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REPUBLIC OF THE PHILIPPINES
COURT OF TAX APPEALS
QUEZON CITY

TALISAY-SILAY MILLING CO., INC.,
Petitioner,

- versus -

C.T.A. CASES NOS.
1399 & 1406

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

Dec. 24/65

D E C I S I O N

These are appeals from the decisions of respondent assessing petitioner the aggregate amount of ₱930,250.12 as deficiency income tax, including 50% surcharge, for the years 1957 to 1961. By agreement of the parties these cases were heard jointly because they involve the same facts and so they are herein decided together.

Petitioner is a domestic corporation engaged in the manufacture of centrifugal sugar from sugar canes. For the years 1957 to 1961, petitioner reported its income and paid the corresponding tax on the basis of a fiscal year which terminated on September 30 of each year.

On January 31, 1958, petitioner filed its income tax return for the period ending September 30, 1957. As a result of the investigation conducted by respondent's examiners, respondent, in a letter dated January 14, 1963, assessed petitioner a deficiency income tax for the years 1957 to 1961 in the total amount of ₱824,724.33. This deficiency assessment was received by petitioner on January 23, 1963. Again, in a letter, dated January 30, 1963, respondent assessed petitioner deficiency income tax for 1957 in the amount of ₱95,390.02 and this assessment was received by petitioner on January 31, 1963. In two letters, dated February 13 and 27, 1963, petitioner's counsel requested that the scheduled conference on the tax liability in question be postponed to February 28 and March 20, 1963, respectively, on the ground of illness of said counsel. And in a communication of February 26, 1963, petitioner contested the assessment of January 31, 1963 and requested that the same be cancelled or withdrawn for lack of legal basis. On May 29, 1963, respondent issued a revised assessment for income tax deficiency in the aggregate amount of ₱930,250.12, computed as follows:

35-ACR-62/57

Net income per return - - - - - - - - - - - - - - - -		₱ 846,131.97
Add: Unallowable deductions:		
1. Depreciation (excessive)		
a. On appraised assets - ₱46,241.41		
b. On rolling stocks, portable tracks & flumes- -30,298.63	₱76,540.04	
2. Bad debts written off - - - - - - - -	49,720.11	
3. Representation expenses - - - - - - -	5,000.00	
4. Prior year's expenses - - - - - - - -	13,495.23	
5. Materials & Supplies written off -	121,457.23	266,212.61
Net income per final investigation - - - - - - - - -		₱1,112,344.58
Tax due thereon - - - - - - - - - - - - - - - - - - -		₱ 303,457.00
Less: Amount already assessed - - - - - - - - - - - -		228,917.00
B a l a n c e - - - - - - - - - - - - - - - - - - -		₱ 74,540.00
Add: 50% surcharge - - - - - - - - - - - - - - - - -		37,270.00
½% mo. int. from 6-20-59 to 6-20-62 - - - - - -		13,417.20
TOTAL AMOUNT DUE & COLLECTIBLE - - - - - - - - - -		₱ 125,227.20

35-ACR-200114-62/58

Net income per return - - - - - - - - - - - - - - - -		₱1,044,634.33
Add: Unallowable deductions:		
1. Depreciation (excessive)		
a. On appraised assets - ₱46,241.41		

b. On rolling stocks, portable tracks & flumes - - 32,766.49	P79,007.90	
2. Bad debts written off - - - - - - - - -	149,011.58	
3. Representation expenses - - - - - - - -	5,000.00	
4. Materials & supplies written off - -	79,146.81	
5. Overstated fire loss - Baguio - - - - -	2,671.18	
6. Legal expenses - - - - - - - - - - - - -	234,974.96	
7. Fertilizer Venture (loss) - - - - - -	1,145.27	550,957.70
Net income per final investigation - - - - - - - - - -		P1,595,592.03
Tax due thereon -		P 438,766.00
Less: Amount already assessed - - - - - - - - - - - - -		284,498.00
B a l a n c e -		P 154,268.00
Add: 50% surcharge - - - - - - - - - - - - - - - - - - -		77,134.00
½% mo. int. from 6-20-59 to 6-20-62 - - - - - -		27,768.24
TOTAL AMOUNT DUE & COLLECTIBLE - - - - - - - - - - - - -		P 259,170.24

