ALGUE, INC.,
Petitioner,

versus

THE COMMISSIONER OF
INTERNAL REVENUE,
Respondent.

Jan. 16, 1968

CTA CASE NO. 1620

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DECISION

This is an appeal from the decision of respondent assessing against and demanding from petitioner payment of ₱20,699.47, ₱27,720.00, and ₱34,-764.38, as personal holding company income tax, deficiency corporate income tax, surcharge and interests for 1958 and 1959, plus ₱300.00 compromise penalty in extra-judicial settlement of its penal liability for failure to produce its books of accounts and other records for inspection.

Petitioner is a domestic corporation organized for the purpose of engaging in engineering works, constructions, real estate business, and other business ventures. It filed income tax returns for 1958 and 1959 and on the basis thereof paid its income tax.

Petitioner is a closed family corporation (p. 126, t.s.n.; Exhs. E & 6, E-1, pp. 44 & 43, BIR rec.). More than 50% of its outstanding stock is owned by Alberto Guevara, Sr. (Exh. FFF-1, see

Envelope). Pursuant to a letter of authority dated June 7, 1963 (Exh. D, p. 18, BIR rec.), Revenue Examiners George Concepcion and Quintin P. Bitanga examined and investigated the income tax returns and accounting records of petitioner from 1957 to 1961. In a report dated March 17, 1964, the said examiners found petitioner liable for deficiency income taxes for 1958, 1959, 1960 and 1961 (Exh. E-2, p. 42, BIR rec.). Pursuant to a request of petitioner to give its side (Exh. J, p. 57, BIR rec.) regarding the findings of Revenue Examiners Concepcion and Bitanga, the latter heard petitioner. After the hearing, the said examiners reiterated their recommendation for assessment against petitioner (Exh. L, pp. 85-86, BIR rec.). Upon instruction of Mr. Antonio T. Mercado, Chief, Investigation Division, Bureau of Internal Revenue (Exhs. M & 9, p. 9, BIR rec.), said examiners amended and revised the income tax to be assessed against petitioner by limiting petitioner's liability to 1958 and 1959 (Exh. 14, pp. 98-100, BIR rec.).

On the basis of the recomputed tax liability recommended for 1958 and 1959, respondent Commissioner of Internal Revenue, in his letter dated December 18, 1964, but released on December 29, 1964 (p. 113, BIR rec.), assessed against and demanded from petitioner the payment on or before January 18, 1965 of personal holding company income tax for

1958, deficiency income tax for 1959, and personal holding company income tax also for 1959, in the respective amounts of ₱20,699.47, ₱27,720.00 and ₱34,764.38, inclusive of interests and surcharge, or a total of ₱83,183.85, plus ₱300.00 as compromise penalty in extrajudicial settlement of its penal liability for the alleged failure to produce its books of accounts and records for inspection (Exhs. 0 & 16, pp. 111-113, BIR rec.). This assessment was received by petitioner on January 14, 1965 (pp. 59, 150-151, t.s.n.).

On January 18, 1965, petitioner filed with respondent a letter of protest or request for reconsideration seeking the cancellation and withdrawal of the income tax assessment on the following grounds, to wit: (1) the right of respondent to assess petitioner for personal holding company income tax for 1958 has prescribed; (2) petitioner is not a personal holding company in 1958 and 1959; and (3) the imposition of 50% surcharge as fraud penalty and the interest of ½% a month is without any legal basis; and (4) the disallowed promotion fees of ₱75,000.00 are deductible business expense of petitioner (Exhs. R-1 & R-2, pp.124-125, BIR rec.).

On March 12, 1965, a warrant of distraint and levy dated February 12, 1965 was presented to petitioner (Exhs. 21, 22 & 0, pp. 116-118 & 122, BIR rec.), through its counsel, Atty. Alberto Guevara, Jr.

who refused to acknowledge the same (Exhs. 23 & R, pp. 127, BIR rec.; pp. 184-185, t.s.n.). Said counsel refused to receive the warrant (pp. 186-187, t.s.n.), because it was allegedly issued before the Commissioner of Internal Revenue acted on petitioner's protest of January 18, 1965 (p. 185, t.s.n.).

