REPUBLIC OF THE PHILIPPINES
COURT OF TAX APPEALS
QUEZON CITY

MAKATI LEASING AND FINANCE CORPORATION,
Petitioner,

- versus - C.T.A. CASE NO. 3354

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

10/25

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

D E C I S I O N

This is an appeal from the decision of respondent Commissioner of Internal Revenue assessing and demanding from petitioner deficiency income tax for the year 1975 in the amount of P1,311,066.12 computed as follows:

ACR No. 04B-032-000623-75/80

Net income per return	P2,318,605.48
Add: Additional income-(Per adoption of Financing Method Rather than Operating Method)	2,637,961.90
Net income per investigation	P4,956,567.38
Tax due thereon	1,724,798.00
Less: Tax already assessed	801,512.00
Balance	923,286.00
Add: 14% int. from 4/16/75-4/16/78 .	387,780.12
AMOUNT STILL DUE AND COLLECTIBLE	P1,311,066.12

and deficiency withholding taxes in the amount of P2,505.34. *(Exh. D, p. 5 CTA rec.)*

From the assessment, on December 1, 1980, petitioner protested and moved for reconsideration of the deficiency income tax stating that "<u>the lease agreements</u> *(Exhs. C, C-1 - G-4,* p. 74, CTA rec.) <u>it has entered into are pure and simple leases and not installment sales."</u> *(Exh. E, pp. 77-80, CTA rec.)*

In the meantime, on March 4, 1975, petitioner wrote a letter to respondent Commissioner of Internal Revenue requesting that its books of account kept in accordance with the "operating" method of accounting for leases be changed to another accounting system known as the "financing" method of accounting. *(Exh. B-1, pp. 72-73, CTA rec.)*

> The "operating" method of accounting, "xxx <u>the aggregate rentals from leases are recorded and reported as income over the lives of the leases in amounts equivalent to the provisions of the lease contracts and deductions are taken from depreciation on the leased equipment. The cost of the lease equipment is depreciated over the estimated useful on a declining balance basis</u>.
>
> "For taxation purposes, percentage taxes are computed on the basis of the gross rentals due/earned during the taxable period. <u>For income tax purposes, net income subject to tax is arrived at by deducting operating costs</u> (e.g. payroll, interest, percentage taxes and other business expenses, <u>and depreciation of leased equipment, etc. from the gross rental</u> due/earned during the taxable period. *(Exh. B-1, p. 72 CTA rec.*

"New System"

"The company desires to change the system of recording its lease transactions in its books of accounts. This new system is known as "financing" method which we are using for internal reporting purposes. Under this method, the gross rentals receivable, estimated market value of the leased equipment, and the estimated income are recorded at the time the lease contract is booked. The estimated income represents the excess of the gross rentals receivable and the terminal market value over the cost of equipment leased. This is recognized as earned over the term of the lease using the sum-of-the-months digits method. This procedure results in recognizing the estimated lease income as revenue in proportion to the declining receivable balance.

The implementation of the new system shall involve the application of accounting concepts widely used in the industry and facilitate the preparation of periodic reports and financial statements. The manner by which percentage taxes and income taxes are computed shall, however, still be under the "operating" method as explained in the earlier portion of this letter-request. Taxwise, therefore, no change will be effected.

In reply thereto, the Deputy Commissioner of Internal Revenue, on January 19, 1976 approved the request of petitioner "on condition that it shall take effect beginning the taxable year 1976." We quote hereunder the Deputy Commissioner's letter of January 19, 1976. *Exh. B, p. 71, CTA rec.)*

In a letter dated May 29, 1981, *(Exh. F, p. 81, CTA rec.)* respondent denied petitioner's motion for reconsideration stating thus:

REPUBLIKA NG PILIPINAS
MINISTRI NG PANANALAPI
KAWANIHAN NG RENTAS INTERNAS
Lungsod ng Quezon

May 29, 1981

Mr. Renato L. De la Fuente
7th Floor, Makati Stock Exchange Bldg.
Ayala Avenue, Makati, Metro Manila

Re: Makati Leasing & Finance Corp.
1975 deficiency income tax case

S i r :

In reply to your letter dated December 1, 1980 protesting our 1975 deficiency income tax assessment in the amount of P1,311,066.12 against your above-named client, please be informed that, after considering the issues raised therein and the records pertinent thereto, this Office regrets not being able to give due course to your protest.

The lease agreement which your client executes with a lessee-client is, in substance, an installment sale and not a contract of lease.

Accordingly, it is hereby requested that you advise your client to settle the aforesaid assessment without further delay.

This is our final decision and should you disagree, you may appeal to the Court of Tax Appeals within thirty (30) days from date of your receipt hereof; otherwise, this Office will take the necessary action to enforce the collection of the aforesaid assessment.

Very truly yours,

(SGD.) RUBEN B. ANCHETA
Acting Commissioner

Hence, petitioner appealed to this Court.

