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HOLLAND EAST ASIA LINES,
Petitioner,

- versus -

C.T.A.
CASE NO. 383

August 5/58

THE COLLECTOR OF INTERNAL REVENUE,
Respondent.

x - - - - - - - - - - - x

DECISION

The respondent assessed against the petitioner the sum of ₱738,509.50 as deficiency income tax for the fiscal year ending May 31, 1955, including 50% surcharge and "compromise". Upon failure of petitioner to secure a reconsideration of the decision of respondent, the former has elevated the case to this Court for review.

Counsel for respondent made a fairly accurate statement of the material facts of the case. We quote:

> "Petitioner in this case is a foreign shipping corporation organized and existing under the laws of the Netherlands with vessels touching Philippine ports. It transacted business in the Philippines through its resident agents, the Royal Inter-Ocean Lines, Marsman Building, Port Area, Manila (Exh. A).
>
> "On October 8, 1955, petitioner, through its local agents, filed its final income tax returns corresponding to the fiscal year ending May 31, 1955 (Exhibit 1, pp. 5-11, BIR rec.), reporting therein the following data:

373

(1) Gross receipts from outgoing freights and passengers from Philippine ports ---------	₱ 1,943,099.41
(2) Gross receipts from outgoing freights and passengers from all ports other than the Philippines ------	12,732,899.33
(3) Total expenses and deductions of the Co. as a whole, including those incurred by Philippine office --------	14,331,937.57

"After applying the formula authorized under Section 163 of Revenue Regulations No. 2, which implemented the provisions of Section 37(e) of the National Internal Revenue Code, it claimed as Philippine expenses, the amount of ₱1,897,545.78, computed as follows:

$$\frac{\text{Philippine Gross Income}}{\text{World's Gross Income}} \times \text{World Expenses, or}$$

$$\frac{₱1,943,099.41}{₱12,732,899.33} \times ₱14,331,937.07 =$$

₱1,897,545.78 (allocated Phil. expenses)

Philippine Gross Income - Allocated Philippine expenses, or

₱1,943,099.41 - ₱1,897,545.78 = ₱45,553.63 (Phil. net income)

"On the basis of the above figures, petitioner reported a net income from Philippine sources in the amount of ₱45,553.63 only and income tax due in the amount of ₱9,110.73. The amount of ₱9,110.73 was paid by the petitioner under Official Receipt No. 654112 dated October 12, 1955 (Exh. H).

"Pursuant to the established policy of the Bureau of Internal Revenue to verify income tax returns of this nature, an investigation was conducted to verify the correctness of petitioner's returns for the fiscal year ending May 31, 1955 (Exh. 2, p. 13, BIR rec.).

"The examiner proceeded with the verification applying therein the new theory that unless a foreign corporation is registered to do business in the Philippines pursuant to Section 68 of the Corporation Law it is not entitled to deductions nor to the application of Section 163 of Revenue Regulations No. 2. Consequently, the allocated expenses claimed by the petitioner as deduction from its Philippine income was disallowed completely and a deficiency assessment for the amount of ₱738,509.50 (Exh. 4, p. 16, BIR rec.) was issued against petitioner, itemized as follows:

Gross receipts from freights and passengers per return ..		₱1,943,099.41
Less: Expenses incurred locally:		
(1) Local inter-island freights-	₱88,616.58	
(2) Lighterage------	35,250.00	
Total adjustments		123,866.58
Net income as per investigation		₱1,819,232.83
Amount subject to tax		₱1,819,232.83
20% and 28% income tax due thereon		₱ 501,384.00
Less: Amount of tax already assessed & paid ...		9,111.00
Deficiency income tax		492,273.00
50% surcharge		246,136.50
Compromise		100.00
TOTAL TAX DUE		₱ 738,509.50

"For a long time the Bureau of Internal Revenue has allowed allocation of expenses as regards foreign steamship companies with vessels touching Philippine ports on the basis of Section 163 of Revenue Regualtions No. 2, which implemented Section 37(e) of the National Internal Revenue Code. However, for a short time during the years 1956 and 1957, the Bureau of Internal Revenue in the desire to raise more revenue for the government denied its application, but as of December 24, 1957, the Bureau of Internal Revenue has again adopted the procedure outlined in Section 163 of Revenue Regulations No. 2 as a fair and equitable method of computing the taxable income of foreign steamship companies engaged in trade or business in the Philippines, subject to the following conditions embodied in the approved memorandum of the Chief, Legal

371

Department to the Collector of Internal Revenue dated December 24, 1957, a copy of which is hereto attached as Annex 'A' and made an integral part hereof:

(1) Foreign shipping companies must submit statements of world operations duly certified by the tax authorities of their respective governments or, if the same are not available, financial statements certified by independent certified public accountants. In both cases, the statements must be authenticated by Philippine consular or Foreign Affairs Officials. In the absence thereof, only verified Philippine deductions should be allowed.

(2) Every foreign shipping company with ships touching Philippine ports should register with the Bureau of Internal Revenue, pursuant to Section 203 of the Tax Code, stating also the name and address of its agent in this country.

