REPUBLIC OF THE PHILIPPINES
COURT OF TAX APPEALS
QUEZON CITY

UNITED STATES LINES COMPANY,
Petitioner,

- versus - C.T.A. CASE No. 1305

THE COMMISSIONER OF INTERNAL REVENUE,
Respondent.
x- - - - - - - - - - - - - - - -x

June 28/73

D E C I S I O N

This is a petition for review of a decision of respondent Commissioner of Internal Revenue dated September 28, 1962 holding petitioner liable for deficiency income tax for the year 1956 in the amount of ₱25,127.30, inclusive of ½% monthly interest from June 20, 1959 to October 9, 1961 and delinquency penalties incident to late payment.

The facts of this case are not in dispute. It appears that petitioner is a foreign corporation authorized to do business in the Philippines, more particularly in the business of carrying passengers or freight with some of its vessels calling on Philippine ports.

Petitioner, on June 25, 1957, filed its corporate income tax return covering the year 1956. In 1960, petitioner was investigated in connection with its income tax for the year 1956 and respondent found petitioner liable for ₱22,076.00 as deficiency income tax. This deficiency was due to petitioner's failure to include as part of its world's gross income in its return the gain of $2,272,654.00 from the sales of some of its vessels abroad in 1956 which is a necessary item for the purpose of determining the portion of world expenses allocable to its Philippine income pursuant to Section 163 of Income Tax Regulations No. 2. In view of this failure a recomputation was made. Thereafter, respondent assessed petitioner on October 9, 1961 in the amount of ₱22,077.00 as deficiency income tax for 1956, plus ½% monthly interest from June 20, 1959 to October 9, 1961 in the sum of ₱3,050.30, or a total tax due of ₱25,127.30 computed as follows:

ACR-1589-61/56

Net income per return..........	₱520,772.00
Add:	
Increase in P.I. income per allocation	38.00
Decrease in P.I. expenses per allocation	78,806.00
Net income per investigation ..	₱599,616.00
Tax due thereon	₱159,893.00
Less: Amount already assessed .	137,816.00
Balance	₱ 22,077.00
Add: ½% monthly interest from June 20, 1959 to October 9, 1961	3,050.30
TOTAL AMOUNT DUE	₱ 25,127.30

The assessment was protested by petitioner in a letter dated October 16, 1961. On February 7, 1962, respondent denied petitioner's protest.

On February 26, 1962, respondent received from petitioner a letter dated February 23, 1962, requesting reconsideration of the former's letter of denial dated February 7, 1962 on the ground that -

> The proceeds from the sale of Victory ships realized by our client in 1956 were deposited as required by U.S. Federal Law in the Capital Reserve Fund and withdrawals have been made only for investment in vessels. Consequently, the said profit from such transaction should not be taken into account in the allocation of expenses under Section 167 of the Regulations.

This request for reconsideration was denied by respondent in his letter dated September 28, 1962 wherein payment of the deficiency within 20 days from receipt thereof was demanded. This letter of denial was received by the Records Control Section of the Bureau of Internal Revenue only on November 28, 1962, apparently for mailing purposes and same was received by counsel for petitioner on December 6, 1962. From this denial, petitioner, on December 13, 1962, interposed this appeal.

The issues before this Court are:

(1) whether or not the petition for review was filed on time in accordance with Section 11 of Republic Act No. 1125;

(2) whether or not the profits realized by petitioner in the sale of its vessels abroad in 1956 should be included in its

world gross income for purposes of prorating its world expenses in the computation of its Philippine income tax; and if in the affirmative,

(3) whether or not petitioner should also be liable for ½% monthly interest provided for in Section 51(e) of the Tax Code.

With respect to the issue of jurisdiction, the record shows that the appealable decision is the letter of respondent dated September 28, 1962. This is so because therein respondent definitely fixed the period within which petitioner should pay the deficiency assessment, which is twenty (20) days from receipt thereof. This letter was received on November 28, 1962 in the records control section of the Bureau of Internal Revenue apparently for mailing to the petitioner. The original thereof was sent to petitioner by registered mail with return card and was received on December 6, 1962. The petition for review was filed on December 13, 1962. Consequently, the petition for review was filed within the thirty-day period provided for in Section 11 of Republic Act No. 1125. At any rate, we note that respondent has obviously abandoned this issue of jurisdiction by his failure to litigate this defense during the trial or treat it in his memorandum.