On April 7, 1965, Examiner Reyes apparently informed Atty. Guevara, Jr. that, with reference to his protest, his superior "'x x x do not want to do anything about it.'" Consequently, Atty. Guevara, Jr. accepted a copy of the warrant of distraint and levy from Examiner Reyes in order not to put the latter "in a precarious position" (p. 187, T.s.n.). On April 23, 1965, petitioner appealed to this Court.

The issues presented for our determination are as follows:

> (1) Whether or not petitioner has seasonably filed its appeal with this Court;
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> (2) Whether or not the right of respondent to assess petitioner for personal holding company income tax for 1958 has prescribed;
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> (3) Whether or not petitioner is a personal holding company and liable as such for income tax for 1959; and
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> (4) Whether or not the amount of ₱75,000.00 spent as promotion fees is a legitimate expense deductible from petitioner's gross income for 1959.

First Issue -

As to the question of whether or not the petition for review was seasonably filed in court, it is contended that respondent's warrant of distraint and levy can not be considered as the answer to petitioner's letter of protest because the same was not seen by respondent before the said warrant was issued and that said warrant having been "actually received" on April 7, 1965 and the petition for review filed on April 23, 1965, the 30-day period to appeal under Section 11 of Republic Act No. 1125 has not prescribed (see p. 19 of Memorandum for Petitioner & p. 7 of petitioner's Rejoinder). However, respondent maintains the contrary view (Memo for Respondent, pp. 5-8, CTA rec., pp. 91-94).

Sections 7(1) and 11 of Republic Act No. 1125, which is applicable to the question at issue, provide as follows:

> SEC. 7. Jurisdiction. - The Court of Tax Appeals shall exercise exclusive appellate jurisdiction to review by appeal, as herein provided -
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> (1) Decisions of the Collector (now Commissioner) of Internal Revenue in cases involving disputed assessments, refunds of internal revenue taxes, fees or other charges, penalties imposed in relation thereto, or other matters arising under the National Internal Revenue Code or other law or part of law administered by the Bureau of Internal Revenue;
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> SEC. 11. Who may appeal; effect of appeal. - Any person, association, or corporation adversely affected by a decision or ruling of the Collector (now Commissioner) of Internal Revenue x x x

may file an appeal in the Court of
Tax Appeals within thirty days after
the receipt of such decision or ruling.

The decision of the Commissioner of Internal Revenue from which appeal can be taken to this Court within 30 days from receipt thereof is that which has the element of finality. The determination of the final decision rests, not with the taxpayer, but with the Commissioner of Internal Revenue himself (See Philippine Planters Investment Co., Inc. v. Acting Commissioner of Internal Revenue, CTA Case No. 1266, Nov. 11, 1962, citing St. Stephen's Association, et al. v. Collector of Int. Rev., G.R. No. L-11238, Aug. 21, 1958).

Where a warrant of distraint and levy was issued, this Court held that such issuance is proof of the finality of the assessment (Philippine Planters Investment Co., Inc. v. Acting Commissioner of Int. Rev., op. cit.), because a warrant of distraint and levy, which is the most drastic action of all media of enforcing the collection of tax, "renders hopeless a request for reconsideration," or is "tantamount to an outright denial" thereof, and makes the said request "deemed rejected." (Vicente Hilado v. Comm. of Int. Rev., CTA Case No. 1256, Oct. 22, 1962.)

