Republic of the Philippines
COURT OF TAX APPEALS
MANILA

January 8, 1962

BICOL TRADING, INC.,
Petitioner,

- versus -

C.T.A. CASE NO. 612

THE COMMISSIONER OF
INTERNAL REVENUE,
Respondent.

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DECISION

This is an appeal from the decision of the respondent holding the petitioner liable for the payment of the sum of ₱228,206.00 as penalty tax for improper accumulation of profits or surplus imposed by Section 25 of the National Internal Revenue Code.

The petitioner is a domestic corporation engaged in the general merchandising business in the Bicol region, with principal office at Iriga, Camarines Sur. It is primarily engaged in the purchase and sale of cars, trucks, automobile spare parts, and household appliances.

Upon investigation, respondent found that petitioner had accumulated earnings and profits from 1951 to 1954 in the aggregate amount of ₱912,822.93 which it did not distribute to its stockholders allegedly for the purpose of preventing the imposition of the tax upon said stockholders. Accordingly, the tax of 25% imposed by Section 25 of the Revenue Code was assessed against petitioner on the total undistributed surplus. An itemized statement of the undistributed surplus is shown below:

Balance of surplus account as of Dec. 31, 1950 --------------	₱ 341,352.53
1951 -------------------	135,166.72
1952 -------------------	147,481.63
1953 -------------------	105,977.15
1954 -------------------	182,844.90
Total ------	₱ 912,822.93

It is contended on behalf of petitioner that its surplus earnings and profits during the aforesaid years were not improperly accumulated and that, assuming the taxability of said surplus, the same should be reduced by the amount of the stock dividends declared.

Section 25 of the National Internal Revenue Code 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 fity *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.

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.)

Some of the circumstances which indicate that the accumulations are beyond the reasonable needs of the business are (a) accumulations for the benefit of stockholders; (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.)

The records show that the accumulated earnings and profits of petitioner for the years under review were used mainly as additions to working capital, expansion of its business activities, and acquisition of interests in related businesses.

During the regular annual meeting of the stockholders of petitioner held on March 7, 1951, the stockholders agreed to and approved a proposal to increase its capital from ₱400,000.00 to ₱1,000,000.00. It was explained that the proposal would be "to the advantage of the Company and (would) give the Company greater leeway of expanding its business for the current year and prepare itself for whatever critical circumstances this year may bring." The proposal was approved unanimously. The following appears in the minutes of said stockholders' meeting:

> TThe Chair then explained that, as appears in the Balance Sheet, the Company had as of December 31, 1950, a surplus of ₱341,352.50, which surplus may be used by the Company to increase its capital from the present ₱400,000.00 to ₱1,000,000.00. He explained that this proposition is to the advantage of the Company and to give the Company greater leeway of expanding its business for the current year and prepare itself for whatever critical circumstances this year may bring.
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> After a thorough discussion of the matter and upon motion of Mr. Federis, duly seconded, the following resolution was unanimously approved and adopted:
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> > "RESOLVED, That the authorized capital stock of the Bicol Trading, Inc., be as it hereby is, increased from ₱400,000.00 to ₱1,000,000.00;
> >
> > "RESOLVED, Further that the President and Secretary be, as they hereby are instructed to take immediate steps to secure the necessary permission or authority from the Securities and Exchange Commission to carry out and give legal effect to said increase."
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> The Chair then explained that in order to utilize the surplus of the Company for the purpose of increasing its capital-

ization, it is within the means of the Company to declare a stock dividend of around 50%. Upon motion of Mr. Federis, duly seconded, the following resolution was unanimously approved and adopted:

"RESOLVED, That the Company declare, as it hereby declares, a stock dividend equivalent to 50% of its authorized capital, or ₱200,000 out of the present existing surplus of the Corporation, to all shareholders of record as of March 7, 1951, and that fractional shares thereof be issued in the form of (?) except in amounts equivalent to one or more full shares and that said fractional shares in the form of scrip shall be redeemable in accordance with the preceding (?) within a period of 90 days maximum from date of issue."

(See pages 63-64, B.I.R. records.)

