REPUBLIC OF THE PHILIPPINES
COURT OF TAX APPEALS
MANILA

June 29, 1957

VISAYAN CEBU TERMINAL
CO., INC.,
Appellant,

- versus - C.T.A. CASE NO. 128

COLLECTOR OF INTERNAL
REVENUE, Appellee.

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D E C I S I O N

The appellant, Visayan Cebu Terminal Co., Inc., is a corporation organized for the purpose of handling arrastre operations in the port of Cebu. It was awarded the contract for the said arrastre operations by the Bureau of Customs, pursuant to Act No. 3002, as amended.

On March 1, 1952, appellant filed its income tax return for 1951 reporting a gross income of ₱420,633.40 and claimed deductions amounting to ₱379,036.95, leaving a net income of ₱41,596.45 on which it paid income tax in the sum of ₱8,319.29. The sum of ₱379,036.95 claimed as deductions consisted of various items, among which were the following:

1. Salaries -		
(a) Salary and bonus of Juan Eugenio Lo ------------	₱1,875.00	
(b) Salary of Felix Go Chan --------	250.00	
(c) Salary of Teotimo Tiu Tian -------	250.00	₱2,375.00
2. Representation expenses ---------		75,855.88

3. Miscellaneous expenses -
    (a) Christmas bonus given to various persons --------- ₱1,500.00
    (b) Tips to ships' officers -------- 4,800.00 6,300.00

Total ----- ₱84,530.88

The said sums of ₱2,375.00, ₱75,855.88 and ₱6,300.00, representing salaries, representation expenses and miscellaneous expenses, respectively, or a total of ₱84,530.88, were disallowed by the Collector of Internal Revenue, thus giving rise to a deficiency assessment of ₱18,991.00. The disallowances were explained by the Collector in his letter of February 4, 1954, as follows:

> ₱2,375.00 - Salaries. This item represents bonus allegedly paid to Messrs. Felix G. Chan, T. R. Tiam and Juan Eugenio Co in the amounts of ₱250.00, ₱250.00 and ₱1,875.00, respectively. The first two amounts were disallowed because they were paid to persons who were not (appellant's) bonafide employees and, therefore, not entitled to any compensation. The amount of ₱1,875.00 given to Mr. Juan Eugenio Co who is (appellant's) employee and a stockholder at the same time was likewise disallowed because the payment is considered distribution of dividend.
>
> ₱75,855.88 - Representation expenses. This amount consists of 15% of the net profit given to your (appellant's) general manager, 8% of the net profit given to (appellant's) vice-president, both of whom are members of the Board of Directors, and 5% of the net profit to each of the rest of the five members of the Board of Directors and to a legal counsel. The amount of ₱75,855.88 represents distributions to (appellant's) aforesaid officers based on the percent of the net profit. It has been observed that the recipients of the afore-

> said amount are (appellant's) substantial stockholders. The alleged payments, therefore, partake more of the nature of dividend distribution than representation expense.
>
> ₱6,300.00 - Miscellaneous expenses. This discrepancy is constituted by the amount of ₱1,500.00 which (appellant) gave as Christmas bonus to various persons who are not (appellant's) bonafide employees and the sum of ₱4,800.00 given as tips to unknown persons. The whole amount cannot be allowed as deduction because they were not ordinary and necessary expenses.

Upon request for reconsideration, the Collector modified the deficiency income tax assessment by allowing the deduction from appellant's gross income of the salary of Juan Eugenio Lo in the sum of ₱1,875.00 and miscellaneous expenses amounting to ₱532.00, at the same time maintaining the disallowance of the full amount of ₱75,855.88 as representation expenses. The revised deficiency assessment is itemized in the letter of the Collector dated March 26, 1955, and is reproduced below:

Net income as per return ------------------------		₱41,596.45
Disallowances:		
per investigation: salaries of officers -----------	₱ 2,375.00	
allowed per reaudit -	1,875.00	500.00
per investigation and reaudit, representation expenses-----------		75,855.88
per investigation, miscellaneous expenses ----------	₱ 6,300.00	
allowed per reaudit -	532.00	5,768.00
Net income subject to tax per reaudit -------------		₱123,720.33

Tax due on ₱123,720.33:

₱100,000.00 at 20% --	₱20,000.00	
₱ 23,720.00 at 28% --	6,642.00	₱26,642.00

Less tax previously assessed and paid --------------------	₱ 8,325.00
Deficiency tax ----------------	₱18,317.00
Add: 5% surcharge -------------	915.85
1% monthly interest from 5/31/53 to 4/30/55 ------	4,212.91
Compromise for late payment ----	40.00
Total amount due on April 30, 1955 ----------------------	₱23,485.76

Appellant has agreed to the disallowance of the sum of ₱500.00, representing the salaries of Felix Go Chan and Teotimo Tiu Tian at ₱250.00 each, and the sum of ₱5,768.00, representing miscellaneous expenses. The only issue raised in this appeal relates to the deductibility of the sum of ₱75,855.88 as representation expenses.

