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REPUBLIC OF THE PHILIPPINES
COURT OF TAX APPEALS
QUEZON CITY

April 30/66

CONNELL BROS. COMPANY (PHIL.),
Petitioner

versus — CTA CASE NOS. 411 & 610

THE COLLECTOR OF INTERNAL REVENUE,
Respondent.

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D E C I S I O N

These are appeals from the decisions of respondent assessing petitioner for deficiency income taxes for 1954 and 1955 in the amounts of ₱45,629.00 and ₱28,065.00, respectively, computed as follows:

1954

Net income per return		(₱ 3,567.97)
Add: Unallowable deductions:		
Bad debts: (a) Dahican American Lumber Co., may still be collectible as debtor Co. still exists in San Francisco, Cal. U. S. A.	₱ 8,488.43	
(b) Dahican Lbr. Co. - pending court decision, may be still collectible	66,610.54	
(c) Sy Chi Lim Sack & others still operating business may still be collectible	1,960.72	
Depreciation - Excess	12,385.74	
Depreciation & Losses of equipment, not property of Connell Bros. Co.	100,233.81	
Leasehold Improvement-Excess	5,421.68	₱195,100.92
Net income per investigation		₱191,532.95
Amount subject to tax		₱191,532.95
Amount of tax due thereon		₱ 45,629.00

1955

Net income per return	₱185,097.35
Add: Depreciation and losses on equipment	100,232.80
Net income per investigation	₱285,330.15
Tax due thereon	71,892.00
Less: Amount already assessed	43,827.00
Amount still due	₱ 28,065.00

The deficiency income tax assessments against petitioner for 1954 and 1955 were itemized in respondent's letters of demand dated July 9, 1956 and July 29, 1957, which were attached as Annex "A" of each petition for review. As the issues in both cases involve the allowance or disallowance of deduction from petitioner's gross income for 1954 and 1955, the appealed cases were submitted by both parties to this Court for a joint resolution.

The pertinent provisions of the National Internal Revenue Code applicable to the disputed facts of these cases read as follows:

> SEC. 30. Deductions from gross income.—In computing net income there shall be allowed as deductions—
>
> (a) Expenses:
>
> (1) In general.—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; x x x
>
> x x x x x
>
> (d) Losses:
>
> (1) x x x x x
>
> (2) By corporations.—In the case of a corporation, all losses actually sustained and charged off within the taxable year and not compensated for by insurance or otherwise.

x x x x x x

(c) Bad debts:
(1) In General.—Debts due to the taxpayer actually ascertained to be worthless and charged off within the taxable year.

x x x x x x

(f) Depreciation:
(1) In general.— A reasonable allowance for deterioration of property arising out of its use or employment in the business or trade, or out of its not being used: Provided, That when the allowance authorized under this subsection shall equal the capital invested by the taxpayer or, in case of purchase made prior to March first, nineteen hundred and thirteen, the fair market value as of that date, no further allowance shall be made. x x x

We are going to consider the various items of deduction in the order of their preference, namely:

1.	Bad debts:	
	(a) Dahican American Lumber Co. ₱	8,488.43
	(b) Dahican Lumber Company	66,610.54
	(c) Sy Chi Lim Sack Factory and Mabuhay Merchandising	1,960.72
2.	Depreciation excess	12,385.74
3.	Depreciation & losses on equipment	100,233.81
4.	Depreciation & losses on equipment	100,232.80
5.	Leasehold improvement excess	5,421.68

(Exh. 3, p. 27, BIR rec.; CTA No. 610)

Bad debt of Dahican American Lumber Co. - ₱8,488.43 -

From June 1951 to November 1952, petitioner sold on credit to Dahican Lumber Company machineries, equipment, spare parts, and supplies. When it became apparent that the said buyer could not pay petitioner the balance of ₱426,406.11 on account of said purchases on credit, both parties entered into an agreement on December 16, 1952 (Exh. "BB," p. 61 BIR rec. - CTA Nos. 411 & 610) whereby they rescinded the sale of the articles mentioned above and provided for the return thereof to the petitioner at its own expense. However, the said articles were not returned or delivered to petitioner because other creditors of Dahican Lumber Company applied for the appointment of a receiver and the Court of First Instance of Camarines Norte in Civil Case No. 480 granted the said application in its order dated February 12, 1953. Moreover, the said court ordered Dahican Lumber Company and Dahican American Lumber Corporation and their employees and representatives to turn over and deliver to the receiver, George H. Evans, all the properties of Dahican Lumber Company. To protect the articles sold on credit by petitioner to Dahican Lumber Company, the former spent ₱8,488.43 for security guards, maintenance, etc. (Exh. "AA-1," p. 59, BIR rec. - CTA Nos. 411 & 610; pp. 124-125, 283-284, t.s.n.) in 1953, which amount was entered in the books of account of petitioner as an indebtedness of Dahican American Lumber Company (instead of Dahican Lumber Company) and was written off as a bad debt in 1954.

