REPUBLIC OF THE PHILIPPINES
COURT OF TAX APPEALS
QUEZON CITY

SIME DARBY INTERNATIONAL TIRE CO., INC. (formerly B.F. GOODRICH PHILIPPINES, INC.),
Petitioner,

- versus -

C.T.A. CASE NO. 3814

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

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8/26/91

D E C I S I O N

This appeal is focused on the question whether petitioner herein, a domestic corporation, registered with the Securities and Exchange Commission in April 1935, engaged in the manufacture of motor vehicle tires, and in recapping of old and new tires, is liable under Section 25 of the National Internal Revenue on improperly accumulated surplus for the year 1975 as determined by respondent in his demand letter dated on October 10, 1980, the details of which are as follows:

ACR-32-04B-000222-75/80

Improperly accumulated surplus .	P15,908,468.00
25% Surtax due thereon	P 3,977,121.50
Add: 14% interest fr. 4/16/76 (42% max.)	1,670,391.03
AMOUNT DUE AND COLLECTIBLE	P 5,647,512.53

On November 24, 1980, petitioner disputed the foregoing assessment and sought the cancellation thereof, stating among other things, that from 1969 to 1979, it had consistently declared substantial dividends; that from 1969 to 1975, a major portion of its surplus was plowed back to plant expansion; and that in 1975 (the year under review) it had spent more than what was set aside as working capital. And, in its memorandum added that the deficiency tax assessment on unreasonable accumulation of surplus was erroneous and without legal basis.

Respondent contends that as of December 31, 1975, petitioner's surplus amounting to P15,908,486.00 was improperly accumulated because sizeable portion thereof was periodically and increasingly invested in money market, not related to its business, petitioner not being a lending investor. He denied the protest by sustaining and reiterating the assessment in his letter dated February 7, 1983.

Not satisfied with respondent's decision, petitioner appealed to this Court on February 2, 1984.

The controlling provisions of Section 25 of the

National Internal Revenue Code, in part pertinent states:

> SEC. 25. <u>Addition tax on corporation improperly accumulating profits or surplus.</u>- (a) <u>Imposition of tax.</u> - If any corporation is formed or availed of for the purpose of preventing the imposition of the tax upon its shareholders or members of another corporation, through the medium of permitting its gains and profits to accumulate instead of being divided or distributed, there is levied and assessed against such corporation for each taxable year, a tax equal to twenty-five <u>per centum</u> of the undistributed portion of its accumulated profits or surplus which shall be in addition to the tax imposed by section twenty-four, and shall be computed, collected and paid in the same manner and subject to the same provisions of law, including penalties, as that tax.
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> (b) <u>Prima facie evidence</u>. - The fact that any corporation is a mere holding company shall be <u>prima facie</u> evidence of a purpose to avoid the tax upon its shareholders or members. Similar presumption will lie in the case of an investment company where at any time during the taxable year more than fifty <u>per centum</u> in value of its outstanding stock is owned directly or indirectly, by one person.
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> (c) <u>Evidence determination of purpose</u>. - The fact that the earnings or profits of a corporation are permitted to accumulate beyond the reasonable needs of the business shall be determinative of the purpose to avoid the tax upon its shareholders or members unless the corporation, by clear preponderance of evidence, shall prove the contrary.
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> xxx xxx xxx

The foregoing provisions of the law are clear but the decision in this case must rest upon its own peculiar facts and circumstances. As this Court explained in **The Manila Wine Merchants, Inc. vs. The Commissioner of Internal Revenue**, C.T.A. Case No. 1415, February 28, 1961* and **Distillerias Ayala, Inc. vs. The Commissioner of Internal Revenue**, C.T.A. Case No. 1664, December 27, 1969, the accumulated earning tax under Section 25 of the Tax Code is a tax on obnoxious hoarding as distinguished from harmless accumulation. If the corporation is availed of for the purpose of avoiding the income tax on its stockholders by permitting its gains and profits to accumulate instead of being divided or distributed among its shareholders, then the accumulated earning tax applies to the corporation. The touchstone of liability is the purpose behind the accumulation of surplus or profits and not the consequences of accumulation (Sauk Investment Co., 34 B.T.A. 732; Law of Federal Income Taxation, Mertens, Vol. 7, p. 347.) As a practical matter, liability for the tax under Section 25 of the Tax Code hinges on whether the corporation has accumulated the earnings in excess of

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*Aff'd in **Manila Wine Merchants, Inc. vs. Commissioner of Internal Revenue**, 127 SCRA 493.