In computing net income, the law allows the deduction from gross income of -

> "All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered . . ." (Sec. 30 (a)(1), National Internal Revenue Code.)

Representation or entertainment expenses fall under the category of business expenses and are allowable deductions from gross income if they meet the conditions prescribed by law.

In order that expenses may be deductible, they must be -

(1) Ordinary and necessary, and

(2) Paid or incurred during the taxable year under one of the following conditions -

(a) In carrying on any trade or

business;

(b) For the production or collection of income;

(c) For the management, conservation, or maintenance of property held for the production of income;

(d) In connection with the determination, refund or collection of any tax. (Par.11,000 P-H Fed. 1955.)

Even if expenses were paid or incurred in carrying on a trade or business within the taxable year; or for the production or collection of income; or for the management, conservation, or maintenance of property held for the production of income; or in connection with the determination, refund or collection of any tax, such expenses would not be deductible unless they were both ordinary and necessary. An expense is generally considered necessary where the expenditure is appropriate or helpful in the development of the taxpayer's business or that the same is proper for the purpose of realizing a profit or minimizing a loss. An expense is ordinary when it connotes a payment which is normal in relation to the business of the taxpayer and the surrounding circumstances. As to the meaning of the word "ordinary", the Supreme Court of the United States stated:

> "Now, what is ordinary, though there must always be a strain of constancy within it, is none the less a variable affected by time and place and circumstance. Ordinary in this context does not mean that the payments must be habitual or normal in the sense that the same taxpayer will have to make them often. A lawsuit affecting the safety of a business may happen once in a lifetime. The counsel fees may be so heavy that repetition is unlikely. None the less, the expense is an ordinary one because we know from experience that payments for such a purpose, whether the amount is large or small, are the common and accepted means of defense against attack. Cf. Kornhauser v. United States, 276 U.S. 145, 48 S. Ct. 219 72 L. Ed. 505 (6 AFTR 7358). The situation is unique in the life of the individual affected, but not in the life of the group, the community, of which he is a part. At such times there are norms of conduct that help to stabilize our judgment, and make it certain and objective. The instance is not erratic, but is brought within a known type." (Welch v. Helvering, 290 U.S. 111, cited in Par. 11,008 P-H Fed. 1955.)

Business expenses, in order to be deductible, must not only be ordinary and necessary but must also meet the further test of reasonableness in amount. The element of reasonableness in amount is inherent in the phrase "ordinary and necessary". It was not the intention of Congress to automatically allow as deductions operating expenses incurred or paid by the taxpayer in an unlimited amount. (Commissioner vs. Lincoln Elec. Co., 176 Fed. 2d 815, 38 AFTR 411.)

Have the requirements for deductibility of the sum of ₱75,855.88 been satisfied?

Counsel for the Government admit that "the expense of ₱75,855.88 was paid and incurred within the taxable year 1951." It is, however, contended that "it is not ordinary and necessary expense nor was it incurred in carrying on the trade or business of the appellant in 1951." It was, according to the Collector, in the nature of a dividend distribution. (Page 5, Memorandum for the Appellee.) On the other hand, appellant sought to prove that the said amount was actually spent by its officers and members of the Board of Directors for the promotion and enhancement of the business of the corporation. Let us examine the facts.

It appears that by a resolution of the Board of Directors of appellant corporation dated July 22, 1949, a dividend of 50% of the net profit was authorized to be declared to the stockholders annually and the other 50% was to be used to reimburse the representation expenses of the General Manager, members of the Board of Directors and the legal consultant at the following rates: General Manager, 12%; Assistant General Manager, 8%; members of the Board of Directors and the legal consultant, 5% each of the net profit. During the period of four years from 1949 to 1952, appellant had gross incomes, net profits and claimed representation expenses, as follows:

Year	Gross Income	Net Profit	Representation Expenses
1949	₱722,135.42	₱61,257.53	₱83,703.54
1950	451,303.21	33,023.78	10,424.39
1951	420,479.39	41,596.45	75,855.88
1952	425,326.86	54,207.31	63,618.64

