Republic of the Philippines
COURT OF TAX APPEALS
Manila

BASILAN ESTATES, INC.,
Petitioner,

- versus - C.T.A. CASE NO. 986

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

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D E C I S I O N

This is an appeal from the decision of the respondent holding the petitioner liable for the payment of deficiency income tax for the year 1953 in the sum of ₱90,788.75.

The facts of the case, as stated in the memorandum of counsel for respondent, are as follows:

> Petitioner is a domestic corporation organized under the laws of the Philippines engaged in the business of coconut production. (p. 3, t.s.n., hearing of December 5, 1962.) It was organized in 1920 with a capital of ₱25,000.00; increased in 1942 to ₱200,000.00; ₱500,000.00 in 1953 and ₱1,000,000.00 in 1956. As of 1942, the following appear as its stockholders and their corresponding stockholdings:
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> | | | |
> |---|---|---|
> | Juan S. Alano ----- | 49,000 | shares |
> | Ramona T. Alano --- | 35,000 | shares |
> | Dolores A. Laconico ------------ | 19,000 | shares |
> | Leonora A. Rivera - | 19,000 | " |
> | Julio T. Alano ---- | 19,000 | " |
> | Fabian T. Alano --- | 19,000 | " |
> | Bartolome Dumadang ------------ | 19,000 | " |
>
> (pp. 10-11, Folder of Exhibits)
>
> Juan S. Alano and Ramona T. Alano are husband and wife; the rest of the stockholders are their children including the latter who is an adopted son (Exh. 3,

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p. 68, BIR rec.). Petitioner is therefore, a close family corporation.

Petitioner filed its income tax return for 1953 on March 24, 1954 and based on said return it paid the sum of ₱8,028.00 as income tax for 1953.

The investigation of the 1953 income tax return of the petitioner was conducted in Manila because the books of accounts of the taxpayer were being kept at the office of Juan S. Alano, Inc. located at Room 401 Madrigal Building, Escolta , Manila (p. 191, t.s.n. hearing of December 7, 1962; pls. see also Exh. 2, p. 44 BIR rec.).

Examiners Emeterio Trinidad and Bienvenido P. Ferrer, who conducted the investigation, interviewed Attorney Felix A. Gulfin, the accountant and lawyer of the petitioner (pp. 40 & 194, t.s.n. hearing of Dec. 7, 1962), at Room 401 Madrigal Building, Manila, who informed them that the books were in Zamboanga at the time (p. 194, t.s.n. hearing of Dec. 7, 1962) and who arranged that the books of the petitioner be brought to Manila. When the books of the petitioner arrived, Atty. Felix A. Gulfin showed them to the examiners at Room 401 Madrigal Building, Escolta, Manila, for examination (p. 46, t.s.n. hearing of Dec. 5, 1962).

In a report of investigation dated February 19, 1959 (Exh. 3, pp. 62-68, BIR rec.), Examiners Trinidad and Ferrer ascertained that there is due from herein petitioner the amount of ₱3,912.00 as deficiency income tax for 1953 and that in the same year petitioner had unreasonably accumulated a surplus of ₱347,501.01 beyond the reasonable needs of the business on which the sum of ₱86,876.85 was recommended to be assessed as 25% surtax, pursuant to section 25 of the Tax Code, the details of which are shown hereunder:

Net income per return as audited-		₱40,142.90
Add:		
Overclaimed depreciation, per above --	₱10,500.49	
Miscellaneous expenses disallowed --------------	6,759.17	
Officer's travelling expense disallowed ----------	2,300.00	19,560.06
(Amount carried forward) ----		₱59,702.96

(Amount brought forward)-	₱59,702.96
20% tax on ₱59,702.96 ------	₱11,940.00
Less: Tax already assessed -	8,028.00
Deficiency income tax ------	₱ 3,912.00
Add: Additional tax of 25% on ₱347,507.00 ----	86,876.75
TOTAL DUE & COLLECTIBLE ----	₱90,788.75

On the basis of the aforesaid report and recommendation, respondent issued assessment notice No. 52-ACR-33-58/53 dated February 26, 1959 (Exh. 10, p. 54-A, BIR rec.) addressed to the petitioner at Room 401 Madrigal Building, Escolta, Manila, at which address petitioner's accountant and lawyer held office.

Petitioner having failed to pay the aforesaid taxes on the due date, respondent, on October 8, 1959, issued a warrant of distraint and levy against petitioner's properties (Exh. 12, p. 95 BIR rec.) which was received by petitioner through its Treasurer Dolores A. Laconico on February 26, 1960.