the reasonable needs of the business. The question of reasonable or unreasonable accumulation of profits or surplus is one of fact. The word "reasonable" is a relative term. What would be reasonable in one situation or for one business, might be clearly unreasonable in another. (William C. de Mille Productions, Inc., 30 B.T.A. 826; Willerson Daily Corp. Ltd., 42 B.T.A. 1266, aff'd 125 F _/2d/ 988 /CCA 9th, 1942/; Law of Federal Income Taxation, Mertens, Vol. 7, p. 360). Petitioner in the instant case, invariably asserts that since it was established for the purpose of manufacturing tires for vehicles and not a mere holding or investment company, it could not have been formed for the purpose of avoiding tax on income of its stockholders under the provisions of Section 25 of the Tax Code. To support this argument, petitioner stresses on its policy of yearly declaring substantial dividends to the extent possible without jeopardizing its operations and claims that the surplus was plowed back to plant expansion. In other words, petitioner contends that there is no evidence of tax avoidance as contemplated under the law.

We find petitioner's contention of little significance, for it will be noted that Section 25 of the Tax Code gives us two possibilities as to what may be considered indicative of tax avoidance - (1) the fact that the corporation is a mere holding company (treated as prima facie evidence) and (2) the fact that the earnings or profits are permitted to accumulate beyond the reasonable needs of the business. However, these are only criteria which are not exclusive. That is to say, that a corporation may still be formed or availed of for the purpose of avoiding tax on its shareholders even though it is not a holding or investment company and although it does not have an unreasonable accumulation of surplus. Thus, it has been ruled that a corporation may be found to have been availed of for the proscribed purpose in the absence of an accumulation beyond reasonable business needs (H.C. Jones V. Koma, Inc., 55-1 USTC).

Looking into the dividend policy of the petitioner, the records show:

TAXPAYER'S DIVIDEND HISTORY
1969 TO 1975

Year	Net Income After Inc. Tax	Cash Dividend Paid	Stock Dividends Distributed	% of Cash Dividend	% of Stock Dividends	Balance of Surplus at Year End
1968 (Beg. Surplus)						P27,863,789.00
1969	P 10,226.498	P 4,321,054	P 5,917,558	41.37%	57.86%	27,941,685.00

1970	17,176,270	6,426,468	7,101,070	37.41%	41.34%	31,890,417.00
1971	18,146,944	5,687,832	6,390,970	31.34%	35.22%	37,688,889.00
1972	18,556,184	8,427,551	4,899,739	45.42%	26.40%	42,887,453.00
1973	18,602,314	9,270,306	5,389,713	49.83%	28.97%	46,829,748.00
1974	33,952,814	10,197,336	5,928,680	30.03%	17.46%	64,686,546.00
1975	35,679,925	13,564,827	26,086,200	38.02%	73.11%	60,685,444.00
	P152,340,949	P57,805,374	P61,713,930	37.94 %	40.51%	

(See Schedule I, p. 235, BIR rec.)

Analyzing the foregoing schedule in relation to petitioner's net income, cash and stock dividends and earned surplus, it can readily be seen that during the period from 1969 to 1975, petitioner had earnings in the total amount of P152,340,949 paying cash dividends in the amount of P57,805,374 or 37.94% and distributing stock dividends in the amount of P61,713,930 or 40.51%. The balance of surplus at year end of December 1975 was P60,685,444.00. And, as observed by respondent's examiners:

> "xxx the non-taxable stock dividends distribution of P61,713,930 for the 7-year period is not allowed as dividends paid credit, per 1939 U.S. Tax Code (Secs. 27(f) and 115(f) from which our Tax Code was patterned. Such being the case, for accumulated earning tax purposes, said tax dividends should be brought back to the surplus balance as of December 31, 1975, and subtracted from the capital stock balance as of the same date, which is computed, thus -

Balance of surplus as of December 31, 1975 Balance Sheet		P 60,685,444.00
Add back: Stock Dividends distributed (1969 to 1975)		61,713,930.00
Surplus Balance, as of Dec. 31, 1975, before stock Dividend Distribution (1969-1975)		P122,399,374.00
Capital Stock Balance as of Dec. 31, 1975 Balance Sheet	94,006,463.00	
Deduct: Stock Dividends Distributed (1969 to 1975)	61,713,930.00	
Capital Stock Balance as of Dec. 31, 1975, before Stock Dividend Distribution	32,292,533.00	

"With the adjusted surplus balance of P122,299,374 and adjusted capital stock balance of P32,292,533, both as of December 31, 1975, we shall now determine if there is an unreasonable accumulation of surplus as of the said date. The amounts to be restricted from this surplus are the working capital requirement of P83,597,350 per S.G.V. computation, using the Bardahl Formula, the amount of P17,534,147 yet to be spent for factory expansion program, and reserve for employee's retirement benefit of P5,359,931 or a total amount of P106,490,888.00. The remaining surplus is therefore P15,908,486.00 (122,399,374 less 106,490,888) which is summarized as follows:

