REPUBLIC OF THE PHILIPPINES
COURT OF TAX APPEALS
QUEZON CITY

CHEMICAL INDUSTRIES OF THE PHILIPPINES, INC.,
Petitioner,

- versus -

C.T.A. CASE NO. 5257

THE COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Promulgated:
OCT 29 1998

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DECISION

This is a petition seeking for the cancellation of the deficiency income tax assessment for the year 1982 issued by respondent amounting to P4,364,539.00.

The antecedent facts of the case are as follows:

Petitioner is a corporation duly organized and existing under Philippine laws. On April 12, 1983, it filed its Annual Income Tax Return for the calendar year ended December 31, 1982 (Exh. G), reflecting a net income of P15,574.00.

On October 5, 1987, petitioner received from respondent Assessment Notice No. 32-06-4b-000512-82 issued by the latter on September 15, 1987. Said assessment was brought about by the disallowance of interest expense and bank charges in the amount of

₱7,822,898.00 which petitioner claimed as deductions from its income. According to respondent, these interest and bank charges should be disallowed because the applicable proceeds of the "loans were applied to" the acquisition of "Investments in Stocks of Affiliated Companies".

Through a letter, dated November 2, 1987, and received by respondent on November 4, 1987, petitioner protested the aforesaid assessment (Exh. B-2). Petitioner explained that the increase in "Investments in Stocks of Affiliated Companies" were the result of stock swapping, spin-off, offset of investment losses and unpaid subscriptions.

On June 5, 1989, petitioner again received a letter from respondent demanding payment of the ₱4,364,539.00. Petitioner responded on June 8, 1989, informing respondent that they have already presented their explanations through their letter of November 2, 1987 and asking for an early resolution on the matter (Annex G of Petition for Review).

On October 1, 1991, petitioner received another letter from respondent, dated September 13, 1991, requesting it to submit documentary evidences showing that the proceeds of the loans which it obtained were not fully applied to the acquisition of the investments in stocks of affiliated companies. Petitioner obliged on October 10, 1991.

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On February 27, 1992, respondent allegedly requested the petitioner to sign a Waiver of the Statute of Limitations which was submitted on March 2, 1992 (Exh. A). The Waiver provided that "petitioner, in consideration of the approval by the Commissioner of Internal Revenue of its request for reconsideration, waives the running of the prescriptive period provided for in Sections 203 and 223 and other relevant provisions of the National Internal Revenue Code, and consent to the assessment and collection of the taxes which may be found due after re-investigation and reconsideration at any time before or after the lapse of the period of limitations fixed by said Sections 203 and 223 and other relevant provisions of the National Internal Revenue Code but not after December 31, 1993."

Through a letter, dated April 26, 1993, petitioner explained again its side on the findings of herein respondent. This was followed by a conference hearing on April 28, 1993 held at the Appellate Division of the Bureau of Internal Revenue.

On May 6, 1995, petitioner received from respondent a letter, dated January 30, 1995, denying its protest and requesting it to pay the amount of ₱4,364,539.00 within fifteen (15) days. Respondent stated in this letter that the same constitutes her final decision on the matter.

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Petitioner again requested for a reconsideration of the subject assessment on May 16, 1995 but later on withdrew the same due to the filing of a Petition for Review before Us on June 2, 1995.

In its Petition, petitioner argued primarily that respondent cannot collect anymore the disputed assessment on the ground of prescription, taking into consideration the Waiver executed by it on March 2, 1992, hereinbefore cited. And even assuming that the period to assess and collect has not prescribed, still, according to petitioner, the loans obtained by it were not applied to investments in stocks of affiliated companies and, therefore, may properly be deducted as expenses.

In her Answer, respondent raised the following Special and Affirmative Defenses:

SPECIAL AND AFFIRMATIVE DEFENSES

> 4. After a duly conducted investigation of the books of accounts and other related accounting records of the petitioner subject of the instant case, it was ascertained that they are under obligation to pay deficiency tax under consideration;
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> 5. Consequently, the deficiency income tax assessment in the amount of ₱4,364,539.00 was issued in accordance with law and regulations;
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> 6. All presumptions are in favor of the correctness of tax assessments. [Interprovincial Autobus Co., Inc. vs. CIR, 98 Phil. 290 (1956); Avelino vs. CIR, 8 SCRA 572 (1963); Mindanao Bus Co. vs. CIR, 1 SCRA 538 (1961)]

The issues We are tasked to resolve are:

First, whether or not the income tax deficiency assessment and action to collect taxes for the taxable year 1982 has prescribed; and

Second, whether or not petitioner correctly treated the interest and bank charges as deductions from its income.