The request for reconsideration of the assessment having been denied (Exh. N; p. 160, BIR rec.), petitioner filed a petition for review with this Court on December 20, 1960. (See pp. 1-3, Memorandum for the Respondent.)

The issues raised are: (1) whether or not the right of the Government to collect the alleged deficiency income tax has already prescribed; (2) whether or not respondent properly disallowed the sum of ₱19,560.06, representing alleged overclaimed depreciation, miscellaneous expenses and officers' traveling expenses; and (3) whether or not petitioner had an unreasonable accumulation of surplus profits subject to the penalty tax of 25%, pursuant to Section 25 of the National Internal Revenue Code.

As to the first issue, it is contended that since petitioner's return for 1953 was filed on March 24, 1954, the Government had only three years from said date, or up to March 24, 1957, within which to collect the deficiency tax by distraint and levy, pursuant to Section 51(d) of the Revenue Code, citing Collector v. Zulueta, G. R. No. L-8840, Feb. 8, 1957. Section 51(d) of the Revenue Code, which authorized the Commissioner of Internal Revenue to collect income tax by distraint and levy within three years from the date the return was due or was filed, was repealed by Republic Act No. 2343, which took effect on June 20, 1959. It is admitted that the warrant of distraint and levy was issued on October 8, 1959. Therefore, the statute of limitation properly applicable is governed by Sections 331 and 332 of the Revenue Code, which provide that internal revenue taxes may be collected by distraint or levy or by judicial action within five years after assessment.

It is argued, however, that the assessment was made after five years from the date the return was filed, hence, the right to assess has prescribed. The records show that an assessment notice dated February 26, 1959, or within five years from the date the return was filed on March 24, 1954, was sent to petitioner. (Exh. 10; see also letter of Regional Director of Regional District No. 3 of the Bureau of Internal Revenue, p. 71, B.I.R. records.) We are, therefore, of the opinion that the right of the Government to assess and collect the deficiency income tax in question has not prescribed. (See Alhambra Cigar & Cigarette Mfg. Co. v. Coll., G.R. Nos. L-12026 & L-12131, May 29, 1959.)

The second issue relates to the disallowance by

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respondent of certain deductions claimed by petitioner in its return. The first item involves alleged over-depreciation in the sum of ₱10,500.49. In previous years, petitioner claimed depreciation allowance on certain assets in the sum of ₱36,842.04. It reappraised said assets in 1953 and claimed a depreciation allowance of ₱47,342.53 for said year, or an increase of ₱10,500.49 over the previous year. The reappraisal of the value of the assets is sought to be justified as follows:

> "From the year 1948 up to the present time, it is of judicial knowledge that our government has imposed some kind of controls for the purpose of promoting the growth of local industries and for the purposes of revenue making. In view of these circumstances, depreciable assets of any business enterprise required depreciation or replacement deductions proportionate to the increase of replacement cost brought about by the increase of acquisition cost of replacement equipments." (Page 9, Reply Memorandum, Sept. 23, 1963.)

Section 30(f) of the Revenue Code provides that a taxpayer may deduct from gross income a reasonable allowance for deterioration of property arising out of its use or employment in the business or trade or out of its not being used. The total amount which may be claimed as depreciation deduction shall in no case exceed the capital invested. (See also Secs. 105 and 108, Rev. Regs. No. 2.) Petitioner is claiming a depreciation deduction in excess of the capital invested; it bases its depreciation deduction on the estimated increased cost of replacement equipment. This is not authorized by law and, therefore, the decision of respondent disallowing the overclaimed depreciation deduction must be sustained.

The other items disallowed by respondent are as follows:

Miscellaneous expenses ------	₱2,001.00
Miscellaneous expenses ------	4,758.17
Officers' traveling expenses ----------------	2,300.40
Total -----	₱9,059.57

Petitioner was unable to give a satisfactory explanation of said expenses. Respondent justifies the disallowance on the following grounds:

> "The foregoing expenses were not satisfactorily explained. Petitioner did not present the receipts or vouchers supporting the alleged expenses. In the case of traveling expenses of officers, for example, the supporting papers, as well as check stubs are presented to the company (p. 37, t.s.n. hearing of Dec. 5, 1962), and yet the said documents were not presented in evidence. Petitioner's witness testified that the vouchers and the supporting papers of the expenses claimed were lost on March 30, 1962 during the fire in Basilan City (p. 40, t.s.n. hearing of Dec. 5, 1962). If these records were lost in 1962, then the same could have been produced and presented during the investigation of this case in 1959. It is therefore quite obvious that either the said supporting papers did not actually exist because the alleged expenses were never incurred or, assuming but without conceding their existence, the petitioner withheld the presentation thereof because the same would have worked against the petitioner had they been presented in court."

