REPUBLIC OF THE PHILIPPINES
COURT OF TAX APPEALS
QUEZON CITY

PHILIPPINE FIBER PROCESSING CO.,
Petitioner,

-versus- C.T.A. CASE NO. 1407

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

x- - - - - - - - - - - - - - - -x Aug. 29, 1966

D E C I S I O N

This is an appeal from the decision of respondent holding petitioner liable for deficiency income tax and interest for 1959, 1960 and 1961 in the total amount of ₱86,497.06, computed as follows:

ACR-400388-62/59

Net income per return		₱177,307.64
Add: Unallowable deduction & additional income:		
1. Bad Debts written off	₱72,299.07	
2. Interest income from Financing Corp. of the Phil..	7,358.66	79,657.73
Net income per investigation		₱256,965.37
Tax Due thereon		₱ 69,090.00
Less: Amount already assessed		45,192.00
Balance		₱ 23,898.00
Add: 1/2% monthly interest from 4-19-60 to 4-19-63		4,301.64
TOTAL AMOUNT DUE & COLLECTIBLE		₱ 28,199.64

ACR-400831-62/60

Net income per return	₱305,609.90
Add: Additional income:	
1. Interest income from Financing Corporation of the Philippines	5,333.70

Net income per investigation	₱310,943.60
Tax due thereon	₱ 85,283.00
Less: Amount already assessed	83,682.00
Balance	₱ 1,601.00
Add: ½% monthly interest from 4-18-61 to 5-29-63	203.04
TOTAL AMOUNT DUE & COLLECTIBLE	₱ 1,804.04

ACR-402289-62/61

Net loss per return		(₱175,591.90)
Add: Unallowable deductions & additional income:		
1. Commission expenses condoned by PNB	₱348,997.72	
2. Representation expenses	24,000.00	
3. Interest income from Financing Corp. of the Philippines	5,748.01	378,745.73
Net income per investigation		₱203,153.83
Tax due thereon		₱ 52,946.00
Add: ½% monthly interest from 4-17-62 to 5-29-63		3,547.38
TOTAL AMOUNT DUE & COLLECTIBLE		₱ 56,493.38

Petitioner is a domestic corporation engaged in the manufacture of jute bags and jute sacks (Exh. 1, p. 91, BIR rec.) with main office at the Araneta Enterprises Bldg., Cubao, Quezon City, while its factory is situated at Maao, Bago, Negros Occidental (Exh. 1, pp. 86-91, BIR rec.). In 1959 and 1960, petitioner declared in its income tax returns a net income of ₱177,307.64 and ₱305,609.90, respectively, while in 1961 it declared a loss of ₱175,591.90 (Exhs. L, M and D, pp. 32, 47 and 59, BIR rec.). However, upon investigation conducted by revenue examiners, it was found that the following items are not deductible or excludable from petitioner's gross income, namely:

(1) The commission expenses of ₱348,997.72 condoned by the Philippine National Bank in 1961;

(2) Bad debts of ₱72,299.07 written off in 1959;

(3) Unreported interest income from the Financing Corporation of the Philippines:

1959	₱7,358.66
1960	5,333.70
1961	5,748.01

(4) Representation expenses of ₱24,000.00 in 1961.

On May 29, 1963, respondent assessed against and demanded upon petitioner payment of the total sum of ₱86,497.06, _supra_ (Exhs. 5 and 4, pp. 122-128, BIR rec.). In the trial of this case, petitioner's counsel conceded that the representation expenses of ₱24,000.00 is not deductible from petitioner's gross income in 1961 (pp. 68-69, t.s.n.). Hence, the exclusion thereof in the discussion of the contested assessment under review.

The controversial issues submitted by the parties to this Court for resolution are the following:

(1) Whether or not the commission expenses of ₱348,997.72 incurred by petitioner for prior years, but which were condoned by the Philippine National Bank in 1961, constitute "income derived from any source whatever" under Section 29 of the National Internal Revenue Code;

(2) Whether or not respondent is justified in disallowing the deduction from petitioner's gross income in 1959 the amount of bad debts written off in the same year; and

(3) Whether or not petitioner has unreported interest income from the Financing Corporation of the Philippines for 1959, 1960 and 1961 in the amounts above-stated.

