REPUBLIC OF THE PHILIPPINES
COURT OF TAX APPEALS
MANILA

KUENZLE & STREIFF, INC.,
Petitioner,

- versus -

C.T.A. CASE NO. 169

July 18, 1956

THE COLLECTOR OF INTERNAL REVENUE,
Respondent.

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D E C I S I O N

This case had its origin in respondent's disallowance of alleged excessive deductions claimed in petitioner's income tax returns for 1950, 1951 and 1952 of items representing bonuses paid to non-resident officers-stockholders, bonus participation of certain resident employees and interest on earned but unpaid salaries and bonuses.

Petitioner Kuenzle & Streiff, Inc., is a domestic corporation engaged in the importation of textiles, hardware, sundries, chemicals, pharmaceuticals, lumber, groceries, wines and liquor; in insurance and lumber; and in some exports. In its income tax returns for the years 1950, 1951 and 1952, it deducted from its gross income certain items representing salaries, directors' fees and bonuses of its non-resident president and vice-president stockholders; bonuses of some of its resident officials and employees; and interests on earned but unpaid salaries and bonuses of its officers and employees. The income taxes computed in accordance with these returns were correspondingly paid.

On July 2, 1953, after disallowing the deductions of the items representing directors' fees, salaries and bonuses of its non-resident president and vice-president stockholders; bonus participation of certain resident officials and employees; and interests on earned but unpaid salaries and bonus, respondent assessed and demanded from petitioner the payment of deficiency income taxes in the sums of ₱26,370.00, ₱53,865.00 and ₱44,412.00, for the years in question, respectively. Petitioner requested for the re-examination of this assessment, and on June 8, 1955, respondent modified the same by allowing as deductible all items comprising directors' fees and salaries of the non-resident president and vice-president stockholders; disallowing the bonuses insofar as they exceed the salaries of the recipients; and totally disallowing the interests. For the years 1950, 1951 and 1952, respondent therefore demanded as deficiency income taxes the amounts of ₱10,147.00, ₱26,783.00 and ₱20,481.00, respectively. Hence, this appeal, which was submitted in a stipulation of facts with the corresponding correction of the amount in controversy.

The law involved is Section 30 (a) (1) and (b) (1) of the National Internal Revenue Code, the pertinent provisions of which follow:

> "Sec. 30. Deductions from gross income. - In computing net income there shall be allowed as deductions -
>
> "(a) Expenses:

"(1) In general. - 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; x x x x

x x x

"(b) Interest:

"(1) In general. - The amount of interest paid within the taxable year on indebtedness, except on indebtedness incurred or continued to purchase or carry obligations the interest upon which is exempt from taxation as income under this Title."

Relative to the bonuses, petitioner contends that the same, when added to the salaries, constitute reasonable compensation for the services of the recipient-officers and should therefore be regarded as "ordinary and necessary expenses" within the meaning of the law. Maintaining otherwise, respondent disallowed the bonuses insofar as they exceeded the salaries, which brings us to the question whether or not on the basis of the findings of facts, the amounts paid by petitioner as salaries and bonuses can all be allowed as reasonable compensation for the services actually rendered by the recipients.

Admittedly, an employer is accorded a substantial amount of discretion in determining and fixing what is a reasonable compensation. It is equally settled that the Collector of Internal Revenue and the courts should not unreasonably encroach upon a due exercise of this discretion. Like salaries, "bonuses to employees made in good faith and as additional compensation for services actually rendered by employees are deductible, provided such payments, when added to the stipulated salaries, do not exceed a reasonable compensation for the services rendered x x x ." (Mertens, Law of Federal Income Taxation, Vol. 4, Sec. 25.50, Page 410). However, when the employer claims deductions for bonuses distributed to his employees, the burden of proving the reasonableness of the bonuses is cast upon him. Just what is reasonable is not defined and delineated by law. There is no fixed and fixable yardstick for determining what is reasonable and what is not. Each case will therefore have to turn on its own facts.

Fortunately, the provisions of our revenue laws on this matter were merely imported and lifted from similar provisions of the United States Federal Income Tax Law and of the regulations issued in connection therewith. Consequently, it would be proper to resort to decisions of American courts for guidance and enlightenment on the subject.

Commenting on the tests that determine whether or not a particular salary or compensation is reasonable, Mertens says by quoting American decisions that:

> " x x x There are various tests which have been commonly applied in determining the reasonableness of the particular salary or compensation, such as the ratio of the particular salary and the aggregate salaries to gross income, the size of the particular business, the extent and scope of the employees' work, the employees' qualifications and contributions to the business venture, amount

of salaries paid to the particular employee in prior years, general economic conditions, prevailing salaries paid to employees performing similar services in a comparable enterprise, the availability of others to fill the office held by the particular employee, and salary policy of the corporation to all employees. x x x ") (Mertens, Law of Federal Income Taxation, Vol. 4, Sec. 25.51, page 412.)

We shall adopt these tests in the case at bar.

In justification of the bonuses in question, petitioner points to its varied business operations, its yearly gross and net incomes, the many years of the recipients' services, and its payment of cash dividends during the years under consideration.