It is proper for Us to tackle foremost the issue on prescription because if, indeed, the assessment and action to collect has prescribed, dwelling on the second issue is nugatory.

Petitioner contends that from March 2, 1992 to December 31, 1993 or a period of four hundred ninety (490) days, the respondent failed to take any move regarding the disputed assessment. Thus, as provided in the Waiver, the respondent can no longer take any action regarding the said assessment.

For easy reference, We shall quote the applicable provisions of the 1982 Tax Code which applies to the case at bar, thus:

> SEC. 318. ***Period of limitations upon assessment and collection.*** - Except as provided in the succeeding section, internal revenue taxes shall be assessed within five years after the return was filed, and no proceeding in court without assessment for the collection of such taxes shall be begun after the expiration of such period. For the purpose of this section, a return filed before the last day prescribed by law for the filing thereof shall be considered as filed on such last day:

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> *Provided*, That this limitation shall not apply to cases already investigated prior to the approval of this Code.
>
> SEC. 319. ***Exceptions as to period of limitation of assessment and collection of taxes.*** - (a) x x x
>
> (b) x x x
>
> (c) Where the assessment of any internal revenue tax has been made within the period of limitation above-prescribed such tax may be collected by distraint or levy or by a proceeding in court, but only if begun (1) within five years after the assessment of the tax, or (2) prior to the expiration of any period for collection agreed upon in writing by the Commissioner of Internal Revenue and the taxpayer before the expiration of such five-year period. The period so agreed upon may be extended by subsequent agreements in writing made before the expiration of the period previously agreed upon.

Based on the above provisions, respondent can issue her assessment within <u>five years after the return was filed.</u> Petitioner filed its annual income tax return on April 12, 1983. Respondent, therefore, had up to April 12, 1988 to issue her assessment. Clearly, then, the assessment notice issued by respondent on September 15, 1987 was well within the five-year prescriptive period provided by law.

We proceed to the collection aspect. Section 319 likewise provides for a similar period of <u>five years after the assessment</u> for respondent to collect. The assessment was issued on September 15, 1987 and so normally, respondent had up to September 15, 1992 to collect.

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In view, however, of the request for reconsideration/protest filed by petitioner, the prescriptive period for collection was interrupted. It is significant to note that on December 31, 1993, when respondent's right to collect could have prescribed under the Waiver, petitioner's protest or request for reinvestigation was still pending. It was only on May 6, 1995, through a letter, dated January 30, 1995, that respondent issued her final decision on the said protest. In **Commissioner vs. Wyeth Suaco Laboratories, Inc., 202 SCRA 125,** the ruling is to the effect that interruption of the prescriptive period for collection takes place when the taxpayer requests for the reinvestigation or reconsideration of the assessment. Section 320 of the 1982 Tax Code provides, thus:

> SEC. 320. ***Suspension of running of statute.*** -- The running of the statute of limitations provided in Section 318 and 319 on the making of assessment and the beginning of distraint or levy or a proceeding in court for collection, in respect of any deficiency, shall be suspended for the period during which the Commissioner of Internal Revenue is prohibited from making the assessment or beginning distraint or levy or a proceeding in court, and for sixty days thereafter; when the taxpayer requests for a re-investigation which is granted by the Commissioner; when the taxpayer cannot be located in the address given by him in the return filed upon which a tax is being assessed or collected: *Provided*, That if the taxpayer informs the Commissioner of Internal Revenue of any change in address, the statute will not be suspended; when the warrant of distraint and levy is duly served upon the taxpayer, his authorized representative, or a

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> member of his household with sufficient discretion, and no property could be located; and when the taxpayer is out of the Philippines.

The Waiver executed by petitioner on March 2, 1992 which extended the period of assessment and collection up to December 31, 1993 is of no moment. We have repeatedly held in a number of cases that for a waiver to be valid, the same must be signed by the Commissioner. Since said signature is wanting in the waiver presented by petitioner, the document is ineffective (see Exhibit A).

Thus, finding respondent's right to collect not prescribed under Section 319 of the Tax Code, We delve on the other issue involved in this case.

Respondent, in disallowing the interest and bank charges claimed by petitioner as deductions, reasoned out that:

> 1. The loans obtained by petitioner were primarily applied to investments in affiliated companies;
>
> 2. In obtaining loans, petitioner offered as collaterals the properties of its affiliates, as such, the loans were in reality loans for the affiliates and therefore, the interest expenses should have been deducted by the affiliates, not by petitioner, in the furtherance of their businesses; Thus, there will be proper matching of income and expenses;
>
> 3. That the loan or the investment of its proceeds does not have any economic substance to petitioner, except to evade the payment of the tax due; and
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> 4. Finally, loans from affiliates like Polyphosphates, Inc., is considered as a sham transaction and, therefore, the same should be

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treated as advance capitalization, and interest payments as dividend payments.

