REPUBLIC OF THE PHILIPPINES
COURT OF TAX APPEALS
QUEZON CITY

AMERICAN EXPRESS INTERNATIONAL, INC.,
Petitioner,

- versus -

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

C.T.A. CASE NO. 5272

Promulgated:

OCT 19 1999

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DECISION

This case involves assessments for alleged deficiency income and branch profit remittance taxes for the calendar year ended December 31, 1991.

The facts are briefly stated as follows:

Petitioner is a Philippine branch of American Express International, Inc. (AMEX, for brevity), a corporation organized and existing under the laws of the State of Delaware, United States of America. It is functioning as a servicing branch of AMEX - Hongkong (TSN, August 22, 1996, p. 25). It has adopted the computerized accounting system of AMEX which is being used by different branches of AMEX worldwide.

On January 16, 1995, petitioner received Assessment Notice Nos. 000048-91-085 and 01-283-91B-94-82-085, both dated February 9, 1995, assessing petitioner for alleged deficiency income and branch profit remittance taxes in the respective amounts of

P51,008,687.81 and P13,091,998.07, inclusive of surcharges and interests, for the calendar year 1991, detailed as follows: (Exhs. E and E-1)

Deficiency Income Tax

Net income per return		P 1,229,301.00
Add unallowable deductions/additional income:		
Unreported paying and service income	P25,103,542.00	
Unreported inter-unit income	44,025,214.19	
Communication expense	6,713,834.37	75,842,591.29
Net income per investigation		P44,071,892.29
Multiply by income tax rate		35%
Income tax due thereon		P26,975,162.00
Less income tax already paid		454,755.00
Deficiency income tax		P26,520,407.00
Add: 25% surcharge	P 6,630,101.75	
Interest	17,858,179.06	24,488,280.81
Total Deficiency Income Tax		P51,008,687.81

Deficiency Branch Profit Remittance Tax

Inter-unit credit remitted to AMEX-Hongkong		P44,025,214.19
Multiply by tax rate		15%
Deficiency tax due thereon		P 6,603,782.13
Add: 25% surcharge	P 1,650,945.53	
Interest	4,837,270.41	6,488,215.94
Total Deficiency Income Tax		P13,091,998.07

On February 15, 1995, petitioner through its external auditor, Punongbayan & Araullo, filed with Revenue Region No. 8, Bureau of Internal Revenue, its protest on the above assessments (Exh. F).

On June 28, 1995, the Chief of the Assessment Division of respondent's Revenue Region No. 8, Ms. Virginia P. Tomas, issued a letter reiterating the original assessments issued against petitioner (instead of their cancellation) due to the latter's non-appearance and non-presentation of evidence at the scheduled conference. Ms. Tomas also directed petitioner to settle the assessed amounts the soonest possible time (Annex C).

Construing the above letter as a denial of its protest, petitioner filed on July 28, 1995, the instant petition for review.

During the trial, both the petitioner and respondent presented and submitted documentary and testimonial evidences. Furthermore, the BIR records of the case were submitted by the respondent pursuant to Section 2, Rule 7 of the Rules of Court of Tax Appeals.

Is petitioner liable to pay the assessed deficiency income and branch profit remittance taxes for the year 1991 in the aggregate amount of P64,100,685.88?

We shall discuss the above assessments individually.

1. Deficiency Income Tax. - P51,008,687.81.

It can be seen from the computation of the revenue examiner that three items were considered in arriving at the deficiency income tax, namely: (Exh. 3, BIR records, p. 110)

Unreported paying and service income	P25,103,542.73
Unreported inter-unit income	44,025,214.19
Communication expense	6,713,834.37
Total	P75,842,591.29

A. Unreported paying and service income.

The unreported paying and service income was arrived at by the Revenue Examiner, Mr. Ignacio B. Ayes Jr., after totaling all the credit entries in the "Accounts

