REPUBLIC OF THE PHILIPPINES
COURT OF TAX APPEALS
QUEZON CITY

LUZON BROKERAGE CORPORATION,
Petitioner,

- versus -

C.T.A. CASE NO. 2005

THE COMMISSIONER OF INTERNAL REVENUE,
Respondent.

x - - - - - - - - - - - - - - x

7/29/74

D E C I S I O N

This is an appeal from a decision of respondent Commissioner of Internal Revenue dated March 20, 1969 assessing petitioner deficiency income tax for 1961 in the amount of ₱64,621.80, inclusive of surcharges, monthly interests, and compromise penalty and denying petitioner's protest against the deficiency assessment.

It appears that petitioner, Luzon Brokerage Corporation, is a corporation formed by the merger of the Luzon Brokerage Company, Inc. and the Philippine Van Service on November 1, 1961. And this case involves a deficiency income tax assessed against the former Luzon Brokerage Company, Inc., before its merger with the Philippine Van Service, into the herein Luzon Brokerage Corporation.

The Luzon Brokerage Co., Inc. was formerly a domestic corporation engaged in the business of transportation, brokerage, warehousing, packing and crating, and superintendence. In the years 1956, 1957 and 1958, there was a steady decline in its business and net earnings; because of this it secured the services of the Columbia Rope Company for the management of its

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business. A management contract was executed by and between the Columbia Rope Company and Luzon Brokerage Co., Inc on December 6, 1958 the pertinent provisions of which are hereunder reproduced:

> 1. LUZON thus hereby engage the services of COLUMBIAN and the latter thus hereby agree to act as the sole and exclusive General Managers of the former;
>
> 2. COLUMBIAN will render all the managerial assistance, general guidance and advices on all areas of management, administrative and company policies of LUZON;
>
> 3. COLUMBIAN shall conduct a review of the financial statements of LUZON and the latter shall furnish all the information required by the former. On the basis of such review, COLUMBIAN shall render monthly reports and/or comments on the financial statements of LUZON for submission to the parent company of COLUMBIAN;
>
> 4. COLUMBIAN shall undertake the typing and finalization of the monthly financial statements prepared by LUZON;
>
> 5. COLUMBIAN shall be entitled by way of remuneration from LUZON for its services under this management contract, a management fee of ₱3,000.00 monthly effective December 1, 1958;
>
> 6. THAT this agreement shall be effective as of December 1, 1958, automatically renewed under the same terms and conditions for another year upon every expiration, unless cancelled or amended in writing by mutual agreement of both parties.

Pursuant to letter of Authority No. 2497 dated January 2, 1963 respondent, through Examiner Claro M. Silva, investigated the Luzon Brokerage Co., Inc. for income tax liability for the year 1961. Thereafter Examiner Silva recommended the disallowance of some

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items claimed as deduction by Luzon Brokerage Co., Inc. in its income tax return for 1961. In view thereof respondent assessed the Luzon Brokerage Co., Inc. the amount of ₱53,626.36 as deficiency income tax for 1961, inclusive of 50% surcharge, and deficiency interest up to July 17, 1964, computed as follows:

ACR-301353-63/61

Net income per return.		₱123,862.27
Add: Unallowable deductions & addt'l income:		
(1) Administrative & General Expenses.	₱49,500.00	
(2) Depreciation, Office Furniture & Fixtures. . .	6,829.81	
(3) Losses, Brokerage Dept. .	20,690.00	
(4) Undeclared Income (Miscellaneous).	13,497.00	
(5) Bad Debts.	18,815.03	109,331.84
Net income per investigation.		₱233,194.11
Tax due thereon.		₱ 61,958.23
Less: Amount already assessed.		29,159.00
B a l a n c e		₱ 32,799.23
Add: 50% surcharge.		16,399.50
1/2% monthly interest from 4-17-62 to 7-17-64.		4,427.86
TOTAL AMOUNT DUE & COLLECTIBLE.		₱ 53,626.36

The assessment was protested by the Luzon Brokerage Co., Inc. in a letter dated September 8, 1964. In a letter dated October 12, 1965, respondent granted the request for reinvestigation conditioned upon the execution of a waiver of the statute of limitation. Luzon Brokerage Co., Inc. submitted the waiver on March 16, 1966. On May 18, 1967, respondent reiterated the demand for the payment of the deficiency income tax for 1961, however raising the amount to ₱64,700.93 computed as follows:

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1961 def. income tax per ACR-301353-63/61.	₱53,626.36
Add: 5% surcharge on ₱32,799.23. .	1,639.96
1% mo. int. on ₱53,626.36 from 7-18-64 to 5-18-67. . .	9,384.61
Compromise for late payment. .	50.00
TOTAL AMOUNT DUE & COLLECTIBLE. .	₱64,700.93

Luzon Brokerage Co., Inc. again protested this assessment in a letter dated July 7, 1967, and requested for further reinvestigation and in compliance with respondent's condition again executed a waiver of the defense of prescription.