Petitioner, on the other hand, explained that the proceeds of the loan were not applied to investments in stock of affiliated companies. The increase in "Investment in Stocks of Affiliated Companies" was allegedly brought about by the following:

<u>1981</u>

Investee	Amount of Increase in Investment	Explanation
Amarem Realty Corporation (AMAREM)	P 426,700.00	- swapping of CIP stockholder's shareholdings in AMAREM with CIP shares
Chemical Bulk Carriers, Inc. (CBCI)	2,437,595.00	- swapping of stockholders' shareholdings in CBCI with CIP shares of stock
Cuyapo Rice Mill (CURIMILL)	165,000.00	- acquisition of company (paid in cash by CIP)
LMG Chemicals, Inc. (LMG)	3,320,500.00	- 25,000 shares offset against investment losses (Main Management) - 3,295,500 unpaid subscription

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Chemphil Mfc. Corporation (CMC)	30,000,000.00	- spin-off of manufacturing operations of CIP to a new corporation, CMC, engaged in manufacture of chemicals, thereby making CIP a management and investment company
	P36,349,795.00	

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LMG	100,000.00	- Acquisition from Rodolfo Y. Eusebio, stockholder (paid in cash by CIP)
AMAREM	24,381.00	- transfer charges capitalized to investment account as a result of CIP/AMAREM swap
	P 124,381.00	

To support its claim, petitioner presented the following exhibits:

1. Financial Statements of petitioner for the years ended December 31, 1982, 1981 and 1980 and Reports of Independent CPAs (Exhs. G, G-1 to G-10, H, H-1 to H-9, I, I-1, I-2, J, J-1 to J-10, K, L, L-1 to L-9) to show the movement of petitioner's financial statements;

2. Certification of Chemphil-LMG, Inc. dated January 29, 1993 (Exh. M) to show that the interest charges paid by the petitioner to Chemphil Manufacturing Corp., which became Chemphil-LMG, Inc., was booked and recorded as interest income and subjected to the 35% corporate income tax;

3. Certification of Polyphosphates, Inc. (Exh. N) to show that the interest charges paid by the petitioner to Polyphosphates, Inc., was booked and recorded as interest income and subjected to the 35% corporate income tax;

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4. Memorandum of Agreement dated June 30, 1981 between CIP and CMC (Exh. P) to show that a pre-incorporation agreement was entered into by and between the petitioner and Chemphil Manufacturing Corp. regarding the spin-off of manufacturing operations requiring the transfer of all of petitioner's manufacturing property, plant and equipment as well as liabilities in exchange for 300,000 shares worth P30 Million;

5. Deed of Assignment dated December 22, 1993 (Exh. Q) to support that the parcels of land stipulated to be transferred in the Memorandum of Agreement was transferred to Chemphil-LMG, Inc. (A merger of LMG Chemicals, Inc. and Chemphil Manufacturing Corp.) by way of a deed of assignment;

6. Amended Articles of Incorporation of CIP dated March 7, 1983 (Exh. II) to show that the petitioner amended in May 8, 1981 its primary purpose from manufacturing to investment and management company;

7. Certificate of Filing of the Articles of Merger (Exh. JJ) to show that the merger of Chemphil Manufacturing Corp. with LMG Chemicals, Inc. to become Chemphil-LMG, Inc. was duly authorized by the Securities and Exchange Commission; and

8. Stock Swap Agreement (Exh. JJ-1) to show that the petitioner, as the owner of shares in Chemphil Manufacturing Corp. (CMC), agreed to swap its 450,000 shares in CMC with 25,630,324 shares in LMG Chemicals, Inc.;

Respondent, on her part, failed to file her formal offer of evidence although she requested for the marking of her documentary evidence found in the BIR records. She also failed to file her memorandum within the period given by the Court.

After an exhaustive and painstaking scrutiny of the evidence, We are constrained to uphold the deficiency

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income tax assessment but in a substantially reduced amount.

For clarity, We shall discuss separately the reasons advanced by respondent in disallowing the interest and bank charges.

First, that the loans obtained by petitioner were primarily applied to investments.

We do not agree.

An analysis of the audited financial statements of the petitioner would reveal that the increase in investment account was basically due to the effected spin-off of the manufacturing operations, whereby shares in the new manufacturing company were traded for the manufacturing assets, machineries and accounts of the petitioner (Exh. H-5). We noticed that with the increase in investments, there was a corresponding decrease in property, plant and equipment of the petitioner (Exhs. H-3 and F).