It also appears from the testimony of Dioscoro B. Casco, Accountant-Bookkeeper of appellant, that reimbursements of representation expenses incurred by the officers and members of the Board of Directors were made upon presentation of the corresponding vouchers and chits, but there were instances when reimbursements were made without presentation of supporting papers. Casco justified reimbursement of a claim for representation expenses without presentation of supporting papers by stating that he did not have the courage to ask the officers and members of the Board to comply with the requirement because of the "unquestioned integrity of these people and the high esteem of the community toward them." Besides, "it was the policy of the office to give them free way to spend such amount without, of course, complete supporting papers."

As to how the amounts claimed by the officers and members of the Board were spent, Casco testified that, with respect to the manager, they were spent for "hotel and accommodation charges and entertainment expenses while in Manila; entertainment of the agents of the ship and other officers and also importers when he comes to Manila on official business for the Company." As regards the members of the Board, he testified that "they used to present chits covering their expenses for the entertainments of friends who came from other places to see Cebu to get indentions of their imports. The members of the Board of Directors or the liason officers entertained them, in which case these liason officers submitted hotel and accommodation expenses and also transportation expenses." (Pp. 61-62, t.s.n.; p. 20, Memorandum for Appellant.)

From the evidence adduced by appellant, there were two sets of representation expenses. One covers expenses supported by appropriate vouchers and chits; the other covers expenses without supporting papers. Unfortunately, it is not possible to determine the actual amount covered by supporting papers and the amount without supporting papers. It is alleged that the records were destroyed when the house of Buenaventura M. Veloso, treasurer of appellant, where the records were kept was burned. We may, therefore, accept as correct the fact that at least a portion of the amount of ₱75,855.88 was spent for representation expenses of appellant corporation, while the portion thereof not covered by supporting papers was spent for purposes not clearly established. The first qualifies for the deduction, the other does not. It is up to us to determine from all available data the amount properly deductible as representation expenses. It would seem unjust to disallow the deduction of the entire amount for lack of documentary evidence to establish the precise amount beyond a reasonable doubt. XXX The practice under the Federal Income Tax Law of the United States is -

". . . that while a taxpayer is not relieved from the burden of substantiating his claimed deductions, the examining agent should exercise careful judgment which will permit reasonable determinations for entertainment expense, provided he is satisfied that there is a proper basis for some allowance. Disallowing amounts claimed for deduction merely because there is available no documentary evidence which will establish the precise amount beyond a reasonable doubt ignores commonly recognized business practices as well as the fact proof may be established by credible oral testimony. On the other hand, it is not the policy to allow an arbitrary percentage of the claimed deduction merely for purpose of settlement. Ir-Min. No. 54-92, Par. 76,750 P-H Fed. 1954." (Par. 11,300 P-H Fed. 1955.)

In this case, it is impossible to determine the precise amount spent for representation. But it is our duty to make a determination, even if the result be merely an approximation.

"In the production of his plays Cohan was obliged to be free-handed in entertaining actors, employees, and, as he naively adds, dramatic critics. He had also to travel much, at times with his attorney. These expenses amounted to substantial sums, but he kept no account and probably could not have done so. At the trial before the Board he estimated that he had spent eleven thousand dollars in this fashion during the first six months of 1921, twenty-two thousand dollars, between July first, 1921, and June thirtieth, 1922, and as much for his following fiscal year, fifty-five thousand dollars in all. The Board refused to allow him any part of this, on the ground that it was impossible to tell how much he had in fact spent, in the absence of any items or details. The question is how far this refusal is justified, in view of the finding that he had spent much and that the sums were allowable expenses. Absolute certainty in such matters is usually impossible and is not necessary; the Board should make as close an approximation as it can, bearing heavily if it chooses upon the taxpayer whose inexactitude is of his own making.

> But to allow nothing at all appears to us inconsistent with saying that something was spent. True, we do not know how many trips Cohan made, nor how large his entertainments were; yet there was obviously some basis for computations, if necessary by drawing upon the Board's personal estimates of the minimum of such expenses. The amount may be trivial and unsatisfactory, but there was basis for some allowance, and it was wrong to refuse any, even though it were the traveling expenses of a single trip. It is not fatal that the result will inevitably be speculative; many important decisions must be such. We think that the Board was in error as to this and must reconsider the evidence." (Pp. 543-544, Vol. 39 Fed. Rep.)