For a clearer appreciation and better determination of whether or not the bonuses are reasonable, we hereby reproduce the amounts of bonuses and salaries of the recipient-officials, as appearing in paragraph 15, pages 11 and 12 of the Stipulation of Facts.

1950

	Yearly Salary	Bonus	Total
A. P. Kuenzle	₱ 6,000.00	₱ 8,000.00	₱14,000.00
H. A. Streiff	6,000.00	8,000.00	14,000.00
A. Jung	15,066.67	42,000.00	57,066.67
J. Cattaneo	14,400.00	17,000.00	31,400.00
H. Rieth	16,800.00	17,000.00	33,800.00
A. Schatzmann	13,066.67	17,000.00	30,066.67
F. E. Rein	13,756.67	17,000.00	30,756.67

M. Klingler	₱13,863.33	₱17,000.00	₱30,683.33
A. Huber	12,850.00	17,000.00	29,850.00
S. Meili	11,793.33	14,500.00	26,293.33
M. Triaca	14,400.00	17,000.00	31,400.00

1951

	Yearly Salary	Bonus	Total
A. P. Kuenzle	₱ 6,000.00	₱ 8,000.00	₱14,000.00
M. A. Streiff	6,000.00	8,000.00	14,000.00
A. Jung	13,800.00	42,000.00	55,800.00
J. Cattaneo	9,993.33	20,000.00	29,993.33
M. Rieth	-.--	-.--	-.--
A. Schatzmann	11,400.00	20,000.00	31,400.00
F. E. Rein	12,050.00	22,000.00	34,050.00
M. Klingler	11,850.00	20,000.00	31,850.00
A. Huber	12,000.00	22,000.00	34,000.00
S. Meili	9,000.00	17,500.00	26,500.00
M. Triaca	11,850.00	20,000.00	31,850.00

1952

	Yearly Salary	Bonus	Total
A. P. Kuenzle	₱ 6,000.00	₱ 7,600.00	₱13,600.00
M. A. Streiff	6,000.00	7,600.00	13,600.00
A. Jung	13,800.00	41,800.00	55,600.00
J. Cattaneo	11,400.00	19,000.00	30,400.00
M. Rieth	-.--	-.--	-.--
A. Schatzmann	11,400.00	19,000.00	30,400.00
F. E. Rein	12,600.00	20,900.00	33,500.00
M. Klingler	12,175.00	19,000.00	31,175.00

A. Huber	₱12,000.00	₱20,900.00	₱32,900.00
S. Meili	9,000.00	16,600.00	25,600.00
M. Triaca	12,000.00	19,000.00	31,000.00

As reflected in its income tax returns, the gross income of petitioner for the taxable years 1950, 1951 and 1952 was ₱1,836,984.04, ₱937,832.08 and ₱51,018.65, respectively. During the same years, its net income was ₱850,273.11, ₱211,195.97 and ₱51,018.65. The recipients-officials have been serving petitioner since before the last war. Petitioner also paid cash dividends amounting to 30% in 1950, 30% in 1951, and 21% in 1952.

It equally appears that with the exception of A. P. Kuenzle, H. A. Streiff and A. Jung, who are the president, vice-president, and treasurer and general manager, respectively, the other recipients-officials are either department or branch managers of petitioner. Kuenzle and Streiff resided in Switzerland during the years in question. They determined the policy of petitioner-corporation through directives. They have also other businesses in Zurich and New York.

The amount of time spent in the business is a factor in determining the reasonableness of the compensation. While it is true that a large compensation may be justified even for a part time attention and dedication to the business where the service is exceptionally valuable, yet, in the case at bar, petitioner did not make any showing of the exceptional value of the services of A. P. Kuenzle and M. A. Streiff. The fact that they are the president and the vice-president, respectively, of petitioner and issued policy-making directives, does not necessarily attest to the exceptional value of their services.

In the taxable year 1950, the bonuses ranged from 133.33% to 278.76% of the corresponding salaries of the recipients-officials during the same year; in 1951, from 133.33% to 304.24%; and in 1952, from 126.66% to 302.89%. In the taxable year 1950, such bonuses represented 10.424% of petitioner's gross income as reflected in its income tax return for the same year; 1951, 21.274%; and in 1952, 24.724%. In 1950, they constituted 22.522% of the net income of petitioner as reflected in its income tax return for the same year; in 1951, 94.4620%; and in 1952, 375.56%.

The bonuses and salaries during the taxable year 1950 amounted to 17.927% of petitioner's gross income as reflected in its income tax return for the same year; during the taxable year 1951, 32.3557%; and during the taxable year 1952, 38.465%. In 1950, they equalled 38.730% of petitioner's net income as reported in its income tax return for the same year; in 1951, 143.6785%; and in 1952, 583.66%.

With the resulting mathematical ratios of the bonuses to the gross and net incomes of petitioner-corporation during the years 1950, 1951 and 1952, the enormity of said bonuses is readily and clearly appreciated.