In 1953, petitioner declared a cash dividend of 10%, retaining a surplus of ₱360,708.93. The Board of Directors was informed in its meeting on February 20, 1953 that "a considerable portion of this surplus (was) still invested in the business and (was) unavailable for cash dividends," and for this reason it was suggested that the matter of declaring stock dividends be referred to the stockholders for approval. In the meeting of the stockholders on March 3, 1953, a resolution was unanimously approved authorizing the declaration of 25% stock dividend. The following appears in the minutes of said meeting:

The Chair then declared the table open for new business. The accumulated surplus profits of the Company in the amount of ₱360,708.93 was brought to the attention of the body. After reference was made to the unissued portion of the authorized capital stock of the corporation, on motion, duly seconded, the following resolution was unanimously approved and adopted:

"WHEREAS, for the year 1952, the Corporation has shown profits which have been continously reinvested in the business; and

"WHEREAS, said undistributed profits, as shown by the President's Annual Report to Stockholders, now amounts to ₱360,780.93, and still are invested in business and could not be available for cash dividends now or in the immediate future due to the business commitments of the Company: Now Therefore,

"BE IT RESOLVED, that in justice to the Stockholders of the Corporation (Unsubscribed and Unissued Stock being available) a 25% dividend in the form of Capital Stock of this Company be declared payable to stocks of record as of March 3, 1953."

(See pages 58-59, B.I.R. records.)

Again, in 1955 it was shown that petitioner had a surplus of ₱588,401.70 as of the close of the calendar year 1954. The matter of disposing of the surplus was submitted to the stockholders who unanimously approved, in its meeting on March 1, 1955, a resolution authorizing a stock dividend of 33-1/3%. We quote from the minutes of the stockholders' meeting of March 1, 1955:

The table was then declared open for new business. The Executive Vice-President stated that, as listed in the President's Annual Report, the Corporation had, as of December 31, 1954 a surplus of ₱588,401.70. With the declaration of

> a 10% cash dividend, this surplus was cut down to about ₱514,000.00 as of the date of the meeting. After a thorough discussion and there being available an unsubscribed and unissued portion of capital stck, it was:
>
> > "RESOLVED, that a 33-1/3% dividend in the form of capital stock of this Corporation be declared, payable to stocks of record as of July 1, 1955."
>
> The above resolution was unanimously approved.

(See page 57, B.I.R. records.)

It will be observed that the authorized capital stock of petitioner corporation was only ₱400,000.00. With the expansion of its business activities, it was deemed necessary to increase its capital stock to ₱1,000,000.00. This was sought to be accomplished by utilizing its surplus earnings and profits as part of its working capital. and to this end, stock dividends were declared, although in two instances cash dividends were also declared. That there was need for increased capitalization is borne out by the evidence. In 1951, the gross sales of petitioner amounted to ₱1,676,836.00; in 1952, ₱1,624,144.92; in 1953, ₱2,039,697.13; in 1954, ₱2,296,792.95. (Page 10, Memorandum for Respondent; Exhs. E, F and G.) Undoubtedly, the volume of sales justified increased inventories.

Under the circumstances, were the surplus profits and earnings of petitioner and the conversion thereof as part of its working capital by the declaration of stock dividends unreasonable as to justify the imposition of the penalty tax imposed by Section 25 of the Revenue Code?

[The intention of the law is not to penalize accumulations of surplus which are within the reasonable requirements of the business.] (Semagraph Company, 3 TCM 812, affd. in 152 F. 2d 62 (CA-4); Trico Products Corporation v. McGowan, 67 F. Supp. 311 (DC N.Y.), affd. in 169 F. 2d 343 (CA-2), cert. den., 335 U.S. 899; Metal Office Furniture Company, 11 TCM 1066.) What is a reasonable accumulation is largely a question of fact, which must be decided upon principles of sound business management. (Almours Securities, Inc., 35 BTA 61, affd. in 91 F. 2d 427, cert. den., 302 U.S. 765; Becton, Dickinson & Company v. Commissioner, 134 F. 2d 354 (CA-3); Eastern Railway & Lumber Company, 12 TC 869.)