38-ACR-62/59

Net income per return - - - - - - - - - - - - - - - -		P 1,300,886.56
Add: Unallowable deductions & addt'l income:		
1. Depreciation (excessive)		
a. On appraised assets - P46,241.41		
b. On rolling stocks, portable tracks & flumes - 29,100.08	P75,341.49	
2. Repairs (capitalized) - - - - - - -	9,673.80	
3. Materials & supplies written off- -	66,240.71	
4. Fertilizer venture (profit) - - - -	1,226.00	
5. Unrecorded income (storage fee 1952 - 1958) - - - - - - - -	24,667.50	167,149.50
Net income per final investigation - - - - - - - -		P1,468,036.06
Tax due thereon - - - - - - - - - - - - - - - - - -		P 432,411.00
Less: Amount already assessed - - - - - - - - - - -		382,266.00
B a l a n c e - - - - - - - - - - - - - - - - - - -		P 50,145.00
Add: ½% mo. int. from 4-19-60 to 4-19-63 - - - - -		9,026.10
TOTAL AMOUNT DUE & COLLECTIBLE - - - - - - - - - - -		P 59,171.10

ACR-38-000071-62/60

Net income per return - - - - - - - - - - - - - - - -		P 331,516.54
Add: Unallowable deductions;		
1. Depreciation (excessive)		
a. On appraised assets - P46,241.41		
b. On rolling stocks, portable tracks & flumes - 29,100.08	P75,341.49	
2. Representation expenses - - - - -	5,000.00	
3. Separation Bonus - Board of Directors (Davao) - - - - - - - - - -	18,000.00	
4. Materials & supplies written off -	1,611.59	
5. Legal expenses - - - - - - - - - -	238,430.80	
6. Profit on fertilizer venture - - -	(778.85)	337,605.03
Net income per final investigation - - - - - - - - -		P 669,121.57
Tax due thereon - - - - - - - - - - - - - - - - - - -		P 192,737.00
Less: Amount already assessed - - - - - - - - - - - -		91,485.00

B a l a n c e ----------------------		₱ 101,282.00
Add: ½% mo. int. from 1-16-61 to 5-29-63 ------		14,398.92
TOTAL AMOUNT DUE & COLLECTIBLE ------------		₱ 115,680.92

<u>ACR-400088-62/61</u>

Net income per return -------------------		₱2,021,639.10
Add: Unallowable deductions:		
1. Depreciation (excessive)		
a. Appraised assets	₱ 46,241.41	
2. Representation expenses	5,000.00	
3. Repairs (Capital expenditures)	65,274.39	
4. Understated Profit (SS Culucundis) -	665,190.56	
5. Profit on fertilizer venture ----	(74.85)	781,631.51
Net income per final investigation ---------		₱2,803,270.61
Tax due thereon ----------------------		₱ 832,981.00
Less: Amount already assessed ------------		598,492.00
B a l a n c e ----------------------		₱ 234,489.00
Add: 50% surcharge -------------------		117,244.50
½% mo. int. from 1-16-62 to 5-29-63 ------		19,267.16
TOTAL AMOUNT DUE & COLLECTIBLE ------------		₱ 371,000.66

(Exh. 13, pp. 211-214, BIR rec.)

Hence, these appeals.

