of materials and services rendered to other airlines, etc.(Sch. 1 p. 1 of Audit Report	₱216,370.71	70,791.76	145,578.95		
Cost of materials and services rendered to PAF per contract.(Sch. 1 p. 1 of Audit Report)	227,892.84	109,637.82	117,385.52		
TOTALS	₱1,225,094.89	₱395,949.76	₱570,161.91	₱10,683.74	₱248,331.48

From the foregoing Stipulation and Supplement Stipulation of Facts, the controversy has been narrowed down to the following principal items, namely:

Resume of Disputed Items of Gross Receipts	AMOUNT DISPUTED
1.Incoming Gross receipts - International	₱60,563,603.46
2.Outgoing Gross receipts - International	29,390,076.46
3.Passengers' Passes -	
a. International	1,431,606.73
b. Domestic	205,914.21
4.Premium on Capital stock	1,799,986.59
5.Cost of materials sold to PAF and other airlines	817,087.93
6.Cost of motor fuels sold to CAA	1,395.46
7.Cost of services rendered to PAF and other airlines	406,551.50
8.Earned surplus items, Per Schedules I, II and III:	
a. Services rendered by Supply & procurement Section from May to April, 1947, per adjustment entry #30, JV-10-14	4,000.00
b.Uncashed checks which were reverted back to the credit of the PAL account with the Hongkong & Shanghai Banking Corporation per JV-48-68	490.97
c.Cancellation of various checks drawn against Hongkong Shanghai Banking Corp.....	349.66
d. Cancellation of various checks per J9-42A	60.50

e. MIATCI's Net Surplus up to June 30,1948 absorbed by PAL	41,989.56
f. Earned Surplus re-acquisition of CALI properties for which PAL paid 37,727 shares of capital stock per list attached to J8-12-101	32,770.33
g. To reverse entry made per JV 48-1-73 in connection with Invoice 6285 which was already paid in Oct. 1947 per Collector of Internal Revenue 12/30 per JC-42CI	1,673.48
h. Cancellation and writing off of liabilities as listed per JV 12-76-51	1,713.61
TOTAL .....P	95,299,270.45

The petitioner maintains that the items listed above do not form part of the "Gross Revenue" or "Gross Receipts" which are taxable under its franchises, whereas the respondent contends that the amounts involved are part of petitioner's taxable "gróss receipts" or "gross revenue".

The petitioner is engaged in the transportation of passengers and cargo by air. It operates under and by virtue of two franchises granted by the former Philippine Legislature under Acts Nos. 4271 and 4272, originally granted to its precedessors - the Philippine Aerial Test Company, Inc. and the Iloilo Air Express Company, Inc.- which franchises were acquired by the herein petitioner and duly sanctioned by legislative authority under Commonwealth Act No. 643 and Republic Act No. 759, respectively. Section 13 of both Acts Nos. 4271 and 4272, which are identical, read as follows:

> Sec. 13 In consideration of the franchise and rights hereby granted, the grantee shall pay to the Insular Government during the first ten years of the life of this franchise a tax of one per cent of the gross revenue derived by the grantee from its operation under this franchise; and during the last fifteen years of the life of this franchise a tax of two per cent of such gross revenue. Such tax shall be due and payable quarterly and shall be in lieu of all taxes, of any kind, nature or description, levied established or collected by any municipal, provincial or Insular authority. The grantee shall pay the tax on its real property in conformity with existing law.

And Section 14 of both Acts, which are also identical, provide -

> SEc. 14. The grantee shall keep an account of the gross receipts of the business transacted by it and shall furnish to the Insular Auditor and the Insular Treasurer a

copy of such account quarterly, during the month next following the close of the quarter. For the purpose of auditing accounts so rendered to the Insular Auditor and treasurer, all the books and accounts of the grantee, and duplicates thereof, shall be kept in the Philippines, and shall be subject to the inspection of the Insular Auditor or his authorized representatives. The audit and approval of such accounts by the Bureau of Audits shall be final and conclusive evidence as to the amount of said gross receipts, except that the grantee shall have the right to appeal to the courts of the Philippines and the Supreme Court of the United States, under the terms and laws of the Philippines and the Act of the United States Congress of March twenty-fourth, nineteen hundred and thirty-four.

"The words "'gross receipts' are herein defined as the total receipts obtained by the grantee from its separation under this franchise.