The only issue posed for our determination is whether or not respondent Commissioner of Internal Revenue erred in considering the lease contract as sales contract entered into by petitioner Makati Leasing and Finance Corporation, wherein it availed of depreciation deductions in 1975 as installment sales.

Respondent contends that petitioner's lease contract is, in substance and purpose, an installment sale; hence, it is covered by Section 43 of the Tax Code as amended. It further claims in his Answer *(p. 28, CTA rec.)* that:

> "6. While petitioner maintained its books of accounts under the operating method, in its financial statements, it used the financing method. Under the "operating method", the entire rent income is recorded as income and depreciation of the leased equipment is claimed as deduction therefrom. Under the "financing method" only a portion of the amount received is considered income and the rest is treated as part of the cost. Depreciation is not claimed as deduction, the equipment being considered sold under the installment basis;

> "7. Some of the terms and conditions of petitioner's lease agreement are different from those of the ordinary contract of lease, to wit:
>
> > 1.) The lessee is required to pay the insurance premium on the equipment;
> >
> > 2.) The lessee, according to the agreement, is required to pay "all license fees, registration fees, assessment, charges and taxes imposed upon the ownership ..... sale, possession or use of the equipment ....."
>
> "8. In determining the real character of a contract, the purpose, rather than the name given to it by the parties, governs;"

On the other hand, petitioner contends that petitioner is licensed under the Finance Company Act since October, 1974, and is engaged in the leasing of equipment, barges, motor vehicles and other articles. It further contends that, as lessor, leases to a lessee, an equipment or article for an agreed period of time and rental, with the lessee being obligated to return to petitioner the leased equipment or article upon the termination of the lease contract.

The distinction between a lease and a sale is clear in law. And We agree with petitioner when he said in his Petition for Review that -

> "x x x. A lease is a contract whereby one of the parties (lessor) binds himself to give to another (lessee) the equipment or use of a thing for a price certain and for a period (Art. 1463, Civil Code of the Philippines). On the other hand, a sale is a contract whereby one of the parties (seller) obligates himself to transfer ownership of and to deliver a determinate thing to another (buyer) who obligates himself to pay for the said thing a price certain in money or its equivalent (Art. 1438, Civil Code of the Philippines). In the former case, title remains with the lessee.
>
> "A contract is the law between the parties and it is what the parties so characterize it. The contracts in question do not even give the lessee an option to purchase the leased equipment and he is obligated to return the same upon the termination of the lease.
>
> "The contracts in question are all lease contracts, intended and so designated by both parties to be such contracts.
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> "9. That the Bureau of Internal Revenue authorized petitioner to use the "operating method of accounting' for computing income taxes on petitioner's leasing activities.
>
> "10. That the Bureau of Internal Revenue will collect the same amount of income taxes under the operating method of accounting, wherein the taxpayer is allowed to deduct depreciation, as in the financing method, wherein only a portion of the amount received by the taxpayer is considered income while the other portion is treated as part of cost or a return of capital." *(pp. 2-3, CTA rec.)*

We are of the opinion and so hold that the petitioner is engaged in leasing properties. This intention can be gathered from the lease contracts and agreements entered into between petitioner Makati Leasing and Finance Corporation and the lessees Liwayway Marketing Corporation. *(Exh. C, p. 74, CTA rec.)*

Petitioner Makati Leasing and Finance Corporation, in 1975 or at the time in question, is still under the "operating " method of accounting, and not under the "financing" method of accounting, of which petitioner is granted to use only in the year 1976. Hence, for "xxx income tax purposes, the net income subject to tax of petitioner (Makati Leasing and Finance Corporation) is arrived at by deducting operating costs xxx and other business expenses, and depreciation of leased equipment, etc. from the gross rentals due/earned during the taxable period." *(Exh. B-1, p. 72, CTA rec.)*

The additional income of P2,637,981.90, for adopting the "financial" method of accounting, rather than the "operating" method in 1975, which was added to the net income of P2,318,605.48 by the Commissioner of Internal Revenue is therefore not in order. *(Exh. E, p. 77, CTA rec.)* And so also with the 14% int. from 4/16/75 - 4/16/78 in the amount of P387,780.12 *(Exh. E, p. 77, CTA rec.)* which is not imposable.

From the assessment and demand from petitioner for payment of deficiency withholding taxes at source from the first, second and fourth quarters of 1975, amounting to P2,505.34, petitioner agrees to pay the same. *(Exh. E, p. 77, CTA rec.)*

WHEREFORE, except for the amount of P2,505.34 withholding tax for 1975 which petitioner is liable thereto, the assessment and demand for deficiency income tax of P1,311,066.12 for the year 1975 against petitioner is hereby annulled and withdrawn.

Without pronouncement as to costs.

SO ORDERED.

Quezon City, Metro Manila, October 25, 1990.

CONSTANTE C. ROAQUIN
Associate Judge

I CONCUR:

ALEX Z. REYES
Associate Judge

CERTIFICATION

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

CONSTANTE C. ROAQUIN
Associate Judge
Court of Tax Appeals