Payable - Service Establishments" account (APSE, for brevity) found in petitioner's general ledger with account code 229 085 229181 242401 (to 242481) 500 (Exhs. D, D-1 to D-109). The examiner is of the opinion that the total credit entries of the APSE should be the correct basis of petitioner's 1% commission since all the charges made by the service establishments based on cardholders' spending are recorded by petitioner under such account. He, therefore, computed the undeclared commission income by multiplying the total amount on the credit side of the APSE by 1% rate and deducted from the result thereof the declared commission income reflected in the financial statements, to wit: (Exh. 3, BIR records, p. 110, *supra*)

I/C Paying & Service Income (Account 229181 248225 471428) per books/financial statements		P25,394,236.65
Less: I/C Paying & Service Income per examination:		
Total credits for the year to account A/P S/E Reg. Air (229 085 229181 242401 500)	P5,049,777,938.26	
Multiply by rate of commission	1%	50,497,779.38
Unreported Paying & Service Income		P25,103,542.73

Petitioner, on the other hand, maintains that the 1% commission should not be based on the total credit entries in the APSE because said credit entries include closing entries using the same APSE account but with a different reference number.

Petitioner further contends that the correct basis of the 1% commission should be the APSE account excluding the closing entries. To include said closing entries would double the amount of the total credits which according to petitioner would be an inaccurate basis for determining the 1% commission.

For purposes of clarity, it is appropriate at this point to describe petitioner's so-called "unique" computerized accounting system as the same is described in the petition, memorandum as well as the testimonies of the witnesses of the petitioner.

When local cardholders of American Express use their cards to purchase items in several service establishments (SE, for brevity), petitioner sets up the Accounts Payable Service Establishments (APSE, for brevity) where the billings of the service establishments based on card members' spending are recorded. This data comes from information relayed to petitioner by AMEX – Hongkong. Based on this report, petitioner will now recognize a liability to the SE for the charges incurred by card members. An accounting entry will now be made in the books of accounts of petitioner, thus:

	Debit	Credit
Inter-company Accounts Receivable-Hongkong	xxx	
APSE J-91303		xxx

The aforementioned accounting entry will be accompanied by a reference number which pertains to the date when the card members incurred charges with the SE. As a servicing unit of AMEX – Hongkong, petitioner will now issue checks in favor of these SE's in payment of the billings. Again, another entry will be made to record the payments of petitioner to the SE and this is done by debiting the APSE account and crediting the cash account, this time the reference number of the APSE account is the check date.

According to petitioner, since the reference number in setting up the APSE account (which was the first step described earlier) is different from the reference number used in recording the payment to the service establishments, their computerized accounting system will not recognize the debit to the account as settlement of the previous credit, hence even if the SE has already been paid, the accounting system will still report that it has an outstanding liability to the SE. Because of this set-up, petitioner saw a need to prepare a third entry in its general journal at the end of the period. This third entry closes the original credit and subsequent debit to the account and this is called the closing entry.

It is the observation of petitioner that the computation made by the revenue examiner of its 1% commission income included these aforementioned closing entries resulting in the assessed income tax liability of P25,103,542.00.

We find for the petitioner.

An analysis of the computation done by the revenue examiner of petitioner's deficiency income tax due to unreported paying and service income reveals that indeed the inclusion of these closing entries would result in an inaccurate basis of the 1% commission income. So the task of this Court was to exclude the credit entries pertaining to closing entries to be able to arrive at a more accurate basis for petitioner's 1% commission income. In accomplishing this task, it was important to determine which credit entries are closing entries. In the course of studying the records of this case, it was found that petitioner was able to establish that credit entries using check dates as reference numbers refer to closing entries, thus should be excluded in the computation.