The final decision of the Commissioner of Internal Revenue from which appeal should be taken to this Court is his letter of assessment and demand dated December 18, 1964, received by petitioner on January 14, 1965, because it is the first and the last unrevised or unmodified assessment (North Camarines Lumber v. Coll. of Int. Rev., G.R. No. L-12353, Sept. 30, 1960; Ker & Co. v. Coll. of Int. Rev., G.R. No. L-12396, Jan. 31, 1962). The thirty (30) day period to appeal began to run from January 14, 1965 and was tolled on January 18, 1965, the date on which petitioner's protest or request for reconsideration was filed (North Camarines Lumber Co., Inc. v. Coll. of Int. Rev., G.R. No. L-12353, Sept. 30, 1960; Pangasinan Transp. Co., Inc. v. Silverio Blaquera, supra; Filipinas Investment Corp. v. Comm. of Int. Rev., G.R. No. L-23501, May 16, 1967). Four (4) days of the statutory period of thirty (30) days was initially used.

On March 12, 1965, when respondent's warrant of distraint and levy was served upon petitioner through its legal counsel, the latter refused to accept or acknowledge the receipt of said warrant because his letter of protest against respondent's assessment has not been acted upon. We find petitioner's stand well taken. A searching examination of the BIR records failed to show that the original letter of protest of petitioner, dated January 18, 1965, was included therein despite the fact that the photostatic copy of said letter (BIR rec., pp. 141-142) bears the stamp of the "Office of the

Commissioner" and the initial of the receiving clerk or employee. Consequently, respondent's warrant of distraint and levy cannot, by any stretch of the imagination, be considered as an outright denial or rejection of petitioner's protest against respondent's assessment because the original copy of said protest has never been attached to or included in the BIR records.

The said protest consisting of two pages is not pro forma. It was based apparently on strong legal grounds and it was neither frivolous nor intended to delay the collection of the disputed income tax assessment. In fact, petitioner's legal counsel finally acknowledged receipt of respondent's warrant on April 7, 1965. Under this circumstance, it can be said that petitioner practically admitted that its protest to the assessment was denied and rejected by respondent on April 7, 1965. Thereafter, petitioner filed with this Court the corresponding petition for review on April 23, 1965, or 16 days after the receipt of said warrant. In short, it took petitioner a total of twenty days from the receipt of respondent's assessment and warrant of distraint and levy within which to appeal to this Court. Accordingly, we hold that petitioner's appeal from the decision of respondent was seasonably filed.

Second Issue -

A copy of the corporate income tax return of petitioner for 1958 is found in the BIR records, inclusive of the financial statement (pp. 13-16). The date of filing does not appear in the said income tax return. We assume, however, that the said return for the calendar year 1958 was filed with respondent's office on or before March 1, 1959 under Section 46(b) of the National Internal Revenue Code before its amendment by Section 6 of Republic Act No. 2343.

As the corporate income tax return of petitioner was filed for legal purposes on March 1, 1958 and the income tax assessments and letter of demand of respondent dated December 18, 1964 were released by mail to petitioner on December 29, 1964, it is clear that respondent's income tax assessment for 1958 was issued within five (5) years, eight (8) months and twenty-eight (28) days from March 1, 1958 when petitioner's corporate income tax return was filed. Accordingly, we hold that the right of respondent to assess petitioner for 1958 personal holding company income tax in the sum of ₱20,699.47, inclusive of interest, has prescribed under Section 331 of the National Internal Revenue Code which provides as follows:

> SEC. 331. Period of limitation 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 purposes 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: Provided, That this limitation shall not apply to cases already investigated prior to the approval of this Code.

Third Issue -

For the taxable year 1959, petitioner filed its income tax return declaring therein a net income of ₱23,320.05 on which it paid the corresponding income tax. A breakdown of the income for the said year shows that petitioner had the following sources of gross income:

Promotion fees and others ..	₱106,320.75
Rentals	65,483.23
Interest	202.50
Sales or exchanges of fixed assets.	(7,565.00)
Total gross income . . .	₱164,441.48

After examining and investigating petitioner's income tax return for 1959, respondent considered the following as personal holding company income:

Net profit for 1959 to surplus	₱ 18,189.65
Promotion fees.	75,000.00
	₱ 93,189.65

(BIR records, pp. 98-99 & 112-113.)

