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Republic of the Philippines
COURT OF TAX APPEALS
Quezon City

VISAYAN TRANSPORTATION
CO., INC.,
Petitioner,

Sept. 30, 1964

- versus - C.T.A. CASE NO. 1119

MELECIO R. DOMINGO, as
Commissioner of Internal
Revenue,
Respondent.

x - - - - - - - - - - - - x

DECISION

The respondent assessed against the petitioner the sum of ₱62,775.00 as alleged deficiency income tax, including interest, for the year 1956, computed as follows:

"Net Income per return ----	₱ 50,537.04
Add: Unallowable deductions & additional income:	
1. Depreciation - Vessels ---------	50,045.87
2. Depreciation - Other properties & equipment ------------	2,172.63
3. Amortization - Improvement to Vessels ----	6,911.71
4. Loss on Bad Debts ----	56,383.22
5. Freight Revenue Adjustment -----------	71,940.04
6. Repairs and Renewals -	23,000.13
7. Other Indirect operating expenses ------	1,147.00
8. Miscellaneous Direct Operating expenses--	25.50
9. Other general supplies & expenses ---------	1,289.00
10. Advertisement --------	500.00
Net income per investigation	₱263,952.14
Tax due thereon -----------	₱ 65,907.00
Less: Amount already assessed ------------	10,107.00
Balance ------------------	₱ 55,800.00
Add: ½% monthly interest from 6-20-59 to 7-20-61	6,975.00
DEFICIENCY TAX DUE & COLLECTIBLE -----	₱ 62,775.00"

Not satisfied with the assessment, petitioner has appealed.

The deficiency assessment was brought about by the disallowance by respondent, partly or wholly, of various deductions claimed by petitioner in its 1956 income tax return, to wit:

Deductions	Amount Claimed	Deductions Allowed	Deductions Disallowed
1. Depreciation, Vessels --	₱73,116.63	₱ 23,070.76	₱50,045.87
2. Depreciation, Other Properties & Equipment --	5,403.64	3,231.01	2,172.63
3. Amortiza tion, Improvement, Vessels ----	9,415.61	2,503.90	6,911.71
4. Loss on Bad Debts ------	51,766.46	--	56,383.22
5. Freight Revenue Adjustment -------	90,000.39	18,060.35	71,940.04
6. Repairs & Renewals ---	125,467.78	102,467.65	23,000.13
7. Other Indirect Operating expenses ---	33,912.12	32,765.12	1,147.00
8. Misc. Direct Operating Expenses ---	12,115.31	12,089.81	25.50
9. Other General Supplies & Expenses ---	1,216.25	---	1,289.00
10. Advertisement	4,882.65	4,382.65	500.00

The questions presented in this appeal relate mainly to the validity of the deductions claimed in petitioner's 1956 income tax return itemized above.

1. <u>Depreciation allowance for vessels.</u>

Petitioner acquired four vessels for use in interisland shipping, namely: MV Sorsogon, MV Gov. Smith, MV. Lourdes, and MV Hiawatha. The MV Sorsogon was acquired by petitioner in 1956 for ₱220,000.00; MV Gov. Smith, in 1954 for ₱225,000.00; and MV Lourdes and MV Hiawatha, in 1953 for ₱70,000.00 each. All of these vessels were built in 1944 as war vessels. Petitioner claimed a depreciation allowance of 14-2/7% for the MV Sorsogon and MV Gov. Smith on the basis of an estimated useful life of 7 years, and 20% for the MV Lourdes and MV Hiawatha on the basis of a useful life of 5 years after their acquisition by petitioner. Respondent, on the other hand, claims that the reasonable allowance for depreciation for all said vessels is only 5% on the basis of a useful life of 20 years following the schedule of depreciation rates established in Bulletin F of the U.S. Bureau of Internal Revenue.

The determination of the length of the useful life of property used in business is generally made by the taxpayer himself. The policy is not to disturb depreciation deductions unless there is a clear and convincing basis for a change. Taxpayers should be afforded freedom from annoying minor changes which would disturb the original estimates of useful life of depreciable assets. But where the Commissioner has determined that the deduction should be less than the amount claimed, the taxpayer must introduce evidence that the Commissioner is wrong. (1955 PH Fed. Taxes, Par. 14,124; Sec. 109, Rev. Regs. No. 2.) In this case, while it is true that the vessels in question were war vessels, the useful lives thereof as estimated by petitioner (5 and 7 years) are too unrealistic.