In order that a bad debt may be deducted from petitioner's gross income in 1954, it is essential that the following requisites must be present, namely: (1)

there be a valid and subsisting debt; (2) the debt be actually ascertained to be worthless; and (3) the debt be charged off within the taxable year (Sec. 30(e)(1), supra; Phil. Trust Co. vs. Collector, CTA Case No. 367, Jan. 30, 1961). The evidence of record does not show the existence of a valid debt. The sum of ₱8,488.43 cannot, therefore, be allowed as a valid debt deduction. However, we find that the said amount is an ordinary and necessary business expense in the pursuit of petitioner's business or trade and in the protection of its business interest. Consequently, the said business expense of ₱8,488.43 is deductible from petitioner's gross income in 1954.

Bad debt of Dahican Lumber Co. - ₱66,610.54. - This amount represents part of the unpaid account of Dahican Lumber Company to petitioner for machineries, equipment, spare parts, and supplies sold by the latter to the former on credit. At the time of the rescission of sale of the said articles on December 16, 1952 (Exh. "BB," p. 61, BIR rec. - CTA Nos. 411 & 610), the unpaid account of Dahican Lumber Company to petitioner amounted to ₱267,078.15, but when the rescission was being implemented, only ₱200,467.61 worth of merchandise sold were identified and considered as recovered by petitioner under the contract of rescission (pp. 133-134, 319-321 and 386-390, t.s.n.), thereby leaving a balance of ₱66,610.54 which was written off by petitioner in its books of account as a bad debt in 1954.

Respondent disallowed the deduction of ₱66,610.54 from petitioner's gross income on the theory that, in 1954, no valid debt existed between petitioner and Dahican Lumber Company considering that the sales agreement between the said parties was nullified by the contract of rescission executed on December 16, 1952. Respondent further contends that, granting arguendo, a valid debt existed between the parties, petitioner is not entitled to deduct the same from its gross income because petitioner failed to prove its worthlessness in 1954.

With respect to the machineries, equipment, spare parts, and supplies sold on credit by petitioner to Dahican Lumber Company, the identity of which could not be ascertained or the return of which could not be effected because they have been consumed or used by the buyer, the said articles were expressly excluded from the contract of rescission and the price thereof remained an indebtedness of the buyer to the petitioner (Paragraph 8, contract of rescission, Exh. "BB"). In other words, as the terms and conditions of the contract of rescission were not comprehensive and all embracing as to include all the articles sold on credit, we find that the debt of Dahican Lumber Company to petitioner in the sum of ₱66,610.54 was valid and subsisting in 1954. As a corollary to this finding, it may be asked: Was the debt worthless in 1954?

Dahican Lumber Company was in a bad financial shape since 1951 (Exhs. "T" and "U," pp. 36 & 40, BIR rec. -

CTA Nos. 411 & 610). Its sawmill ceased to operate in October 1952 (see p. 208, t.s.n.). A foreclosure case was filed on February 12, 1953 against it in the Court of First Instance of Camarines Norte, Civil Case No. 480, by People's Bank and Trust Company and Atlantic Gulf and Pacific Co. of Manila (Exh. "LL") and on the same date the Court appointed a receiver (Exh. "HH," pp. 157-159, BIR rec. - CTA Nos. 411 & 610) who took possession of the company's properties in August, 1953 (see p. 225, t.s.n.). Even respondent considered Dahican Lumber Company insolvent in 1953 when he said:

> "The balance sheet of the Dahican Lumber Company as of December 31, 1953 shows that its indebtedness to its aforementioned secured creditors amounted to ₱1,480,850.02, including accrued interest in the amount of ₱181,685.84, so much so that when all the available assets of the insolvent company were adjudged by the courts to the said secured creditors, the unsecured creditors, like Connell Bros. (Phil.) can no longer expect payment from the debtor-company." (See Exh. "Y-6," pp. 52-54, BIR rec.)

