REPUBLIC OF THE PHILIPPINES
COURT OF TAX APPEALS
QUEZON CITY

HAWAIIAN - PHILIPPINE COMPANY,
Petitioner,

- versus -

THE COMMISSIONER OF INTERNAL REVENUE,
Respondent.

C.T.A. CASE NO. 4400

Promulgated:
NOV 09 1994

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D E C I S I O N

This is an assessment case for alleged deficiency income tax for the years 1983 and 1985 in the respective amounts of P2,591,348.80 and P2,026,235.28, or a total amount of P4,617,584.08. Both assessments arose from disallowed deductions of management fees paid to Petitioner's managing agent during said years.

Petitioner is a domestic corporation engaged in the processing of sugar and its by-product, molasses.

On March 22, 1989, Petitioner received a letter of demand together with the respective Assessment Notice Nos. 00591-89 and 00592-89 under respective Assessment Nos. 06B-56-6-000205-83/89 and 06B-56-7-000194-85/89 assessing Petitioner for alleged deficiency income taxes computed as follows:

DEFICIENCY INCOME TAXES

Assessment Notice No. 00591-89

068-56-6-000205-83/89

Net income per return	P4,451,001.00
Add: Disallowances per investigation	
Management Fees	4,627,408.00
Net income per investigation & review	P9,078,409.00
Less: Exemptions	-0-
Net taxable income	P9,078,409.00
Income tax due thereon	P3,167,443.00
Less: Tax paid per return	1,547,850.00
Deficiency tax due	P1,619,593.00
Add: 20% annual interest from 4-16-84 to 3-1-89 (60% max.)	971,755.80
TOTAL AMOUNT DUE AND COLLECTIBLE	P2,591,348.80

Assessment Notice No. 00592-89

068-56-7-000194-85/89

Net income per return	(P 889,769.00)
Add: Disallowances per investigation	
Management Fees	4,548,333.00
Net income per investigation & review	P3,658,564.00
Less: Exemptions	-0-
Net taxable income	P3,658,564.00
Income tax due thereon	P1,273,997.00
Less: Tax paid per return	-0-
Deficiency tax due	P1,273,997.00
Add: 20% annual interest from 4-16-86 to 3-1-89 (.5914553)	752,238.28
TOTAL AMOUNT DUE AND COLLECTIBLE	P2,026,235.28

(Exh. 4, BIR Records, p. 285)

On April 5, 1989, Petitioner, through its managing agent duly protested Respondent's above-mentioned assessments (Exh. CN, BIR Records, pp. 289-294).

Notwithstanding Petitioner's letter of protest and its subsequent letters reiterating such protest (Exhs. CO-2 and CS), Respondent, through his agent served Warrants of Garnishment dated September 7, 1989 to the Bank of the Philippine Islands and the Philippine Commercial Industrial Bank on October 9, 1989 and to the Far East Bank and Trust Company on October 10, 1989 (Exhs. CP, CQ and CR, BIR Records, pp. 320-326).

In a letter dated October 17, 1989 filed on even date with the Collection Enforcement Division, Petitioner requested Respondent to lift the warrants issued against it (Exh. CT, BIR Records, pp. 347-359).

On October 26, 1989, Petitioner reiterated its request to Respondent that the warrants of garnishment be lifted and offered the amount of P1,500,000.00 to be held in escrow in a bank pending the resolution of the assessments in question. Subject to the offered escrow, Respondent lifted the warrants of garnishment (Exh. CU, BIR Records, pp. 361-362).

Considering the issuance and service of warrants of garnishment as Respondent's denial on the disputed assessments, Petitioner filed this appeal.

The basic issue to be resolved in the case at bar is: whether or not the disallowance by the Respondent of the management fees due to its managing agent, Jardine Davies, Inc. as deduction by Petitioner for income tax purposes, on the ground that such management fees are disguised dividends, was proper.

In justifying the disallowance of the management fees from Petitioner's gross income, Respondent invoked the "doctrine of piercing the veil of corporate entity" inasmuch as "Jardine Davies, Inc., owns 88% of the total stocks of the Hawaiian-Philippine Company," (Memorandum letter of the Revenue Enforcement Officers, dated January 18, 1989, Exh. 1, BIR Records, pp. 264-266). Thus, following the doctrine laid down in the case of **Yutivo Sons Hardware, Co. vs. Court of Tax Appeals**, G.R. No. L-13203, January 28, 1961, 1 SCRA 160, Respondent disregarded the separate corporate personality of the Petitioner and its managing agent, Jardine Davies, Inc., thus, the disallowance of the management fees by Petitioner to the latter (see Answer, C.T.A. Records, p. 38). The pertinent portion of the said Memorandum Letter is hereby quoted, thus:

> <u>JUSTIFICATION FOR THE DISALLOWANCE AND COMMENTS</u>
>
> Hawaiian-Philippine Company is a subsidiary of Jardine Davies Inc., a domestic

corporation with offices at No. 222, Buendia Ave., Makati, Metro Manila, Philippines. The Jardine Davies, Inc., owns 88% of the total stocks of the Hawaiian-Philippine Company. (A xerox copy of the list of stockholders is hereto attached.) On March 20, 1981, the Hawaiian-Philippine Company entered into an agreement between Jardine Davies, Inc., wherein, in accordance with the terms thereof, the Jardine Davies, Inc. will manage the operations of the Hawaiian-Philippine Company. (A copy of the management agreement is also hereto attached.) Mr. Erwin G. Vorster, a stockholder and a member of the Board of Directors of the Hawaiian-Philippine Company, who is also the President of the Jardine Davies, Inc., signed the contract in behalf of Jardine Davies, Inc.

In a Supreme Court decision in the case of Yutivo Sons Hardware Co., vs. CTA, et al., (SCRA 160), the Court disregard the corporate personality of Southern Motors, Inc. and taxed them by consolidating the income of Southern Motors, Inc. with Yutivo Sons Hardware Co., on the theory that both corporation were owned by the same family.

We the undersigned so hold that, in the same manner as the Court disregard the corporate personalities of Yutivo Sons Hardware Co. and Southern Motors Inc. because they were owned by the same family, the execution thereof of a management contract between Hawaiian-Philippine Company and Jardine Davies Inc., which is 88% controlled, is but a cover up to justify their deduction of management fees from the gross income of Hawaiian-Philippine Company. In effect, the management fees thereof are considered disguised dividends and are unallowable deductions from its gross income.

The answer to the question: Was the Respondent correct in disregarding the separate corporate entity of the Petitioner and its managing agent, Jardine Davies, Inc., therefore, is the key determinant in the resolution of the issue in this case.

And We answer in the negative.

The doctrine of corporate entity has been recognized repeatedly in income tax cases. In fact, the income tax law could not be administered effectively unless this doctrine were freely recognized. "It is one of substance and vitality and that the disregard of the doctrine is the exception instead of the rule" (Ayer vs. Commissioner, 100 F2d 850 [CCA 1st, 1939]). And "the exception to the general rule is limited to sham transactions and situations involving transactions or matters that lack a business purpose and are a mere formality" (Ingle Coal Corp., vs. U.S., 127 F Supp 753). "The mere fact that the taxpayer owned all the stock in the corporation is not sufficient to establish the existence of exceptional circumstances under which a court might be justified in disregarding the corporate entity" (Benedict A. Kausal, Jr., TC Memo 1956-289).

In the case at bar, Respondent's only justification for disallowing the management fees as proper deduction was that "the Jardine Davies, Inc., owns 88% of the total stocks of the Hawaiian-Philippine Company" (Exh. 1-C, BIR Records, p. 271). On this basis alone, We are not prepared to disregard the doctrine of corporate entity.

It may be admitted that there were already cases wherein this Court and the Supreme Court have pierced the veil of corporate entity but it is assured that a multitude of factors have been considered in arriving at a conclusion that a taxpayer and its subsidiary must be regarded as one taxable entity. Certainly, We would like to reiterate that ownership and control "is not sufficient to establish the existence of exceptional circumstances under which a court might be justified in disregarding the corporate entity" (Benedict A. Kausal, Jr., supra).

The case of **Yutivo Sons Hardware Co. vs. Court of Tax Appeals**, 1 SCRA 160 used by the Respondent to support her case simply cannot be applied to the case at bar as the facts are entirely different. In a form of summary, the High Court in arriving to its conclusion that Yutivo and Southern Motors should be regarded as one taxable entity, thus held:

> Briefly stated, Yutivo financed principally, if not wholly, the business of SM and actually extended all the credit to the latter not only in the form of starting capital but also in the form of credits extended for the cars and vehicles allegedly sold by Yutivo to SM as well as advances or loans for the expenses of the latter when the capital had been exhausted. Thus, the increases in the capital stock were made in advances or "Guarantee" payments by Yutivo and credited in favor of SM. The funds of SM were all merged in the cash fund of Yutivo. At all times Yutivo thru officers and directors common to it and SM, exercised full control over the cash

> funds, policies, expenditures and obligations of the latter.
>
> Southern Motors being but a mere instrumentality or adjunct of Yutivo, the Court of Tax Appeals correctly disregarded the technical defense of separate corporate entity in order to arrive at the true tax liability of Yutivo.