It will be noted that under Section 13 of Acts Nos. 4271 and 4272 petitioner is required to pay a franchise tax on the gross revenue derived from the operation of its franchise, while under Section 14 it is required to keep an account of the gross receipts of the business transacted by it and to furnish to the insular auditor (Auditor General) and insular treasurer (National Treasurer), a copy of such accounts quarterly. Section 14 defines the term "gross receipts" as meaning "the total receipts obtained by the grantee from its operation under this franchise." The Supreme Court has ruled that the term "gross receipts" appearing in franchises granted by the Philippine Legislature under the authority of Section 74 of the Philippine Bill of 1902 and Section 28 of the Jones Law should be interpreted to mean the same as "gross earnings", because said organic acts required that all franchises, privileges or concessions granted by the Philippine Legislature shall provide for the payment of a reasonable percentage of the gross earnings of the grantees. (The Philippine Long Distance Telephone Co. v. the Collector of Internal Revenue, G.R. No. L-3222, Jan. 21, 1952) Accordingly, the terms "gross revenue" and "gross receipts" appearing in Sections 13 and 14 of Acts Nos. 4271 and 4272 should be interpreted to mean the same as "gross earnings". The question presented for our consideration is whether or not the various items here in controversy are part of the taxable "gross revenue", "gross receipts" or "gross earnings" of petitioner.

We shall first consider the following items:

1. Incoming Gross Receipts, International . ..... ₱60,543,693.45

2. Outgoing Gross Receipts, International 29,390,076.46

Total .....₱ 89,953,679.92

These two items refer to the gross receipts or gross

revenue of petitioner derived from the operation of its international lines.

It is a general rule that although the taxing power may be broad, it is subject to an inherent limitation that the state can not tax anything beyond its territorial jurisdiction. Stated otherwise, this means that the state can levy a tax only upon persons, property, income or acts or business that are within its territorial limits and bars it from collecting a tax on subjects or objects outside of these limits.

> "No state may tax anything not within its jurisdiction without violating the due process clause of the Constitution. The taxing power of a state does not extend beyond its territorial limits, but within such limits it may tax persons, property, income or business. If an interest in property is taxed, the situs of either the property or interest must be found within the state. If an income is taxed, the recipient thereof must have a domicile within the state or the property or business out of which the income issues must be situated within the state so that the income may be said to have a situs therein." (Manila Gas Corporation v. Collector of Internal Revenue, 62 Phil.895).

In going over the provisions of the franchises granted to petitioner or its predecessors, we note that under Section 13 of the franchises, the tax therein imposed is levied upon the petitioner " in consideration of the franchise and rights" granted to petitioner. This tax appears to us to be an excise tax. It is a charge imposed upon the petitioner for the performance of an act the enjoyment of a privilege, or the engaging in an occupation. (51 Am. Jur. 61.) Being thus an excise tax, the same can be levied by the state only when the acts, privileges or businesses are done or performed within the jurisdiction of the Philippines.

> "Situs of excise taxes.- The power to levy an excise tax upon the performance of an act or the engaging in an occupation does not depend upon the domicile of the persons subject to the excise tax, nor upon the physical location of the property used in connection with the act or occupation taxed, but depends upon the place in which the act is performed or the occupation is engaged in. A state may constitutionally tax the performance of a certain act within its limits, and may enforce payment of the tax even when the act is performed by nonresidents of the state with respect to property which has never been within its bounderies provided the act which is subject to the tax is performed within the state. Its power to impose a tax on transactions within the state is not affected by the fact that the exaction of the tax is contingent upon events occurring outside the state. A state may not, however, lay a privilege or excise tax upon the

> exercise or enjoyment of a right or privilege in another state derived from the laws of that state and therein exercised and enjoyed. It cannot constitutionally impose an excise upon the performance of an act outside the limits of the governmental unit by which the excise tax is levied. A state cannot levy an occupation tax upon a person or corporation after he or it has ceased to carry on the business taxed within the state; the carrying out of contracts previously made is not engaging in business." (51 Am. Jur. pp. 460, sec. 445).

Of course it is to be noted that under the law herein involved, the 2% tax levied upon petitioner is supposed to be one "in lieu of all other taxes". A provision of law imposing a tax "in lieu of all taxes of any kind, nature or description" has been generally considered as a commutation tax, that is, it is a combination of two or more taxes as an excise or franchise tax, payment of which would give rise to a privilege exemption from all other taxes. (12 C.J. 216). However, it must be admitted that as a commutation tax, it does not cause to be subject to the general limitations imposed upon all burdens in character of taxes, whatever their denomination may be. Since the tax imposed by Section 13 is a tax upon the gross receipts of the petitioner derived from the operation of franchises granted to it by the legislative body to establish, operate and maintain an air transport service for the transportation of passengers, mail and property by aircraft, the 2% commutation tax is to be deemed imposed as a substitute for all other taxes that may be levied or assessed upon the petitioner. However, the 2% commutation tax can be a substitute only of taxes that the Philippines could validly impose and collect from the petitioner. The tax so imposed can not be made to reach the subjects or objects of taxation which the Philippines can not validly tax. The tax involved herein being a substitute or commutation of all taxes which are or may be legally exacted, the right of the Philippine Government to collect taxes must be considered in relation to the aforesaid doctrine limiting the power of a state to collect taxes to subjects or objects within its jurisdiction. It follows that the Philippine Government lacks the authority to levy a tax upon the business transactions or acts done by petitioner outside its territorial limits. The fact that the petitioner is a domestic corporation does not alter the situation. Consequently, any attempt on the part of respondent to collect a franchise tax upon transactions done outside of the Philippines would be void and wanting in authority, as it would constitute a deprivation of the property of the taxpayer without due process of law.

