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MA-AO SUGAR CENTRAL
Co., Inc.,
Petitioner,

-versus- C.T.A. CASE NO. 1434

COMMISSIONER OF
INTERNAL REVENUE,
Respondent.
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Sept. 21, 1967

D E C I S I O N

Petitioner has appealed from the decision of respondent dated July 9, 1963 (Exhibit 7, pp. 403-404, BIR rec.), holding it liable for the sum of ₱875,333.40 as deficiency income tax and interest for the years 1957, 1958, 1959, 1960 and 1961.

Petitioner, a domestic corporation engaged in the manufacture of centrifugal sugar, with head office at the Araneta Enterprises Bldg., Cubao, Quezon City, filed in due course its income tax returns for the fiscal years 1957, 1958, 1959, 1960 and 1961, and paid the corresponding income tax due. Subsequently, said returns were verified and investigated, and as a result thereof, certain deductions which were claimed by petitioner were disallowed by respondent. Accordingly, on January 15, 1963, a deficiency income tax assessment in the total amount of ₱765,938.42, inclusive of deficiency interests, was issued for the years 1957 to 1961. (Exhibit 3, pp. 288-290, BIR rec.) This assessment was disputed by petitioner in its letter dated March 15, 1963. (Exhibit 5, pp. 299-304, BIR rec.) Finally, in a letter dated July 8, 1963 (Exhibit 7, pp. 402-404, BIR rec.), the deficiency assessment for said years was increased to a total of ₱875,333.40 itemized as follows:

"35-ACR-800003-63/57

Net income per return ----------------------		₱ 974,893.55
Add: Unallowable deductions:		
1. Depreciation (excessive)		
a. Appraised mill plants ---	₱ 46,267.73	
b. Mill plants from 5% to 3% ----------------	103,726.02	149,993.75
2. Loss on materials & supplies		232,702.13
3. Prior years administration expenses		5,589.82
4. Bad debts written off		546,571.36
Net income per investigation		₱1,909,750.61
Tax due thereon		₱ 526,730.00
Less: Amount already assessed		264,970.00
Balance		₱ 261,760.00
Add: 50% surcharge		130,880.00
½% monthly interest from 6-20-59 to 6-20-62		47,116.80
TOTAL AMOUNT DUE & COLLECTIBLE		₱ 439,756.80

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Net income per return		₱ 829,533.56
Add: Unallowable deductions:		
1. Depreciation (excessive)		
a. Appraised mill plant	₱ 46,267.73	
b. Mill plant from 5% to 3%	113,815.26	160,082.99
2. Loss on materials & supplies		13,000.72
3. Estimated losses		54,174.31
4. Fertilizer venture		1,145.27
5. Bad debts written off		50,522.63
Net income per investigation		₱1,108,459.48
Tax due thereon		302,369.00
Less: Amount already assessed		224,269.00
Balance		₱ 78,100.00
Add: 50% surcharge		39,050.00
½% monthly interest from 6-20-59 to 6-20-62		14,058.00
TOTAL AMOUNT DUE & COLLECTIBLE		₱ 111,208.00

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Net income per return		₱ 800,378.16
Add: Unallowable deductions:		
1. Depreciation (excessive)		
a. Appraised mill plant	₱ 46,267.73	
b. Mill plant from 5% to 3%	157,590.67	203,858.40
2. Loss on materials & supplies		62,277.03
3. Fertilizer venture		1,225.99
4. Bad debts written off		87,209.78
Net income per investigation		₱1,154,949.36
Tax due thereon		₱ 338,485.00
Less: Amount already assessed		232,113.00
Balance		₱ 106,372.00
Add: 50% surcharge		53,186.00
½% monthly interest from 1-16-60 to 1-16-63		19,146.96
TOTAL AMOUNT DUE & COLLECTIBLE		₱ 178,704.96