On March 20, 1969 respondent rendered his final decision assessing Luzon Brokerage Co., Inc. the sum of ₱74,621.80 as deficiency income tax for 1961, inclusive of 50% surcharge, 5% monthly interest and compromise penalty for late payment, computed as follows:

1961 def. inc. tax (ACR -301353-63/61).	₱53,626.36
Add: 5% surcharge on ₱32,799.23 (basic tax). . .	1,639.96
1% mo. int. on ₱53,626.36 fr. 7-18-64 to 7-1867. . .	19,305.48
Compromise for late payment. .	50.00
TOTAL AMOUNT DUE & COLLECTIBLE. . .	₱74,621.80

As it may be noted the deficiency assessment against the Luzon Brokerage Co., Inc was brought about by the disallowance of the items claimed as deductions by petitioner in its income tax return for 1961.

Respondent disallowed the amount of ₱36,000.00 paid by Luzon Brokerage Co., Inc. in favor of Columbia

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Rope Company pursuant to the management contract. Respondent contends that the amount is a dividend distribution in the guise of a management fee because the Columbia Rope Company, the recipient of the aforesaid amount, is the controlling stockholder of Luzon Brokerage Co., Inc., the expenditure not being ordinary, necessary nor reasonable.

For convenience, Luzon Brokerage Co., Inc. will be referred to herein as LBC and Columbia Rope Co. of the Philippines as CRC.

From the evidence on record it appears that after the management contract in question CRC took charge of the management of LBC, mostly through M. S. Robie, William Pendarvis and John Waldroup, respectively General Manager, Assistant General Manager and Comptroller of CRC. It was through their effort that the company acquired new customers such as Shell Refining, Bataan Refining, Union Carbide, Standard Brands and others. It also appears that CRC secured loans for LBC and attended to its bids in the American Embassy, Clark Air Force, U.S. Veterans Administration and others; that it took charge of legal and accounting matters and labor problems of LBC. BIR Examiner Silva himself admits that CRC rendered "so many services" to LBC.

The profits of LBC for the fiscal year 1955-56 was ₱111,622.45, dropped to ₱71,788.74 in the fiscal year 1956-57 and dipped further to ₱5,128 in the fiscal

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year 1957-58. After the management contract, it rose to ₱41,838.00 in fiscal year 1959-60 and ₱54,703.00 in the 1960-61 fiscal year.

Management contracts between firms are not uncommon in the business world and the very testimony of Examiner Silva confirms this. To say that the contract in question is not ordinary is to lose sight of a practice in the business world. From the deterioration in the profits of LBC one can readily see that in 1958 something had to be done with its management. Any business enterprise suffering a decline of its income will have second thoughts of its management. On the other hand, the rise in the profits of the company shows that the transfer of its management was not in vain. That the compensation was not unreasonable may be gathered from the variety and nature of the task undertaken by CRC which prompted respondent examiner to say that CRC rendered "so many services" to LBC. Again, it appears that when Arturo Tanco, then head of a management firm was asked his price for the management of the company he gave a figure much higher than ₱3,000.00 a month. From all these circumstances it can hardly be questioned that the expenses in question are ordinary, necessary and reasonable. And with this background the most natural conclusion one can draw is that the management contract in question is not a disguised distribution of dividends.

Respondent contends that under Section 44 of the Revenue Code he has the power to allocate gross income or deduction between organizations, trades or business owned or controlled by same interest if such is necessary to prevent evasion of taxes or clearly to reflect the income of such organization. Respondent, however, has not shown that there was such an evasion and neither has he shown that the payment of the management fee prevented the income of the two companies from being reflected clearly. It may well be noted in this connection that Robie, Pendarvis and Waldroup who bore the brunt of the management operation of LBC are not salaried employees or officers of LBC and if they had been, the income of LBC would have been reduced to that extent. Having been saved from paying them individually for their services by entering instead in a management contract with CRC, it can scarcely be said that LBC distorted its net income by paying CRC for management services.

The next item claimed as deduction by LBC is the amount of ₱13,500.00. Of this amount ₱7,500.00 correspond to the audit fee paid to the accounting firm of Sycip, Gorres and Velayo to determine the assets and liabilities of LBC as of June 30, 1961 for purposes of its impending merger with the Philippine Van Service.

