PHILIPPINE PAPER PRODUCTS COMPANY,
Petitioner,

- versus -

MISAEL P. VERA, in his capacity as Acting Commissioner of Internal Revenue,
Respondent.

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March 31/69

C. T. A. CASE NO. 1706

DECISION

This is an appeal from the decision of respondent holding petitioner liable for deficiency income tax for the year 1959 in the amount of ₱7,747.00, plus interest of ₱1,394.46, or a total of ₱9,141.46, and the sum of ₱100.00, as compromise penalty for non-compliance with the requirements of Section 77 of the National Internal Revenue Code.

The facts of this case appear in a written stipulation of the parties and, in addition thereto, in the evidence introduced during the trial. The stipulated facts are as follows:

> 1. That petitioner is a corporation duly organized in 1934 under the laws of the Philippines, and as of 1959, its subscribed and paid-up capital was ₱400,000.00.
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> 2. That as shown by the purpose clause of its Articles of Incorporation, petitioner was organized:
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> > "To carry on the business of manufacturers, importers, exporters, and distributors of, and dealers in, papers and paper products of every

kind and for all purposes, including writing papers, envelopes, blotting papers, book papers, tissue papers, cards, cardboards, paper bangs, corrugated boxes, solid fibre packing containers, and other converted articles of paper; to construct, build and operate pulp and paper mills, and to engage in the manufacture, and sale of pulp and paper or any products in which pulp or paper, or any materials used in the manufacture of pulp or paper, may be used; to buy or otherwise deal in and dispose of such real and personal property as may be necessary or convenient in connection with the aforesaid business or the corporation; to act as general agent of any non-life insurance company; to make contracts, promissory notes, mortgages, and any other documents or papers deemed advisable or necessary and, in general, to carry on any other lawful business whatsoever in connection with the foregoing or which is calculated, directly or indirectly, to promote the interest of the corporation or to enhance the value of the properties."

3. That shortly after its incorporation in 1934, petitioner acquired machinery and equipment and since that time up to the present has been actually engaged in the manufacture or conversion of raw material paper into various finished consumer paper products such as napkins, toilet papers, wrapping papers, counter rolls and sheets, etc.

4. That on September 16, 1958, petitioner herein entered into a contract of lease with Mr. Andres J. Sanchez, or ANSAN for short, copy of which is hereto attached and made an integral part hereof as ANNEX "A".

5. That on October 29, 1959, petitioner herein and ANSAN entered into a "Compromise and settlement Agreement" copy of which is hereto attached and made an integral part hereof as ANNEX "B".

6. That since retaking possession of the leased machineries, tools and equipment from ANSAN, petitioner resumed its operations

of converting raw paper material into finished paper products and continued to do so up to the present.

7. That on March 29, 1960, petitioner herein filed its 1959 income tax returns, showing therein a net taxable income of ₱67,923.35.

8. That upon examination and audit of the said income tax return by the respondent, the following expenses were disallowed on the ground that the same are not considered ordinary and necessary business expenses under Section 30(a)(1) of the National Internal Revenue Code.

a. Condonation by petitioner of rentals receivables of . . .	₱14,000.00
b. Assumption of and payment by petitioner of light and power account of ANSAN . .	763.82
c. Payment by petitioner to Andres J. Sanchez of	16,000.00
d. Value of motor car of petitioner transferred to Andres J. Sanchez	3,575.00
T o t a l . .	₱34,338.82

9. That accordingly, on the basis of the said disallowances, respondent assessed the petitioner the sum of ₱7,747.00 as deficiency income tax for 1959, plus interest of ₱1,394.46 or a total of ₱9,141.46 under Assessment Notice No. 90-5C-300417 and Letter of Demand No. 90-B-42831-59 imposing a penalty of ₱100.00 for non-compliance with the requirements of Section 77 of the National Internal Revenue Code, which assessment and demand were duly received by petitioner on September 14, 1963.