Petitioner did not demand the payment of this unpaid account because Dahican Lumber Company volunteered the rescission of the sale and petitioner did not charge off this amount in 1953 because of its expectation that the rescission would result in the acquisition by petitioner of the machineries, equipment, spare parts, and supplies in question. The debtor's affairs were so hopelessly involved as to make the collection in 1954 of this unpaid account futile. An effort to collect a debt is not necessary where it would be futile (See Mertens Law of Federal

Income Taxation, Vol. 5, Chapter 30, p. 72, Sec. 30.43).

The evidence of record bears out the futility of an attempt to collect in 1954 the debt of ₱66,610.54 and the consequent worthlessness of the same. As correctly stated by petitioner:

> "The evidence shows that in said Civil Case No. 20987 of the Court of First Instance of Manila, the assets of Dahican Lumber Company were sold by the receiver, with the approval of the Court, for only ₱175,000.00 (Exhs. 'JJ' and 'KK') of which one-half (₱87,500.00) was allocated as the value of the undebated assets, that is, of those which were claimed by the therein plaintiffs only (People's Bank and Trust Company and Atlantic Gulf and Pacific Company of Manila) and the other half as the value of the 'debated' assets, that is, those which were claimed by the said plaintiffs and by the defendants therein (Connell Bros. Co. (Phil.), Dahican Lumber Company and Dahican American Lumber Corporation) (Exh. 'LL'). According to the decision of the Court of First Instance of Manila (Exh. 'LL'), the ₱87,500.00 allocated as the proceeds from the sale of the debated assets would be divided (after the deduction of expenses) by the parties in proportion to the following amounts:
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> | | |
> |---|---|
> | People's Bank . . . . | ₱300,000.00 |
> | Atlantic Gulf . . . . | 900,000.00 |
> | Connell Bros. . . . . | 452,860.55 |
> | Dahican American Lumber Company. . . | 2,151,678.34 |
>
> which means that Connell Bros. (petitioner herein) is entitled to approximately 12% of the ₱87,500.00. Considering that this ₱87,500.00 was further reduced to ₱43,750.00 as a result of deduction for the receiver's fees and expenses and the fees of the receiver's attorney, (Exh. 'OO') it is apparent that even if the lower court's decision is affirmed, the petitioner will receive only about ₱5,250.00. And even if the petitioner's stand in the appeal should be fully sustained, to wit, that only Dahican American Lumber Corporation

> and itself are entitled to the debated properties, it will receive only about ₱7,600.00, based on the fact that it shares with Dahican American Lumber Corporation in the proportion of 452,860.55 to 2,151,678.34 (equivalent to their respective credits against Dahican Lumber Company). It is thus clear that there is no probability of recovering in the pending case the ₱200,466.61 claimed by petitioner as deductions for depreciation or losses. x x x" (pp. 153-154, Petitioner's memorandum, CTA 411.)

We agree with petitioner that the bad debt of ₱66,610.54 was properly deducted from its gross income because, in 1954, the said indebtedness was valid and subsisting; it was ascertained to be worthless; and it was charged off in the books of account of taxpayer within the taxable year.

Bad debt of Sy Chi Lim Sack Factory and Mabuhay Merchandising - ₱1,960.72. - Petitioner deducted from its 1954 gross income the bad debts in the amounts of ₱1,726.00 and ₱211.12, or a total of ₱1,937.12. Respondent, however, disallowed as deduction the amount of ₱1,960.72, or an excess of ₱23.60.

The amount of ₱1,726.00 represents unpaid interest due from Sy Chi Lim Sack Factory covering the period from June to September 1953 on an indebtedness of ₱70,000.00. As the said interest was considered by petitioner as an unpaid debt in 1954, the same was deducted from its gross income for the said year. However, respondent's examiner found that the promissory note evidencing the debt of ₱70,000.00 was payable without interest and, therefore, disallowed the amount of ₱1,726.00 as a bad debt deduction. The disallowance made by respondent is legal and justified because the interest of ₱1,726.00 was not a valid and subsisting debt to petitioner in 1954.

The amount of ₱211.12 represents the balance of the account of Mabuhay Merchandising with petitioner. This amount was deducted from petitioner's gross income in 1954 because, despite the efforts exerted by petitioner's sales representative to collect the same since 1951, the said debt remained uncollected in 1954 as the debtor could not be located (pp. 120-122, t.s.n.). Respondent contends that a bad debt is not worthless simply because the creditor finds it difficult to collect the debt. We are convinced, however, that petitioner had exerted reasonable efforts to collect the debt and the flight or disappearance of the debtor is an evidence of the worthlessness of the debt. (Hart-Wood Lumber Co., 5 BTA 1171; Jones & Co., 2 BTA 1218.) The amount of ₱212.12 should, therefore, be allowed as a deduction from petitioner's gross income in 1954.

