REPUBLIC OF THE PHILIPPINES
COURT OF TAX APPEALS
QUEZON CITY

GESTETNER LIMITED,
Petitioner,

- versus - C.T.A. CASE NO. 3549

COMMISSIONER OF INTERNAL REVENUE,
Respondent.
x - - - - - - - - - - - - - x

11/29/90

D E C I S I O N

In this petition for review, petitioner disputes the assessment for deficiency income tax for the fiscal years ending September 30, 1976 and September 30, 1977 made by the Commissioner of Internal Revenue ordering it to pay the amount of P1,013,772.99 which represents twenty-five percent (25%) surtax plus interest for unreasonable accumulation of profits or surplus as provided for in Section 25 of the National Internal Revenue Code (NIRC) of 1977.

Petitioner is a foreign corporation having been organized and existing under the laws of the United Kingdom *(Exhs. "A" and "C")*. It is licensed to do business in the Philippines *(Exh. "A")* and was operating through a branch here during the taxable years in question.

An investigation by the Bureau of Internal Revenue of the tax case of petitioner for the fiscal years abovementioned allegedly showed that the latter did not remit any profit to Gestetner Limited of London. That, having funds because of undistributed earnings, it used such funds for short-term investments which are not deemed to be for the reasonable needs of the business *(Exhs. 4 & 5, p. 111 and p. 119, respectively, BIR record)*. It was consequently recommended that Section 25 of the NIRC of 1977 be applied against petitioner and that in accordance with said section a tax be imposed on petitioner for improperly accumulating profits or surplus.

Petitioner controverts the conclusion of the respondent's investigating examiners by positing that a mere branch in the Philippines of a foreign corporation that has no stockholder who is a citizen or resident of the Philippines, like itself, is not subject to the 25% additional tax under Section 25 of the NIRC of 1977.

The respondent counters with these averments, among others:

> 1.) The 25% surtax under Section 25 is also imposable on foreign corporations no shareholder of which is a resident or citizen of the Philippines;

2.) Foreign corporations, whether resident or non-resident, are subject to additional tax under the above section of the Tax Code of 1977 (Section 18, Revenue Regulations No. 2).

3.) Gestetner, Manila Branch, is a mere holding company engaged in the collection of royalties from Philippine Duplicators, Inc., a domestic corporation, for Gestetner Limited of England; hence, it falls squarely under subsection (b) of Section 25 of the Tax code of 1977.

The subject for interpretation, the additional tax on corporations improperly accumulating profits or surplus under Section 25 of the NIRC of 1977 is recognized as a provision bodily lifted from Section 102 of the U.S. Internal Revenue Code of 1939 *(**The Manila Wine Merchants, Inc. v. The Commissioner of Internal Revenue**, G.R. No. L-26145, February 20, 1984)*. Expectedly, the tax against improper accumulation of profits or surplus appears in our National Internal Revenue Code of 1939. Revenue Regulations No. 2 followed in February 2, 1940 containing rules for the effective enforcement of the tax.

The pertinent provisions of Section 25 read as follows:

> Sec. 25. Additional tax on corporations improperly accumulating profits or surplus.- (a) Imposition of tax. - If any corporation is formed or availed of for the purpose of preventing the imposition of the tax upon its

> shareholders or members of another corporation, through the medium of permitting its gains and profits to accumulate instead of being divided or distributed, there is levied and assessed against such corporation, for each taxable year, a tax equal to 25% of the undistributed portion of its accumulated profits or surplus which shall be in addition to the tax imposed by Section 24, and shall be computed, collected and paid in the same manner and subject to the same provisions of law, including penalties, as that tax.
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> (b) *Prima facie* evidence. - The fact that any corporation is a mere holding company shall be *prima facie* evidence of a purpose to avoid the tax upon its shareholders or members. Similar presumption will lie in the case of an investment company where at any time during the taxable year more than fifty *per centum* in value of its outstanding stock is owned, directly or indirectly, by one person.
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> (c) Evidence determinative of purpose. - That fact that the earnings or profits of a corporation are permitted to accumulate beyond the reasonable needs of the business shall be determinative of the purpose to avoid the tax upon its shareholders or members unless the corporation, by clear preponderance of evidence, shall prove the contrary.
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> (d) Exception. - The provisions of this section shall not apply to banks, non-bank financial intermediaries, corporations organized primarily, and authorized by the Central Bank of the Philippines to hold shares of stock of banks, insurance companies, or personal holding companies, whether domestic or foreign. (As amended by PD 1739)

