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REPUBLIC OF THE PHILIPPINES
COURT OF TAX APPEALS
QUEZON CITY

ORANBO REALTY CORPORATION,
Petitioner,

- versus -

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

C.T.A. CASE NO. 5082

Promulgated:

JAN 16 1997

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DECISION

This appeal involves petitioner's claim for refund or tax credit of the sum of P922,311.00, representing overpaid creditable withholding tax for calendar year ended December 31, 1991.

Petitioner Oranbo Realty Corporation is a domestic corporation duly organized and existing under the laws of the Philippines with business address at 4th Floor, Sycip Law All Asia Bldg., Paseo de Roxas, Makati, Metro Manila.

During the calendar year 1991, petitioner leases its properties to Aris Philippines, Inc. and Sehwani, Inc. from which it realized a total rental income in the amount of P19,761,612.00 broken down as follows:

LESSEE	AMOUNT
Aris Philippines	₱19,461,612.00
Sehwani, Inc.	300,000.00
Total	₱19,761,612.00

Petitioner alleged that out of the income payments of Aris Philippines, Inc., a 5% expanded withholding tax was deducted by the latter in the sum of ₱973,081.00 (₱19,461,612.00 x 5%).

On April 15, 1992, petitioner filed its income tax return for the calendar year ending December 31, 1991 reflecting a net taxable income of ₱145,058.00 with a corresponding income tax liability of ₱50,770.00 (₱145,058.00 x 35%) but with a refundable income tax in the amount of ₱922,311.00 arising from the unutilized portion of the 5% expanded withholding tax from Aris Philippines, Inc., detailed as follows:

INCOME:	
Aris Philippines, Inc.	₱19,461,612.00
Sehwani, Inc.	300,000.00
Miscellaneous	4,886.00
Total	₱19,766,498.00
LESS: DEDUCTIONS	19,621,440.00
NET TAXABLE INCOME	₱ 145,058.00
TAX DUE	₱ 50,770.00
LESS: 5% CREDITABLE WITHHOLDING TAX	973,081.00
AMOUNT REFUNDABLE	₱ 922,311.00

This overpaid income tax for 1991 was not utilized by petitioner in the succeeding taxable year 1992. Instead, it opted to file a written claim for refund or tax credit with the Bureau of Internal Revenue on April 28, 1993.

However, the inaction of respondent on its letter-claim for refund/tax credit compelled petitioner to file the instant petition for review on March 28, 1994 in order to preserve its right to judicially claim for the refund of excess payment of creditable withholding tax pursuant to Section 230 of the National Internal Revenue Code, as amended.

While the case was pending trial, respondent cause the immediate investigation of petitioner's request by virtue of a Referral Letter No. 6447/461, dated November 14, 1994, issued to Revenue Enforcement Officer Roberto Baquiran (Exh. 1 of respondent, p. 140, CTA records).

On November 21, 1994, a memorandum report of investigation was served by said revenue officer finding the petitioner liable for deficiency income tax in the total amount of ₱10,442,959.84 (Exh. 3 of respondent, pp. 142-144, CTA records).

The issues posed before Us are as follows:

1. Whether or not the revenue examiner's report of investigation can negate petitioner's entitlement for the refund; and if not,

2. Whether or not petitioner has proven its entitlement thereto.

Anent the first issue. Respondent asserts that petitioner is not entitled to the refund or tax credit centering her position on the report of investigation conducted by the revenue examiner on petitioner's income tax return. Pertinent portion of said report is hereby quoted as follows:

"FINDINGS:

We disallow the interest expense claimed for the following reasons:

1. Item A: Loan from BPI was incurred on July 19, 1989 and the purpose of the loan was to finance the acquisition by ORANBO (taxpayer) of all outstanding shares of stock of NOMA Devt. Corp. (see Term Loan Agreement dated July 19, 1989 page 116). Financial statements from 1990-1991 however, do not reflect these transactions (purchase of shares of stock and its disposition, the proceeds of disposition, gain/loss from disposition, etc.)

This indicates that the loan is not only inexistent but also fictitious or simulated. The taxpayer should be required to submit proof of the transactions above.

Furthermore, the loans obtained greatly exceeds the stock/equity of ORANBO and should have been treated as investment in stock by the creditor bank. In our jurisdiction we follow the thin incorporation rule, whereby loans obtained in excess of capitalization shall be treated as equity contribution (capital investments on the part of the lender) and not as liabilities.