Depreciation excess - ₱12,385.74. - In 1950, petitioner depreciated its trucks and automobiles in the amount of ₱49,557.82, representing 33-1/3% of their value, but respondent allowed only a depreciation of 25% (Exhs. "L" & "L-1," p. 8, BIR rec. - CTA Nos. 411 & 610) in the sum of ₱37,172.08. The difference of ₱12,385.74 was considered by respondent as part of petitioner's net taxable income in 1954 because said amount was deducted from taxpayer's gross income in said year when petitioner came to know, for the first time, of its disallowance. In other words, petitioner paid the deficiency tax for 1950 on account of the disallowance of said depreciation of ₱12,385.74, but deducted the same from its gross income in 1954. Before the said year, the trucks and automobiles in question were already disposed of by petitioner.

Respondent contends that, since the said vehicles were not used or employed in the trade or business of petitioner in 1954, no legal justification exists for the allowance of the depreciation deduction. On the other hand, petitioner contends that, inasmuch as it was informed of the disallowance of the excess depreciation in 1954, it could still deduct the amount of the disallowed depreciation in 1950 from its 1954 gross income.

Section 30(f)(1) of the National Internal Revenue Code provides "a reasonable allowance for depreciation of property arising out of its use or employment in the trade or business" of a taxpayer. It is clear, therefore, that petitioner cannot deduct from its 1954 gross income the sum of ₱12,385.74 as depreciation of its trucks and automobiles because they were not used in petitioner's trade or business during the year. Moreover, petitioner failed to adduce any evidence that the yearly depreciation of 33-1/3% of the value of its trucks and automobiles represents a fair and reasonable depreciation resulting from their wear and tear. Accordingly, the 1950 excess depreciation of ₱12,385.74 is not deductible from petitioner's gross income in 1954.

Depreciation and losses on equipment - ₱100,233.81 and ₱100,232.80 for 1954 and 1955, respectively.— The machineries and equipment sold by petitioner to Dahican Lumber Company, valued at ₱200,467.61 after deducting the sum of ₱66,610.54, were identified and found in its premises. They would have been acquired by petitioner by virtue of the contract of rescission were it not for the injunction issued by the court. Notwithstanding this development, petitioner considered that it had acquired the machineries and equipment in question and estimated the useful life thereof at two (2) years. One-half of the said property valued at ₱100,233.81 was written off by petitioner in 1954 (Exhs. "A" and "1," pp. 9-10, BIR rec. in CTA Case No. 610) and the other half of ₱100,232.80 was written off in 1955 (Exh. "9," pp. 49-50, BIR rec. in CTA Case No. 411). The said amounts, labelled as depreciation and losses, were deducted from petitioner's gross income in 1954 and 1955.

The machineries and equipment in question cannot be depreciated by petitioner in 1954 and 1955 because they were not used or employed in petitioner's trade or business. Neither can the value thereof be treated as deductible losses for said years because petitioner has not sustained the actual loss of said property which were in the hands of the receiver appointed by the Court.]

After we have ruled that the amounts of ₱100,233.81 and ₱100,232.80 are not deductible depreciation and losses from petitioner's gross income in 1954 and 1955, we are constrained to hold that they are valid and subsisting debts of Dahican Lumber Company to petitioner despite the contract of rescission dated December 16, 1952. This is so because the said contract was never implemented and enforced when the receiver appointed by the Court took possession of the machineries and equipment in question. Moreover, the said articles were previously mortgaged by Dahican Lumber Company to other parties before the contract of rescission was executed on December 16, 1952. In short, the total amount of ₱200,466.61 represents a valid and subsisting debt of Dahican Lumber Company to petitioner in 1954. As the worthlessness of only one-half thereof in the sum of ₱100,233.81 was charged off by petitioner in its books of account in 1954, only said amount is deductible from petitioner's gross income in 1954. No portion of the total indebtedness of ₱200,466.61 is deductible from petitioner's gross income in 1955 because the said debt was determined to be worthless in 1954 and, therefore, it is only deductible as a bad debt for that year. Consequently, respondent correctly disallowed the deduction of ₱100,232.80 from petitioner's gross income in 1955.