The Supreme Court in ***The Manila Wine Merchants Case***, *supra*, cognizant of the origin of Section 25 deemed that it is "proper to resort to applicable cases decided by the American Federal Courts for guidance and enlightenment". We shall therefore be similarly guided. The Supreme Court proceeded to set the prerequisites to the imposition of the tax *(citing Mertens, Law of Federal Income Taxation, Vol. 7, Chapter 39, p. 44)*, thus:

> "A prerequisite to the imposition of the tax has been that the corporation be formed or availed of for the purpose of avoiding the income tax (or surtax) on its shareholders, or on the shareholders of any other corporation by permitting the earnings and profits to accumulate instead of dividing them among or distributing them to the shareholders (underscoring supplied).

The language of the provision in Section 25(a), to wit: "If any corporation is formed or availed of for the purpose of preventing the imposition of the tax upon its shareholders or members or the shareholders or members of another corporation" has also been interpreted as indicative of the intent to apply the tax in the instance where the avoidance is accomplished through the use of one corporation to shield its shareholders from income tax, or, through the use of more than one corporation, as for instance, where one corporation owns the stock of another and the subsidiary fails to pay dividends to the parent thereby permitting the parent's stockholders to escape the tax *(Ibid, p. 3, citing Revenue Regulations Section 532-1[a][2])*. Our own Section 18 of Revenue Regulations No. 2 carries an example.

> "xxx if the capital stock of the M Corporation is held by the N Corporation so that the dividend distributions of the M Corporation would not be returned as income subject to the tax on individuals until distributed in turn by the N Corporation to its individual shareholders, nevertheless the tax imposed by Section 25 applies to the M Corporation, if that corporation is formed or availed of for the purpose of preventing the imposition of the tax upon the individual shareholders of the N Corporation. xxx"

In relation to foreign corporations in the United States it was determined by the U.S. Commissioner of Internal Revenue that certain preconditions have to be met before it can be said that any foreign corporation has been formed or availed of for the interdicted purpose, to wit: "Whether resident or non-resident, with respect to any income derived from sources within the United States, if any of its shareholders are subject to income tax on the distribution of the corporation by reason of being (1) citizens or residents of the United States, or (2) non-resident alien individuals to whom Section 871 is applicable, that is, those subject to United States income tax, or

(3) foreign corporations if a beneficial interest is owned directly or indirectly by any shareholder specified in (1) or (2) *(Ibid, citing Revenue Regulations Section 532-1[c]; underscoring supplied)*.

The above treatment given by the U.S. Commissioner on the imposition of the accumulated earnings tax as to foreign corporations leads petitioner to assert that similar construction must also be given Section 25. The petitioner proceeds to postulate the conditions precedent for the 25% tax on unreasonable accumulation of surplus to apply as: (1) that the corporation is subjected to the tax had individual, as opposed to corporate stockholders and (2) that such individual stockholders were subject to Philippine income tax on the dividends they receive from the corporation. In this connection, petitioner tries to reinforce its position by giving evidence, unrebutted, that it had no shareholder who has either an individual or an entity which could have been subject to Philippine income tax on any dividends declared by petitioner *(Exhs. "N", "N-1", "N-2", and "R")*. Further, that petitioner's share capital had been registered through the years, either in the name of Gestetner Holdings PLC or Gestetner Management

Services Limited Corporation, which are also organized and existing under the laws of the United Kingdom *(Exhs. "N", "N-1")*. It is emphasized that such shareholders are corporate entities not individuals and the dividends they receive from petitioner would not have been subject to Philippine income tax.