Having reached the conclusion that the franchise tax imposed by Acts Nos. 4271 and 4272 in the nature of an excise tax and that no excise tax may be levied, imposed or collected on gross receipts or earnings derived from transactions made or effected beyond the territorial limits of the Philippines, let us now consider whether the gross receipts or earnings derived by petitioner from its

international lines were the result of transactions made or effected within or without the taxing jurisdiction of the Philippines. The first item in the amount of ₱60,563,603.46, relates to the gross receipts denominated as "International gross receipts-Incoming". This amount is the total gross receipts during the period in question for the transportation of passengers and freight from foreign countries to the Philippines. There can be no doubt that in regard to the gross receipts for the transportation of passengers and freight in foreign countries the transactions were exclusively foreign. Consequently, said gross receipts can not be reached by taxation in the Philippines. The transportation of passengers and freight originating in some foreign countries with the Philippines as destination presents a more difficult problem, a portion of the services rendered by petitioner to its customers being actually rendered in the Philippines when its planes land on Philippine soil.

We have studied the matter carefully and found some assistance from the administrative rulings and interpretations of the Bureau of Internal Revenue on the taxability of the gross receipts of common carriers in general. Section 192 of the National Internal Revenue Code imposes a percentage tax of 2% of the gross receipts of common carriers and transportation contractors, whether engaged in domestic or foreign trade. In the case of common carriers engaged in international trade, the Bureau of Internal Revenue has ruled that receipts derived from incoming freight and passenger service are not subject to said tax, and that only receipts from outgoing freight and passenger service are taxable.

> "Receipts derived by Foreign steamship companies engaged in business in the Philippines from outgoing freight and passenger service are subject to the percentage tax imposed in Section 192 of the National Internal Revenue Code. However, receipts derived from incoming freight and passenger service are not subject to the percentage tax imposed in the said section of the Tax Code. In both cases, it is immaterial whether payment of the freight or passage is made here or abroad. (Ruling, B.I.R. 140.02 dated Oct. 5, 1950.)" (Aranas, Commentaries and Jurisprudence on Business and Occupation Taxes, 2d Ed., p. 277).

It is obvious that the gross receipts derived by common carriers engaged in international trade are derived from transactions partly within and partly without the Philippines. This is true as regards both outgoing and incoming passenger and freight service. Great difficulty would be encountered if the gross receipts from incoming service were to be apportioned by segragating the portion actually earned for services rendered in the Philippines from that portion earned for services rendered outside. The same is true with respect to the gross receipts from outgoing traffic. To facilitate the determination of the taxable from the non-taxable gross receipts, the Bureau of Internal Revenue has ruled that only the gross receipts of common carriers engaged in international trade derived from outgoing service are deemed earned from

transactions within the Philippines, while the gross receipts earned from incoming service are considered derived from transactions without the Philippines. In short, the origin of the business, or the place of embarkation, and not the place of completion of the fare or freight service, determines the situs of the transaction. This to us is a sound rule and is advantageous from the point of view of both the Government and the taxpayers concerned. If the Bureau of Internal Revenue has seen fit to apply this rule to common carriers engaged in international trade under Section 192 of the Revenue Code, we find no justification for the application of a different rule to carriers operating under franchises granted by the Philippine Legislature or by Congress. If it is considered illegal under Section 192 of the Revenue Code to tax the gross receipts of common carriers derived from incoming international service, on the ground that they are derived from transactions outside the Philippines, certainly the taxation of similar gross receipts cannot be justified on the ground that such gross receipts are earned by common carriers operating under franchises. Where the legislature or Congress lacks power to levy or impose a tax, the imposition or collection thereof may not be justified under the guise of a franchise tax.

We are, therefore, of the opinion that the "incoming gross receipts-international" of petitioner in the amount of ₱60,563,603.46 are not taxable, while the outgoing gross receipts in the amount of ₱29,390,076.46 are subject to the franchise tax.