After the hearing of the cases, respondent, in his memorandum, admitted the following: (1) That the bad debt of Mr. Vicente Layson, written off in 1958, in the amount of ₱149,011.58 is justified (pp. 149-150, C.T.A. rec.); (2) the representation expenses paid to Atty. Nicolas Santiago during the years 1957, 1958, 1960 and 1961, in the sum of ₱20,000.00, may be allowed as ordinary and necessary business expense (pp. 150-151, C.T.A. rec.); (3) the amount of ₱13,495.23, representing salaries of security guards, which was disbursed in 1957 is deductible as ordinary and necessary business expense in the years it was accrued (pp. 151-152, C.T.A. rec.); (4) the legal expenses in the sum of ₱473,405.76, consisting of back wages paid to laborers, which were accrued in petitioner's books in 1958 and 1960 in consequence of the decisions of the Court of Industrial Relations are deductible (pp. 151-152, C.T.A. rec.); (5) the expenses for repairs in the sum of ₱74,948.19 during the years 1959 and 1961 are deductible (pp. 155-156, C.T.A. rec.); and (6) the profits on sugar shipments aboard the S.S."CULUCUNDIS" amounting to ₱665,190.56 were properly earned and returnable in the fiscal year 1962, not in 1961 (pp. 159-161, C.T.A. rec.).

On the other hand, petitioner did not discuss, in its memorandum, the items of overstated fire loss of bagasse amounting to ₱2,671.18 and the profits and losses on the fertilizer ventures pertaining to the years 1958 to 1961. Accordingly, we take it that petitioner admits the correctness of the inclusion of these items in its taxable net income.

Several issues have been raised by the parties, to wit: (1) Whether or not the right of respondent to assess petitioner for deficiency income tax for the year 1957 has already prescribed; (2) whether or not respondent is justified in disallowing the claimed deductions of (a) the sum of ₱49,720.11, representing the amount embezzled by Jorge Garcia; (b) depreciations on appraised assets, rolling stocks, portable tracks and flumes, for the years 1957 to 1961; (c) separation bonus of the directors; and (d) materials and supplies written off from 1957 to 1960; (3) whether or not petitioner has not reported income in the amount of

₱24,667.50; (4) whether or not the imposition of 50% surcharge as fraud penalty is proper; and (5) whether or not the imposition of ½% interest is justified.

Petitioner contends that the right of respondent to assess deficiency income tax for 1957 has already prescribed for the reason that the revised assessment of May 29, 1963 was issued beyond five years from the date of filing of the income tax return.

There is no doubt that the revised assessment of May 29, 1963 was issued beyond the statutory period of five years. However, this revised assessment was induced by petitioner itself. The fact is petitioner's counsel twice asked respondent for the postponement of a conference on the tax liability in question. Furthermore, petitioner, in its letter, dated February 26, 1963, requested that the assessment be cancelled or withdrawn for lack of legal basis. Having, by these positive acts, induced the revision of the assessment, petitioner cannot now successfully invoke the bar of prescription on the assessment.

Respondent disallowed the deduction as bad debt of the amount of ₱49,720.11 representing the amount embezzled by petitioner's employee, Jorge Garcia. The embezzlement was discovered during the audit of petitioner's accounts for 1951. Upon said discovery, Garcia signed a promissory note for the amount of ₱49,720.11. And this amount was maintained in petitioner's ledger as suspense account until 1959 when it was written off as bad debt.

From the evidence of record, it appears that when the account was not paid for sometime, one of the lawyers of petitioner went to Garcia to collect. Later, it was ascertained by petitioner's auditor that Garcia neither had property nor visible income. Evidently, the worthlessness of the debt was determined in 1957. Hence, the debt is deductible in 1957.

Respondent disallowed depreciation on appraised assets in the amount of ₱46,241.41 or 3% of ₱1,541,380.-66, the net capital surplus appearing in the September 30, 1949 Analysis of Surplus (Exh. LL-3) as follows:

"STATEMENT OF CAPITAL SURPLUS
AS OF SEPT. 30, 1949

Reserve for Depreciation Closed to Capital Surplus - - - - - - -	₱2,926,530.91
Appraisal of Investment in Central Azucarera del Danao from Cost to Par Value - - - - -	1,614,849.75
	₱4,541,380.66
Less: Reduction from Cost to Book Value of 6,000,000 shares of Financing Corporation of the Philippines - - -	3,000,000.00
Balance, September 30, 1949	₱1,541,380.66"