From the evidence of record, we find no justification to reverse the finding and conclusion of respondent with respect to the disallowance of the aforesaid alleged expenses.

The third and last issue relates to the 25% penalty tax on the alleged unreasonable accumulation of surplus amounting to ₱347,507.01. This amount has been arrived at as follows:

SURPLUS, (Dr. Balance), January 1, 1947 ----------------		₱ 83,240.32
Add: Profit for 1947 -------------		202,694.19
SURPLUS, December 31, 1947 -------		₱119,453.87
Add: Profit for 1948 -------------		316,737.23
TOTAL ----------------------------		₱436,191.10
Less: Charges against Surplus:		
Income tax ---------	₱24,323.30	
Refund, Mrs. Jareño for post war right-	200.00	
Freight for 1947 ---	201.53	
Dividends ----------	50,000.00	
Reserve for Electrification of driers & Mechanization ---	200,000.00	
Reserve for Malaria Control & Infirmary	50,000.00	
Reserve for General Research & Industrialization ------	50,000.00	374,724.83
SURPLUS, December 31, 1948 -------		₱ 61,466.27
Add: Profit for 1949 -------------		109,855.70
TOTAL ----------------------------		₱171,321.97
Less: Charges against surplus:		
Income tax --------	₱ 38,008.47	
1948 expenses in 1949 not taken up in 1948 -------	5,098.34	43,106.81
SURPLUS, December 31, 1949 -------		₱128,215.16
Add: Profit for 1950 -------------		287,990.29
TOTAL ----------------------------		₱416,205.45
Less: Charges against surplus:		
Income tax --------	₱ 13,182.68	
Dividends ---------	100,000.00	113,182.68
SURPLUS, December 31, 1950 -------		₱303,022.77
Add: Rent income -----------------		800.00
TOTAL ----------------------------		₱303,822.77
Less: Charges against surplus:		
Loss in 1951 ---------	₱-2,270.03	
Income tax 1950 ----	46,078.00	
Representation expenses ------------	1,840.20	
Charitable contributions -----------	1,257.65	51,445.88
SURPLUS, December 31, 1951 -------		₱252,376.89
Add: ½ participation of Philippine National Plantation in 1951 less (½ of ₱2,270.03)-	1,135.01	
Profit for 1952 ------	133,577.21	134,712.22
SURPLUS, December 31, 1952 -------		₱387,089.11
Add: Profit for 1953 ---	40,142.90	
Reserve for Electrification of driers & Mechanization ----	200,000.00	

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Reserve for malaria control ---------	50,000.00	299,142.90
TOTAL ---------------------------		₱677,232.01
Less: Charges against surplus:		
Expenses corresponding to 1952 ------	250.00	
Income tax, 1953 --	29,475.00	
Unissued Capital Stock ------------	300,000.00	329,725.00
SURPLUS, December 31, 1953 ------		₱347,507.01

(Exh. 3, pp. 66-67, BIR rec.)

Section 25 of the Revenue Code, which imposes a tax of 25% on unreasonable accumulation of surplus of corporations, provides:

> SEC. 25. Additional tax on corporations improperly accumulating profits or surplus. (a) Imposition of tax.- If any corporation, except banks, insurance companies, or personal holding companies, whether domestic or foreign, is formed or availed of for the purpose of preventing the imposition of the tax upon its shareholders or members or the shareholders or members of another corporation, through the medium of permitting its gains and profits to accumulate instead of being divided or distributed, there is levied and assessed against such corporation, for each taxable year, a tax equal to twenty-five *per centum* of the undistributed portion of its accumulated profits or surplus which shall be in addition to the tax imposed by section 24, and shall be computed, collected and paid in the same manner and subject to the same provisions of law, including penalties, as that tax.
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> (b) Prima facie evidence.- The fact that any corporation is a mere holding company shall be *prima facie* evidence of a purpose to avoid the tax upon its shareholders or members. Similar presumption will lie in the case of an investment company where at any time during the taxable year more than fifty *per centum* in value of its outstanding stock is owned, directly or indirectly, by one person.
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> (c) Evidence determinative of purpose.- The fact that the earnings or profits of a corporation are permitted to accumulate beyond the reasonable needs

> of the business shall be determinative of the purpose to avoid the tax upon its shareholders or members unless the corporation, by clear preponderance of evidence, shall prove the contrary.