Item B. Loan from UCPB, for ₱27,000,000.00, was incurred on August 15, 1990 for working capital requirements. Financial statement for 1990 (Statement of Changes in

Financial Position) showed that the taxpayer acquired land in the amount of ₱25,821,745.00.

Since the proceeds of the loan was used in the purchase of real estate above the correct treatment should be to capitalize the interest expense attributable to the purchase price. It is a settled rule that the cost of money (interest expense) and all other expenses attending the acquisition of capital assets is a capital expenditure.

Rationale behind this rule is that land do not depreciate, save only on some exceptional cases, in fact in most instances it appreciates. It is therefore proper that the expenses incurred for the acquisition of said property should be capitalized as part of the cost and not charged to operation as current expenses.

C. Due to Aris Philippines was series of advances way back in 1984. Aris Phil. (ARIS for short) is a 40% stockholder of ORANBO. All of this advances were used in the purchased land and in meeting working capital requirements. The records show that advances taken are sometimes settled in kind. (*dacion en pago*) real estate.

ORANBO leases all its land and building to ARIS. (See Notes to 1991 F/S). As can be seen above, financial profile, the company declared a taxable net' income of ₱145,058.00 from gross income of 19,884,420.00 or measly .00729 or seventh of one-percent. The land and building leased is valued at ₱96,744,856.00. The records do not show any lease contract between the parties neither is there a way to establish or standards to be used to determine whether the amount of rental being paid by ARIS is based on commercial rates.

ORANBO and ARIS are related taxpayers if not commonly owned by one or group of stockholder. While the taxpayer admits being 40% owned by ARIS the document however show otherwise. In various loan document entered into by ORANBO with third party (BPI & UCPB), it is being represented by Mr. ROLF H.

SCHROEDER as Chairman of ORANBO REALTY CORP. But in ORANBOs transaction with ARIS, this time ORANBO is represented by Mr. DENILDO G. HERNANDEZ as President, while ARIS is represented by Mr. ROLF H. SHROEDER, as President.

It is a settled rule in this jurisdiction that payment of interest between related taxpayers are not deductible because of (possible) connivance.

Taking all the above circumstances, we are left with no option but to recommend for the disallowance of the entire interest expenses claimed as deduction.

In view thereof, we most respectfully recommend that all the interest expenses claimed as deduction be disallowed and assessment based on adjusted taxable income be approved."

We shall tackle each item one by one.

Item A. Loan with BPI.

Respondent's revenue examiner is of the opinion that the interest expense arising from the loan from BPI is not deductible. The financial statements for the years 1990-1991 do not reflect the purchase of all the outstanding shares of stock of NOMA Development Corporation. Thus, reaching to a conclusion that such loan is fictitious and inexistent.

In an earlier case of **Oranbo Realty Corporation vs. CIR, CTA Case No. 4820, January 23, 1995,** this Court had the occasion to rule in this wise:

"(P)etitioner [ORANBO] is a corporation duly organized and existing under the laws of the Philippines. It wholly owns Noma Development Corporation, a domestic corporation whose term of existence was shortened to December 31, 1988 by an amendment of the Articles of Incorporation duly approved by the Securities and Exchange Commission on September 28, 1989 (Exh. C).

A Deed of Conveyance was executed by Noma Development Corporation (Assignor) and Oranbo Realty Corporation (Assignee) on June 29, 1990 with respect to the transfer of real properties together with its buildings and improvements without any consideration but by way of liquidating dividends in pursuance to the dissolution of Noma Development Corporation (Exh. A). (Underlining supplied)"

Clearly, the acquisition of shares of stock of NOMA Development cannot in any way reflect in the financial statements of petitioner for the calendar years 1990-1991 because NOMA Development Corporation was earlier dissolved on December 31, 1988. As a matter of fact, the shares of stock acquired by petitioner were replaced by real estate of NOMA Development Corporation by way of liquidating dividends due to its dissolution.

Item B. Loan with UCPB.

Respondent contends that the interest expense pertaining to the loan from UCPB which was used to purchase land should be capitalized. Her reason behind such statement was that "land do not depreciate, save only [i]n some exceptional cases, in fact in most instances it appreciates. It is therefore proper that the expenses incurred for the acquisition of said property should be capitalized as part of the cost and not charged to operation as current expenses."