The disallowances were made by respondent on the ground that the depreciation charges claimed by petitioner during the years in question were based on the appraised value of ₱2,018,981.86 of the mill buildin and machineries and therefore, they should not hav deducted from income, but should have been charge against capital surplus. It is alleged by respon that the appraisal of the pre-war fixed assets wa reflected in the closing of the reserve for depreciation of ₱2,926,530.91 to capital surplus as shown in the analysis of surplus. On the other hand, petitioner contends that the depreciation charges were based on the salvage value of the pre-war assets which represents the value to the company of such assets after the war, after considering costs, the accumulated depreciation and damage to the assets on account of the war; and that the entry crediting reserve for depreciation to capital surplus was made not to appraise the fixed assets, but to correct an erroneous entry.

Petitioner's contention is not substantiated. Counsel for petitioner did not present a breakdown of the depreciation charges during the years involved, and the basis upon which they were computed. These could have refuted respondent's allegation that the depreciation was based on the appreciated value of the fixed assets. Furthermore, no satisfactory explanation was offered by petitioner as to the erroneous entry adjusted by the debit to reserve for depreciation and the credit to capital surplus in the amount of ₱2,926,530.91. Petitioner should at least have shown what the erroneous entry was. Under the circumstances, we are constrained to sustain the disallowance of the depreciation charges on the ground that the assessment on these particular items is presumed to be correct.

Respondent disallowed 3% of the claimed 8% depreciation rate on the rolling stocks, portable tracks and flumes on the ground that the Ma-ao Sugar Central

Inc., a sister corporation of petitioner which is located within the same vicinity, adopted the depreciation rate of 5% per annum during the years in question. Respondent insists that the rate should be only 5% per annum, instead of the 8% consistently adopted by petitioner during the past years.

The fact that a company is depreciating similar assets at a lower rate does not mean that another company within the same vicinity should use the same rate. A taxpayer may adopt the rate of depreciation it deemed reasonable. While the burden of sustaining the deductions rests upon the taxpayer, such deductions must not be disallowed unless shown by clear and convincing evidence to be unreasonable (See Sec. 109, Rev. Reg. No. 2). Considering the use for which the assets in question were devoted and their estimated lifetime, we are convinced that the 8% rate of depreciation adopted by petitioner is reasonable.

The deduction claimed in 1960 in the amount of ₱18,000.00 as separation bonuses of directors of the Central Azucarera del Danao, 90% of the shares of stock of which is held by petitioner, was disallowed by respondent on the ground that there were no past services warranting the payment of the said bonuses, and that this item is actually the acquisition cost of shares of stocks of Bacolod-Murcia Milling Co. and Ma-ao Sugar Central Co., Inc. These directors were paid separation bonuses pursuant to a resolution of the board, the pertinent portion of which we quote:

> "That in view of the final settlement of the cases between the Central Azucarera del Danao and the Philippine National Bank by virtue of the agreement entered into between the parties on March 3, 1960, the officers and members of the Board of Directors were replaced at a special meeting of the stockholders held on May 18, 1960, and in consideration of the services rendered by the outgoing officers and directors of the Central Azucarera del Danao be, as they are hereby given a separation bonus in the amount of TWO THOUSAND PESOS (₱2,000.00) each director." (Exh. X, p. 66, Petitioner's Folder No. 1)

We do not find any evidence of services actually and bona fidely rendered by these directors to petitioner to warrant the deduction of the bonuses. The recipients of these bonuses were members of the Board of Directors of Central Azucarera del Danao, a corporation possessing a juridical personality distinct from that of petitioner and to which their alleged services were rendered. Hence, the disallowance of this claimed deduction of ₱18,000.00 is justified.

Petitioner claimed deduction in 1957 for losses of materials and supplies which it considered obsolete unserviceable and unusable. The competence and credibility of petitioner's Chief Engineer, who testified on the obsolescent condition of these materials and supplies, are not impugned. In this circumstance, we hold that the claimed deduction should be allowed.