First Issue

Respondent has determined that petitioner is indebted to the Philippine National Bank in the total sum of ₱475,902.13 covering the years 1955 to 1960 for services rendered by the said bank for various trade acceptances wherein the bank charged 1% commission to the petitioner (Exh. O, p. 57, CTA rec.; pp. 21-22, t.s.n.). The said indebtedness of ₱475,902.13 was condoned or cancelled by the bank under its Resolution No. 1476 dated November 29, 1961, in relation to Resolution No. 825 of the same bank dated December 19, 1955, thereby reducing petitioner's principal obligation in the total sum of ₱2,549,481.07 to ₱2,200,000.00 (Exhs. A and B, pp. 27-31, CTA rec.).

In its 1961 income tax return (Exh. D, pp. 54-59, BIR rec.), petitioner declared ₱126,904.41 as part of its "gross income from other sources" but failed to declare as part of its income for the said year the balance of the condoned indebtedness in the sum of ₱348,997.72 (₱475,902.133 less ₱126,904.41). Consequently, the investigating revenue examiners considered the said amount of ₱348,997.72 as part of the 1961 gross income of petitioner, in line with the provisions of Revenue Regulations No. 2, otherwise known as the Income Tax Regulations, which read as follows:

> "SEC. 50. Forgiveness of indebtedness. - The cancellation and forgiveness of indebtedness may amount to a payment of income, to a gift, or to a capital transaction, dependent upon the circumstances. If, for example, an individual performs services for a creditor, who, in consideration thereof cancels the debt, income to that amount is realized by the debtor as compensation for his services. If, however, a creditor merely desires to benefit a debtor and without any consideration therefor cancels the debt, the amount of the debt is a gift from the creditor to the debtor and need not be included in the latter's gross income. If a corporation to which a stockholder is indebted forgives the debt, the transaction has the effect of the payment of a dividend." (Promulgated Feb. 11, 1941, 39 O.G. 18, p. 325.)

Under the provisions of the foregoing income tax regulations, the cancellation and forgiveness of indebtedness constitute an income, a gift, or a payment of dividend depending upon the circumstances of a particular case. In the case at bar, we do not consider that the amount of ₱348,997.72 is a gift of the Philippine National Bank to the petitioner. It is highly unlikely that a bank would intend to make a gift to one of its borrowers (Bradford v. Commissioner of Internal Revenue, 22 T. C. 1074, citing as Cf. Noel v. Parrot [C. A. 4] 15 Fed. 2d. 669, certiorari denied 273 U. S. 754). Moreover, the remission or condonation of petitioner's indebtedness is not without any consideration because the condonation or cancellation of the said indebtedness of petitioner, which was granted by the Philippine National Bank, is subject to the condition "that the condonation and plan of payment herein authorized shall take effect only after the applicant shall have paid in full the amount of ₱349,481.07" (Exh. A-1, p. 28, CTA rec.) and "that the applicant be required to pay ₱356,470.63, plus such amount as is sufficient to reduce the aforesaid amount of ₱2,200,000.00" (Exh. B-1, p. 30, CTA rec.). In other words, the condonation of the indebtedness in question was not gratuitous because the receipt by petitioner of financial advantages arising therefrom is subject to the conditions quoted above.

After concluding that the cancellation or remission of indebtedness in the sum of ₱348,997.72 was not a gift of the Philippine National Bank to the petitioner, we hold that, following the provisions of Section 50 of our Income Tax Regulations, _supra_, the said amount of ₱348,997.72 is a part of petitioner's 1961 "income derived from any source whatever" within the meaning of the term "gross income" under Section 29(a) of the National Internal Revenue Code. Our view is predicated on the theory that when a creditor cancels a debt as a part of a business transaction, the debtor is thereby enriched or his net assets has been increased, and therefore he realizes taxable income.