Section 63 of the National Internal Revenue Code imposes a tax of 45% of the undistributed income of a personal holding company. Under Section 64 of the same Code, a personal holding company is defined as any corporation at least 80% of its gross income is personal holding company income as defined in Section 65 thereof and if any time during the last half of the taxable year more than 50% in value of its outstanding stock is owned, directly or indirectly, by or not more than five (5) individuals.

Petitioner admits that during the year 1959, five (5) out of the eight (8) stockholders of Algue, Inc. owned more than 50% of petitioner's outstanding capital stock (Petitioner's Memo., p. 17; CTA rec., p. 60). Consequently, the stock ownership requirement of the law for a personal holding company has been satisfied. The legality, therefore, of respondent's assessment depends upon the question of whether the gross income of petitioner in 1959 consisted of at least 80% personal holding company income as defined in Section 65 of the Revenue Code.

In 1959, Algue, Inc. had a gross income of ₱164,441.48. It is indispensable, therefore, that 80% of said income amounting to at least ₱131,553.18 should be personal holding company income. By adding the rental income of ₱65,483.23, which is less than 50% of the gross income, and the promotion fees of ₱75,000.00 considered as a personal service contract, it would appear that petitioner is a personal holding company because more than 80% of its gross income is personal holding company income.

Respondent's examiners (Messrs. George T. Concepcion and Quintin P. Bitanga) claim that the promotion fees of ₱75,000.00 are personal holding company income because said fees were realized by the petitioner on account of the personal service contract of Mr. Alfredo Guevara, who is the controlling stockholder of Algue, Inc. (Exh. E-5, BIR rec., p. 43). The said claim of the revenue examiners is predicated on Section 65(e) of the Revenue Code which reads as follows:

> SEC. 65. Personal holding company income.—For the purposes of this Title the term "personal holding company income" means the portion of the gross income which consists of:
>
> x x x x x
>
> (e) Personal service contracts.—(1) Amounts received under a contract under which the corporation is to furnish personal services, if some person other than the corporation has the right to designate (by name or by description) the individual who is to perform the services, or if the individual who is to perform the services is designated (by name or by description) in the contract; and (2) amounts received from the sale or other disposition of such a contract. This subsection shall apply with respect to amounts received for services under a particular contract only if at some time during the taxable year twenty-five *per centum* or more in value of the outstanding stock of the corporation is owned, directly or indirectly, by or for the individual who has performed, is to perform, or may be designated (by name or by description) as the one to perform, such services.

Inasmuch as respondent considered that the promotion fees of ₱75,000.00 were earned by petitioner under a personal service contract with the Philippine Sugar Estates Development Company, the decisive fact to be determined is whether or not Mr. Alfredo Guevara is "designated by the contract as the one to perform such services" for the Philippine Sugar Estates Development Company or some person other than petitioner has the right to designate him, by name or by description, as the individual who is to perform the service.

Under the contract between Algue, Inc. and the Philippine Sugar Estates Development Company (Exh. QQ, Petitioner's Envelope of exhibits), the former was appointed and authorized by the latter to sell its land, factory, and oil manufacturing process subject to the terms and conditions stipulated therein. But nowhere and in no wise does the contract show that some person other than petitioner had the right to designate, by name or by description, Mr. Alfredo Guevara as the individual who was to perform the service for the Philippine Sugar Estates Development Company. On the contrary, the stockholders of Algue, Inc. agreed that the sale of the properties in question should be undertaken by Alberto B. Guevara, Jr., Eduardo Guevara, Edith O'Farrell, Pablo Guevara, Rosario Sanchez and Isabel Guevara (Exh. RR, petitioner's Envelope of exhibits).