The view of petitioner is well founded.

At the beginning, notice has been taken of the fact that the Supreme Court in ***The Manila Wine Merchants Case*** had previously lent authoritative value to the interpretation attached to the law by the source of the law. Given notice also that Section 25 of the NIRC of 1977 was adopted from the U.S. Tax Code, and considering the circumstances surrounding the accumulated earnings tax from its introduction into our Tax Code of 1939 up to the time of the inception of the branch profits remittance tax in 1975 (P.D. No. 778, promulgated August 24, 1975), such interpretation of American courts and treatment of the law as embodied in American Revenue Regulations would not only be persuasive but decisive in this case.

When the accumulated earnings tax under Section 25 first appeared in our Tax Code in 1939 there was as yet no branch profits remittance tax being imposed since the latter is to appear only in 1975. It could not be conceived therefore that the accumulated earnings tax can be linked to the non-remittance of branch profits as respondent would have it. The accumulated earnings tax is a penalty for improper accumulation of surplus or profits *(Mertens, Ibid, p. 3, citing* ***New Oakmont Corp. v. US****, 86 F. Supp. 897).* Such tax however, considering the time lag between it and the branch profits remittance tax, can not be said to have been formed in anticipation of the latter, so that even with the two eventually co-existing during the taxable years in question, it can not be ventured that this accumulated earnings tax is also a penalty for non-remittance of branch profits as the co-existence is apparently merely coincidental. We see also that following this proposition of respondent would make for a penalty preceding the tax proper. We will have an instance then, as some would put it, of a horse placed before the carriage.

Nor can it simply be argued that the non-remittance of branch profits is a way of or can be used to accumulate earnings or surplus in violation of the Tax Code. For in the conditions of a branch of a foreign corporation with no individual shareholder who is a citizen or resident of the Philippines like petitioner, the interdicted purpose, the avoidance of individual income tax on the individual shareholder, is incongruous. It is easy to see that the non-citizen or non-resident individual shareholder, recipient of the declared dividends by the foreign corporation, is not subject to income tax by the Philippines.

The point that petitioner is a mere holding company assuming the same is correct will also be not reason enough for the imposition of the tax, for such fact even if existing is only *prima facie* evidence of a purpose to avoid the tax upon the shareholders or members. "The statutory presumption in the case of a mere holding or investment company does no more than make the corporation come forward with its proof *(Ibid, p. 113, citing **United Business Corp. of America v. Comm.**, 62 F2d 754,78 L Ed 552, 54 S Ct 53 [1933])* and the tax may not be imposed unless the purpose of the corporation was to prevent the imposition of the income tax on its shareholders" *(Ibid, citing **Cecil B. de Mille**, 31 BTA 1161, affd 90 F2d 12, 82 L ed 551, 58 S Ct 32 [1937])*.

This case if we may add, reveals an undisclosed flaw in the continuity of the statutes which we have looked into here, that is, if we assume that there was really an intent, which became unfulfilled, to put the branch profits remittance tax provision within the scope of the accumulated earnings tax if that is at all possible.

WHEREFORE, the petition is GRANTED. The assessment against petitioner, with No. 01-32-1-000868-77-81 issued on October 31, 1981, in the amount of P1,013,772.99 is hereby ordered withdrawn, cancelled and revoked.

SO ORDERED.

Quezon City, Metro Manila, November 29, 1990.

ALEX Z. REYES
Presiding Judge

I CONCUR:

CONSTANTE C. ROAQUIN
Associate Judge

C E R T I F I C A T I O N

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.

ALEX Z. REYES
Presiding Judge
Court of Tax Appeals