It is to be noted that Section 50 of our Income Tax Regulations is identical to or similar with Treasury Department Regulations 77, 86 and 94 (U. S.), relating to the U. S. Revenue Acts of 1932, 1934 and 1936, respectively. In fields closely related to the cancellation of indebtedness similar to Section 50 of our Income Tax Regulations, the United States Supreme Court in the case of United States v. Kirby Lumber Co., 284 U. S. 1, has treated gains in net assets as income. In that case, the taxpayer purchased its own bonds at a discount. It was held taxable on the increase in net assets which resulted. This holding was confirmed by the U. S. Supreme Court in the case of Helvering v. American Chicle Co., 291 U. S. 426 (See also Commissioner v. Coastwise Transp. Corp., 71 Fed. 2d. 104).

Petitioner, however, contends that the condoned indebtedness of ₱348,997.72 cannot be considered as "income derived from any source whatever" because the said indebtedness does not represent money or property received by it. This contention is devoid of merit. In the first place, Section 50 of our Income Tax Regulations, supra, which implemented Section 29(a) of the National Internal Revenue Code, does not distinguish between debts for money, property, or services as constituting income from other sources. In the second place, when the Philippine National Bank condoned petitioner's indebtedness on account of trade acceptances and other bank services, petitioner received financial advantages thereby increasing its net assets. Lastly, the financial advantages received by petitioner from the cancellation of its indebtedness with the Philippine National Bank are not exempt from tax or excludable from gross income as provided and enumerated in Section 29(b) of the National Internal Revenue Code.

Petitioner also contends that, even assuming that the condoned indebtedness is income derived from any source whatever, the same cannot be considered as income in 1961 because the cancellation of its indebtedness, which is conditional, took effect on January 3, 1962 when petitioner complied with or paid part of its monetary obligation to the Philippine National Bank. On this point, we cannot subscribe to the validity of petitioner's contention. It should be noted that the condonation of petitioner's indebtedness was made pursuant to Resolution No. 1476 of the Philippine National Bank dated November 29, 1961, or more than a month before the end of said year (Exh. B, p. 29, CTA rec.). Moreover, the said condonation of indebtedness was accepted by petitioner when on December 31, 1961, it caused to be recorded in its books of accounts under Journal Voucher No. 193 the following entries:

(Dr.) Acceptance Payable - PNB - ₱475,902.13

(Cr.) Surplus Adjustment . . . . . . ₱475,902.13
(Exh. C, p. 32, CTA rec.)

Finally, the method employed by petitioner in determining its income is the "<u>accrual method.</u>" Under this method of accounting, the income of petitioner is determined by alloting income and expenses to the period in which earned or incurred, regardless of when received or paid. In the instant case, the bank charges for trade acceptances and other banking services were accrued by the petitioner from year to year since 1955. This method of accounting was consistently followed by petitioner as shown by its corporate income tax returns and recorded also in Journal Voucher No. 193 mentioned above. We cannot see any justifiable reason to deviate from the accounting method adopted and pursued by petitioner by ruling that the cancellation of petitioner's indebtedness took place in 1962. After all, the partial payment made by petitioner on January 3, 1962 would not materially alter the situation because petitioner had pledged most of its assets to the bank as collateral to secure the greater bulk of its debt as evidenced by Resolution Nos. 825 and 1476 of the Philippine National Bank dated December 19, 1955 and November 29, 1961, respectively (Exhs. A and B, pp. 27-31, CTA rec.).

In its determined effort to cushion the effect of Section 50 of our Income Tax Regulations, supra, petitioner invoked as a defense against the deficiency income tax assessment arising from the condoned indebtedness the "Equitable Doctrine of Tax Benefit." Petitioner alleged that in 1956, 1957 and 1958, despite the deduction from its gross income of the bank charges or commissions, it suffered substantial and huge losses during those years. Consequently, petitioner argued that, since its debt consisting of bank charges or commissions effected no reduction in its income tax liability for 1956, 1957 and 1958, the complete or partial relinquishment of its debt in 1961 by way of condonation or cancellation thereof would not constitute taxable income in 1961 with the exception of the bank charges or commissions deducted from its gross income in 1959 and 1960 which resulted in a reduction of its income tax liability for those years (See Exh. O, p. 57, CTA rec.).