We do not agree. In refutation, We are of the opinion that the case of **PAPER INDUSTRIES CORP. OF THE PHILS. (PICOP) vs. COURT OF APPEALS, COMMR. OF INTERNAL REVENUE AND COURT OF TAX APPEALS, G.R. Nos. 106949-50; and COMMR. OF INTERNAL REVENUE vs. PICOP, THE COURT OF APPEALS AND THE COURT OF TAX APPEALS, G.R. Nos. 106984-85, December 1, 1995, decided by the Supreme Court *En Banc*** is applicable to the case at bar. Although it involves the allowance of interest on loans for the purchase of machinery and equipment as a deduction from gross income, it nevertheless may apply to interest expense paid on loan contracted by herein petitioner from UCPB since it involves the purchase of capital asset out of a loan obtained from a bank. Said the High Court:

> **"(1) Whether Picop is entitled to deduct against current income interest payments on loans for the purchase of machinery and equipment.**
>
> In 1969, 1972 and 1977, Picop obtained loans from foreign creditors in order to finance the purchase of machinery and equipment needed for its operations. In its 1977 Income Tax Return, Picop claimed interest payments made in 1977, amounting to ₱42,840,131.00, on

these loans as a deduction from its 1977 gross income.

The CIR disallowed this deduction upon the ground that, because the loans had been incurred for the purchase of machinery and equipment, the interest payments on those loans should have been capitalized instead and claimed as a depreciation deduction taking into account the adjusted basis of the machinery and equipment (original acquisition cost plus interest charges) over the useful life of such assets.

Both the CTA and the Court of Appeals sustained the position of Picop and held that the interest deduction claimed by Picop was proper and allowable. In the instant Petition, the CIR insists on its original position.

We begin by noting that interest payments on loans incurred by a taxpayer (whether BOI-registered or not) are allowed by the NIRC as deductions against the taxpayer's gross income. Section 30 of the 1977 Tax Code provided as follows:

> 'Section 30. Deduction from Gross Income. The following may be deducted from gross income:
>
> (a) Expenses:
>
> xxx xxx xxx
>
> (b) Interest:
>
> (1) In general. - The amount of interest paid within the taxable year on indebtedness, except on indebtedness incurred or continued to purchase or carry obligations the interest upon which is exempt from taxation as income under this Title: x x x' (Underscoring supplied)

Thus, the general rule is that interest expenses are deductible against gross income and this certainly includes interest paid under loans incurred in connection with the carrying on of the business of the taxpayer. In the instant case, the CIR does not dispute that the interest payments were made by Picop on loans incurred in connection with the carrying on of the registered operations of Picop, i.e., the financing of the purchase of machinery and equipment actually used in the registered operations of Picop. Neither does the CIR deny that such interest payments were legally due and demandable under the terms of such loans, and in fact paid by Picop during the tax year 1977.

The CIR has been unable to point to any provision of the 1977 Tax Code or any other statute that requires the disallowance of the interest payments made by Picop. The CIR invokes Section 79 of Revenue Regulations No. 2 as amended which reads as follows:

> 'Section 79. Interest on Capital. - Interest calculated for cos-keeping or other purposes on account of capital surplus invested in the business, which does not represent a charge arising under an interest-bearing obligation, is not allowable deduction from gross income.' (Emphases supplied)

We read the above provision of Revenue Regulations No. 2 as referring to so called "theoretical interest," that is to say, interest "calculated" or computed (and not incurred or paid) for the purpose of determining the "opportunity cost" of investing funds in a given business. Such "theoretical" or imputed interest does not arise from a legally demandable interest-bearing obligation incurred by the taxpayer who however wishes to find out, e.g., whether he would have been better off by lending out his funds and earning interest rather than investing such funds in his business. One thing that Section 79 quoted above makes clear is that interest which does constitute a charge arising under an interest-bearing obligation is an allowable deduction from gross income.

It is claimed by the CIR that Section 79 of Revenue Regulations No. 2 was "patterned after" paragraph 1.266-1 (b), entitled "Taxes and Carrying Charges Chargeable to Capital Account and Treated as Capital Items" of the U.S. Income Tax Regulations, which paragraph reads as follows:

> `(B) <u>Taxes and Carrying Charges</u>. - the items thus chargeable to capital accounts are -
>
> (ii) In the case of real property, whether improved or unimproved and whether productive or nonproductive.
>
> (a) Interest on a loan (but not theoretical interest of a taxpayer using his own funds).'