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Section 65 of the Revenue Code is an exact copy of the United States Federal Income Tax Law on the subject (See I.R.C. [1954], Sec. 543[a][5]; I.R.C. [1939], Sec. 502[e]; 1948 Rev. Act, Sec. 403[e]; 1936 Revenue Act, Sec. 353[e], as amended by 1937 Rev. Act, Sec. 1; see also 7 Mertens, Law on Federal Income Taxation, p. 22). As construed in the United States, the provision in regard to personal service contracts (Sec. 65[e]), are intended primarily to reach cases of "incorporated talents," which is a tax avoidance scheme through the formation of a corporation whereby the individual who is practically the sole incorporator, enters into a contract with the corporation to perform personal services for the person or persons whom the corporation might designate at a nominal compensation but for which services the corporation collects a much bigger amount from the person or persons for whom the services are actually performed. Thus the individual achieves substantial immunity from high individual rates by having the corporation accumulate most of the sums received, paying thereon only the normal corporate tax (7 Mertens, Law of Federal Income Taxation, supra). By the device of the personal holding company, therefore, an individual whose income from his extraordinary skill or exceptional talent is large, like a movie star or business executive, would form a corporation and contract his services to such corporation at a nominal sum. In turn, the corporation would then contract with third persons, who are the real employers, who are willing to pay huge amounts for the extraordinary skill or exceptional talent of the designated party, and the highly skilled or talented person would thereby avoid high income tax rates. The highly skilled or talented person, who is to furnish the services, is always named or designated in the contract with the real employers (see Marcial P. Lichauco, Inc., v. Commissioner of Internal Revenue, CTA Case No. 1723, Aug. 7, 1967).

In the case at bar, there is no indication that Algue, Inc., was designed to avoid the income tax due from Mr. Alberto Guevara through the formation of a personal holding company. The said corporation was organized to engage in a legitimate business. Probably, the services of Mr. Alberto Guevara were some of its valuable assets, but the contract with the Philippine Sugar Estates Development Company did not specifically require his services by name or description. Moreover, petitioner was incorporated on May 12, 1953 while the services under question were not rendered until 1959. It cannot be said, therefore, that Mr. Alberto Guevara formed Algue, Inc. for the purpose of siphoning the income to be derived by him from the Philippine Sugar Estates Development Company. The promotion fees of ₱75,000.00, therefore, are not personal holding company income.

Accordingly, we hold that petitioner is not a personal holding company in 1959 and, therefore, not subject to personal holding company income tax for the said year.

Fourth Issue -

Respondent contends that the amount of ₱75,000.00 representing expenses paid to the stockholders of Algue, Inc., is not deductible from petitioner's gross income in 1959 because said payment to the stockholders is fictitious considering that it is a family corporation (Exh. E-3, BIR rec., p. 43).

The general and specific requirement for the deduction of salaries or other compensation from gross income is embodied in Section 30(a)(1) of the Revenue Code which provides, among others, 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

(Under the foregoing provisions of law, the deductibility of salaries from gross income must meet and comply with the following requisites, to wit:

1. The expense for salaries must be both ordinary and necessary;

2. The salaries must be paid or incurred within the taxable year;

3. The salaries must be incurred in carrying on a trade or business;

4. The expenses must in fact be salaries or other compensation;

5. The salaries must be for personal services actually rendered; and

6. The salaries must be reasonable in amount.

In implementing the provisions on Section 30 (a)(1) of the Revenue Code, supra, as authorized by Section 338 of the same Code, the Secretary of Finance promulgated Revenue Regulations No. 2, otherwise known as the Income Tax Regulations. Section 70(1) thereof provides as follows:

> Sec. 70. Compensation for personal services. - Among the ordinary and necessary expenses paid or incurred in carrying on any trade or business may be included a reasonable allowance for salaries or other compensation for personal services actually rendered. The test of deductibility in the case of compensation payments is whether they are reasonable and are, in fact, payments purely for service. This test and its practical application may be further stated and illustrated as follows:
>
> (1) Any amount paid in the form of compensation, but not in fact as the purchase price of services, is not deductible. (a) An ostensible salary paid by a corporation may be a dis-

> tribution of a dividend on stock. This is likely to occur in the case of a corporation having few stockholders, practically all of whom draw salaries. If in such a case the salaries are in excess of those ordinarily paid for similar services, and the excessive payment correspond or bear a close relationship to the stockholdings of the officers or employees, it would seem likely that the salaries are not paid wholly for services rendered, but that the excessive payments are a distribution of earnings upon the stock. x x x (Promulgated Feb. 11, 1941, 30 O.G. No. 18, 325.)