For a better understanding of the "equitable doctrine of tax benefit", it may be stated that our Income Tax Regulations provide that any amount subsequently received on account of a bad debt previously charged off and allowed as a deduction from gross income for prior years must be included in gross income for the taxable year in which received (Section 102, Revenue Regulations No. 2). This treatment of income on account of recoveries from bad debts has been followed consistently by the Bureau of Internal Revenue since the promulgation of our Income Tax Regulations. But construing a similar provision in the Federal Income Tax Regulations, it was ruled that recoveries of bad debts previously deducted from gross income do not constitute taxable income unless the deductions of debts in prior years resulted in a reduction of income tax liability (Official Cumulative Bulletin of Treasury Department Rulings 1939-1, 102). This has given rise to the "equitable doctrine of tax benefit". Under this doctrine, petitioner contends that its debt to the Philippine National Bank consisting of bank charges or commissions which were deducted from its gross income for prior years effected no tax benefit. Petitioner argues, therefore, that the condonation in 1961 of its indebtedness for prior years (1956 to 1960) in the total sum of ₱475,902.41 for which no tax benefit was derived by petitioner in 1956, 1957 and 1958 should not be included as income derived from any source whatever under the equitable doctrine of tax benefit. Petitioner concedes, however, that the amount of ₱126,904.41 which it deducted from its gross income in 1959 and 1960 should be included, as it was in fact included, in its gross income for 1961.

The "equitable doctrine of tax benefit", which was invoked by petitioner as a defense, is predicated on the reasoning that, ordinarily, a repayment of loan is a reimbursement of capital and that unless a taxpayer has already recovered his capital, recoveries of debts are not income for income tax purposes. It is clear, therefore, that the equitable doctrine of tax benefit can only be availed of by a creditor like the Philippine National Bank but never by a debtor like the petitioner.

Accordingly, we hold that the condoned indebtedness of ₱348,997.72 (₱475,902.13 less ₱126,905.41) was income of petitioner in 1961 under the provisions of Section 29 of the National Internal Revenue Code, in relation to Section 50 of the Income Tax Regulations.

Second Issue

In 1959, petitioner deducted from its gross income the total sum of ₱72,299.07 as bad debts, in line with the provisions of Section 30(e) of the National Internal Revenue Code. Respondent, however, disallowed the said amount deducted from petitioner's gross income because petitioner had allegedly exerted no efforts to prove or ascertain the worthlessness of the debts as a condition precedent to the deductibility thereof. These debts consisted of the following items:

(1) Philippine Milling Co.:	
(a) Accounts receivable . . .	₱27,594.00
(b) Advances . . .	30,223.69
(pp. 54-60, t.s.n.)	
(2) Cotine (Phils.):	
Advances . . .	5,000.00
(pp. 57 & 59, t.s.n.)	
(3) Laborers & employees:	
(a) Ma-ao Plant . . .	7,271.33
(b) Others . . .	2,211.05
(Exh. G-1, p. 45, CTA rec.; respondent's memo. p. 14)	
T O T A L	₱72,299.07

With respect to the account receivable from and advances to the Philippine Milling Co., respondent has conceded the legality and validity of the deduction of ₱57,817.69 from petitioner's gross income in 1959 as a bad debt because the said debtor of petitioner was heavily indebted to the Development Bank of the Philippines and the Philippine National Bank and court decisions show that the debt of Philippine Milling Company to petitioner is actually worthless.

The advances made to Cotine (Phil.) in the amount of ₱5,000.00 for the purchase of planting of Kenaf seeds were written off as a bad debt by petitioner on the belief of petitioner's chief accountant that the said debtor is no longer existing and the collectors and investigators sent to follow up the accounts could no longer collect them.

Before any deduction for bad debt is allowed, the taxpayer must ascertain and be able to demonstrate, with a reasonable degree of certainty, the uncollectibility of the debt. He should submit with his return a statement showing the propriety of the deductions. (Sec. 102, Income Tax Regulations). The belief alone that debtor Cotine (Phils.) is no longer existing does not warrant writing off the indebtedness. No evidence was presented as to the facts which generated the belief that the debtor company no longer exists. These facts, not the conclusion of petitioner's employee, must be presented to enable us to form an independent opinion on this question. (See Schuman v. Commissioner of Int. Rev., 20 BTA 1167). Similarly, the mere act of sending collectors and investigators to follow up the accounts does not justify such write off in the absence of satisfactory evidence as to the nature of the efforts they exerted to make the collection successful.