The truncated excerpt of the U.S. Income Tax Regulations quoted by the CIR needs to be related to the relevant provisions of the U.S. Internal Revenue Code, which provisions deal with the general topic of adjusted basis for determining allowable gain or loss on sales or exchange of property and allowable depreciation and depletion of capital assets of the taxpayer:

> `<u>Present Rule.</u> The Internal Revenue Code and the Regulations promulgated thereunder provide that "<u>No deduction shall be allowed for amounts paid</u> or accrued for such taxes and <u>carrying charges</u> as, under regulations prescribed by the Secretary or his delegate, are chargeable to capital account with respect to property, <u>if the taxpayer elects,</u> in accordance with such regulations <u>to treat such</u> taxes or <u>charges as so chargeable.</u>"
>
> At the same time, under the adjustment of basis provisions which have just been discussed, it is provided that adjustment shall be made for all `expenditures, receipts,

> losses, or other items' properly chargeable to a capital account, thus including taxes and carrying charges; however, an exception exists, in which event such adjustment to the capital account is not made with respect to taxes and carrying charges which the taxpayer has not elected to capitalize but for which a deductions instead has been taken.'
> (Underscoring supplied)

The 'carrying charges' which may be capitalized under the above quoted provisions of the U.S. Internal Revenue Code include, as the CIR has pointed out, interest on a loan '(but not theoretical interest of a taxpayer using his own funds)'. What the CIR failed to point out is that such 'carrying charges' may, either be (a) capitalized in which case the cost basis of the capital assets, e.g., machinery and equipment, will be adjusted by adding the amount of such interest payments or, alternatively, be (b) deducted from gross income of the taxpayer. Should the taxpayer elect to deduct the interest payments against its gross income, the taxpayer cannot at the same time capitalize the interest payments. In other words, the taxpayer is not entitled to both the deduction from gross income and the adjusted (increased) basis for determining gain or loss and the allowable depreciation charge. The U.S. Internal Revenue Code does not prohibit the deduction of interest on a loan obtained for purchasing machinery and equipment against gross income, unless the taxpayer has also or previously capitalized the same interest payments and thereby adjusted the cost basis of such assets.

We have already noted that out 1977 NIRC does not prohibit the deduction of interest on a loan incurred for acquiring machinery and equipment. Neither does our 1977 NIRC compel the capitalization of interest payments on such a loan. The 1977 Tax Code is simply silent on a taxpayer's right to elect one or the other tax treatment of such interest payments. Accordingly, the general rule that interest payments on a legally demandable loan are deductible from gross income must be applied.

The CIR argues finally that to allow Picop to deduct its interest payments against its gross income would be to encourage fraudulent claims to double deductions from gross income:

> '[t]o allow a deduction of incidental expense/cost incurred in the purchase of fixed asset in the year it was incurred would invite tax evasion through fraudulent application of double deductions from gross income.' (Emphases supplied)

The Court is not persuaded. So far as the records of the instant cases show, Picop has not claimed to be entitled to double deduction of its 1977 interest payments. The CIR has neither alleged nor proved that Picop had previously adjusted its cost basis of the machinery and equipment purchased and claim, e.g., increased deductions for depreciation.

We conclude that the CTA and the Court of Appeals did not err in allowing the deductions of Picop's 1977 interest payments on its loans for capital equipment against its gross income for 1977."

Item C. ***Due to Aris Philippines.***

Respondent alleges that petitioner and Aris Philippines are related taxpayers. In which, if found true would disallow the deduction of the subject interest expense pursuant to Section 29(b)(2)(ii) of the Tax Code, as amended.

Section 29(b)(2)(ii) in relation to Section 30(b) of the Tax Code, as amended, provide as follows:

"**SEC. 29. Deductions from gross income.** - xxx.

(a) *Expenses*:

x x x

(b) *Interest*:

x x x

(2) No deduction shall be allowed in respect of interest under the succeeding sub-paragraphs:

(i) x x x

(ii) If both the taxpayer and the person to whom the payment has been made or is to be made are persons specified under Section 30(b)."