With respect to the second issue, petitioner contends that the deficiency income tax in the amount of ₱25,127.30 assessed against it was arrived at by including in petitioner's "world gross income" the profits it realized from the sales of its vessels abroad. This is improper because said profits are income derived in full from sources without the Philippines and should, therefore, be excluded from petitioner's "world gross income" under Section 163 of Revenue Regulations No. 2. Moreover, petitioner contends that since these profits were realized from the sales of its vessels abroad, which is income not related to the business of transportation, it is not taxable because the phrase "income of nonshipping character but incidental to the shipping business" refers only to the incidental income in connection with the service of transportation of the foreign shipping company.

Respondent, however, contends that the profit was derived from sources partly within and partly without the Philippines because the sales of its vessels is an income of a nonshipping character but incidental to the shipping business, such as dividends from investments, interest on deposits, etc., pursuant to Section 163 of Revenue Regulations No. 2 inplementing Section 37(e) of the Tax Code. He then concludes that such income from the sales of vessels should, therefore, be included in petitioner's "world gross income."

Section 37 of the National Internal Revenue Code classifies the income of foreign corporations into three: (1) income which is derived in full from sources within the Philippines; (2) income which is derived in full from sources without the Philippines; and (3) income which is derived partly from sources within and partly from sources without the Philippines. Non-resident alien individuals and foreign corporations, like petitioner herein, are taxable only on income from sources within the Philippines. The taxable income of foreign corporations from sources within the Philippines includes those derived in full from sources within the Philippines and that portion of the income which is derived partly from sources within and partly from sources without the Philippines which is allocable to sources within the Philippines. (See also Section 152, Rev. Regs. No. 2; Daiichi Chuo Kisen Kaisha v. Commissioner of Internal Revenue, CTA Case No. 1277, May 31, 1969.) Needless to say, any portion of the income of petitioner which is derived in full from sources without the Philippines is not subject to Philippine income tax.

The income from the sale of vessels in question is income from sources without the Philippines. Says Section 159 of Revenue Regulations No. 2:

> Sec. 159. Sale of personal property. - Income derived from the purchase and sale of personal property shall be treated as derived entirely from the country in which sold. The word "sold" includes "exchanged." The "country in which sold" ordinarily means the place where the property is marketed. This section does not apply to income 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. (See section 162 of these regulations.)

Since the vessels in question were sold abroad, it goes without saying that it is income from sources without the Philippines.

It is improper for respondent to include the profits realized from the sale of petitioner's vessels in the computation of income which is derived partly from sources within and partly from sources without the Philippines. It will be noted that under Section 37(e) of the Revenue Code, only items of gross income falling under the third classification, i.e., income from sources partly within and partly without the Philippines should be allocated or apportioned to sources within or without the Philippines. This allocation is made in accordance with Sections 162, 163 and 164 of Revenue Regulations No. 2. Thus, the first part of Section 37(e) states:

> x x x. 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. x x x.

However, Section 165 of Revenue Regulations No. 2 expressly provides:

> Sec. 165. Computation of income.- It a taxpayer has gross income from sources within or without the Philippines as defined by section 37(a) or (c) together with gross income derived partly from sources within and partly from sources without the Philippines, the amounts thereof, together with the expenses and investment applicable thereto, shall be segregated, and the net income from sources within the Philippines shall be separately computed therefrom. (Underscoring supplied.)

It is thus evident that respondent can not include income which is clearly derived in full from sources without the Philippines in the computation of income which is derived partly from sources within and partly from sources without the Philippines. Since there is no question that petitioner's profits realized from the sale of its vessels abroad in the amount of $2,272,654.00 are clearly from sources without the Philippines, they are therefore excludible from the world gross income of the company for the purpose of determining its Philippine income under Section 163 of Revenue Regulations No. 2.

Respondent, however, contends that the profit was derived from sources partly within and partly without the Philippines because the sale of petitioner's vessels is an income of a nonshipping character but incidental to the shipping business, such as dividends from investments, interest on deposits, etc., pursuant to Section 163 of Revenue Regulations No. 2 implementing Section 37(e) of the Tax Code. Such income, according to respondent, should therefore be included in petitioner's world income for purposes of computing its taxable net income from Philippine sources for the year 1956 under the formula of general apportionment provided in Section 163 of Revenue Regulations No. 2.

