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REPUBLIC OF THE PHILIPPINES
COURT OF TAX APPEALS
QUEZON CITY

MARCIAL P. LICHAUCO, INC.,
Petitioner,

versus

CTA CASE NO. 1723

Request 7/67

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

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D E C I S I O N

Petitioner Marcial P. Lichauco, Inc. questions a decision of respondent Commissioner of Internal Revenue declaring it a personal holding company in the taxable year 1958 and assessing against it the amount of ₱29,389.08 as personal holding company tax for the said year.

Section 63 of the National Internal Revenue Code imposes a tax of 45% of the undistributed income of a personal holding company. Under Section 64 of said Code, a personal holding company is defined as any corporation at least 80% of whose gross income is personal holding company income as defined in Section 65 and if at any time during the last half of the taxable year more than 50% in value of its outstanding stock is owned, directly or indirectly, by or for not more than five individuals.

Petitioner admits under paragraph 8 of its amended petition for review that "during the year 1958, five (5) of the twelve stockholders of Marcial P. Lichauco, Inc. together owned more than 50% of the company's outstanding capital stock." With this admission, it may be stated that the stock ownership requirement for a personal holding company has been satisfied. Consequently, the legality of the respondent's assessment depends upon whether the gross income of petitioner during the taxable year in question consisted of at least 80% personal holding company income as defined in Section 65 of the Revenue Code, which reads as follows:

> SEC. 65. Personal holding company income.—For the purposes of this Title, the term "personal holding company income" means the portion of the gross income which consists of:
>
> (a) Dividends, interest (other than interest constituting rent as defined in subsection /g/ hereof), royalties (other than mineral, oil, or gas royalties), and annuities. The term "royalties", as herein used, includes income from copyrights, patents, and other similar revenues.
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> (b) Stock and securities transactions.—Except in the case of regular dealers in stock or securities (as defined in subsection /s/ of section eighty-four), gains from the sale or exchange of stock or securities.
>
> (c) Commodities transactions.—Gains from future transactions in any commodity on or subject to the rules of a board of trade or com-

modity exchange. This subsection shall not apply to gains by a producer, processor, merchant, or handler of the commodity which arise out of <u>bona fide</u> hedging transactions reasonably necessary to the conduct of its business in the manner in which such business is customarily and usually conducted by others.

(d) <u>Estates and trusts</u>.—Amounts includible in computing the net income of estates and trust under section fifty-six; and gains from the sale or other disposition of any interest in an estate or trust.

(e) <u>Personal service contracts</u>.—(1) Amounts received under a contract under which the corporation is to furnish personal services, if some person other than the corporation has the right to designate (by name or by description) the individual who is to perform the services, or if the individual who is to perform the services is designated (by name or by description) in the contract; and (2) amounts received from the sale or other disposition of such a contract. This subsection shall apply with respect to amounts received for services under a particular contract only if at some time during the taxable year twenty-five <u>per centum</u> or more in value of the outstanding stock of the corporation is owned, directly or indirectly, by or for the individual who has performed, is to perform, or may be designated (by name or by description) as the one to perform, such services.

(f) <u>Use of corporation property by shareholder</u>.—Amounts received as compensation (however designated and from whomsoever received) for the use of, or right to use, property of the corporation in any case where, at any time during the taxable year, twenty-five <u>per centum</u> or more in value of the outstanding stock of the corporation is owned, directly or indirectly, by or for an individual entitled

> to the use of the property, whether such right is obtained directly from the corporation or by means of a sub-lease or other arrangement.
>
> (g) Rents.—Rents, unless constituting fifty *per centum* or more of the gross income. For the purposes of this subsection, the term "rents" means compensation, however designated, for the use of, or right to use, property, and the interest on debts owed to the corporation, to the extent such debts represent the price for which real property held primarily for sale to customers in the ordinary course of its trade or business was sold or exchanged by the corporation; but does not include amounts constituting personal holding company income under subsection (f).
>
> (h) Mineral, oil, or gas royalties.—Mineral, oil, or gas royalties, unless (1) constituting fifty *per centum* or more of the gross income, and (2) the deductions relating to expenses, other than compensation for personal services rendered by shareholders, constitute fifteen *per centum* or more of the gross income.