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The remaining amount of ₱6,000.00, was paid to Atty. San Luis by LBC as attorney's fees for legal services rendered in the preparation of documents necessary for the merger of LBC and Philippine Van Service. Petitioner contends that the professional fees having been received and paid in connection with its business in 1961, such expense is deductible. Respondent, on one hand, contends that this amount is not deductible as business expense. We find respondent's position to be correct and in this respect suffice it to quote the following authority:

> The deductibility of an expenditure as a business expense is based on the theory that such expenditure is properly part of the cost of operating the business for the year in which it was paid or incurred. If, however, an expenditure is paid or incurred to acquire an asset, the useful life of which is substantially longer than the taxable year, such expenditure is generally treated as being a capital item and not deductible as a business expense. Expenditures for organizing, recapitalizing, merging or dissolving a business enterprise may properly be said to be *sui generis*. On the one hand, none of them can hardly be considered as part of the cost of operating the business for the taxable year in which they were paid or incurred. On the other hand, it is arguable that no capital asset is acquired by the taxpayer which, as a business enterprise, is being organized, recapitalized, merged or dissolved. It is well established, however, *that expenditures in connection with organizing, recapitalizing or merging as business enterprise are generally capital expenditures, and, therefore, not deductible as business expenses*. Such expenditures have been characterized as being "something intangible with an indefinite life." Conversely,

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> expenditures in connection with dissolving or liquidating a business enterprise are generally considered deductible as business expenses. (4 Mertens, Law of Federal Income Taxation, Sec. 25.35; pp. 119-120, 1960 Ed.; Underlining supplied.)

Another amount claimed as deduction is a 20% depreciation on its fixtures, furnitures and office equipments in the total amount of ₱6,829.81. Said rate of depreciation is based on the ground that the equipments were allegedly used almost 12 hours everyday and that the office being in Port Area, Manila, dust and sea breeze easily cause deterioration of the fixtures, furnitures and thus the five years life given to the said machines and equipments is fair and just. Respondent for his part insists on a rate of 10% equivalent to 10 years of life.

The proper rate of depreciation to our mind, is 10% as urged by respondent. This rate is in accordance with the rates of depreciation prescribed in Bulletin "F" of the U.S. Federal Internal Revenue Service which has a strong persuasive effect in this jurisdiction as the same has been the result of long and scientific study. (Limpan Investment Corporation v. Comm. of Int. Rev., G.R. No. L-21570, July 26, 1966.) Moreover the very witness of petitioner admits that some furnitures and equipments in use by the Company are more than 10 years old. On the other hand there is no definite evidence of furnitures and equipments discarded before

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10 years.

The next item is the amount of ₱20,690.00 advanced by Luzon Brokerage Co., Inc. for the Philippine Refining Company as wharfage fees in connection with the latter's importations. Luzon Brokerage Co., Inc. failed to obtain reimbursement from the Philippine Refining Company because the latter claimed that it is not liable for wharfage fee since the goods were unloaded in private piers. Respondent does not dispute the fact that this amount is considered a loss to LBC but contends that same should have been claimed in 1959, the year in which the Philippine Refining Company notified the LBC of its refusal to reimburse same. It appears however that the Philippine Refining Company filed a claim for refund before the Bureau of Customs in 1960 with the understanding that LBC would follow-up the claim and get the refund but same was denied by the Commissioner of Customs in a letter dated December 5, 1960 on the ground that it was filed out of time. It is quite obvious that it was only upon the rejection of said claim that the loss became a close and completed transaction. This is evidently a case where the taxpayer tried to exhaust his remedies to recover the loss as required by law (Plaridel Surety and Insurance Company v. Commissioner of Internal Revenue, G.R. No. L-21520, December 11, 1967).

We now come to the alleged bad debts of ₱18,815.03.

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This amount is composed of three items to wit:

(1) Adjustments in billings . . . . ₱13,019.15
(2) Losses in the delivery of goods. . . . . ₱ 5,124.00
(3) Bad debts. . . . . ₱ 671.88

Adjustments to the "Accounts Receivable" account in the amount of ₱13,019.15 were made by petitioner in its books to correct the said account due to erroneous billings to its customers. The erroneous billings arose from discrepancies in the weight of the cargo as appearing in the shipping manifest and the actual weight of the said cargo as later verified and in some cases from questionable charges which the customers refused to pay.

As a result of these discrepancies, the billings against the customers were reduced, so that in the books of the petitioner, there remained unpaid balances after payments on the reduced billings were made against the accounts receivables entered in the books based on the original billings. These unpaid balances were corrected by petitioner by directly crediting the "Accounts Receivable" account so that these adjustments were not reflected in the financial statement, thus giving rise to respondent's allegations that these were actually bad debts written off.

In his testimony, petitioner's witness, Mr. Castro, explains the procedure of correcting such billings by their issuance of credit memos. However, the investigating examiner claims not to have been shown such

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credit memos but as explained by the witness said documents were destroyed during a typhoon that lashed the LBC office and we are satisfied with this explanation.