We now proceed to the disputed items regarding Passenger Passes. As a consequence of being a government-controlled corporation, passenger passes are issued by the petitioner to government officials and other airline officials by virtue of which holders of passes are allowed to book passage free of charge including their baggage, subject to availability of space. (Par. XXI, subpar. 3, Stipulation of Facts.) In addition, passes are issued to employees of the petitioner as well as those issued under regulations of the International Air Transport Association the latter being an organization to which the majority of international airlines of the world are members. Passes are issued not only in connection with its foreign service but also in connection with its domestic service, and it appears that the holders thereof are required to waive all claims for damages against the petitioner in case of any mishap. Furthermore, pass-holders are entitled only to free transportation of baggage to the same extent as a paying passenger and any excess baggage are subject to the usual freight charges. The respondent maintains that the money value of all these passes constitutes part of the gross revenue or gross receipts of the petitioner subject to the franchise tax.

As already adverted to, Section 13 of both Acts Nos. 4271 and 4272, require petitioner to pay the franchise tax on its <u>gross revenue</u> derived from its operation under the franchises, while Section 14 of the same Acts require the petitioner to keep an account of the <u>gross receipts</u> of the business transacted by it, furnishing the Insular Auditor and the Insular Treasurer with a copy of such

account. The terms "gross revenue" and "gross receipts" should be interpreted to mean the same as "gross earnings".

> "The acts of the Legislature granting the franchise should be construed so as not to contravene or violate the organic acts above mentioned, for otherwise said legislative acts would be null and void or unconstitutional. The organic acts use the word 'earnings'. A person may have earned his salary but may not have collected it, or may be unable to collect it from an insolvent employer. A person cannot demand payment of his unpaid salary unless he has earned it. This would show that to collect is different from to earn. Consequently, the uncollected 'gross receipts' which should be construed as meaning the same thing as 'gross earnings' should be subject to the franchise tax.
>
> "Therefore, the amounts above mentioned due from customers which are uncollected or written off or carried in the books are subject to the franchise tax in the amount of ₱3,066.57." (Philippine Long Distance Telephone Co. v. The Collector of Internal Revenue, supra.)

For purposes of the franchise tax, therefore, the gross revenue of the petitioner is represented by its gross earnings from its patrons in exchange for the services rendered, including amounts due which are uncollected or written off or carried in its books.

Applying the foregoing criterion to the case at bar, it will readily be noted that the money value of the free passes was never earned by the petitioner. From the time the passes were issued, it was already definitely understood that no amount can be and will ever be received by the petitioner from the holders thereof. There was never any intention, hope or expectation that the petitioner would ever collect the money value of the passes when they were issued. And as alleged by the petitioner, the money value of the free passes never appeared in its books as accounts receivable. Hence, the money value of the passes issued by the petitioner to government officials and its employees is never due from customers. Neither may they be considered as accounts uncollected or written off or carried in the books. As such it can not be considered as "gross receipts", "gross revenue" or "gross earnings" of petitioner from whatever angle the question is viewed.

Moreover, as stated above in the Stipulation of Facts, passenger passes are issued by the petitioner to government officials and other airline officials as a consequence of being a government-controlled corporation. Under the provisions of the Civil Aeronautics Act, Republic Act No. 776, the petitioner is expressly allowed to grant free passes to certain persons, including its officers, agents and employees and their immediate families, as well as to members of Congress (Section 42(d),(3), Republic Act No. 776). Passes might therefore be considered as issued in accordance with said provision of law with no expectation

of any consideration for the return of services rendered. While it is true that the said Republic Act No. 776 was approved only on June 20, 1952, it seems more in consonance with the purpose and spirit of Acts Nos. 4271 and 4272 to consider the passes issued before this date as purely incidental to its being a government-controlled corporation and the only domestic airline company engaged in foreign operations which, for managerial purposes, were reasonably necessary for its successful management. Moreover, since the issuance of the passes were made upon compliance with regulations of the International Air Transport Association, which are observed by the majority of the international airlines of the world, we believe that such practice in the commercial world should be recognized, there being no showing that the same is contrary to law. (Art. 2, Spanish Code of Commerce; Art. 6, Spanish Civil Code; Arts. 9-12, New Civil Code.) At any rate, passes are granted subject to "space Availability", and there being no loss of revenue to the petitioner and no increase in operating expense, there is likewise no loss in the franchise tax to the Government.

Of course, it is to be understood that the exemption of passes whould be limited to those issued in accordance with prescribed rules and are not intended as a means for evading payment of lawful taxes. In the case of petitioner, it appears that passes are issued in accordance with law and the rules promulgated and approved by a board, the majority of which is represented by the Government itself. Neither does it appear that the power to issue passes has been abused, nor has any pass been issued which is intended to evade payment of the franchise tax. We find no legal basis, therefore, for holding petitioner liable to the franchise tax on the estimated money value of passes issued by it during the period in question.