We shall, therefore, endeavor to ascertain the amount actually spent by appellant for representation or entertainment which we deem reasonably necessary in carrying on its business. As already adverted to above, appellant claimed representation expenses from 1949 to 1952 in the following amounts:

1949 - - - - - - - - -	₱83,703.54
1950 - - - - - - - - -	10,424.39
1951 - - - - - - - - -	75,855.88
1952 - - - - - - - - -	63,618.64

We presume that, as in 1951, the expenses incurred by the officers and members of the Board of Directors were not all covered by supporting papers showing that said expenses were all for entertainment purposes as testified by appellant's accountant-bookkeeper. From the above figures, we may infer that the sum of ₱10,000.00 may be considered reasonably necessary for entertainment expenses of appellant in 1951, it having claimed a little over that amount in 1950, when its gross income was more than its gross incomes in 1951 and 1952. Moreover, it allegedly spent for entertainment purposes in 1948 the sum of ₱500.00 only.

It is argued, however, that the whole amount claimed by the appellant should be disallowed because there is no necessity for appellant to incur expenses for entertainment, the business in which it is engaged being a monopoly. To accept this proposition is to ignore the commonly recognized business practices. A business concern, whether a monopoly or one which operates in a highly competitive market, has need to provide for entertainment or representation expenses to preserve and maintain the goodwill and patronage of its customers and to win more customers if possible. Moreover, in the case of appellant, while it is true that it has the exclusive contract to undertake arrastre operations in the port of Cebu, the contract is for a limited period after which it has to compete again with others before it may win a renewal of the contract. There is, therefore, necessity for it to provide for a reasonable amount for representation or entertainment expenses.

It is also contended that the sum of ₱75,855.88 being claimed as representation expenses was an indirect distribution of dividend, the officers and members of the Board of Directors of appellant being the holders of the majority stock of the corporation, together with their relatives. The records show that the officers and members of the Board of Directors of appellant corporation had never been the holders of the majority stock of the corporation. It is true that some of their relatives were and are stockholders of said corporation, but it has not been shown that the stocks in the names of such relatives were owned or controlled, directly or indirectly, by the officers and members of the Board of Directors. Accordingly, there is no basis for holding that the officers and members of the Board of Directors of appellant own or control the majority stock to justify the inference that representation expenses being claimed are an indirect distribution of dividend.

Finally, it is argued that while the officers and members of the Board of Directors of appellant corporation reported in their income tax returns the amounts received by them as reimbursements for alleged representation expenses, they did not claim deduction of the amounts actually spent by them. From this the conclusion is drawn that the amounts received by them were not in reality reimbursements for representation expenses but a distribution of part of the net profit of the corporation. We can not accept the soundness of this proposition. The failure of a person to claim deduction in connection with income derived from a corporation cannot affect the legality of the deduction claimed by the corporation in respect of the amount paid by it to such person. Of the same nature is the argument of appellant that because the Collector of Internal Revenue has not questioned the legality of the deduction for representation expenses claimed in other years in amounts nearly the same as the claim in 1951, there is no justification for questioning the deduction for representation expenses in that year. The legality of a deficiency assessment cannot be affected by the failure to assess in cases of similar nature. The rule is well established that the Government is not estopped by error or mistake on the part of its agents. (Pineda v. Court of First Instance of Tayabas, 52 Phil. 803.)

FOR THE FOREGOING CONSIDERATIONS, the decision appealed from is hereby modified, and appellant is hereby ordered to pay to the Collector of Internal Revenue, within a reasonable period to be fixed by the latter, the sum of ₱15,517.00, computed below:

Net income per return ----------		₱ 41,596.45
Disallowances:		
(1) Salaries ------------------		500.00
(2) Representation Expenses:		
As claimed by appellant ----	₱75,855.88	
Allowed -------	10,000.00	65,855.88
(3) Miscellaneous expenses ----------------		5,768.00
Net income subject to tax -------		₱113,720.33
Tax due on ₱113,720.33:		
₱100,000.00 at 20% --	₱20,000.00	
₱ 13,720.00 at 28% --	3,842.00	₱ 23,842.00
Less tax previously assessed and paid --------------------		8,325.00
Deficiency tax ----------------		₱ 15,517.00

With costs against appellant.

SO ORDERED.

Manila, June 29, 1957.

ROMAN M. UMALI
Associate Judge

WE CONCUR:

MARIANO NABLE
Presiding Judge

AUGUSTO M. LUCIANO
Associate Judge