The giving of the bonuses in question was not authorized by petitioner's board of directors, but, by its president and vice-president. "Salaries informally provided for are naturally open to greater scrutiny than those which are fixed by formal action of the board of directors." (Mertens, Law of Federal Income Taxation, Vol. 4, sec. 25.61, p. 424). We believe that, in the same manner, the bonuses in the instant case invite greater scrutiny.

Except that the recipients of the bonuses are occupying the positions of president, vice-president, and managers, the first two being non-resident executives who ran the affairs of petitioner by directives and casual inspections, and the suggestion, in general terms, of the functions and responsibilities attached respectively to these different positions, the record of the case does not show the nature or extent of the services actually rendered by these officers either as directors, executives, department managers or branch managers. Neither is there any showing as to their qualifications, their contributions to the business venture of petitioner, the amounts of salaries and bonuses they received prior to the years in question, the prevailing salaries and bonuses paid to employees performing similar services in comparable enterprises, the availability or non-availability of others to fill the offices held by them and the salary policy of petitioner as to all its employees. While it is true that salaries should bear some relation to the size and complexities of the business, the profits realized, as well as the general economic conditions of the country, this Court was not furnished with the necessary basis from which it can determine the reasonableness of the purported compensation. It needs hardly necessary to add that excessive, extraordinary and unusual amounts paid by a corporation to a few of its officers in the guise and form of bonuses, in addition to their salaries, with little or no substantial reference to the scope of their actual services except certain connection with the corporation and which are not commensurate to their value, are not in reality reasonable allowances for salaries or other compensation for personal services actually rendered and should not be regarded as ordinary and necessary expenses within the meaning of section 30 (a), (1), supra, of the Tax Code.

As petitioner has not sustained the burden of showing that the amounts disallowed by respondent were in fact parts of its ordinary and necessary expenses, we therefore find no reason for disturbing the findings and conclusion of the latter that the bonuses paid by the former to its officers in excess of their annual salary rates are unreasonable.

Coming to the question of the interest, it is the contention of petitioner that this interest, having been paid on unpaid salaries and bonuses, is deductible from the gross income. On the other hand, respondent maintains that unpaid salaries and bonuses not being indebtedness within the meaning of the law, the interest is not an allowable deduction.

Under the facts of the case, we are constrained to agree with respondent that interest on the unpaid salaries and bonuses is not interest on indebtedness within the contemplation of Section 30 (b) (1), supra, of the Tax Code. The statutory term "interest on indebtedness" is not all-embracing. It does not mean interest on any obligation of whatever nature. It "means compensation for the use or forbearance of money, and it is the usual and everyday meaning of the term that Congress is deemed to have employed". (Mertens, Law of Federal Income Taxation, Vol. 4, Sec. 26.09, p. 550, citing Deputy v. Pierre S. du Pont, et al., Adm'rs, 308 U. S. 488, 84 L Ed 416, 60 S. Ct. 363 (1940), rev'g 103 F. (2d) 257 (CCA 3rd, 1939), which rev'd 22 F. Supp. 589 (1933).

The record of the case does not show whether the earned but unpaid salaries and bonuses on which the alleged interest in question was paid were made available for withdrawal at the convenience of the employees from the time they were due but such employees only failed to claim them. However this may be so, in the light of the evidence with regards to the stable financial condition of petitioner and the general principle that deductions are a matter of legislative grace which should be strictly construed against the taxpayer, it seems clear that an indebtedness on which the interest paid thereon is deductible within the meaning of Section 30 (b) (1), supra, is not created if earned salaries and bonuses are merely not paid or claimed at the time they are placed at the disposal of the recipients. The term "interest" as used by the law should be understood in its usual import, and it does not appear to us that the interest in question had been contracted by petitioner for the use or forbearance of money borrowed from its employees. While it is true that as a general rule delay in the fulfillment of an obligation which consists in the payment of a sum of money carries with it the payment of interest, the debtor-creditor relationship for the purpose of the forbearance or use of money between petitioner and its employees has not been duly established. Consequently, the unpaid salaries and bonuses not being an existing indebtedness which gave rise to an interest charge, the interest paid on them is not therefore a proper deduction.

Anent petitioner's contention that the right of respondent to assess and collect through summary administrative methods the deficiency taxes for the years 1950, 1951 and 1952 has already prescribed, suffice it to say that respondent has not yet taken any action to prosecute the assessment and collection through administrative proceedings.

IN VIEW OF THE FOREGOING, the decision appealed from is hereby affirmed with the modification as regards the amount of tax, so that petitioner Kuenzle & Streiff

Inc., should pay respondent Collector of Internal Revenue the sums of ₱9,209.89, ₱26,783.00 and ₱19,920.52 as deficiency income taxes for the taxable years 1950, 1951 and 1952, respectively, as computed on the basis of the stipulation of facts submitted by the parties. No special pronouncement as to costs.

SO ORDERED.

Manila, Philippines, July 18, 1956.

MARIANO NABLE
Presiding Judge

WE CONCUR:

AUGUSTO M. LUCIANO
Associate Judge

ROMAN M. UMALI
Associate Judge