The second item in the amount of ₱5,124.00 represents the claim made by the Bureau of Public Schools against petitioner for the cost of milk damaged due to loss and spoilage during its delivery to different public schools in the Philippines. Since petitioner is responsible for the safe delivery of goods, it had to settle the claim for the cost of the damaged milk. This was treated by petitioner in its books by reversing the receivables due from the Bureau in the amount of ₱5,124.00. As these losses in transit were chargeable to petitioner, they should be allowed as proper deductions from gross income.

With respect to the amount of ₱671.88 which purports to represent bad debts it appears that its breakdown was explained by Castro as follows:

> Q. You also mentioned that one other item constituting this bad debts deduction pertains to bad debts proper in the amount of ₱671.88. Now will you kindly refer again to this memorandum marked Exhibit O and cite an example of actual bad debts which was charged by petitioner in 1961?
>
> A. This account of Lim Tuan in the amount of ₱2.61; the next one is the account of S.G. Linusco in the amount of ₱18.00; then J.M. Figueras - ₱13.20; Mr. Dornbosch - the amount is ₱482.57; Essex Enterprises - ₱12.65; Amado Cornejo - ₱12.00; Rufina S. Cruz - ₱31.98; Robert

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Corominas - ₱54.49; B. Basco - ₱38.63; and Desco - ₱5.75.

Petitioner tried to collect the aforesaid credits short of filing actions in Court for collection but could not get payment. Considering the small amounts involved in said credits petitioner was justified in not filing cases for collection which would only entail more expenses with but little prospects of eventual collection (El Porvenir Rubber Products, Inc. v. Comm. of Int. Rev., C.T.A. Cases Nos. 1702 & 1705, July 26, 1969; Coll. of Int. Rev. v. Goodrich International Rubber Co., G.R. No. L-22265, Dec. 22, 1967).

The last item of ₱13,497.00 involves two separate transactions. One refers to a sale on February 1961 by the LBC of three (3) trucks to the Philippine Van Service for ₱7,500.00; the other appears to be an amount of ₱6,000.00 which was a management fee from the Philippine Van Service for the period from January to June, 1961. These credits were not paid by the LBC in view of the merger of said companies. With the merger, LBC transferred all its assets and liabilities to the Philippine Van Service, and the latter acquired all the assets and assumed all the liabilities of LBC and to record same said credits of LBC were reversed in the book entries by debiting the income previously reported and crediting the account of Philippine Van Service. Clearly the said two items cannot be considered as income of LBC for the fiscal year ending October 31, 1961 there having been a confusion or merger of the character of debtor and creditor on October 30 when the merger took effect (Art. 1271, Civil Code of the Philippines).

With respect to 50% fraud penalty imposed by respondent Commissioner of Internal Revenue, we find that same is not supported by sufficient evidence. Fraud is not to be presumed and it is incumbent upon respondent to prove its existence by clear and convincing evidence which is lacking in this case (Collector of Internal Revenue v. Alberto D. Benipayo, G.R. No. L-13656, Jan. 31, 1962; Republic of the Philippines v. Ker & Co., Ltd., G.R. No. L-21609, Sept. 29, 1966).

With respect to the ₱50.00 compromise penalty imposed by respondent, the same cannot be imposed against petitioner without its agreement and conformity. (Coll. of Int. Rev. v. University of Sto. Tomas et al., G.R. Nos. L-11274 and L-11280, Nov. 28, 1958; The Coll. of Int. Rev., v. Bautista, et al., G.R. Nos. L-12250 and L-12259, May 27, 1959; The Phil. Int. Fair, Inc. v. Coll. of Int. Rev., G.R. Nos. L-12928 and L-12932, March 31, 1962.)

On the basis of our findings, petitioner's liability is hereby computed as follows:

Net income per return.		₱123,862.27
Add: Unallowable deductions		
1) Professional fees -	₱13,500.00	
2) Depreciation -	6,829.81	20,329.81

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Net income per investigation	₱144,192.08
Tax due thereon	₱ 35,258.00
Less: Amount already assessed	29,159.00
Balance	₱ 6,099.00
Add ½% monthly interest from 4/17/62 to 7/17/64.	823.36
Deficiency income tax due.	₱ 6,922.36
Add 5% surcharge on ₱6,099.00.	304.95
1% monthly interest on ₱6,922.36 from 7/18/64 to 7/18/67.	2,492.05
Total amount due & collectible	₱ 9,719.36

WHEREFORE, the decision of respondent Commissioner of Internal Revenue appealed from is hereby modified. Petitioner is hereby ordered to pay respondent the sum of ₱9,719.36 as deficiency income tax, inclusive of deficiency interest and surcharges as prescribed in Section 51 (e) of the Tax Code as amended. Without pronouncement as to costs.

SO ORDERED

Quezon City, July 29, 1974.

RAMON L. AVANCEÑA
Associate Judge

WE CONCUR:

ROMAN M. UMALI
Presiding Judge

ESTANISLAO R. ALVAREZ
Associate Judge

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