The estimate made by respondent appears to us to be more realistic and in conformity with experience in cases of such nature. The determination made by respondent must, therefore, be sustained.]

2. Depreciation of other properties and equipment.

Petitioner claimed a depreciation allowance of ₱5,403.64 for the floating equipment of the aforesaid vessels, wharf equipment, etc. Of the said amount, respondent allowed only the sum of ₱3,231.01 and disallowed the sum of ₱2,172.63. Respondent determined the depreciation deduction for said equipment on the same basis as the depreciation deduction for the vessels. In line with our opinion in the case of vessels, the determination made by respondent must be upheld.

3. Amortization of improvements on vessels.

During the year 1956, petitioner made improvements on its vessels and the expenditures were amortized at the same rates applied to the vessels. On this basis, petitioner deducted the sum of ₱9,415.61, of which amount respondent allowed ₱2,503.90 and disallowed ₱6,911.71. Since it is admitted that the cost of such improvements must be amortized at the same rates as the depreciation allowance for the vessels, it follows that the disallowance made by respondent is proper.

4. Bad debts.

Petitioner claimed a bad debt deduction of ₱51,-766.46. However, respondent disallowed the sum of ₱56,383.22.

The sum of ₱51,766.46 was claimed as a bad debt deduction for the year 1956. It appears, however, according to petitioner's own accountant, that most of the alleged bad debts had actually been collected. To quote from the testimony of said accountant:

> The company sent letters to the Customs. We sent our representative . . . collector to collect that account but this amount could not be collected because the Customs reasoned out that due to fire in Surigao, flood in Butuan and other calamities, they could not pay that account. Then, we found out that the purser also embezzled his collections which, after verification, we found that most of the accounts which showed in the books to be outstanding, were already collected by our pursers of the said vessel MV Hiawatha. (T.s.n., pp. 28-30, January 15, 1963, quoted on page 18, Memorandum for Petitioner.)

If the accounts had been collected, although embezzled by petitioner's employees, there can be no justification for claiming a bad debt deduction.

However, since petitioner deducted the sum of ₱51,766.46 only, respondent cannot legally disallow more than that amount. The claim that the amount actually written off in the books was ₱56,383.22 will not justify disallowance of that amount if the taxpayer claimed a deduction for a lesser amount in its income tax return. Accordingly, we agree with petitioner that the amount which should be taken into account in arriving at its net taxable income is ₱51,766.46 and not ₱56,383.22.

5. Freight revenue adjustments.

Petitioner claimed a deduction of ₱90,000.39, representing freight revenue adjustments and freight revenue discounts. Respondent allowed the sum of ₱18,060.35 and disallowed ₱71,940.04. The latter amount represents short payments of freight on cargoes actually loaded and freight discounts.

It appears that when a portion of freight charges is not paid and petitioner fails to collect the same, it is treated as freight discount and is claimed as a deduction from gross income. The position taken by petitioner is untenable. As correctly stated by counsel for respondent:

> Ordinarily, discounts and rebates when properly determined and given are deductible from gross income. Rebates and discounts are legitimately given when made at the time of sale and in accordance with a prearranged agreement between the seller and the customer. The discounts or rebates are represented by a fixed percentage of deductible cost which shall appear on the face of the contract, document or invoice. (See Valparaiso Grain & Lumber Co., 44 BTA 125; Messenger Publishing Co., 2 BTA 30; and Central Consumers Wine & Liquor, 1 BTA 1190.) Furthermore, rebates and discounts being in the nature of business expenses, they are subject to the overriding limitations of public policy and that when the deduction by way of rebate or discount would frustrate public policy the same should be denied. (I.C. Moser, 18 TCM 116.) On the basis of the foregoing principles, the deductions claimed by the petitioner in 1956 for accounts rebated and/or discounted should be denied. (Page 17, Memorandum for Respondent.)