Petitioner is a domestic corporation organized and registered with the Securities and Exchange Commissioner sometime in 1951. The principal subscribers are the spouses Marcial P. Lichauco and Jessie C. Lichauco, while their brother Thomas M. Lichauco, their mother, Luisa F. Lichauco, and Victoria V. Herrera are the other nominal incorporators. The primary purpose of the corporation is to engage in real estate business but it was also authorized to act as agent, attorney-in-fact, purchasing agent and general agent. It appears that the reasons why the Lichauco spouses decided to form this family corporation were to subdivide into small lots and sell on installment basis a big residential land in Antipolo, then to distribute to each of their children shares of stock in the corporation in such amounts as the spouses wished to donate to their children.

For the taxable year 1958, petitioner filed its income tax return declaring therein a net income of ₱40,908.18 on which it paid the corresponding income tax. A breakdown of the income for the said year shows that it had the following sources of gross income:

Gross income from properties . .	₱24,160.00
Dividends received	11,212.30
Commissions earned	26,620.50
Proceeds from the sale of palay	7,020.00
Income from investment in Back Pay certificates.	1,477.30
T O T A L	₱70,490.10

Of the amount of ₱11,212.30 received by petitioner as dividends from other corporations, only 25% thereof or ₱2,803.08 was declared as taxable income, pursuant to Section 24(a) of the Revenue Code. Hence, only the amount of ₱62,080.88 was reported as its gross income.

After examination of petitioner's income tax return for 1958, respondent considered the following as personal holding company income:

1.	Dividends (25%)	₱ 2,803.08
2.	Commissions earned . . .	26,620.50
3.	Rental income (gross income from properties)	24,160.00
	TOTAL PERSONAL HOLDING COMPANY INCOME	₱ 53,583.58

Inasmuch as the reported gross income of petitioner for the year involved was ₱62,080.88, respondent contends that petitioner's personal holding company income of ₱53,583.58 exceeds the 80% requirement (₱62,080.00 x 80% = ₱49,664.70). Consequently, respondent considered petitioner as a personal holding company subject to the personal holding company tax under Section 63 of the Revenue Code.

Parenthetically, it may be stated that in computing the amount of ₱29,389.08 as alleged personal holding company tax, respondent based it on a net income of ₱55,347.47 instead of ₱40,908.18. The difference of ₱14,439.29 was a certain commission income of petitioner for 1957 but erroneously included by respondent as income for 1958. Respondent admitted this error in his letter to counsel for petitioner dated November 10, 1965 (Annex A of the Petition for Review and the Amended Petition for Review), but continues to include the ₱14,439.29 as part of the income of the taxpayer for purposes of the personal holding company tax. It may also be stated that for purposes of the personal holding company income requirement, respondent now alleges on page 11 of his memorandum that the following are the personal holding company income of petitioner:

Dividend received	₱ 11,212.30
Commissions earned	26,620.50
Gross income from properties	24,160.00
Sale of palay (considered as rents)	7,020.00
T O T A L	₱ 69,012.80

Under Section 65(e) of the Revenue Code, supra, personal service income includes any amount received under a contract pursuant to which the corporation is to furnish personal services, if (a) some person other than the corporation has the right to designate (by name or by description) the individual who is to perform the services, or if the individual who is to perform the services is designated (by name or by description) in the contract, and if (b) at some time during the taxable year 25% or more in value of the outstanding stock of the corporation is owned, directly or indirectly, by or for the individual who has performed, is to perform, or may be designated (by name or by description) as the one to perform such services. Inasmuch as respondent considered the commissions earned by petitioner in the sum of ₱26,620.50 as amount received under a personal service contract between petitioner and the Thomas de la Rue & Co., Ltd. of England, the first, and the decisive, question is whether Marcial P. Lichauco is "designated by the contract as the one to perform such service" for De la Rue or some person other than petitioner has the right to designate him, by name or by description, as the individual who is to perform the service.