Similarly, deduction items, consisting of materials and supplies written off in 1958 to 1960, were claimed as losses arising from pilferages, wrong pricing, shrinkage, and mainly from failure to record in the stock cards the materials and supplies that were directly issued to the requisitioning departments of petitioner. Respondent now contends that the materials and supplies, which were issued without having been entered in the stock cards, cannot be claimed as deduction for losses under Sec. 30(d)(2) of the Revenue Code, but as expenses under Sec. 30(a)(1) of the same Code because they actually formed part of the direct or indirect cost of manufacturing. Therefore, it is argued that this claimed deduction for losses should be disallowed.

The losses arising from pilferages, shrinkage and wrong pricing are clearly deductible under Sec. 30(d)(2) of the Revenue Code.] Similarly, the claimed deductions on materials and supplies, which were directly delivered to the various departments of petitioner without having been enetered in the stock cards, are allowable as expenses under Sec. 30(a)(1) of the same Code since they form part of the cost of manufacturing.

The objection of respondent to allowing the claimed deduction of the materials and supplies, which were delivered without corresponding entries in the stock card, merely because the same cannot be justified as a deduction for losses, but as deduction for expenses, is too technical. In fairness to the taxpayer an item claimed as a deduction under

Sec. 30(d)(2) of the Revenue Code may, nevertheless, be allowed as a deduction under Sec. 30(a)(1) if it turns out that its deduction is justified as an expense, as in the case at bar.

As regards the third issue, respondent contends that petitioner has undeclared income of ₱24,667.50, representing 50% of storage fees amounting to ₱49,-375.00 which were credited, in the journal voucher of the Philippine Fiber Processing Company, to Associated Sugar, Inc., a corporation jointly owned by petitioner, the Bacolod Murcia Milling Co. and the Ma-ao Sugar Central Co. However, neither of these owners sent a statement of account to the Philippine Fiber Processing Co. and this account was not entered in the books of petitioner. Similarly, there is no evidence that any of these owners received a credit memo or notice on the amount of the storage fees.

In this connection, it may be stated that petitioner reported its income and expenses on an accrual basis. It is its right to receive its corresponding portion of the storage fees in question which determines the inclusion of this portion in petitioner's income. It is not necessary that petitioner receive a credit memo or notice of the storage fees. And it appearing that the right to receive its corresponding portion of the storage fees became fixed in 1959, the same accrued in the said year and should, therefore, be included as income earned in 1959. Since petitioner is only one of the three owners of the Associated Sugar, Inc., only 1/3 of the storage fees of ₱49,335.00 should be reported as income of petitioner in 1959.

On the issue of whether or not the imposition of fraud penalty is proper, it appears that the fraud penalty of 50% was imposed for the years 1957, 1958 and 1961 on account of the big amounts of bad debts claimed and the unrecorded profits on the sugar shipment on the S/S "CULUCUNDIS."

In view of our finding that the bad debt written off in 1957 is deductible and of the admission by respondent, in his memorandum, that the writing off of the bad debts in 1958 appears to be justified and that the income on the sugar shipment should not be reported in the fiscal year ended September 30, 1961, the assessment of 50% fraud penalty should therefore be reversed.

Finally, petitioner assails the imposition of ½% monthly interest on the deficiency assessment. The legality of the action of respondent on the imposition of this monthly interest has been settled in Heald Lumber Co. v. Commissioner of Internal Revenue, C.T.A. No. 1222, March 23, wherein we held:

> "After a careful consideration of the question, we are of the opinion that the decision of respondent is more in accord with law. The deficiency assessment was made on November 24, 1961, after the effectivity of Rep. Act No. 2343. The new law is therefore, applicable to the assessment of the deficiency tax against petitioner for the year 1953. We think Congress has full power to provide for payment of interest on delinquency taxes which should have been paid before the enactment of the

law prescribing payment of interest but assessed after the new law became effective. We cannot subscribe to the theory of herein petitioner to the effect that to impose interest on deficiency income tax for years prior to the effectivity of the new law would have the effect of applying the same retroactively, which is not sanctioned by the law. Precisely, the interest which is sought to be collected has been computed only from June 20, 1959, the date of effectivity of the new law. The allegation that the law is sought to be applied retroactively has no legal basis." (See also Central Azucarera Don Pedro v. Commissioner of Internal Revenue, C.T.A. No. 1273, June 15, 1964.)