The nature of the penalty tax and the accumulations of surplus profits of corporations which are taxable or non-taxable are explained briefly in Bicol Trading, Inc. v. Commissioner of Int. Revenue, C.T.A. No. 612, Jan. 8, 1962, from which we quote:

> Section 25 of the Revenue Code imposes for each year, in addition to the tax imposed by Section 24, a tax of 25% on the undistributed portion of the profits or surplus of a corporation which is formed or availed of for the purpose of preventing the imposition of the tax upon its shareholders or members or the shareholders or members of any other corporation through the medium of permitting gains or profits to accumulate instead of dividing or distributing them. It is a prerequisite to the imposition of the tax that the corporation be formed or availed of for the purpose of avoiding the income tax on its stockholders by permitting the earnings and profits of the corporation to accumulate instead of dividing them among or distributing them to the stockholders. If the failure to pay dividends is due to some other cause, such as the use of the undistributed earnings and profits for the reasonable needs of the business, such purpose does not fall within the interdiction of the statute. Inasmuch as purpose involves a state of mind or intent, it is always necessary to inquire into the facts in each individual case to determine whether the purpose of the failure to make distribution was to permit the shareholders to avoid the income tax or for some other purpose, such as the use of the earnings and profits for the reasonable needs of the business. (7 Mertens, Law on Federal Income Taxation, Sec. 39.26; see also Sec. 21, Rev. Regs. No. 2.)
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> Some of the circumstances which indicate that the accumulations are beyond the reasonable needs of the business are (a) accumulations for the benefit of stockhold-

ers; (b) loans to shareholders or the expenditure of funds by the corporation for the personal benefit of the stockholders; and (c) investments unrelated to the corporation's business. (7 Mertens, Law on Federal Income Taxation, Secs. 39.33-39.36; Sec. 19, Rev. Regs. No. 2.) On the other hand, accumulations are deemed for reasonable business needs if they are retained for (a) expansion of plant, facilities, and activities; (b) additions to working capital; and (c) acquisitions of related business. (7 Mertens, Law on Federal Income Taxation, Secs. 39.38-39.40; Sec. 21, Rev. Regs. No. 2.)

Petitioner seeks to justify the accumulation of surplus profits on the ground that it was necessary for the expansion and industrialization of its coconut industry. It appears, however, that while reserves for these purposes were set up in 1948, they were reverted to surplus in 1953. On this point, it is pertinent to quote from the report of the B.I.R. examiners:

> We wish to state another pertinent observation which we believe points clearly to the intent and purpose of the corporation to prevent the imposition of the tax upon its shareholders. We have observed that whenever the accumulated earnings or profits of the corporation tend to become considerable, charges are made against the surplus account to unduly reduce the same. For instance, in 1948, when the corporation realized a net profit of ₱316,737.23 which swelled the surplus to ₱436,191.10, the following reserves were created against the surplus account: Reserve for electrification of driers and mechanization - ₱200,000.00; Reserve for malaria control - ₱50,000.00; and Reserve for General Research and Industrialization - ₱50,000.00; or a total of ₱300,000.00. These various reserves plus the other charges reduced the balance of the surplus account to only ₱61,466.27. It is important to note that these various reserves remained undisturbed and outstanding until December 31, 1953, when the reserves for electrification of driers and mechanization, and the reserves for malarial control were reverted to the surplus account.

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> The fact that the reserves remained undisturbed and untouched shows that the projects for which the reserves were created were never pursued or that if they were pursued the same were taken care of by the working capital of the business; and the reversion of the reserves to surplus shows either that the projects for which the reserves have been set up are already terminated or that they are being abandoned and would not be pursued anymore. So it is clear that, the creation of the reserves in 1948, was in the first place not necessary and that they merely constituted an undue reduction of the surplus profits at the time. (P. 64, B.I.R. records.)

Another important factor which indicates that the surplus was accumulated beyond the reasonable needs of the business of petitioner is the fact that advances in substantial amounts were made yearly to officers who are at the same time stockholders. While it is true that certain expenses of the corporation were credited against those advances, the unspent balances of said advances were permitted to be retained by the officers without being refunded to petitioner at the end of each year. These advances are, therefore, indirect loans to officer-stockholders, a strong indication that the surplus was accumulated beyond the reasonable needs of the business. (See Sec. 21, Rev. Regs. No. 2.)

Finding no error in the decision appealed from, the same is hereby affirmed, with costs against petitioner.

SO ORDERED.

Manila, October 31, 1963.

ROMAN M. UMALI
Associate Judge

I CONCUR:

MARIANO NABLE
Presiding Judge