However, after excluding all the credit entries in the APSE account with reference number of check dates, this Court found out that petitioner still has an undeclared income of P5,863,380.04, computed as follows:

Month (1991)	Summation of CR Entries per General Ledger	Less CR Entries With With Reference No. of Check Date	Basis of 1% Commission Income
January	P 153,392,554.73	P -	P 153,392,554.73
February	153,846,143.68	-	153,846,143.68
March	750,359,481.73	587,231,763.65	163,127,718.08
April	485,096,360.02	243,109,119.90	241,987,240.12
May	549,076,993.49	150,148,908.52	398,928,084.97
June	494,692,923.42	198,967,155.60	295,725,767.82
July	454,074,074.97	151,386,226.38	302,687,848.59
August	411,824,116.86	147,202,230.00	264,621,886.86
September	204,100,665.59	-	204,100,665.59
October	555,917,839.52	293,637,925.69	262,279,913.83
November	400,654,168.70	1,435,676.83	399,218,491.87
December	436,742,615.55	150,897,262.87	285,845,352.68
Total	P5,049,777,938.26	P1,924,016,269.44	P3,125,761,668.82
Multiply by commission rate			1%
Commission income			P 31,257,616.69
Less commission income declared (428225)			25,394,236.65
Unreported Paying & Service Income			P 5,863,380.04

Therefore, the unreported paying & service income in the amount of P5,863,380.04 is now a valid basis for deficiency income tax.

B. Unreported Inter-Unit Income

The unreported inter-unit income in the amount of P44,025,214.19 was arrived at by the Revenue Examiner from the credit balance of the account name "I/C CR FRM OTHER" with account code 98889 as reflected in petitioner's computerized printout of trial balance (Exh. 5, BIR records, p. 30). This amount according to the examiner, upon inquiry from Ms. Jeanne Gallardo, Director, Finance & Planning Department of petitioner, represents renewal of annual card fees which are $65.00 for green cardholders and $150.00 for gold cardholders. These annual fees were not reported by petitioner as income from the Philippines and were already remitted to AMEX-Hongkong in the guise of an expense. Hence, a basis for deficiency income tax and a corresponding deficiency for branch profit remittance tax (Exh. 3, BIR records, p. 110, *supra*; TSN, February 23, 1998, pp. 17 - 19).

However, petitioner has a different explanation about this account. According to petitioner's witness, Mr. Rodel Lumbo[1], the "Inter-Company Credit From Others" is a reimbursement of expenses incurred by petitioner in behalf of Hongkong branch. This statement of Mr. Lumbo is further supported and clarified by another petitioner's witness, Ms. Lilian Santos Linsangan, Audit Partner of Punongbayan and Araullo, the auditing firm who examined the financial statements of petitioner for the year 1991. She testified that the "Inter-Company Credit From Others" is a contra expense account which means a deduction from expense. Ms. Linsangan described this account in this manner:

> Q. Describe briefly the nature of this account when you say contra account?
>
> A. Since American Express, Philippine branch is rendering services from other co-centers of American Express. They incur expenses that are chargeable to other co-centers. And what they do is, when they incurred expenses, they record it at gross. And then, they charged out, meaning they seek

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[1] Manager of Accounting and Business Planning Department of AMEX-Philippines.

reimbursement from other co-centers. And they credit the amount charged out to other co-centers to a contra account. Like the inter-company credit others that you have shown me. So, at the end of the month of any reporting period, the balance of contra account is set off against the balance of the expense.

Q. Is this recording according to general accounting principles?

A. Yes.

Q Is the amount being reimbursed by the co-centers from Hongkong, is this considered as a branch profit remittance?

A. No. That is a charged out, a reimbursement. There is no cash outflow, so, there is no remittance. (TSN, February 6, 1997, pp. 22 - 24)

To further support the above testimonies, petitioner presented in evidence an example of how it recorded the expenses incurred in behalf of other cost centers (Exhs. I, I-1 to I-12).

An analysis of these documents discloses that the expenses recorded under the account "I/C CR FRM OTHERS" were expenses not of petitioner but of other cost centers outside the Philippines.

It should be emphasized that petitioner has no control over what account name should be used in recording a transaction. The account titles having been taken from AMEX - USA are not very descriptive of the transaction that have taken place. Thus, petitioner gives more emphasis on account code rather than on the account name.