Adjusted Surplus balance as of Dec. 31, 1975	P122,399,374.00

Deduct: Restrictions to Surplus:

1) Working capital requirements per S.G.V. Computation (see page 12 of Protest Letter)		P83,597,350	
2) Amount yet to be spent on the BOI approval expansion program:			
Total as Approved -	P55,000.00		
Less: Construction in Progress Account -	37,456,853	17,534,147	
3) Reserve for employees' retirement benefits ..		5,359,391 .	106,490,888.00
Free Surplus as of December 31, 1975			P 15,908,486.00

(Exh. H, pp. 327-239, BIR rec.).

The problem lies in the fact that petitioner has disputed the manner respondent arrives at the surplus as of December 31, 1975. Petitioner believes that the stock dividends declared should not have been flowed back for purposes of determining the surplus balance as of December 31, 1975. Petitioner in its memorandum cited the following decisions of the Philippine Supreme Court and the United States Court of Appeals to support is stand that what the Respondent Commissioner has done "is arbitrary and devoid of legal basis and that in compliance with the Supreme Court Rulings the account must be computed as follows:

BIR adjusted surplus balance December 31, 1975 (including Stock Dividends for 1969-1975)	P122,399,374.00
Deduct: Stock dividends for 1969-1975	61,713,930.00
Surplus Balance, December 31, 1975	P 60,685,444.00

These Supreme Court rulings and US tax cases are as follows:

(1) **Fisher V. Trinidad,** 43 Phil. 973

(2) **Commissioner of Internal Revenue vs. Manning,** 66 SCRA 14

(3) **Electric Regulator Corporation vs. Commissioner of Internal Revenue** (U.S. Court of Appeals 2nd Circuit No. 28, 609, August 11, 1964, 336 F.2d 339 CCH US Tax Cases Vol. 64-2)

(4) **Smoot Sand & Gravel Corp. vs. Commissioner of Internal Revenue** (U.S. Court of Appeals, Fourth Circuit No. 7886 January 11, 1960, 274 F.2d 495 American Federal Tax Reports 2d Series Volume 5

We have reviewed the cited cases by petitioner and found that issues are not exactly similar to the instant case. The Philippine Supreme Court rulings except for the definition and description of what a stock dividends is have no bearing on the issues raised in the instant case. On the contrary, in the case of **Commissioner of Internal Revenue v. Manning**, it was held by the Supreme Court:

> "Where corporate earnings are used to purchase outstanding stock treated as treasury stock as a technical, but prohibited device, to avoid effects of income taxation, distribution of said corporate earnings in the form of stock dividends will subject stockholders receiving them to income tax".

In other words, this decision even supports the view of respondent that the declaration of stock dividends may be used as a device to avoid the imposition of income taxation on the stockholder so that in the words of the Philippine Supreme Court "the distribution of said corporate earnings in the form of stock dividends will subject stockholders receiving them to income tax".

Again the cited US Tax Case of Electric Regulator Corporations, although the US Appellate Court decided in favor of the taxpayer, it was found out however that in this case the accumulated cash surplus has been intended definitely to satisfy "anticipated substantial current liabilities like accrued expenses, mortgage, amortization, federal income taxes, state franchise taxes, profit sharing plan, officers compensation payable and Christmas bonus to employees. Consequently, the taxpayer was able to prove the purposes for which the surplus was being retained, unlike in the instant case the substantial portion of the surplus balance is just invested in money market placements. More important, the US Court in determining the surplus balance for the years in question had adjusted the earned surplus figures by restoring the amounts of the two non-taxable stock dividends of $49,820 (1952) and $490,000 (1957). Therefore, this cited case even supports the position taken by respondent that the amount of the stock dividend declared should be added back to surplus in the determination of unjust accumulation of surplus profit.

Likewise, this court has taken note of the statement made by petitioner's counsel in his memorandum to the effect that "To borrow the language of the Court in Smoot Sand & Gravel, supra, the surplus paid as stock dividends and the book surplus had been translated into plant expansion, increased receivables, enlarged inventories or other assets related to its business". The Court was quoted out of its context for if the quotation will be continued, the US Court states further, "Where, on the other hand, the accumulation of surplus is reflected in liquid assets in excess of the immediate or reasonably foreseeable business needs of the corporation, there is a strong indication that the purpose of the accumulation is to prevent the imposition of income taxes upon dividends which would have been distributed to the shareholders". The completeness of the quotation is important in order to present the actual jurisprudence enunciated by the Supreme Court, especially considering that in this particular case the latter court decided in favor of imposing the surtax in view of its findings that there is no "immediate or reasonably foreseeable business needs" for the retention of the excess liquid assets. Besides, in this cited case stock dividend is not an issue nor is it part of the facts of the case.