"As regards the first requirement, the Bureau of Internal Revenue has subsequently allowed authentication by the U.S. Consulate when there are no Philippine Consular or other foreign affairs officials in the country where such corporations are domiciled." (pp.1-4, Memorandum for Respondent.)

Petitioner is a foreign shipping company which transacts business in the Philippines through its local agent, the Royal Inter-Ocean Lines. It derives its income mainly from the operation of its vessels which touch Philippine ports. There is no question that as a foreign corporation transacting business in the Philippines, it is subject to income tax at the rates of 20% and 28% provided in Section 24 of the National Internal Revenue Code, and that it is taxable "only on its income from sources within the Philippines." (Section 16, Rev. Regs. No. 2, 39 O. G. 325.)

Section 37 of the Revenue Code defines "gross income" and "net income" from sources within the Philippines and "gross income" and "net income" from sources without the Philippines. With respect to income from sources partly within and partly without the Philippines, as in the case of the income of petitioner from the operation of its inter-ocean vessels, paragraph (e) of said section provides:

> "SEC. 37. Income from sources within the Philippines. -
>
> x x x x
>
> "(e) Income from sources partly within and partly without the Philippines. - Items of gross income, expenses, losses and deductions, other than those specified in subsections (a) and (c) of this section shall be allocated or apportioned to sources within or without the Philippines, under the rules and regulations prescribed by the Secretary of Finance. Where items of gross income are separately allocated to sources within the Philippines, there shall be deducted (for the purpose of computing the net income therefrom) the expenses, losses, and other deductions properly apportioned or allocated thereto and a ratable part of other expenses, losses or other deductions which cannot definitely be allocated to some item or class of gross income. The remainder, if any, shall be included in full as net income from sources within the Philippines. In the case of gross income derived from sources partly within and partly without the Philippines, the net income may first be computed by deducting the expenses, losses, or other deductions apportioned or allocated thereto and a ratable part of any expenses, losses, or other deductions which cannot definitely be allocated to some items or class of gross income; and the portion of such net income attributable to sources within the Philippines may be determined by processes or formulas of general apportionment prescribed by the Secretary of Finance. Gains, profits, and income from

> (1) transportation or other services rendered partly within and partly without the Philippines, or (2) from the sale of personal property produced (in whole or in part) by the taxpayer within and sold without the Philippines, or produced (in whole or in part) by the taxpayer without and sold within the Philippines, shall be treated as derived partly from sources within and partly from sources without the Philippines. Gains, profits, and income derived from the purchase of personal property within and its sale without the Philippines or from the purchase of personal property without and its sale within the Philippines shall be treated as derived entirely from sources within the country in which sold."

In view of the difficulty of providing in the law in precise terms what portion of the income derived partly from within and partly from without the Philippines is income from sources within the Philippines, and the expenses, losses and deductions allocable thereto, Section 37(e) provides that "the portion of such net income attributable to sources within the Philippines may be determined by processes or formulas of general apportionment prescribed by the Secretary of Finance." Pursuant to Sections 37 and 338, the Secretary of Finance, upon recommendation of the Collector of Internal Revenue, promulgated Revenue Regulations No. 2, published in the Official Gazette of February 11, 1941 (39 O.G. 325), Section 163 of which provides:

> "SEC. 163. Foreign steamship companies. — The returns of foreign steamship companies whose vessels touch ports of the Philippines should include, as

gross income, the total receipts of all out- outgoing business whether freight or passengers. With the gross income thus ascertained, the ratio existing between it and the gross income from all ports, both within and without the Philippines of all vessels, whether touching ports of the Philippines or not, should be determined as the basis upon which allowable deductions may be computed, the principle being that allowable deductions shall be computed upon a basis which recognizes that the income arising and accruing from business done in any from this country shall bear its share, and no more, of expense, incident to the earning or creation of such income, in the ratio that the gross income arising in and from this country bears to the entire gross income arising from business done both within and without this country. In other words, the net income of a foreign steamship company doing business in or from this country is ascertained for the purpose of the income tax, by deducting from the gross receipts from outgoing business such a portion of the aggregate expenses, losses, etc., as such receipts bear to the aggregate receipts from all ports of all vessels, including in each case income of a nonshipping character but incidental to the shipping business such as dividends from investments, interests on deposits, etc. For example --

"<u>GIVEN</u>

"(a) Gross receipts from outgoing freights and passengers from P.I. ports ...	₱20,000.00
"(b) Gross receipts from outgoing freights and passengers from all ports other than those of P.I....	200,000.00
"(c) Interests and other nonshipping income received by P.I. office	5,000.00
"(d) Interests, dividends, and other nonshipping income received by all offices other than those in P.I.	50,000.00
"(e) Total expenses and deductions of the company as a whole, including those incurred by P.I. office ..	150,000.00

"COMPUTATION OF P. I. NET INCOME

"(f) P. I. gross income:

Freights and passengers...	₱20,000.00
Interests and other income	5,000.00
Total	₱25,000.00

"(g) P.I. expenses:

$$\frac{\text{P.I. gross income}}{\text{World's gross income}} \times \text{World's expenses, or}$$

$$\frac{20{,}000 \text{ plus } 5{,}000}{200{,}000 \text{ plus } 20{,}000 \text{ plus } 50{,}000 \text{ plus } 5{,}000} \times$$

$$\times\ 150{,}000 \text{ or } \frac{25{,}000}{275{,}000} \times 150{,}000 = 13{,}636$$

"(h) P.I. net income: 13,636

P.I. gross income less P.I. expenses, or ₱25,000 less ₱13,636 = ₱11,364."