In view of all the foregoing, we find petitioner liable for deficiency income tax for the years 1957 to 1961 in the amount of P219,399.91, computed as follows:

1957

Net income per return - - - - - - -		P 846,131.97
Add: Unallowable deduction:		
(1) Depreciation -	P46,241.41	
Total adjustment - - - - - - - - - -		46,241.41
Net income - - - - - - - - - - - - -		892,373.38
Income tax due thereon - - - - - -		241,764.50
Less: Amount already assessed - - -		228,917.00
DEFICIENCY TAX DUE - - - - - -		P 12,847.50

1958

Net income per return - - - - - - -		P1,044,634.33
Add: Unallowable deductions:		
(1) Depreciation -	P46,241.41	
(2) Overstated fire loss (Bagasse)	2,671.18	
(3) Fertilizer venture (loss)	1,145.27	
Total adjustment - - - - - - - - - -		50,057.86
Net income - - - - - - - - - - - - -		1,094,692.19
Income tax due thereon - - - - - -		298,513.81
Less: Amount already assessed - - -		282,498.00
DEFICIENCY TAX DUE - - - - - -		P 16,015.81

<u>1959</u>

Net income per return - - - - - - -		₱1,300,886.56
Add: Unallowable deductions:		
(1) Depreciation -	₱46,241.41	
(2) Fertilizer venture (profit)	1,226.00	
(3) Storage fees -	16,458.33	
Total adjustment - - - - - - - - - -		63,925.74
Net income - - - - - - - - - - - - -		1,364,812.20
Income tax due thereon - - - - - - -		401,643.66
Less: Amount already assessed - - -		284,498.00
DEFICIENCY TAX DUE - - - - - - -		₱ 127,145.66

<u>1960</u>

Net income per return - - - - - - -		₱ 331,516.54
Add: Unallowable deductions:		
(1) Depreciation -	₱46,241.41	
(2) Fertilizer Venture - - - - -	778.85	
(3) Bonuses - - -	18,000.00	
Total adjustment - - - - - - - - - -		65,020.26
Net income - - - - - - - - - - - - -		396,653.70
Income tax due thereon - - - - - - -		140,961.34
Less: Amount already assessed - - -		91,455.00
DEFICIENCY TAX DUE - - - - - - -		₱ 49,506.34

<u>1961</u>

Net income per return - - - - - - -		₱2,021,639.10
Add: Unallowable deductions:		
(1) Depreciation -	₱46,241.41	
(2) Fertilizer Venture - - -	74.85	
Total adjustment - - - - - - - - - -		46,316.26
Net income - - - - - - - - - - - - -		2,067,955.36
Income tax due thereon - - - - - - -		612,386.60
Less: Amount already assessed - - -		598,492.00
DEFICIENCY TAX DUE - - - - - - -		₱ 13,884.60
AGGREGATE AMOUNT DUE & COLLECTIBLE -		₱ 219,399.91

WHEREFORE, the assesaments appealed from are hereby modified. Petitioner is hereby ordered to pay to respondent the amount of ₱219,399.91 as deficiency income tax for the years 1957 to 1961, plus the corresponding interest provided in Section 51(d) of the Revenue Code. If the deficiency tax is not paid in full within thirty (30) days from the date this decision becomes final and executory, petitioner shall pay a surcharge of five per cent (5%) of the unpaid amount, plus interest at the rate of one per cent (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, 1965.

TEOFILO D. REYES, SR.
Presiding Judge

I CONCUR:

ROMAN M. UMALI
Associate Judge

Associate Judge Alejandro B. Afurong did not take part.