Going now to the question of the taxability of premiums on capital stock in the sum of ₱1,799,986.59, this amount was derived by the petitioner from the various increase of its capital stock which the petitioner sold to the stockholders of record at a price above par value. The respondent contends that the amount received by the petitioner in excess of par and called "premiums", should be considered as part of the gross revenues subject to the franchise tax. On the other hand, petitioner maintains that such excess represents capital transactions or are in the character of contribution by the stockholders of the corporation, and having been credited to capital and not to the earned surplus account, the same should not be subject to the franchise tax. (Par. 21, sub-par. 2, Stipulation of Facts.)

Under our income tax law as implemented by Revenue Regulations No. 2 (39 O.G. 325), the receipt by a corporation of shares subscribed does not give rise to any taxable gain even if the price be in excess of the par of stated value. Thus, under Section 55 of Revenue Regulations No. 2, it is provided that whether the acquisition or disposition by a corporation of its shares gives rise to taxable gain or deductible loss depends upon the real nature of the transaction. The receipt of the subscription

price upon the original issue of its capital stock would give rise to neither gain nor loss, whether the price at the time of issue be in excess or less than the par or stated value of such capital stock. This rule is almost identical with the federal regulations on income tax under a similar law in the United States (Sec. 29-22(a)-15, Reg. No. 111; Sec. 39-22(a)-15 Reg. 116). As a matter of fact, it is our belief that a gain or a loss can not as yet arise from a mere sale of the shares, in the absence of a basis upon which a gain would be derived. If, for income tax purposes, the receipt by a corporation of premium on the subscription or issue price over the par value of its own capital stock does not constitute a taxable gain, it follows that the receipt by the petitioner of premium on its capital stock does not constitute any gross earning or revenue upon which the franchise tax may be assessed.

> "We are satisfied that the entire proceeds of sales by a corporation of its own stock, even when sold for more than par value, are part of its original assets or capital stock, and therefore cannot be profits earned through the conduct of its business. The phrase 'capital stock', as used in section 309 of the Civil Code, means 'not the shares of which the nominal capital is composed, but the actual capital; i.e., assets, with which the corporation carries on its corporate business.' Schults v. Boulevard Gardens Lands Co., 164 Cal. 464, 469, 129 P. 582, 44 L.R.A., N.S., 156, Ann. Cas. 1914 B,1013. The sole purpose of selling stock is to acquire assets with which to carry on that business. This is equally true whether the stock be sold at par, or below par, or above par. The capital stock referred to in said section 309 is the actual property of the corporation contributed by the shareholders.' Tapscott v. Mexican Colorado, etc., Co., 153 Cal. 664, 96 P. 271; Escelsior, etc. Co. v. Pierce, 90 Cal. 131, 140, 27 P. 44. It is, in brief, the 'capital' of the corporation." (Merchants & Insurers' Report Co. v. Schroeder, 39 Cal. App. 226, 178 p. 540.)

> "All agree that premium received on the issue of capital stock with par value is not a form of income, although legally viewed as a section of surplus. Similarly the excess of amount paid in one issue of no-par shares over the stated value is never recognizable as income." (Paton , Accountants' Handbook, Third Edition, p. 168.)

Moreover, it has been generally accepted that no gain may be derived from the initial transaction of corporations on the issuance of its shares of stock. The money or property obtained by the corporation upon the organization thereof or upon additional or subsequent issues of shares if a fund raised to provide for capital for purposes of its operation as well as a fund to act as a security for the payment of the corporate creditors. This fund or capital stock is usually carried in the books

of the corporation as a liability and the amount derived from raising such capital and not subject to distribution as dividend or profits. In corporate law and practice, it is the rule that only when the corporation derives gain in the course of its transactions or from its operations may the Board of Directors lawfully divide such gains and declare them payable to the stockholders by way of dividends. As a corrolary, the amount received as capital and forming part of the capital stock is in no way deemed to be profits derived from the operation of the corporation, hence the same should be treated as part of the capital stock. (Par. 3, Section 16, Act 1459, Corporation Law; See Kahl, Corporate Dividends (1941 Ed.) p. 70-73).