The testimony of Mr. Ignacio Ayes, the revenue examiner of the BIR, during the hearing held on February 23, 1998, is revealing, to quote:

Q. Now Mr. Witness, you also mentioned that there is unreported inter-unit income of P44,025,214.19, will you also give us the details of this assessment, Mr. Witness?

A. Yes, sir. I considered this as unreported income in our report because during the examination, when I inquired from the branch manager of AMEX, Philippine branch, Ms. Jeanne Gallardo about the payment of renewal of the cardholders which is amounting to 65 dollars and 120 dollars, respectively for green cards and gold cards where they have logs this amount of renewals. And I was informed by Ms. Gallardo that they log this amount under this account, income from others. Since it is found out in our analysis that this income from others which comes from renewals of credit cards did not come into the recognition of the Philippine reportable income. So, I assess them recognizing that this is an income reportable for income tax purposes.

Q. But the petitioner, Mr. Witness, contended that these are reimbursements thru service establishments?

A. I was not able to encounter this because I was not informed by Ms. Gallardo or anybody else in the staff.

Q. With respect to your investigation, Mr. Witness, can you affirm if this is actually a reimbursement as claim by the petitioner?

A. I cannot say whether it is a reimbursement what I can say is that, it is an income as reflected in their financial print out, computer print out.

Q. Is that computer print out part of the records of this case, Mr. Witness?

A. Yes, sir. It is on page 30 of our report. (TSN, February 23, 1998, pp. 18 - 19; underlining supplied).

It can be gleaned from the aforequoted testimony of Mr. Ayes that he did not consider the unique feature of this particular accounting method in conducting his examination. Furthermore, Mr. Ayes based his conclusion, that account number 98889 is an income account, from certain statements made by Ms. Jeanne Gallardo, Director of the Finance and Planning Department of petitioner, and from mere computer printouts of petitioner's general ledger accounts. We find all of these to be flimsy bases for such a conclusion in the absence of a document that will prove that the account "I/C CR FRM OTHERS" pertains to annual fees received from the card members.

The testimony of Mr. Ayes whose affirmations are based on statements that have been made to him by Ms. Gallardo, without his being able to affirm that he had personal knowledge of the facts set forth in his testimony, is undoubtedly hearsay evidence (**Aldecor & Co. vs. Warner Barnes & Co., 30 Phil. 153; cited in Rules of Court in the Philppines, Vol. IV, Martin, p. 297**). In order to stand the test of judicial scrutiny, the assessment must be based on actual facts. The presumption of correctness of assessment being a mere presumption cannot be made to rest on another presumption (**Collector of Internal Revenue vs. Benipayo, G.R. No. L-13656, January 31, 1962; cited in Commissioner of Internal Revenue vs. Island Garment Corporation and The Court of Tax Appeals, G.R. No. L-46644, September 11, 1987**). Therefore, the unreported inter-unit income in the amount of P44,025,214.19 should be disregarded.

C. Communication Expense

The revenue examiner disallowed a portion of the "Communication Expense" pertaining to "Telephone and Telegraph Special Purchase of Communication Equipment" for failure of petitioner to present receipts supporting such expense in the sum of

P6,713,834.37 (Exh. 3, BIR records, p. 110, *supra*; see also pp. 36-37 of the same record). Petitioner, on the other hand, was of the mistaken notion that the reason for respondent's disallowance of such an expense is because these should be capitalized (TSN, August 22, 1996, pp. 19 - 21).

An analysis of records of the case reveals that "Telephone and Telegraph Special Purchase of Communication Equipment" with account code of 952505 is a communication expense incurred by petitioner for the usage of AMEX computerized system that is reimbursed by or charged out to AMEX-Hongkong (Exhs. J-1 to J-43). Petitioner's witness, Mr. Lumbo, further explained this account in this manner:

> Q. Why are you protesting this assessment for disallowance of the communications expense amounting to P6,713,834.37?
>
> A. Because this expense pertains to the share of American Express International, Inc., - Philippine Branch of the total CPU charges of American Express as a whole.
>
> Our Central Processing Unit, like the general ledger, process the cardmembers' data. We examined the data in Phoenix, Arizona, U.S.A. There is only one system being used and for that share of Philippine branch it is being allocated based on the total number of hours used or usage. So this expense which is being charged to us by the Phoenix American Express Branch is booked into this account which is the Account No 952505 telephone and telegraph credit authorization book (TSN, August 22, 1996, p. 9).