In fine, the High Court considered Southern Motors as a mere shell corporation used as a business conduit by Yutivo.

Obviously, the same is not true in the case at bar.

Pursuant to its management contract with Petitioner, management fees are paid for services actually rendered by Jardine Davies, Inc. As testified by witness Lutgarda Samaniego, Sugar Marketing and Administrative Consultant of Jardine Davies, Inc., she stated thus:

> Q. Mrs. Witness, who takes charge, if any, of the activities of HP Co. outside of Silay City?
>
> A. Jardine Davies, Inc., before Theo H. Davies, its managing agents for Hawaiian-Philippine Company. And anything that is out of the day-to-day operations are handled by them.
>
> Q. What are these operations of HP Co. in Manila?
>
> A. The marketing of its main product, sugar and molasses, that is handled by Jardine Davies. They handle corporate relations, tax and legal system; they handle the investments and money management; they handle purchasing for Hawaiian-

Philippine Company for items that are not locally available in Bacolod; they take care of all the foreign exchange requirements; they represent Hawaiian-Philippine Company in various offices in Manila.

Q. And how did this relationship between Jardine Davies and Hawaiian-Philippines arise?

A. It arose from a management contract, management agreement, which started as early as 1948 with Theo H. Davies. And then, when it became Jardine Davies, the same management agreement is enforced.

xxx xxx xxx

Q. Mrs. Witness, how did Jardine Davies perform this general management services?

A. Jardine Davies, through the president, the senior vice-president of Natural Resources Division, now Sugar Division, the senior vice-president for Treasury and Finance, the senior vice-president for Corporate Relations, Legal and Tax, they set the policies and the annual planning sessions, goals to be achieved and targets to be attained, the officers conduct plant visits regularly, the manager of the mill, the administrative manager of the mill, the factory manager are usually called to Manila from time to time to settle various concerns and to set their plans. They talk about capital expenditure, projects; they talk about financial matters, and personnel.

(T.S.N. p. 9-10; 11-12, Hearing of February 18, 1991)

And these management fees were subjected to contractor's tax and reported as part of income of Jardine Davies, Inc.

Q. And what remuneration, if any, did Jardine Davies receive for these management services?

A. They receive this in the form of management fees.

Q. And how does Jardine Davies treat these management fees?

A. Well, <u>these management fees were, during the time in question, subjected to contractor's tax and reported as part of income of Jardine Davies. Currently, it is reported as part of the income of Jardine Davies, Incorporated and was subject to the Value Added Tax</u>.

(Emphasis supplied; T.S.N. p. 39, Hearing of April 23, 1991)

Clearly, the business dealings between the Petitioner and its managing agent, Jardine Davies, Inc., are at arms-length. We find nothing to conclude that their business dealings are unusual or irregular.

At this juncture, it should be stated that the intention to minimize taxes, when used in the context of fraud, must be proved to exist by clear and convincing evidence amounting to more than mere preponderance, and cannot be justified by a mere speculation. This is because fraud is never lightly to be presumed. (**Vitelli and Sons vs. U.S.**, 250 U.S. 355; **Duffin vs. Lucas**, 55 F(2d) 786; **Budd vs. Comm.**, 43 F(2d) 509; see also Balter, Fraud Under Federal Law, pp. 301-302, citing numerous authorities; **Arroyo vs. Granada, et al.**, 18 Phil. 484). Fraud is never imputed and the courts never sustain findings of fraud upon circumstances which, at the most, create only suspicion. (**Haygood Lumber and Mining Co. vs. Commissioner**, 178 F(2d) 769; **Dalone vs. Commissioner**, 100 F(2d) 507).

WHEREFORE, in all the foregoing discussions, We so believe that it was not proper on the part of the Respondent to disallow the management fees as deduction from the Petitioner's gross income. **ACCORDINGLY**, Respondent is hereby **ORDERED** to **CANCEL** the assessments in question for being null and void. Respondent is likewise **ORDERED** to **LIFT** the amount of P1,500,000.00 held in escrow in her favor, which amount served as guarantee for payment of the deficiency income taxes in question.

SO ORDERED.

RAMON O. DE VEYRA
Associate Judge

WE CONCUR:

ERNESTO D. ACOSTA
Presiding Judge

MANUEL K. GRUBA
Associate Judge

CERTIFICATION

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

ERNESTO D. ACOSTA
Presiding Judge