"**SEC. 30. Items not deductible.** (a) *General rule.* - In computing taxable income no deduction shall in any case be allowed in respect of -

x x x x x x x x x

(b) *Losses from sales or exchanges of property.* - In computing net income no deduction shall in any case be allowed in respect of losses from sales or exchanges of property, directly or indirectly -

(1) Between members of a family. For the purposes of this paragraph, the family of an individual shall include only his brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants;

(2) Except in the case of distributions in liquidation, between an individual and a corporation more than fifty *per centum* in value of the outstanding stock of which is owned, directly or indirectly, by or for such individual;

> (3) Except in the case of distributions in liquidation, between two corporations more than fifty per centum in value of the outstanding stock of each of which is owned, directly or indirectly, by or for the same individual, if either one of such corporations, with respect to the taxable year of the corporation preceding the date of the sale or exchange was, under the law applicable to such taxable year, a personal holding company or a foreign personal holding company;
>
> (4) Between a grantor and a fiduciary of any trust;
>
> (5) Between the fiduciary of a trust and the fiduciary of another trust, if the same person is a grantor with respect to each trust; or
>
> (6) Between a fiduciary of a trust and a beneficiary of such trust." (Underscoring ours)

This Court noted, based on the examiner's report, that Aris Philippines, Inc. only owns 40% of the outstanding stock of petitioner-Oranbo. Since Aris Philippines, Inc. does not own more than 50% of the outstanding stock of petitioner then it is not covered under the items not deductible as a business expense.

Furthermore, Mr. Rolf H. Schroeder, being the Chairman of petitioner-Oranbo and at the same time President of Aris Philippines, Inc. does not mean that the corporations he represented are related taxpayers. Respondent should have vital evidence to support her contention.

As regards the second issue, petitioner must prove its entitlement to the refund sought. It therefore, must comply with the following three basic requisites, to wit:

> "1. That it filed a claim for refund within the two (2) year period from date of payment of the tax as prescribed under Section 299 (now 230) of the National Internal Revenue Code, as amended;
>
> 2. That the income upon which the taxes were withheld at source under Section 53 were included as part of the income declared in the income tax return of the recipient; and
>
> 3. The fact of withholding is established by a copy of statement (BIR Form 1743.1) duly issued by the payor (withholding agent) to the payee, showing the amount paid and the amount of tax withheld therefrom." **[Sec. 10, Rev. Regs. 6-85; see Citytrust Finance Corporation vs. The Commissioner of Internal Revenue, CTA Case No. 4134, November 11, 1991; affirmed by the Court of Appeals in Citytrust Finance Corporation vs. Court of Tax Appeals and the Commissioner of Internal Revenue, CA-G.R. SP No. 28239, March 14, 1994; and Citytrust Finance Corporation (Formerly Investor's Finance Corporation/FNCB Finance) vs. Commissioner of Internal Revenue, CTA Case No. 4046, February 24, 1993; affirmed by the Court of Appeals in Commissioner of Internal Revenue vs. Citytrust Finance Corporation (Formerly Investors Finance Corporation/FNCB Finance) and the Court of Tax Appeals, CA-G.R. SP No. 31104, April 18, 1994].**

A perusal of the evidence presented by petitioner revealed that it has satisfactorily proven its claim for refund or tax credit. Petitioner has filed its claim for refund/tax credit within the two-year period with the BIR and with this Court. The letter-claim for refund/tax credit was filed with the BIR on April 28, 1993 (Exh. E of petitioner; pp. 101-102, CTA records) and the petition for review was filed on March 28, 1994. The two-year period, in the instant case, commences to run on April 15, 1992, the actual date of filing petitioner's 1991 Annual Income Tax Return which is also the time required by law for a taxpayer to file the final income tax return **(Commissioner of Internal Revenue v.** TMX sales, Inc. et **al., G.R. No. 837736, January 15, 1992).** The certificate of creditable withholding tax at source (BIR Form 1743.1), offered in evidence by petitioner (Exh. B of petitioner, p. 72, CTA records), sufficiently established the amount of creditable withholding tax for the year 1991. Furthermore, as testified by petitioner's witness, Ms. Zaida Agutaya, the income upon which these creditable withholding taxes were paid were included in petitioner's income tax return (TSN, Hearing of October 3, 1994, pp. 8-9). Thus, petitioner has satisfactorily proven its claim for refund or tax credit. Therefore there is no reason why We should not grant petitioner's prayer.

WHEREFORE, in view of the all the foregoing, respondent is hereby ORDERED to REFUND or in the **alternative to ISSUE A TAX CREDIT CERTIFICATE** in favor of petitioner the sum of ₱922,311.00, representing overpaid income tax for the year 1991.

SO ORDERED.

ERNESTO D. ACOSTA
Presiding Judge

I CONCUR:

RAMON O. DE VEYRA
Associate Judge

CERTIFICATION

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

ERNESTO D. ACOSTA
Presiding Judge
Court of Tax Appeals