The Court finds it immaterial to discuss whether or not the account telephone and telegraph is a capital expenditure or not because the examiner only disallowed this expense due to lack of supporting receipts. We find it also of less importance to discuss how petitioner recorded this kind of expense in its books of accounts. What We believe to be of great significance is petitioner's presentation of evidence that will establish the charges of AMEX to its Philippine branch for the number of hours its computerized system was used.

Based on the documents submitted, petitioner failed to prove that the amount of P6,713,834.17 represents charges of AMEX-USA for the number of hours it used the computerized system. The evidences presented by petitioner lead Us to conclude that all the charges of AMEX-USA to petitioner are being charged out to the Hongkong branch. This is clearly manifested in Exhibits J-13 to J-16 and I-4 to I-8 where it is shown that all expenses incurred by the cost centers 501 and 518 are totally being charged out to AMEX-Hongkong (Exhs. I-9). If this is the case then, petitioner will be left with no expense for account no. 952505 pertaining to the account name the "Telephone and Telegraph Special Purchase of Communication Equipment". This is contrary to the statement of petitioner that the amount of P6,713,834.17, forming part of P11,363,691.00 reflected in the financial statements, represents the balance of communication expense chargeable to Philippine branch.

Therefore, in the absence of supporting documents or receipts that will prove that the amount of P6,713,834.17 represents communication charges of AMEX – USA to petitioner, the same should be disallowed as an expense.

2. Deficiency Branch Profit Remittance Tax. P13,091,998.07.

Petitioner was also assessed for deficiency branch profit remittance tax in the amount of P13,091,998.07. The basis of this assessment according to respondent is petitioner's failure to report as income the annual fees charged to card members in the total amount of P44,025,214.19 but was already remitted to AMEX-Hongkong in the guise of an expense (Exh. 4, BIR records, p. 109).

It should be noted that the basis of this assessment is also the basis of respondent in assessing petitioner for undeclared income in the amount of P44,025,214.19 pertaining to alleged unreported inter-unit income (see letter B of discussion). Since We already ruled that the examiner's mere reliance on the statement of petitioner's "branch manager", Ms. Gallardo, is inadmissible, the assessment for deficiency branch profit remittance tax should also be cancelled.

In conclusion, petitioner is still liable to pay for deficiency income tax in the amount of P5,471,906.74, computed as follows:

Net income per return		P 1,229,301.00
Add additional income/unallowable deductions:		
Unreported paying and service income	P5,863,380.04	
Communication expense	6,713,834.37	12,577,214.41
Net income per Courts' computation		P13,806,515.41
Multiply by income tax rate		35%
Income tax due thereon		P 4,832,280.39
Less income tax already paid		454,755.00
Deficiency income tax		P 4,377,525.39
Add: 25% surcharge		1,094,381.35
Total Deficiency Income Tax		P 5,471,906.74

WHEREFORE, in view of the foregoing, petitioner is hereby **ORDERED** to **PAY** the sum of P5,471,906.74 representing deficiency income tax, inclusive of 25% surcharge, plus 20% interest per annum from April 15, 1992 until fully paid pursuant to

Section 249(b) of the Tax Code, as amended. However, respondent is hereby **ORDERED** to **CANCEL** the assessment for deficiency branch profit remittance tax issued against petitioner.

SO ORDERED.

ERNESTO D. ACOSTA
Presiding Judge

WE CONCUR:

RAMON O. DE VEYRA
Associate Judge

AMANCIO Q. SAGA
Associate Judge

CERTIFICATION

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

ERNESTO D. ACOSTA
Presiding Judge