Respondent contends that the advances made to Mr. Agustin Cosculuella, former Plant Manager of the Ma-ao Fiber Plant of petitioner, in the sums of ₱873.33 and ₱1,692.00, or a total of ₱2,565.33, cannot be written off as bad debts in 1959 because they represent traveling and representation expenses which, as admitted by petitioner, were incurred prior to 1959. Therefore, respondent is justified in disallowing their deduction from petitioner's gross income in 1959 for lack of factual and legal basis.

Respondent also disallowed the deduction of the sums of ₱7,271.33 and ₱2,211.05 representing advances to and receivable from petitioner's employees and laborers who are no longer connected with it. In view of the numerous debtor-employees and the meagerness of their individual indebtedness, further action on the accounts would entail expenses exceeding the amounts sought to be collected. The deduction from gross income of the said accounts should therefore be allowed.

<u>Third Issue</u>

During the investigation of petitioner's tax liability, it was ascertained that the Financing Corporation of the Philippines, a sister-company of petitioner, credited the latter in 1959, 1960 and 1961 the sums of ₱7,358.66, ₱5,333.70 and ₱5,748.01 as interest on advances made by petitioner to the former. Since the interest income did not appear in petitioner's books of accounts, respondent considered the same as unreported income.

The evidence on record shows that petitioner received from the Financing Corporation of the Philippines interests on advances made by it to the latter. On the other hand, the Financing Corporation charged petitioner interests for the guarantee account on petitioner's PNB acceptances payable. Instead of taking up the interests credited to petitioner by a credit to the Financing Corporation and a credit to interest income, petitioner's accountant deducted or off-set the interest income against the interest expense which is bigger, and took up the net. In short, the interests received from the Financing Corporation of the Philippines were already accounted for as part of petitioner's gross income during the years in question. Consequently, the alleged unreported interest income of petitioner from the Financing Corporation of the Philippines in 1959, 1960 and 1961 did not exist because of the balancing effect of the interest expense and interest income of petitioner resulting in the correct declaration of the net interest income.

For the foregoing considerations, we find petitioner liable for deficiency income tax in 1959 and 1961 in the amounts of ₱2,678.60 and ₱60,441.96, computed as follows:

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Net income per return		₱177,307.64
Add: Unallowable bad debts deduction:		
1. Advances - Cotine (Phil.)	₱5,000.00	
2. Advances - Agustin Cosculuella	2,565.33	7,565.33
Net income		₱184,872.97
Income tax due thereon		₱ 47,462.00
Less amount already assessed		45,192.00
Deficiency income tax due		₱ 2,270.00
Add: 1/2% monthly interest from 4-19-60 to 4-19-63 (18%)		408.60
TOTAL AMOUNT DUE AND COLLECTIBLE		₱ 2,678.60

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Net loss per return		(₱175,591.90)
Add: Additional income and unallowable deduction:		
1. Commission expenses condoned by PNB ...	₱348,997.72	
2. Representation exp.	24,000.00	372,997.72
Net income		₱197,405.82
Deficiency income tax due		₱ 51,222.00
Add: 1/2% monthly interest from 4-17-62 to 4-17-65 (18%)		9,219.96
TOTAL AMOUNT DUE AND COLLECTIBLE		₱ 60,441.96

WHEREFORE, respondent's deficiency income tax assessment appealed from is hereby modified. Petitioner is ordered to pay respondent or his duly authorized collection agent the amounts of ₱2,678.60 and ₱60,441.96, or a total of ₱63,120.56, as deficiency income tax for 1959 and 1961, respectively. If the said deficiency income taxes are not paid in full within thirty (30) days from the date this decision becomes final and executory, petitioner shall also pay a surcharge of 5% of the unpaid amount, plus interest of 1% a month computed from the date this decision becomes final until paid, provided that the maximum amount that may be collected as interest shall not exceed the amount corresponding to a period of three (3) years. Without pronouncement as to costs.

SO ORDERED.

Quezon City, December 29, 1966.

Estanislao R. Alvarez
ESTANISLAO R. ALVAREZ
Associate Judge

WE CONCUR:

R M Umali
ROMAN M. UMALI
Prediding Judge

Ramon L. Avanceña
RAMON L. AVANCEÑA
Associate Judge