Since the management of a corporation is entrusted to its board of directors, its decision as to the reasonableness of retaining the corporation's surplus earnings and profits must be given great weight. In R. C. Tway Coal Sales Company v. U. S., 3 F. Supp. 668 (DC Ky.), affd. in 75 F. 2d 336 (CA-6), the Court stated:

> "Necessarily, the directors and officers of a corporation must be given, even in Federal tax matters, some discretion and some latitude as to what constitutes the reasonable needs of the corporate business. It may well be doubted if the Federal government, for the purpose of increasing its taxes, can absolutely destroy or arbitrarily limit this discretion resting in the directors of a corporation organized under state law."

But while the judgment of corporate directors is not to be lightly disregarded, there is no rule that it is conclusive. (L. Schepp Company, 25 BTA 419.) As to what constitutes a reasonable accumulation must be determined, in the final analysis, by the court. (Trico Products Corporation, 46 BTA 346, affd. in 137 F. 2d 424 (CA-2), cert. den., 320 U. S. 799.) In Jerome E. Casey, 267 F. 2d 26 (CA-2), reversing the decision of the U.S. Tax Court in 16 TCM 1024, it was held:

> "We think that the 1954 and 1955 enactments indicate that Congress did not want the taxing authorities to be second-guessing the responsible managers of corporations as to whether and to what extent profits should be distributed or retained, unless the taxing authorities were in a position to prove that their position was correct."

Judge Hand's concurring opinion is even more emphatic. He expressed the view that:

> ". . . the statute meant to set up as a test of 'reasonable needs,' only the corporation's honest belief that the existing accumulation was no greater than was necessary. Section 532(a) was a penal statute, designed to defeat any plan to evade the shareholders' taxes, and there can be no doubt that it presupposes some deliberate purpose to do so and is not satisfied by proving that the corporation was mistaken in its estimate of its future 'needs'.
>
> "In the case at bar the embarrassment is in deciding what were those 'needs', and for that one must look to the estimate of those in control of the corporation, because, being an artificial person, it could obviously have no independent estimate."

However, in order to justify a holding that an accumulation is reasonable, it is necessary that the records of the corporation show why the earnings are being retained.

> "Prerequisite to a holding that an accumulation is reasonable, is a well documented corporate record as to why the earings are being retained. There must be substantial proof of a specific plan, objective or contingency which, in the exercise of good business judgment, demanded the accumulation of the earnings and profits in a reasonable and reasonably definite amount. In order to justify an accumulation the need must be treated as an economic reality; the penalty tax cannot be avoided by simple recognition of a need. Definiteness of plan coupled with action taken toward its consummation are essentials." (What is "Accumulation Beyond Reasonable Needs" of the Business?, Edward N. Delaney, Taxes, May, 1961, pp. 402, 409; see also cases cited therein.)

In the case at bar, the minutes of the meetings of the Board of Directors and stockholders show clearly the necessity of retaining the surplus earnings and profits of the corporation. And what is significant is the fact that the need for retention of the surplus earnings and profits for use as additional working capital was considered, passed upon and approved not only by the Board of Directors of petitioner but also by all its stockholders. The records clearly show that the bulk of its surplus earnings and profits were invested in inventories. And in the case of the investments in stocks and securities of other corporations, such corporations were affiliated companies with which petitioner has business dealings.

In the case, for instance, of the Motor Service Company and the B. F. Goodrich Philippines, Inc., petitioner secures automobile spare parts and tires from said companies. It has been held that -

> "To the extent that surplus has been translated into plant expansion, increased receivables, enlarged inventories or other assets related to the business, the corporation may accumulate surplus with relative impunity." (39 Taxes, 402, 410, citing Smoot Sand & Gravel Corporation 274 F. 2d 495 (CA-4), affirming 17 TCM 1086, cert. den., 362 U. S. 976; emphasis supplied.)

Under the circumstances described above, we are not prepared to substitute our judgment for that of the Board of Directors of petitioner and its stockholders.