"AGR-400187-63/60

Net income per return		₱1,650,759.96
Add: Unallowable deductions:		
1. Depreciation (excessive)		
a. Appraised mill plant	₱ 46,267.73	
b. Mill plant from 5% to 3%	154,341.18	
	₱200,608.91	
2. Fertilizer venture	(778.86)	199,830.05
Net income per investigation		₱1,850,590.01
Tax due thereon		₱ 547,177.00
Less: Amount already assessed		487,228.00
Balance		₱ 59,949.00
Add: ½% monthly interest from 1-16-61 to 7-8-63		8,912.39
TOTAL AMOUNT DUE & COLLECTIBLE		₱ 68,861.39

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Net income per return		₱2,816,403.13
Add: Unallowable deductions:		
1. Depreciation (excessive)		
a. Appraised mill plant	₱ 46,267.73	
b. Mill plant from 5% to 3%	127,726.95	
	₱173,994.68	
2. Fertilizer venture	(74.85)	173,919.83
Net income per investigation		₱2,990,322.96

Tax due thereon	₱ 889,097.00
Less: Amount already assessed	836,921.00
Balance	₱ 52,176.00
Add: ½% monthly interest from 1-16-62 to 7-8-63	4,626.25
TOTAL AMOUNT DUE & COLLECTIBLE	₱ 56,802.25"

The only issue raised is whether or not the disallowance of certain deductions, hereafter separately treated, is valid and justified.

(a) Disallowed depreciation claim of ₱46,267.73 for all the years under review

In view of the decision of this Court in the Talisay-Silay Milling Co., Inc. vs. Commissioner of Internal Revenue, CTA Cases Nos. 1399 and 1406, December 29, 1965, petitioner voluntarily withdrew its protest in regard to the disallowance of its claim for depreciation amounting to ₱46,267.73 on the appraisal of the mill plants for each of the fiscal years 1957, 1958, 1959, 1960 and 1961.

(b) Reduction of depreciation of mill plants from 5% to 3%

1957	₱103,736.02
1958	113,815.26
1959	157,590.67
1960	154,341.18
1961	127,726.95

Petitioner claimed a deduction for depreciation on its mill plants at the rate of 5%, which rate it consistently adopted since the operation of the mills after the war. To justify its claim for depreciation rate of 5%, petitioner presented in evidence the "Depreciation Guidelines and Rules" (Publication No. 456 (9-62)) issued by the United States Treasury, Department of Internal Review Service (Exhibit A), which indicates the life span of 18 years for machinery on sugar (Exhibit A-1).

Respondent, however, maintains that the correct and reasonable rate of depreciation for the mill plants in question should be 3% for the reason stated in the report and recommendation of eight examiners (Exhibit 2, p. 280, BIR rec.), pertinent portion of which reads as follows:

> "It was noted that the taxpayer depreciated its mill plants and machineries at 5% per annum. The Talisay-Silay Milling Company, Incorporated and Bacolod Murcia Milling Company, Incorporated, sister and affiliated sugar centrals located in the Municipality of Talisay and Bacolod City, respectively, Negros Occidental, depreciated this kind of assets at the rate of 3% per annum. These kind of assets are used uniformly in the same period, same vicinity and like circumstance. The Refinery Machineries were installed only on or before the year 1955 which were included and depreciated at 5% per annum. It will be reasonable, therefore, to adopt the 3% rate used by its affiliated and sister companies and disallow the excess of 2% of the rate used by subject taxpayer. Please see Annex 'C' for the detailed computation of the disallowance." (P. 280, BIR rec.)

The adoption of a depreciation rate upon an asset does not foreclose the application of a different or even a higher rate on similar assets used during the same period, in the same locality, and under the same conditions, if other attendant circumstances warrant. In view of the estimated life span of 18 years of machineries on sugar (see "Depreciation Guidelines and Rules", Publication No. 456 (9-62), issued by the United States Treasury, Department of Internal Revenue Service), and the absence of evidence showing a different life span, we believe that the 5% depreciation rate claimed by petitioner on the mill plants in question is reasonable and should be allowed.