The next point of controversy refers to items 5, 6, and 7 enumerated above, consisting of the cost of materials furnished the Philippine Air Force, other airlines and the Civil Aeronautics Administration in connection with an agreement for the repair of the planes and other forms of services rendered by the Philippine Air Lines. Under their agreement, the Philippine Air Force, Civil Aeronautics Administration and other airlines undertook to pay petitioner for the cost of labor and materials in the repair of their planes. However, it was also agreed between them that the petitioner herein would supply the materials, spare parts and supplies whenever the same could not be provided by the said Philippine Air Force, other airline or the Civil Aeronautics Administration. The petitioner, according to the agreement charged the cost of repairs, labor, maintenance or other forms of charges plus 20% of such actual cost and where materials have been provided by the petitioner, the petitioner was entitled to recover the actual cost of such materials with a 10% premium thereon. The petitioner returned for franchise taxes only the 20% and 10% premiums on the actual cost of materials and labor, respectively. However, respondent contends that the amount subject to the franchise tax includes not only the said 10% and 20% premium but the cost of the materials and labor as well. The petitioner having admitted in its memorandum that the franchise tax should be collected with respect to the cost of labor plus 20% premium thereon, the question has therefore been narrowed down to whether or not the actual cost of materials, spare parts and supplies furnished by the petitioner are taxable. Under the second paragraph of Section 13, Acts Nos. 4271 and 4272, the gross receipts subject to tax has been defined as "the total receipts obtained by the grantee from its operation" of the franchise. Since the amount received by the petitioner for rendering services and/or providing materials for the repair and maintenance rendered by it for the benefit of the Philippine Air Force, Civil Aeronatutics Administration and other airlines fell within the purview of the broad concept of "gross receipts" as defined, we believe and hold that such receipts in its entirety are subject to the payment of said franchise tax. We find no reason to depart from the long-continued interpretation placed upon the meaning of "gross receipts" or "gross earnings", in the case of operators of repair shops, as to include the cost of labor or the cost of labor and materials if both are furnished.

Item 8 consists of miscellaneous disputed items contained in Schedules I, II and III. The first of these

items (Item No. 1-a) involves an adjustment entry in petitioner's records covering a credit to Earned Surplus in the sum of ₱4,000.00 representing services rendered by the Supply and Procurement Section of the Philippine Air Lines. This amount represents services rendered by the petitioner to the Manila International Air Terminal Company, Inc. (hereinafter referred to as MIATCI) by the Surplus and Procurement Section of the former, and for such services the value thereof was charged the MIATCI. The MIATCI was then a subsidiary corporation of petitioner and likewise managed by it. The MIATCI was then engaged in the maintenance of the Makati airport, but due to the closure of such airport, it became necessary to likewise dissolve the corporation. The petitioner claims that the disputed item involves solely bookkeeping entries and is not therefore part of the gross receipts of the petitioner subject to tax. The services rendered by the herein petitioner for the MIATCI were performed in the ordinary course of business. Although the MIATCI was admittedly a subsidiary corporation of petitioner, that is, it was practically wholly owned by the latter, nevertheless, the two corporations were separate and distinct juridical entities. Hence, the compensation for services rendered by the petitioner therein in the course of its business are taxable as within the purview of its franchises, irrespective of whether the services were performed for a related or totally independent corporation.

Moreover, although no actual cash payment was made or transfer of funds effected between the parties, we believe and hold that the amounts entered in the books of petitioner as compensation for its services to MIATCI were intended to be collected. If there was no intention to collect, we see no reason or justification for the entries in the books. The fact that said amounts have remained uncollected does not militate against their taxability. On an analogous point, our Supreme Court has held that amounts due from customers which are or have remained uncollected or have been written off from the books of accounts of the taxpayer are nevertheless subject to the franchise tax. (Philippine Long Distance Telephone Company v. Collector of Internal Revenue, supra.)

The next group of items (Item 8-b, c, and d) in controversy consists of several checks in separate totals of ₱490.97, ₱349.66 and ₱60.30, which have remained uncashed and have been reverted to the Surplus Account. These checks were drawn by the petitioner against the Hongkong-Shanghai Banking Corporation in payment of claims of various creditors but which were never cashed by the respective payees. Consequently, the petitioner cancelled these checks and transferred the amounts covered hereby to the Earned Surplus Accounts. These amounts were disbursed by the petitioner in payment for expense items. The fact that these claims have been reverted to Surplus would not affect the gross receipts subject to the franchise tax because they merely represent a reduction of the expenses when the same were incurred. As mere expense accounts, they do not form part of the gross receipts. Instead, they are part of the deductions from the Gross Income of petitioner in order to arrive at its net income. Any saving of petitioner's expenses would solely be a reduction of what petitioner incurs

The next item (Item 8-f) represents the sum of ₱32,770.33, consisting of earned surplus-re-acquisition of CALI properties. The Commercial Airlines, Inc. herein referred to as CALI, was a corporation formerly engaged in the international air transportation in the Philippines. On August 31, 1948, all of its assets with a stated amount of ₱1,052,931.08 were acquired by petitioner, and the payment thereof was made in shares of stock of petitioner and by the application by the petitioner of receivables owed by CALI to MIATCI in the aforesaid sum of ₱32,770.33. This MIATCI receivables had been previously transferred to petitioner after the absorption of MIATCI, The petitioner contends that the application of said accounts receivable to the purchase price of CALI properties constituted a mere bookkeeping entry and, therefore, is not taxable, whereas the respondent contends that the amount constitutes profit on the part of the petitioner when the same was applied to the purchase price and that subject to the franchise tax.