This question is not one of first impression. In the case of Daiichi Chuo Kisen Kaisha v. Commissioner of Internal Revenue, supra, where the factual background is similar to that in the instant case, this Court ruled that the income derived from the sale of fixed assets abroad is not incidental to, and in connection with, the service of transportation, and therefore not included in the "world gross income" in accordance with the formula prescribed in Section 163 of

Revenue Regulations No. 2 because it is treated as being derived fully from sources without the Philippines.) Due to its decisive effects on the case at bar, we quote the pertinent portions of the decision:

> Respondent, however, argues that the phrase "world gross income" denotes not only gross income realized within the Philippines but also includes other income from all sources "including in each case income of a nonshipping character but incidental to the shipping business such as dividends from investments, interest on deposits." (Sec. 163, Rev. Regs. No. 2.) Again, respondent seems to have lost sight of the division by the law of income of taxpayers into three distinct classes (Sec. 152, Rev. Regs. No. 2; Sec. 37, Revenue Code) which is specially significant to petitioner herein as a foreign corporation deriving income from sources within the Philippines. As already shown above, under Section 37(e) of the Revenue Code, only items of gross income coming under the third classification, i.e., income from sources partly within and partly without the Philippines, should be allocated or apportioned to sources within or without the Philippines in accordance with Section 163 of Revenue Regulations No. 2. Consequently, where an item of income is directly classified as income which is derived in full from sources within the Philippines or income which is derived in full from sources without the Philippines under the provisions of Section 37(a) or (c) of the Tax Code, in relation to Section 152 of Revenue Regulations No. 2, then Section 37(e) of the same Code, as well as the provisions of Section 163 of Revenue Regulations No. 2, cannot apply. Inasmuch as there is no question that

petitioner's profits realized from the sale of its fixed assets located abroad are income derived in full from sources without the Philippines under Section 37(c), it follows that the said profits are not subject to allocation or apportionment to sources within or without the Philippines in accordance with Section 163 of Revenue Regulations No. 2. Because of the inapplicability of the said Section 163, we can see no materiality in respondent's argument that the phrase "world gross income" denotes not only gross income realized within the Philippines but also includes other incomes from all sources "including in each case income of a nonshipping character but incidental to the shipping business such as dividends from investments, interest on deposits."

At any rate, it was the intention of Congress to place the taxation of transportation companies upon a sounder and more scientific basis, and so the principle was adopted of considering income derived from transportation to be income for services, with the result that the place where the services are rendered determines the source. The result is income from sources partly within and partly without the Philippines under Section 37(e) of the National Internal Revenue Code. But the problem was not yet solved. It was still necessary to allocate income to the two sources. (See Mertens' Law of Federal Income Taxation, Vol. 8, Sec. 45.43, p. 112.) For this reason, we have the formula of general allocation or apportionment set out in Section 163 of Revenue Regulations No. 2. The term "including in each case income of a nonshipping character but incidental to the shipping business, such as dividends from investments, interests or deposits," should be limited to incidental income in connection with the service of transportation derived by foreign shipping companies whose vessels touch

> Philippine ports, and which is not income derived in full from sources without the Philippines under Section 37(e) of the Revenue Code. Otherwise, the inclusion of income which is not derived from the service of transportation and which is income from sources clearly without the Philippines in the phrase "world gross income" under the formula of general apportionment set out in Section 163 of the Income Tax Regulations for the purpose of determining Philippine taxable income, as respondent theorizes, will result in the taxation of property or activities beyond the taxing jurisdiction of the Philippines. (Daiichi Chuo Kisen Kaisha vs. Comm. of Int. Rev., CTA Case No. 1277, May 31, 1969.)

The income derived from the sale of the vessels abroad being unquestionably a sale of fixed assets and not being incidental to, and in connection with, the service of transportation, and that said income having been derived fully from sources without the Philippines, such income is, therefore, clearly not included in petitioner's "world gross income" for purposes of the formula prescribed in Section 163 of Revenue Regulations No. 2.

Having reached a conclusion on the second issue adverse to respondent, we deem it unnecessary to consider the third or last issue.

WHEREFORE, the decision appealed from is hereby reversed. Without pronouncement as to costs.

SO ORDERED.

Quezon City, June 28, 1973.

RAMON L. AVANCEÑA
Associate Judge

WE CONCUR:

ROMAN M. UMALI
Presiding Judge

ESTANISLAO R. ALVAREZ
Associate Judge