(c) Losses on materials and supplies

1957	₱232,702.13
1958	13,000.72
1959	62,277.03

Petitioner claimed a deduction for losses of materials and supplies valued at ₱232,702.13 in 1957; ₱13,000.72 in 1958; and ₱62,277.03 in 1959. These amounts represent the difference between the book inventories and the actual physical count conducted at the end of each fiscal year. The difference consists mainly of unaccounted materials and supplies which, having been sent directly to the requisitioning department for operational use, were not entered in the stock cards. A small percentage thereof was due to actual losses, pilferages and wrong pricing or posting (pp. 98-99, t.s.n.).

Respondent disallowed the deductions on the grounds that loss thru pilferage was highly improbable due to the strict and tight security measures employed in the office and mill premises, and that a loss deduction on account of materials and supplies dropped from inventories for being obsolete are not allowed by law (Resp. Memo. pp. 5-6; Exh. 2, p. 280, BIR rec.).

We have had an occasion to rule on the deductibility of these items. In the Talisay-Silay Milling Co., Inc. case, supra, we said:

> "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 entered 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."

(d) Prior years administration expenses .... ₱5,589.82

The deduction of the amount of ₱5,589.82 was claimed as part of petitioner's expenses for additional salaries, the payment of which was decided only at the time the checks were issued in 1957. The deductibility of this amount is conceded by respondent. (P. 6, Resp. Memo.)

(e) Bad debts written off:

1957	₱546,571.36
1958	50,522.63
1959	87,209.78

In view of the evidence presented to the effect that the said amounts were debts owing to petitioner which were ascertained to be worthless (Exhibits N, O & P), respondent likewise concedes that these amounts were deductible in the years above mentioned, except the account of Mr. Woodrow Araneta in the sum of ₱50,773.37, which was written off in 1957 and which petitioner now admits was properly disallowed (pp. 6-7, Petitioner's Memo.; p. 6, "espondent's Memo.). Consequently, of the claimed bad debt deduction for 1957 amounting to ₱546,571.36, only the sum of ₱50,773.37 should be disallowed. The claims for bad debt deduction for the fiscal years 1958 and 1959 in the respective amounts of ₱50,522.63 and ₱87,209.78 are allowed.

(f) Estimated Losses in 1958 - ₱54,174.31.

For the fiscal year 1958, petitioner claimed as losses a portion of its stock of sugar which was wet, dirtied and stained. The sum of ₱64,900.28 represents the net value of bags that would be required to change the old bags to new bags, the cost of reprocessing the dirty and stained sugar, and shrinkage. Of this amount, only ₱10,725.97 was allowed as deduction for loss due to shrinkage. The balance of ₱54,174.31 which pertains to the net value of the new bags and the cost of reprocessing was disallowed on the ground that the deduction should have been claimed in 1959 when the rebagging or reprocessing took place. Inasmuch as the petitioner keeps its books on the accrual basis, and the damage to the sugar was actually sustained during the year ending September 30, 1958, said losses were properly claimed during said fiscal year. Moreover, even if the losses due to the damaged sugar were not taken up in the previous year, and the original cost was carried over to the subsequent year, the sale of the damaged sugar would result in a loss, and the net effect would be the same because said loss will be reflected in the return for the year it occurred. Therefore, the deduction of the sum of ₱54,174.31 in 1958 is justified.

(g) Fertilizer Venture

1958	₱1,145.27
1959	1,225.99
1960	(778.86)
1961	(74.85)

With respect to these deductions, called "Fertilizer Ventures" which respondent disallowed, petitioner, in line with the decision in Talisay-Silay Milling Co., Inc. vs. Comm. of Internal Revenue, supra, withdrew its objection to the disallowance. Accordingly, the disallowance of the deduction of ₱1,145.27 for the fiscal year 1958; ₱1,225.99 for the fiscal year 1959; ₱778.86 for the fiscal year 1960; and ₱74.85 for the fiscal year 1961, is hereby sustained.

(h) <u>Fraud penalty - 50% surcharge</u>

1957	₱130,880.00
1958	39,058.00
1959	53,186.00

The assessment under review carries with it the 50% fraud penalty for the fiscal years 1957, 1958 and 1959, in the amounts of ₱130,880.00, ₱39,050.00, and ₱53,186.00, respectively, or a total of ₱223,116.00.