6. Repairs and renewals.

The sum of ₱125,467.78 was claimed as a deduction for repairs of the four vessels of petitioner. Of this amount, ₱102,467.65 was allowed, while the balance of ₱23,000.13 was disallowed by respondent. Respondent claims that the said sum of ₱23,000.13

was spent for improvements of said vessels and not for ordinary repairs and should, therefore, be capitalized.

The rule governing deductibility of ordinary repairs is expressed in Section 68 of Revenue Regulations No. 2, which provides:

> Sec. 68. Repairs.- The cost of incidental repairs which neither materially add to the value of the property nor appreciably prolong its life, but keep it in an ordinarily efficient operating condition, may be deducted as expense, provided the plant or property account is not increased by the amount of such expenditure. Repairs in the nature of replacement, to the extent that they arrest deterioration and appreciably prolong the life of the property should be charged against the depreciation reserves if such account is kept.

Incidental repairs, to be deductible, must not "appreciably prolong" the life of the property. The life referred to is the probable, normal, useful life for the purpose of the allowance for the return of the capital investment - not what the life would have been if no repairs had been made after the property was damaged by a casualty. (Illinois Merchants Trust Co., 4 BTA 103; Alhambra Cigar & Cigarette Mfg. Co. v. Coll. of Int. Rev., C.T.A. No. 143, July 31, 1956, affd. in G. R. Nos. L-12026 and L-12131, May 29, 1959.) In this case, it is admitted that the repairs for which the expenditures in question were incurred prolonged the lives of the said vessels of petitioner. The disallowance of the deduction must, therefore, be sustained.

7. Miscellaneous expenses.

Respondent disallowed the deduction of the sums of ₱1,147.00, ₱25.50, ₱1,289.00 and ₱500.00 as miscellaneous expenses on the ground that no evidence was presented that such expenses were actually incurred and paid.

The law allows deduction from gross income of ordinary and necessary business expenses. To be deductible, it must be shown that such expenses have been actually paid or incurred. Petitioner has not satisfactorily shown that the expenses in question were actually paid or incurred during the taxable year. The disallowance of the deduction is, therefore, in order.

It appears, however, that petitioner claimed a deduction for the sum of ₱1,216.25 as alleged expenses for "other general supplies and expense" but respondent disallowed the sum of ₱1,289.00, or a difference of ₱72.75. As stated elsewhere in this decision in connection with bad debts, respondent cannot disallow more than what the taxpayer has claimed as deduction as it would distort the taxable income of the taxpayer.

In the assessment of the deficiency tax against petitioner, respondent added the interest of 1/2% per month of the deficiency tax from June 20, 1959 to July 20, 1961, pursuant to Section 51 of the Revenue Code, as amended by Republic Act No. 2343, which took effect on June 20, 1959. Petitioner claims that this is not in accordance with law for it would in effect make Republic Act No. 2343 retrospective in operation. This question has already been passed upon and considered in Heald Lumber Co. v. Padilla, C.T.A. No. 1222, March 23, 1964, wherein it was held:

> The deficiency assessment was made on November 24, 1961 (for deficiency income tax for the taxable year 1953), after the effectivity of Republic 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. Com., C.T.A. No. 1273, June 15, 1964.)

In line with the foregoing opinion, the decision appealed from is hereby modified and petitioner is ordered to pay the sum of ₱54,486.00, computed as follows:

Net income per return -----	₱ 50,537.04
Add: Deductions disallowed -	208,725.59
Adjusted net taxable income ------------------	₱ 259,262.63
Tax due on ₱259,262.00 -----	₱ 64,593.00
Tax previously assessed ----	10,107.00
Deficiency tax -----------	₱ 54,486.00

Petitioner is also ordered to pay the interest at the rate of 1/2% per month on the said sum of ₱54,486.00 from June 20, 1959, but not exceeding the interest corresponding to three years, pursuant to Section 51 of the Revenue Code, as amended by Republic Act No. 2343. If the deficiency tax is not paid within thirty days from the date this decision becomes final, petitioner is also ordered to pay the corresponding surcharge and interest, in accordance with Section 51 of the Revenue Code, as amended. With costs against petitioner.

SO ORDERED.

Quezon City, September 30, 1964.

ROMAN M. UMALI
Associate Judge

WE CONCUR:

MARIANO NABLE
Presiding Judge

AUGUSTO M. LUCIANO
Associate Judge