In view of the foregoing, this court believes that the manner respondent computed the free surplus as of December 31, 1975 is not devoid of legal basis as alleged by the petitioner. On the contrary, the same is computed pursuant to the US Tax Code as illustrated in the cited case of Electric Regulator Corporation which have persuasive effect on our jurisprudence.

Furthermore, what strongly persuade us to agree to the imposition of the 25% surtax against petitioner is its substantial and continuing renewal of investments in the money market. As shown by the records, said money market placements are as follows:

As of	Balance/Balance Sheet
Dec. 31, 1969	P 9,131,273.00
Dec. 31, 1970	9,000,000.00
Dec. 31, 1971	6,017,392.00
Dec. 31, 1972	13,500,000.00
Dec. 31, 1973	15,000,000.00
Dec. 31, 1974	20,449,204.00
Dec. 31, 1975	22,500,000.00

The records also show that petitioner's average balance of placement for 13 months, i.e., from January to December 1975, stood at P27,267,769.00.

It cannot be denied that money market placement is in no way related to petitioner's business of tire manufacturing. Along this line, it has been held that investment of earnings and profits of the corporation in unrelated business or in stock or securities of unrelated business usually indicate an accumulation beyond the reasonable needs of the business (**Helvering v. National Grocery Co.**, 304 US 282, 82 L Ed 1364, 58 S Ct 932 (1938); it has also been held that an investment in unrelated business enterprise is not deemed to be for the reasonable needs of the business. (**J.M. Perry & Co. v. Commissioner**, 120 F(2d) 123 /9th Circ. 1941/, cited in **The Manila Wine Merchants, Inc. v. The Commissioner of Internal Revenue**, supra.) If petitioner's surplus in the case at bar can be invested in money market unrelated to its business, we see no reason why the same cannot be made available for dividend distribution.

To summarize, this court has observed that for the past eight years including the year in question, petitioner has consistently been declaring minimal amount of cash dividends averaging 37.94% compare to stock dividends of 40.51% leaving an average surplus balance of 21.55%. The Revenue Examiner in fact has reasonably and equitably computed the improperly accumulated surplus by deducting such items as readily recognizable restrictions to surplus such as working capital requirement, BOI approved expansion program and employees retirement benefits. An actuation done in consonance with the cited US Tax Court decisions. This conclusion is more importantly supported by the fact that for the past seven years including the year in question, petitioner has invested substantially its surplus cash balance in money market placements which are entirely of different business. To reason out that such investment is necessary so as to have readily available cash to finance its BOI expansion program is not supported by the figures presented for instead of decreasing if it's being used in the expansion program, it is even increasing by the years. Moreover, this court noted that the BIR examiner has already excluded in the computation the amount corresponding to the BOI approved expansion program.

On the basis of the analysis and observation, it can be safely assumed that petitioner could have declared more cash dividends.

Viewed in this light, we are of the opinion that petitioner had unreasonably accumulated earnings beyond its business needs. It necessarily follows that petitioner had not sustained the burden which Section 25 of the Tax Code places upon it to overcome the presumption that for 1975, it was availed of for the purpose of preventing the imposition of income tax upon its shareholders.

Our attention is drawn to the contention of petitioner that the 25% surtax for unreasonable accumulation of surplus in this case was erroneous and without basis, but suffice it to state that the assessment in question was based on the findings substantiated by the evidence submitted to this court and fortified by the law and jurisprudence.

WHEREFORE, the petition for review is dismissed and petitioner in the above-entitled case is hereby ordered to pay the amount of P5,647,512.53 representing the 25% surtax and interest on its unreasonable accumulation of surplus for 1975, and an additional 5% surcharge and 14% interest per annum on the said amount for a maximum of three years computed from receipt by the petitioner of the final decision of the respondent under his letter dated February 7, 1983, pursuant to Section 51(e)(2) & (3) of the National Internal Revenue Code.

SO ORDERED.

Quezon City, Metro Manila, August 26, 1991.

ERNESTO D. ACOSTA
Associate Judge

WE CONCUR:

ALEX Z. REYES
Presiding Judge

(on official leave)
CONSTANTE C. ROAQUIN
Associate Judge

CERTIFICATION

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

ALEX Z. REYES
Presiding Judge
Court of Tax Appeals