From the business and accounting viewpoint, it is recognized that no profit is realized by the purchaser for having acquired properties at a price lower than its stated purchase price. The application of the MIATCI accounts receivable now held by petitioner to the purchase price of the CALI properties had the effect of merely reducing the amount that was paid for the assets acquired from the CALI (Finney and Miller, Principles of Accounting, Intermediate, Fourth Edition, 53. p. 420). The mere fact that the petitioner had chosen to reflect the book value of the assets as then appearing in Cali's books in petitioner's books of accounts and the corresponding amount of ₱32,770.33 as surplus, does not mean that a profit has been obtained by the petitioner. This situation is analogous to a case where an ordinary person acquires a piece of property at determinate price say ₱1,000.00 a nd then subsequently reflects in his books of accounts a price higher than his purchase price say ₱1,200.00 by crediting the difference of ₱200.00 to a special account. Such special account would in fact be a mere "paper profit" as in the case of the earned surplus account established by the petitioner for the herein disputed amount of ₱32,770.33. A mere accounting entry does not create profit on the part of the petitioner nor does it make an earning upon which a gross receipt tax may be legally imposed. No form of income has been received by the petitioner from the acquisition of properties, there being no exchange resulting therefrom.

The next item (Item No. 8-9) represents the sum of ₱1,673.48 under Schedule II, covering the amount of passenger fares from Oakland to Manila and actually paid to petitioner but which was credited to Earned Surplus, Domestic. For obvious reasons, this amount should be treated as properly falling under the Incoming International Gross Receipts (or Earned Surplus, International). Since the amount involves revenue derived by the petitioner for transportation from a foreign country to the Philippines, the same is not taxable in accordance with the rule that the gross receipts derived from operations

to carry on its trade or business and cannot be considered to have been received by it in the conduct of its business.]

/The next disputed item represents the sum of ₱4,939.58 which is the net surplus of MIATCI which has been carried over as part of the Earned Surplus of the petitioner upon the liquidation of MIATCI. As already adverted to above, MIATCI was a subsidiary of the petitioner and the purchase of the shares of stock of MIATCI by the petitioner Philippine Air Lines is represented in its books as investments. Subsequently, the MIATCI was liquidated and its assets and liabilities at book value were absorbed by the petitioner including the Earned Surplus accounts of MIATCI in the sum of ₱41,989.58 which the petitioner had taken over. This in effect constituted a realized income on the part of the petitioner arising from its investments in the MIATCI. In exchange for its investment originally made in MIATCI, it received assets and acquired all the properties of MIATCI which was over and above the capital stock investments the petitioner had and such excess consisted of the earned surplus of MIATCI made up of the accumulated profits of the latter. Such surplus accounts of the subsidiary became actually income to petitioner as the holding company when the transfer was effected and is analogous or similar to the distribution of dividends to the stockholders of the corporation, wherein the dividends or the realized profits are treated as income on the part of the stockholders. The fact that the petitioner absorbed the earned surplus of MIATCI made such surplus as petitioner's own.]

> "Where the transaction is a true business merger, not only should the earned surplus of the surviving corporation be preserved in tact, but there should be added to it the earned surplus of the absorved corporation. In general, in a true merger, all balance sheet items of the absorved corporation are added at straight book value to the corresponding balance sheet items of the surviving corporation. Thus the treatment is generally similar to a consolidated balance sheet of a parent corporation and its subsidiaries. In most cases, however, a difference in the par or stated value of the shares of stock of the two corporations, or the ration of the exchange, will require a reduction or increase in the combined capital stock account of the surviving corporation and a corresponding increase or reduction in its combined capital surplus account. But the combined earned surplus account will be the sum of the earned surplus accounts of the two constituent corporation." (Fuld, "Some Practical Aspects of a Merger", 60 Harvard Law Review, Sept. 1947, p. 1116.)

While the earned surplus remained a part of MIATCI no income was as yet realized by the petitioner, but when such surplus was made available to the petitioner, the petitioner actually derived an income from its investment in the MIATCI, and such income is subject to the franchise tax due from the petitioner.

or transactions outside the Philippines are beyond its taking jurisdiction.