Leasehold improvement excess - ₱5,421.68. - In 1948, petitioner rented a building in Dasmariñas, Manila, for its offices. The lease provided for a period of six (6) years ending on July 31, 1954 and that all improvements constructed therein would become the property of the lessor at the end of the lease (Exh. "P," pp. 12-21, BIR rec. - CTA Nos. 411 & 610). On July 28, 1954, the lease was extended for one year, renewable for another year at the option of petitioner (Exhs. "Q" & "Q-1," pp. 23-27, BIR rec. - CTA Nos. 411 & 610). Petitioner occupied the premises up to July 31, 1956. Various improvements were made on the leased premises and petitioner amortized the value thereof in the following manner:

> "x x x Each month the total of the unamortized value of the improvements as of said month was divided by the number of months still remaining of the term of the lease (Exh. 'R'; t.s.n., pp. 148-149). Because the improvements were not made all at one time but at different times over some years, the amounts of the monthly depreciation were necessarily unequal, with the depreciation charge becoming larger for each succeeding year of the lease as more improvements are made. The sum of ₱17,259.19 charged off by the petitioner as depreciation during the fiscal year 1953-1954, is equivalent to the unamortized balance of the leasehold improvements as of June 30, 1953 (Exh. 'R'). Such amount of depreciation for that fiscal year, which was the last year of the six-year term of the lease, is but a necessary consequence of the above-stated manner of computing the monthly depreciation charge. It was not known then that the lease would be extended for two more years (Exh. 'Q')." (Petitioner's memorandum, p. 155, CTA rec. No. 411.)

Out of the balance of ₱17,257.19 charged off by petitioner as depreciation on leasehold improvements, respondent disallowed ₱5,421.68 as excess depreciation. Respondent considered the correct yearly amortization at ₱11,837.51 by dividing the total value of all the improvements with the total number of years of the lease, including the extension of two years, or a total of eight (8) years (Exh. 2, p. 21, BIR rec., CTA No. 610). We cannot agree with the straight-line method used by respondent in depreciating the value of the improvements in question. The various improvements were not made at the same time. They were effected during a period of years. To follow respondent's theory would result in overstating the depreciation rate for the early years and understating those for the later years of the lease. We find the declining balance method adopted by petitioner to be in order. Under this method, the amount of depreciation is subtracted annually from the cost or other bases of the property and the rate applied only to the remaining balance. This method gives satisfactory results for improvements made at different times. Moreover, petitioner's method of computing the depreciation allowance is sanctioned by law (Sec. 109, Revenue Regulations No. 2). Consequently, the leasehold improvement depreciation of ₱5,421.68 should be allowed as a deduction from petitioner's gross income in 1954.

Accordingly, petitioner is subject to the following deficiency income taxes:

1954 (CTA Case No. 610)

Net income per return		(₱ 3,567.97
Add: Unallowable deductions:		
(a) Sy Chi Lim Sack Factory	₱ 1,726.00	
(b) Depreciation excess	12,385.74	
		14,111.74
Net income subject to tax		₱ 10,543.77
Tax due thereon		₱ 2,109.00

1955 (CTA Case No. 411)

Net income per return	₱185,097.35
Add: Unallowable deductions:	
(a) Depreciation & losses on equipment	100,232.80
Net income subject to tax	₱285,330.15
Tax due thereon	₱ 71,892.00
Less: Amount already assessed	43,827.00
Amount of tax still due	₱ 28,065.00

WHEREFORE, the decision appealed from with respect to the 1954 assessment (CTA Case No. 610) is hereby modified, as indicated above, while the decision in regard to the 1955 assessment (CTA Case No. 411) is hereby sustained. Petitioner is ordered to pay respondent the amounts of ₱2,109.00 and ₱28,065.00 as deficiency income taxes for 1954 and 1955, respectively, plus the corresponding interests provided in Section 51 of the Revenue Code. If the said deficiency taxes are not paid in full within thirty (30) days from the date this decision becomes final and executory, petitioner shall pay a surcharge of five per cent (5%) of the unpaid amount, plus interest at the rate of one per cent (1%) a month, computed from the date this decision becomes final until paid, provided that the maximum amount that may be collected as interests shall not exceed the amount corresponding to a period of three (3) years. Without pronouncement as to costs.

SO ORDERED.

Quezon City, April 30, 1966.

ESTANISLAO R. ALVAREZ
Associate Judge

I CONCUR:

ROMAN M. UMALI
Acting Presiding Judge