There is no doubt that, as respondent alleges, Mr. Marcial P. Lichauco, who is the president of petitioner, is a well-known lawyer and an influential figure. He has degrees obtained in the United States. He is also a corporation lawyer who has travelled far and wide, and probably known to the British printer, Thomas de la Rue & Co., Ltd. as a man of considerable prestige and connections. But nowhere and in no wise does the record of the case show that some person other than petitioner had the right to designate, by name or by description, Mr. Marcial P. Lichauco as the individual who was to perform the service for De la Rue. Neither does the record show that Mr. Marcial P. Lichauco was the individual who was designated, by name or by description, as the person to perform such services. As a matter of fact, it has been shown that not only Mr. Marcial P. Lichauco but also his brother Thomas rendered the services in question for De la Rue. And it could never be said that Mr. Marcial P. Lichauco was named in the contract with De la Rue because when its representative from England called on him, he said, "You do not need a lawyer. What you need is a representative or agent" (p. 142, t.s.n.).

An analysis of the nature of the services rendered to or performed for De la Rue by petitioner, acting through Thomas M. Lichauco and/or Marcial P. Lichauco, reveals that it is basically the work of an agent, which is included in the secondary purpose of the taxpayer. Accompanying a De la Rue representative to such Central Bank officials as he may wish to call on in connection with proposed bidding for printing of paper currency and bonds, when the contract is always awarded to the lowest bidder; making inquiries to determine what would be needed, how much it would cost and what personnel should be hired to look after De la Rue's exhibits in a trade show; looking into the possibilities of De la Rue entering into an informal partnership with a good Filipino printing firm for the setting up of a machinery in Manila for the printing of postage stamps and cigarette strip stamps; being requested to offer for sale a De la Rue banknote counting machine to the Central Bank which the Bank rejected; and securing the printing in various Manila newspapers of a statement that would make the Filipino reading public more conscious of the superiority of De la Rue's work in connection with the printing of Philippine paper currency - all these and other similar services do not by any stretch of the imagination require the talent or skill of a well-known corporation lawyer, an influential figure with degrees obtained in the United States and a man of considerable prestige and connections.

Section 65 of the Revenue Code is an exact copy of the United States Federal Income Tax Law on the subject (See I.R.C. [1954], Sec. 543 [a] [5]; I.R.C. [1939], Sec. 502[e]; 1938 Rev. Act, Sec. 403[e]; 1936 Rev. Act, Sec. 353 [e], as amended by 1937 Rev. Act, Sec. 1; see also 7 Mertens, Law of Federal Income Taxation, p. 22). As construed in the United States, the provision in regard to personal service contracts (Sec. 65 [e]), is intended primarily to reach cases of "incorporated talents," which is a tax avoidance scheme through the formation of a corporation whereby the individual who is practically the sole incorporator, enters into a contract with the corporation to perform personal services for the person or persons whom the corporation might designate at a nominal compensation but for which services the corporation collects a much bigger amount from the person or persons for whom the services are actually performed. Thus the individual achieves substantial immunity from high individual rates by having the corporation accumulate most of the sums received, paying thereon only the normal corporate tax (7 Mertens, Law of Federal Income Taxation, *supra*). By the device of the personal holding company, therefore, an individual whose income from his extraordinary skill or exceptional talent is large, like a movie star or business executive, would form a corporation and contract his services to such corporation at a nominal sum. In turn, the corporation would then contract with third persons, who are the real employers, who are willing to pay huge amounts for the extraordinary skill or exceptional talent of the designated party, and the highly skilled or talented person would thereby avoid high income tax rates. The highly skilled or talented person, who is to furnish the services, is always named or designated in the contract with the real employers.