The remaining amount (Item 8-b) represents cancelled checks in the sum of ₱1,713.61 which were issued by the petitioner to pay for obligations to creditors for materials and services rendered or given to the herein petitioner. Since the items or checks involved had not been cashed by the corresponding payee or creditor, the said amount represents in effect a saving of expenses. This amount not having been an item of income or receipts, we believe and hold that the same does not constitute part of the gross receipts subject to the franchise tax.

In resume, we are of the opinion that -

(1) The gross receipts or earnings of petitioner derived from outgoing international service are subject to the franchise tax prescribed in Acts Nos. 4271 and 4272, while its gross receipts or earnings derived from incoming international service are not subject to said tax;

(2) Passes regularly issued by petitioner are not subject to the franchise tax, no taxable revenue or earnings having been derived therefrom by petitioner;

(3) The receipt by petitioner of premiums on its capital stock does not constitute gross earnings or revenue upon which the franchise tax may be assessed;

(4) The gross receipts or earnings of petitioner for the operation of a repair shop, which include the cost of labor, or the cost of labor and materials if both are furnished, are subject to the franchise tax, the operation of the repair shop being incidental to its main business; and

(5) All items carried under Earned Surplus Accounts, other than those which constitute mere adjusting entries of expense accounts and/or all non-income accounts, form part of the taxable gross receipts or earnings of petitioner.

In line with the foregoing opinion, we find that the total deposits made by petitioner to cover the franchise tax due from it under its franchises from July 1, 1946 to December 31, 1952, exceed the total tax legally due by ₱817,487.71, computed as follows:

Gross Revenues per Government audit October 1, 1946 to December 31, 1952	₱172,595,403.19
Less: Items Recognized as Non-Taxable:-	
Sales of Motor Fuels Employees	₱ 14,733.01
Sales of Materials & services Rendered to Employees	228,080.65

Rental of Aircraft for Domestic use for use in International Services	₱105,344.99	₱ 348,158.65
		₱172,247,244.54
Less - Items in Schedules I, II and III admitted as Non-Taxable per Supplemental and Additional Stipulation of Facts:-		
Reversion of accounts payable to Surplus, San Miguel Brewery	₱ 1,429.30	
A. Soriano y Cia. July 1946 Rental	616.67	
Medical Services rendered to MIATCI per Adjustment # 29, JV 10-14	375.00	
Road Roller and Road Grader issued by PAL to MIATCI Sept. 1946	7,500.00	
Estimated Cost of Samar Equipt, Guiuan, transferred to PEATI	16,500.00	
Uncashed Check a/c with Hongkong-Shanghai Bank reverted per JV 48-4-53	276.91	
S.F. Invoice # 99, dated July 5, 1947 paid by A. Soriano y Cia J-10-423	65.50	
Writing of "Out of Date" checks, outstanding per PAL'S bank Reconciliation per J 12-68	486.38	
Cancellation of Checks per J 2-43	2,285.73	29,385.49
		₱172,217,859.05
Less- Item found as Non-Taxable by Court:-		
Incoming Gross Receipts International	₱60,563,603.46	
Passenger Passes-International	1,431,606.73	
Passenger Passes-Domestic	805,914.21	
Premium on Capital Stock	1,799,986.59	
Uncashed checks reverted to credit of PAL per JV 48-68	490.97	
Earned Surplus reacquisition of CALI properties	32,770.33	

Cancellation of various checks against NEEC J-3-42	₱ 349.66	
Reversing Entry made per JV 48-1-73 re Invoice 6285 already paid per J 6-42 Cl	1,673.48	
Cancellation of various checks J 9-421	60.50	
Cancellation of Liabilities JV 12-96-51	1,713.61	₱64,638,169.54
AMOUNT TAXABLE		₱107,579,689.51
2% tax due on Taxable amount of ₱107,579,689.51		₱ 2,151,393.79
Add - Deficiency Tax for prior period		298.02
AMOUNT OF TAX		₱ 2,151,891.81
Less Amounts Deposited by taxpayer		2,969,379.52
TOTAL EXCESS DEPOSIT - Subject to Refund		₱ 817,487.71

FOR THE FOREGOING CONSIDERATIONS, the deduction of respondent appealed from is hereby modified, in accordance with the foregoing opinion, and he is hereby ordered to refund to petitioner the sum of ₱817,487.71 with costs against petitioner.

SO ORDERED.

Manila, Philippines, February 8, 1956.

SGD. ROMAN M. UMALI
ROMAN M. UMALI
Associate Judge

WE CONCUR:

SGD. MARIANO NABLE
MARIANO NABLE
Presiding Judge

SGD. AUGUSTO M. LUCIANO
AUGUSTO M. LUCIANO
Associate Judge

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