10. That the petitioner wrote to the respondent under date of September 16, 1963, a letter requesting the reinvestigation of the assessment and demand abovementioned.

11. That on October 5, 1965, the respondent, in reply to the petitioner's request for

> reinvestigation, reiterated the assessment and demand in paragraph 9 hereof, which reply was received by petitioner on October 15, 1965. (See Stifacts, pp. 37-39, CTA rec.; underlining supplied.)

During the hearing, it was established by additional evidence that the lease was for two years beginning 1959 ending December 1960. After Andres T. Sanchez, who was an employee of petitioner before the lease took effect, had taken possession of petitioner's machinery and equipment pursuant to the lease contract, he paid the stipulated rentals and the light and power consumption for the first four months. Sanchez, it appears, overused the machinery and equipment and neglected to give them proper care and maintenance. Four months after the default in the payment of rentals, petitioner entered in negotiations with Sanchez to terminate the lease before the end of the stipulated period. Sanchez was agreeable to the termination, but demanded to be compensated for the alleged losses and damages he would incur in the form of unrealized profits, etc. In October, 1959 a compromise agreement was reached between petitioner and Sanchez whereby in consideration for the termination of the lease in question, petitioner condoned in favor of Sanchez the amount of ₱14,000.00 and ₱763.82 representing unpaid rentals and light bills respectively; paid to him the sum of ₱16,000.00, as separation pay as former manager of petitioner; and

(3) transferred to him an automobile valued at ₱3,575.00.

The principal issue raised by the parties in this appeal is whether or not the expenses in question in the total amount of ₱34,338.82 are deductible as ordinary and necessary expenses from petitioner's gross income for 1959 pursuant to Section 30(a)(1) of the National Internal Revenue Code which provides as follows:

> "SEC. 30. Deductions from gross income. - In computing net income there shall be allowed as deductions -
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> (a) Expenses:
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> (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." (Underlining supplied.)

Respondent maintains that the foregoing expenses are not ordinary and necessary expenses because, to terminate the lease, petitioner could have merely availed itself of the conditions set forth in the contract which states that: "In the event the Contractor fails to pay the rent for two (2) consecutive months, the Company has the right to cancel this contract and take possession of the equipments and machineries immediately without notice." (See par. 12, Exh. "A", p. 41, CTA rec.); or that petitioner could have interposed a counterclaim for actual damages for losses sustained due to the unsatisfactory operation of its machines and equipment by Andres J. Sanchez since the contract also provides that the lessee shall be liable for maintenance and repair due to ordinary wear and tear of the machinery and equipment (par. 10, Exh. "A", supra.) In other words, respondent's theory is that petitioner should have elected to enforce its right under the contract of lease instead of entering into a compromise agreement.

On the other hand, petitioner asserts that the compromise agreement was an ordinary and necessary expense made as it was to avoid a protracted litigation to cancel the lease and protect its expensive machinery and equipment from being impaired which could result to a loss of a sizeable investment in capital asset.

An expense is ordinary when it connotes a payment which is normal in relation to the business of the taxpayer under the circumstances (Visayan Cebu Terminal Co. vs. Comm. of Int. Rev., CTA Case No. 128, June 29, 1957). And the term ordinary as used in Section 30 of the Revenue Code does not mean that payments must be habitual or normal in that the same taxpayer will have to make them often. The situation may be unique in the life of an individual but it may still be ordinary within the context of the law if it is not unique in the life of the group, the community of which he is a part. (Welch vs. Helvering, 290 U.S.