Respondent admits that the determination of petitioner's income and expenses as shown in its income tax return for its fiscal year ending May 31, 1955 is in accordance with Section 37(e) of the Revenue Code and Section 163 of Revenue Regulations No. 2. It is, however, contended that in order that the formula for determining net income under Section 163 of Revenue Regulations No. 2 may be availed of by a foreign shipping company, it is necessary that two conditions be complied with, viz: (1) submission of a statement of world operations certified by the tax authorities of the government of the foreign country in which the foreign corporation is domiciled, or, if the same is not available, a financial statement certified by an independent certified public accountant, and authenticated in both cases by a Philippine consular or foreign affairs official or, in the absence thereof, by an American consular official; and (2) registration of the foreign shipping company with the Bureau of Internal Revenue, pursuant to Section 203 of the Revenue Code. These conditions are embodied in a memorandum of the Chief, Legal Department of the Bureau of Internal Revenue dated December 24, 1957 and approved by the Collector of Internal Revenue. They are now being applied to the income tax return of petitioner for the fiscal year ending May 31, 1955, which return was filed with the Bureau of Internal Revenue on October 8, 1955. May respondent limit the application of Section 163 of Revenue Regulations No. 2 by imposing additional conditions or requirements and applying the new requirements retroactively?

Section 37(e) of the Revenue Code authorizes the Secretary of Finance to prescribe the processes or formulas of general apportionment for the purpose of determining the net income of foreign corporations transacting business in the Philippines whose gross income is derived from sources partly within and partly without the Philippines. No similar authority is granted to the Collector (now Commissioner) of Internal Revenue. Section 163 of Revenue Regulations No. 2 was promulgated by virtue of such authority. The authority to prescribe the processes or formulas for determining the net income of foreign corporations transacting business in the Philippines having been conferred by Congress on the Secretary of Finance, and the said Secretary having exercised such authority, respondent has no power to limit or enlarge the application of the processes or formulas prescribed by his superior officer. If respondent believes that Section 163 of Revenue Regulations No. 2 has outlived its usefulness, the proper procedure is for him to recommend its repeal or amendment.

Not only has respondent encroached upon the power of the Secretary of Finance but he has sought to apply to petitioner's income tax return for 1955 the new requirements devised and conceived only in December, 1957. To cap it all, respondent considers the income tax return of petitioner for 1955 fraudulent for failure to comply with the new requirements and is seeking to collect from petitioner the 50% fraud penalty. In addition, petitioner is being required to pay ₱100.00 as "compromise" for an unexplained violation of the National Internal Revenue Code, which we assume is also for non-compliance with the new requirements because respondent admits that petitioner's income tax return was filed in accordance with law and the regulations before the advent of the new requirements. (See p. 3 , supra.)

The sole purpose of respondent in prescribing the new requirements is, as admitted by respondent through his counsel, "the desire to raise more revenue." We do not believe that respondent has power or authority to raise more revenue for the support of the government by means or methods which the Constitution and the laws do not permit. The power to raise revenue is an exclusive prerogative of Congress. But even Congress may not, for the purpose of raising revenue, provide for the retroactive application of a taxing statute and penalize taxpayers for violation thereof in respect to past transactions. The reason is obvious. Such a statute would be an ex post facto law.

Assuming that the new requirements are valid, petitioner contends that it has fully complied with the same. Respondent, however, claims that while petitioner has complied with the second requirement (registration under Section 203 of the Revenue Code), it has failed to comply with the first by not submitting a statement of world operations. Petitioner submitted Exhibit G, a statement of its world income for fiscal year 1954-1955, certified by a "Member of the Nederlands Instituut van Accountants," and Exhibit G-1, a statement of world expenses for fiscal year 1954-1955, also certified by a "Member of the Nederlands Instituut van Accountants." Both statements were authenticated by a Vice Consul of the United States (Exhs. G-2 and G-3). No question has been raised as to the correctness of the entries contained in said statements, Exhs. G and G-1. After going over the said statements, we find that they are in form and in substance in accordance with the requirement of respondent.

Finding the deficiency income tax assessment against petitioner arbitrary and illegal, the decision appealed from is hereby reversed. No pronouncement as to costs.

SO ORDERED.

Manila, August 5, 1958.

ROMAN M. UMALI
Associate Judge

WE CONCUR:

MARIANO NABLE
Presiding Judge

AUGUSTO M. LUCIANO
Associate Judge

Not appealed.