Likewise, in the Statement of Changes in Financial Position for the years 1982 and 1981, proceeds of the loans in 1982 were mostly used to pay currently maturing obligations (Exh. H-6) and in 1981, increase in investments account was associated with the disposal of property and equipment due to the above-mentioned spin-off.

Respondent's allegation, therefore, that the loans obtained by petitioner were primarily applied to investments in affiliated companies was based on mere presumptions. It is well-settled that "(a)ssessments should not be based on presumptions no matter how logical the presumptions might be. In order to stand the test of judicial scrutiny the assessment must be based on actual facts." **(Collector of Internal Revenue vs. Benipayo, 4 SCRA 182).**

The same holds true with regard to respondent's allegation that the loans do not have any economic substance except to evade the payment of the tax due. Respondent's finding is bereft of any basis that will lead Us to believe that the purpose of petitioner's loans was merely for tax evasion.

As to respondent's third ground, that the loans in which petitioner offered as collaterals the properties of its affiliates should in reality be the loans of the affiliates, We rule otherwise. Under Article 2085 of the Civil Code, while it required that the mortgagor be the absolute owner of the thing mortgaged, the second paragraph provides that:

> "Third persons who are not parties to the principal obligation may secure the latter by pledging or mortgaging their own property."

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It follows then that petitioner may validly offer as collateral the property of its affiliate and claim the interest paid for that loan as its own expense.

Finally, respondent avers that loans from affiliates like Polyphosphates, Inc. is considered as a sham transaction and therefore, the same should be treated as advance capitalization, and interest payments as dividend payments.

Petitioner, however, explained that "(t)he outstanding liability to Polyphosphates, Inc., which was then wholly owned by the petitioner, arose from the earlier years when petitioner was engaged in the marketing and selling of the chemical produce of the former, and invoicing and collecting payments from the customers. Since there was a need to extend credit to customers, Polyphosphates had to grant a credit line to the petitioner."

It further argued that by 1982, Polyphosphates was no longer wholly-owned by the petitioner and that forty percent (40%) in equity was transferred to Albright & Wilson of the United Kingdom. On arms length basis, the petitioner claims that it had to pay interests of long outstanding payables to Polyphosphates. Polyphosphates, on its part, declared and paid tax on the interest income in its income tax return for 1982 - for the interest that

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the petitioner had paid and deducted as expense from its taxable income. (p. 481, CTA records)

Clearly, petitioner still owns 60% of Polyphosphates, Inc. Under Section 30(b)(3)(B) of the Tax Code,

> "3. No deduction shall be allowed in respect of interest otherwise deductible under the preceding subparagraph -
>
> xxx
>
> (B) If both the taxpayer and the person to whom the payment has been made or is to be made are persons specified within any one of the paragraphs of subsection (b) of Section 31."

Section 31(b)(3), which applies to the instant case, provides:

> "(3) Except in the case of distributions in liquidation, between two corporations more than fifty per centum in value of the outstanding stock of each of which is owned, directly or indirectly, by or for the same individual, if either of one such corporation, with respect to the taxable year of the corporation preceding the date of the sale or exchange was, under the law applicable to such taxable year, a personal holding company or a foreign personal holding company."

Thus, under the preceding sections of the 1982 Tax Code, any interest payment made by petitioner to Polyphosphates. Inc. cannot be allowed as a deduction, they being considered as "related taxpayers". Their alleged "loans" and consequent "interest payments" fall within the prohibition under the aforecited Section 30(b)(3)(B).

WHEREFORE, in view of all the foregoing, the Court hereby **ORDERS** petitioner to **PAY** deficiency income tax for 1982 amounting to P1,966,547.26, computed as follows:

Net income per return	P 15,574.00
Add interest expense paid to Polyphosphates Inc.	2,023,851.00
Adjusted net income	P2,039,425.00
Tax due:	
first P100,000.00	P 25,000.00
in excess at 35%	678,798.75
Total	P 703,798.75
Less: income tax paid	5,451.00
Basic deficiency income tax	P 698,347.75
Add:	
a. Interest on deficiency -Sec. 51(d), 1982 Tax Code maximum 3 years (698,347.75 x 60%)	419,008.65
b. Additions to tax -Sec. 51(e)(2), 1982 Tax Code maximum 3 years (1,117,356.40 x 60%)	670,413.84
c. 10% Surcharge (1,787,770.24 x 10%)	178,777.02
TOTAL TAXES DUE	P1,966,547.26

SO ORDERED.

AMANCIO Q. SAGA
Associate Judge

WE CONCUR:

ERNESTO D. ACOSTA
Presiding Judge

RAMON O. DE VEYRA
Associate Judge

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CERTIFICATION

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

ERNESTO D. ACOSTA
Presiding Judge

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