In the case at bar, there is no indication that petitioner corporation was designed to avoid the income tax due from M. P. Lichauco through the formation of a personal holding company. The corporation was organized to engage in a legitimate business. Probably, the services of Mr. Marcial P. Lichauco were some of its valuable assets, but the contract with De la Rue did not specifically require his services by name or by description. No doubt De la Rue probably desired his services, but the services were equally performed by Mr. Thomas M. Lichauco. Even more, as stated above, petitioner was incorporated in 1951 while the services now under question were not rendered until

1958. It can hardly be said that Mr. Marcial P. Lichauco formed petitioner corporation for the purpose of siphoning the income to be derived from the personal services to be performed by him personally for De la Rue at a not too substantial commission of ₱26,620.50. The instant case is only that of a taxpayer engaged in a legitimate business with no purpose or intention to use the corporation to evade taxes, even if it is owned or controlled by one family.

Inasmuch as no person other than petitioner had the right to designate, by name or by description, Mr. Marcial P. Lichauco as the individual who was to perform the services with De la Rue, or Mr. Marcial P. Lichauco was not designated, by name or by description, in the contract as the individual to perform such services, the sum of ₱26,620.50, which petitioner earned as commissions in the taxable year 1958, can not be considered as amount received under a personal service contract with the Thomas de la Rue & Co., Ltd. of England. Consequently, it is not a personal holding company income for purposes of determining whether petitioner is a personal holding company in the taxable year 1958. With this conclusion, it becomes unnecessary to decide whether Mr. Marcial P. Lichauco, at some time during the taxable year 1958, owned, directly or indirectly, 25% or more in value of the outstanding stock of petitioner corporation. At any rate, it is alleged by petitioner on page 35 of its memorandum, and it is not disputed by respondent, that neither Marcial P. Lichauco nor his brother Thomas owns 25% of petitioner's outstanding capital stock. And as testified by Mr. Marcial P. Lichauco, out of the total shares of petitioner corporation of 34,050 on January 1, 1958, he owns only 3,800, which is only 11.16% in value of the outstanding stock (pp. 127-128, t.s.n.).

Petitioner also argues that the personal holding company income requirement has not been satisfied because its income from rents during the taxable year 1958 is not only ₱24,160.00 but actually ₱31,180.00 as the difference of ₱7,020.00, declared as proceeds from the sale of palay in its income tax return also represented rentals of properties transferred by the Lichauco spouses to the petitioner corporation sometime in 1956. Under Section 65(g) of the Revenue Code, if rents constitute 50% or more of the corporation's gross income, the same cannot be considered personal holding company income. Since the total rental income of ₱31,180.00 is in excess of 50% of its gross income of only ₱62,080.00, petitioner contends that the gross income requirement for a personal holding company has not been satisfied.

With the exclusion, however, of the sum of ₱26,620.00, representing commissions earned from Thomas de la Rue & Co., Ltd. of England, from the personal holding company income of petitioner, the question as to whether the sum of ₱7,020.00, declared as proceeds from the sale of palay, represented rentals has become moot. If the following are the personal holding company income of petitioner as claimed by respondent on page 11 of his memorandum -

Dividend received	₱11,212.30
Commissions earned	26,620.50
Gross income from properties .	24,160.00
Sale of palay (considered as rents)	7,020.00
T O T A L	₱69,012.80

with the exclusion of the sum of ₱26,620.00, the amount of personal holding company income is reduced to ₱42,392.41. If the total gross income of petitioner is ₱70,490.00, ₱42,392.41 is only 60.13% of gross income. Inasmuch as it is necessary that at least 80% of the corporation's gross income be "personal holding company income," petitioner can not be considered a personal holding company.

WHEREFORE, the decision of respondent Commissioner of Internal Revenue declaring petitioner Marcial P. Lichauco, Inc. a personal holding company in the taxable year 1958 and requiring it

to pay the sum of ₱26,389.08 as personal holding company tax for that year is hereby reversed.
No costs.

SO ORDERED.

Quezon City, August 7, 1967.

ROMAN M. UMALI
Presiding Judge

WE CONCUR:

ESTANISLAO R. ALVAREZ
Associate Judge

RAMON L. AVANCEÑA
Associate Judge