113, 78 L. Ed. 2d 212; General Electric [P. I.] Inc. vs. Comm. of Int. Rev., CTA No. 1117, July 14, 1963; Collector of Int. Rev. vs. Philippine Education Co., Inc., 99 Phil. 321). (Compromises to avoid or settle a litigation when losses can thereby be avoided or minimized is a common business practice and finds indorsement from our Civil Code.) In Wigmore Realty Co. v. United States (104 F. Supp. 441-442) the following doctrine was held:

> In Welch v. Helvering, 290 U.S. 111, 54 S. Ct. 8, 9, 78 L. Ed. 212, Justice Cardozo stated the considerations involved in determining whether an expense is "ordinary" and "necessary". He there stated that if the taxpayer considered the expenditure a necessary one, the court "should be slow to override his judgment." With respect to whether an expense is "ordinary" he made the following observation:
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> > "Now, what is ordinary, though there must always be a strain of constancy within it, is none the less a variable affected by time and place and circumstance. Ordinary in this context does not mean that the payments must be habitual or normal in the sense that the same taxpayer will have to make them often. A lawsuit affecting the safety of a business may happen once in a lifetime. The counsel fees may be so heavy that repetition is unlikely. None the less, the expense is an ordinary one because we know from experience that payments for such a purpose, whether the amount is large or small, are the common and accepted means of defense against attack." See also Kanne v. American Factors, Ltd., 9 Cir., 190 F. 2d 155.
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> It would appear that the expense in question was "ordinary" under Justice Cardozo's definition. As pointed out by the

> taxpayer, transactions of the type involved here were common during the depression. At any time, compromise is a common business practice where losses thereby can be avoided.
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> The taxpayer believed that the expenses were necessary. It stood to benefit by getting out of an unprofitable business arrangement immediately. I can see no reason to "override" its judgment. It added nothing of capital to what it all ready had. It bought its peace by expending a necessary sum to gain it. It was an expenditure, not an investment.
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> For the reasons stated herein, I am of the opinion that the deduction claimed by the taxpayer should have been allowed. Accordingly, it is entitled to a judgment in the amount demanded.

The next question to resolve is the necessity and reasonability of the sum involved in the settlement. In this jurisdiction an expense is considered necessary where the expenditure is appropriate and helpful in developing and maintaining the taxpayer's business or that the same is proper for the purpose of realizing a profit or minimizing a loss. (See Welch v. Helvering, 290 US 111, 78 L. Ed. 2d 212; Coll. v. Phil. Education Co., 99 Phil. 321; Visayan Cebu Terminal Co. v. Comm. of Int. Rev., CTA Case No. 128, June 29, 1957; General Electric (P.I.) Inc. v. Comm. of Int. Rev., CTA No. 1117, July 14, 1963; See also Esso Standard Eastern, Inc. v. Comm. of Int. Rev., CTA Case Nos. 1251 & 1558, Oct. 23, 1967.) And normally, a taxpayer will not incur an expenditure unless required or justified by the needs of the business. Proceeding on that logical assumption, the courts are slow to override the taxpayer's judgment as to the necessity for incurring the expenditure)(Merten's Law On Federal Income Taxation, 1960 Revision, Vol. 4, Sec. 25.09). In this case, it is not denied that the machinery and equipment of the petitioner were being overused by Sanchez who was in arrears of rentals besides; that petitioner feared a costly deterioration of said machinery and equipment; that the value of the machinery and equipment was ₱272,565.96; and that the settlement for ₱34,338.82 is nearly half of what Sanchez demanded for the cancellation of his lease. A litigation for the cancellation which must of necessity involve conflicting claims for damages was believed by petitioner to be expensive and inexpedient for its purposes. In its judgment a settlement of ₱34,338.82 is far more acceptable than a protracted litigation with all the troubles entailed by it and we find nothing in respondent's evidence to show that such a litigation is a far better solution to petitioner's predicament or do we find in said evidence anything that shows that the amount is not reasonable. By and large we are constrained to respect petitioner's opinion that the settlement and the amount involved therein is necessary and at the same time reasonable in the absence of anything indicating the contrary.

WHEREFORE, the appealed decision of the Commissioner of Internal Revenue is hereby reversed, without pronouncement as to costs.

SO ORDERED.

Quezon City, Philippines, March 31, 1969.

RAMON L. AVANCEÑA
Associate Judge

WE CONCUR:

ROMAN M. UMALI
Presiding Judge

ESTANISLAO R. ALVAREZ
Associate Judge