We note that respondent did not offer any argument in his memorandum in support of the imposition of the 50% fraud penalty. We have searched in vain for evidence in the record justifying said imposition. We believe that petitioner has been candid in the preparation and filing of its returns and that the resulting controversy between the parties was due to an honest difference of opinion. The imposition of the above-mentioned fraud penalty is reversed for lack of basis.

WHEREFORE, the decision appealed from is hereby modified and petitioner is ordered to pay to the respondent or his representative the sums of ₱32,062.78, ₱15,665.68, ₱16,813.82, ₱15,677.67, and ₱15,088.59, as deficiency income tax, including interests, for the years 1957, 1958, 1959, 1960 and 1961, respectively, or a total of ₱95,308.54, computed as follows:

<u>1957</u>

Net income per return		₱ 974,893.55
Add: Unallowable deductions:		
1. Depreciation - appraised mill plants	₱46,267.73	
2. Bad debts written off ..	50,773.37	97,041.10
Net income per investigation		₱1,071,934.65

Tax due thereon		₱ 292,142.00
Less: Amount already assessed		264,970.00
Balance		₱ 27,172.00
Add: ½% monthly interest from 6-20-57 to 6-20-62		4,890.78
Total amount due & collectible		₱ 32,062.78

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Net income per return		₱ 829,533.56
Add: Unallowable deductions:		
1. Depreciation - appraised mill plant	₱46,267.73	
2. Fertilizer venture	1,145.27	47,413.00
Net income per investigation		₱ 876,946.56
Tax due thereon		₱ 237,545.00
Less: Amount already assessed		224,269.00
Balance		₱ 13,276.00
Add: ½% monthly interest from 6-20-59 to 6-20-62		2,389.68
Total amount due & collectible		₱ 15,665.68

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Net income per return		₱ 800,378.16
Add: Unallowable deductions:		
1. Depreciation - appraised mill plant	₱46,267.73	
2. Fertilizer venture ...	1,225.99	47,493.72
Net income per investigation		₱ 847,871.88
Tax due thereon		₱ 246,362.00
Less: Amount already assessed		232,113.00
Balance		₱ 14,249.00
Add: ½% monthly interest from 1-16-60 to 1-16-63		2,564.82
Total amount due & collectible		₱ 16,813.82

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Net income per return		₱1,650,759.96
Add: Unallowable deductions:		
1. Depreciation - appraised mill plant	₱46,267.73	
2. Fertilizer venture	(778.86)	45,488.87
Net income per investigation		₱1,696,248.83
Tax due thereon		500,875.00
Less: Amount already assessed		487,228.00
Balance		₱ 13,647.00
Add: ½% monthly interest from 1-16-61 to 7-8-63		2,030.67
Total amount due & collectible		₱ 15,677.67

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Net income per return		₱2,816,403.13
Add: Unallowable deductions:		
1. Depreciation - appraised mill plant	₱46,267.73	
2. Fertilizer venture	(74.85)	46,192.88
Net income per investigation		₱2,862,596.01
Tax due thereon		₱ 850,779.00
Less: Amount already assessed		836,921.00
Balance		₱ 13,858.00
Add: ½% monthly interest from 1-16-62 to 7-8-63		1,230.59
Total amount due & collectible		₱ 15,088.59

1957	₱32,062.78
1958	15,665.68
1959	16,813.82
1960	15,677.67
1961	15,088.59
	₱95,308.54

If the said sum of ₱95,308.54 is not paid in full within thirty (30) days from the date this decision becomes final and executory, petitioner shall pay the delinquency penalties provided for in Section 51(e) of the Revenue Code. Without pronouncement as to costs.

SO ORDERED.

Quezon City, September 21, 1967.

R M Umali
ROMAN M. UMALI
Presiding Judge

WE CONCUR:

Estanislao R. Alvarez
ESTANISLAO R. ALVAREZ
Associate Judge

Ramon L. Avanceña
RAMON L. AVANCEÑA
Associate Judge