The evidences, testimonial and documentary, show that the amount of ₱75,000.00 was paid by petitioner in 1959 as compensation for services rendered by the following stockholders, namely:

Alberto B. Guevara, Jr.	₱15,000.00
Eduardo Guevara	10,000.00
Isabel Guevara	10,000.00
Pablo Guevara	10,000.00
Rosario Sanchez	20,000.00
Edith O'Farrell	10,000.00
Total	₱75,000.00

The amount of compensation received by each of them from Algue, Inc. was declared in their respective income tax return for 1959 and the income taxes due thereon were paid. The said expense of the petitioner out of a total income of ₱125,000.00 which was received by petitioner from the Philippine Sugar Estates Development Company in 1959 and 1960 in the amounts of ₱95,000.00 and ₱30,000.00, respectively, is considered as ordinary, necessary, and reasonable. In the first place, the said stockholders were responsible in forming the Vegetable Oil Industries

Corporation which eventually purchased the land, factory and manufacturing process of the Philippine Sugar Estates Development Company. In the second place, they approached and convinced prominent businessmen and investors to buy the shares of stock of the new corporation and they succeeded in doing so. And lastly, by reason of their individual merit and qualification to handle the business transaction under question, they were able to push through the profitable business deals involving millions of pesos.

Moreover, it cannot be said that the compensation in the total amount of ₱75,000.00, which was paid by the petitioner to its stockholders, is a distribution of cash dividend in disguise. An examination and analysis of the evidence of record failed to show that the said payment of ₱75,000.00 to the various stockholders bear a close relationship to their stockholdings in Algue, Inc.

Accordingly, we hold that a corporation has the right to fix the compensation of its employees (Ledesma v. Collector of Internal Revenue, 42 Phil. 912) and courts are not inclined to intervene with that right if properly exercised (Levine & Bros., Inc. v. Commissioner, 101 F [2d]; Wagegro Corp., 38 BTA 1225). It follows, therefore, that the amount of ₱75,000.00 is deductible from petitioner's gross income in 1959.

With respect to the compromise penalty of ₱300.00 for the alleged failure of petitioner to produce its books of accounts and other records for inspection, suffice it to say that respondent does not have any power to impose a compromise penalty without the consent of petitioner (Collector v. U.S.T. et al., G.R. Nos. L-11274 and L-11280, November 28, 1958; Collector v. Bautista, et al., G.R. Nos. L-12250 and L-12259, May 27, 1959; Philippine International Fair, Inc. v. Collector of Internal Revenue, G.R. Nos. L-12928 & L-12932, March 31, 1962). The imposition of the compromise penalty in this case is, therefore, illegal.

WHEREFORE, the decision of respondent Commissioner of Internal Revenue assessing petitioner the amounts of ₱20,699.47, ₱27,720.00, and ₱34,764.38 as 1958 personal holding company income tax and 1959 deficiency corporate income tax and personal holding company income tax, respectively, is reversed. Accordingly, respondent's assessments against petitioner are hereby cancelled and declared of no force and effect. Without pronouncement as to cost.

SO ORDERED.

Quezon City, January 16, 1968.

Estanislao R. Alvarez
ESTANISLAO R. ALVAREZ
Associate Judge

WE CONCUR:

R M Umali
ROMAN M. UMALI
Presiding Judge

Ramon L. Avanceña
RAMON L. AVANCEÑA
Associate Judge