Respondent argues that petitioner's original working capital of ₱399,200.00 was sufficient for its business operations so that there was no need to capitalize its earnings. Said counsel for respondent:

> "As heretofore stated, in 1951, the working capital of the petitioner was only ₱399.200.00 for which it realized a sale of ₱1,676.836.00 with a net gain thereon of ₱236,798.00. In 1954, the working capital of the petitioner was already ₱749,600.00 and yet it only realized a net profit of ₱232,822.00. This goes to show that the capitalization by the corporation of its net earnings or surplus was not necessary, the gains or profits for the periods in 1951 and 1954 having been more or less the same. We therefore submit that the accumulation by the petitioner for the periods under review was beyond the reasonable needs of the business." (Page 10, Memorandum for Respondent.)

To our mind, the facts and figures mentioned above weaken rather / strengthen the stand of respondent. If, with a working capital of ₱399,200.00 in 1951, petitioner was able to derive a net profit of ₱236,798.00 it does not necessarily follow that the employment of the same amount of capital would produce the same amount of profit in 1954. This is shown by the fact that despite a working capital of ₱749,600.00 in 1954, it derived only a net profit of ₱232,822.00. The reason is obvious. Conditions in 1954 must have been different from those existing in 1951 to justify an increase in the working capital, so that if petitioner had maintained its working capital in 1954 to the 1951 level, the net profit would undoubtedly have been reduced by about 50%. It would seem, therefore, that the retention of surplus earnings and profits for use as part of petitioner's working capital was a sound business judgment.

Our attention has been drawn to the facts that petitioner is controlled by J. M. Tuason & Co., which is practically owned by the Tuason family, namely, Nicasio Tuason, Severo Tuason and Jose Tuason; that out of the total shares of 5,999 in paid-up stocks in 1952, 4,000 shares were owned by Tuason & Co.; and that although qualifying shares were issued, the business of petitioner was in the hands of J. M. Tuason & Co. From these facts, it is contended that the intention and purpose of petitioner in not distributing its surplus was to maintain at the minimum the tax bracket of the Tuason family who are the stockholders of petitioner.[1] Therefore, respondent submits "that the organizational arrangement of this nature demands the strictest judicial consideration of the case." (Page 11, Memorandum for Respondent.)

It must be admitted that corporations most vulnerable to the penalty tax have been "corporations the stock of which was owned or controlled by a single family or at the most by a few individuals. In the case of one-man corporations and so-called 'incorporated talents' companies, the reasons for accumulations have been carefully investigated." (7 Mertens, Law on Federal Income Taxation, Sec. 39.53.) However, the fact that a corporation is closely held does not give rise to the conclusive presumption that all its accumulations of earnings and profits are unreasonable. Authorities are agreed that such fact justifies careful scrutiny of the reasons for the accumulations. If earnings and profits are accumulated because they are needed to maintain and expand its business activities, as has been proven in the case at bar, the fact that a corporation is closely held will not make the accumulation unreasonable. As aptly stated by counsel for respondent:

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[1] However, no attempt was made to produce evidence as to the extent of the tax savings on the part of the controlling stockholders, although such evidence was available to respondent.

"On the other hand, it requires no argument that the aforecited section does not contemplate that a business shall remain static; it must be assumed that 'any business shall have the right to grow. Necessarily incident to the exercise of this right are the making and pursuit of plans both as to the organization and as to finances which will permit the accomplishment of contemplated developments.' (William C. de Mille Productions, Inc. v. Comm. of Internal Revenue, 30 BTA 826, 830.)." (Page 2, Memorandum for Respondent.)

We believe the foregoing quotation sufficiently answers respondent's contention as regards the significance of the ownership by members of the same family of the majority stock of petitioner corporation.

In view of our opinion that the accumulations of earnings and profits of petitioner for the years under review were reasonably necessary for the maintenance and expansion of its business operations, we find it unnecessary to pass upon the question whether or not stock dividends are deductible from the taxable earnings and profits unreasonably accumulated under Section 25 of the Revenue Code.

The decision appealed from is reversed, without pronouncement as to costs.

SO ORDERED.

Manila, January 8, 1962.

ROMAN M. UMALI
Associate Judge

WE CONCUR:

MARIANO NABLE
Presiding Judge

AUGUSTO M. LUCIANO
Associate Judge