REPUBLIC OF THE PHILIPPINES
COURT OF TAX APPEALS
QUEZON CITY

BPI LEASING CORPORATION,
(formerly Makati Leasing
Finance Corp.)
Petitioner,

- versus -

CTA CASE NO. 4328

COMMISSIONER OF INTERNAL
REVENUE,
Respondent.

Promulgated:
JUN 22 1995

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DECISION

This case involves a disputed assessment issued by the respondent against petitioner for alleged deficiency income and documentary stamp tax for the taxable years 1977 and 1978, detailed as follows:

1977

Deficiency income tax assessment	P2,669,339.43
Deficiency documentary stamp tax assessment	394,147.28
TOTAL	P3,063,486.71

1978

Deficiency income tax assessment	P1,793,810.34
Deficiency documentary stamp tax assessment	372,352.55
TOTAL	P2,166,162.89
AMOUNT STILL DUE AND COLLECTIBLE	P5,229,649.60

Petitioner is a domestic corporation organized and existing under the laws of the Philippines and was formerly known by its corporate name of Makati Leasing and Finance Corporation. It is primarily engaged in the leasing of various equipment to different kinds of clients and as such, it enters into lease agreements whereby clients pay a certain amount as rent for an agreed period of time. The amount it receives from its various clients as a result of such lease agreements is reported as rental income by the petitioner and a certain amount is deducted from its annual income corresponding to the depreciation of the leased equipment.

In a letter, dated April 6, 1983, respondent assessed petitioner for deficiency income tax and documentary stamp tax for the taxable years 1977 and 1978. This was protested by the petitioner in a letter dated May 2, 1983. Respondent on his part, modified the original assessment by merely reducing the amounts assessed but remained firm in the legal foundation upon which the assessment stands hence there still remained a substantial amount to be paid by the petitioner. As a last administrative recourse, petitioner filed a letter of reconsideration with respondent but this was denied by respondent in a letter, dated October 24, 1988, reiterating therein the amounts due and collectible.

This letter of denial was received by the petitioner on December 26, 1988. Subsequently, petitioner sought the assistance of this Court through a petition for review filed on January 25, 1989 praying for the cancellation of the assessments on the ground that they were issued without legal basis.

The alleged tax deficiencies described in the assessment letters arose from two theories adopted by the examiner in the investigation she conducted on petitioner's tax liabilities for the years 1977 and 1978. The theory adopted with respect to the income tax liability of petitioner is that the so-called lease agreements entered into by petitioner with its clients are in reality installment sales hence a different tax implication ensues resulting in the deficiency. Quoted hereunder are some of the findings of the revenue examiner with respect to the income tax liability of the petitioner.

<u>Details of Leasing Activities</u>

> When a client-lessee needs a particular kind of equipment, it goes to the lessor (Makati Leasing and Financing Co.) and the latter acquires the equipment desired. A lease agreement is then executed (a sample of the agreement form is hereto attached). The terms and conditions in the lease contract contain certain terms and conditions which make it entirely different from the ordinary contract of lease, some of which are as follows:

xxx xxx xxx

> In form, the transaction is no doubt a lease but in substance, it is one of installment sales. It is well settled that in a conflict between form and substance, the former must necessarily yield to the latter.

As regards the documentary stamp tax liability of the petitioner, respondent's examiners adopted the theory that the non-negotiable promissory notes executed by petitioner are considered as "certificates of indebtedness" hence, subject to documentary stamp tax.

The two basic issues that confront this Court in the instant case are the following:

1) Whether or not the lease contracts entered into by petitioner BPI Leasing Corporation are in reality, installment sales, thus covered by Section 43 of the Tax Code;

2) Whether or not the non-negotiable promissory notes are to be considered as investment securities or certificates of indebtedness, hence, subject to documentary stamp tax.

Petitioner disagrees with the respondent's findings and maintains that the lease agreements cannot be treated as installment sales and in support of this contention, offered as evidence a specimen or a sample of a "Lease Agreement" entered into by petitioner to show that the provisions therein prove that these are genuine leases and not installment sales (Exhibit "D"). The findings of the examiner however, pointed to several provisions of the lease agreements which bolstered the theory that such agreements are, in substance and purpose, contracts of sale payable in installments, such provision are quoted hereunder, thus:

1. Section 10 thereof impliedly grants to the lessee an option to acquire the equipment upon expiration or termination of the lease by paying the "stipulated loss value" agreed upon in the contract.

2. Section 11 thereof requires the lessee to pay the insurance on the equipment, unlike in ordinary lease where insurance is invariably paid by the owner of the leased property.

3. Section 12 thereof requires the lessee to pay taxes incident to the leased property.

The revenue examiner also took notice of the fact that petitioner used two different methods in recording the lease transactions and computing the net income for income tax purposes. It is the opinion of the examiner and later adopted by the respondent that there should only be one method used for recording the transactions and computing the net income arising from these transactions in accordance with Section 37 of the Tax Code. This inconsistency in methods led the examiner to treat the lease agreements as installment sales as gleaned from her testimony, thus:

Q. Madam Witness, you now testify that there is a difference in the method of accounting for transactions under the bookkeeping or accounting books and for tax purpose?

A. Yes.

Q. Would you know if any method which the taxpayer should have used in recording for its transaction in the accounting books?

A. The method being used or the method used then because I don't know the method used now, the method used at that time was the financing method for recording the transactions in the books. But for taxation purposes, for computing the net income, the method used was the so-called operating therefore the methods were not the same, one method was for accounting purposes another for taxation purposes.

Q. Then what would be your basis for determining that for tax purposes should also be the financing method or that would be similar to installment sale?

A. I believe the method for recording the transactions in the books must also be the method that should have been used in computing the taxable income. I think I remember that Section 38 then of the NIRC which is now Section 37 which, would I be allowed to read?

JUDGE ACOSTA

Yes.

A. Under Section 38 then which is Section 37 now, the net income should be computed upon the basis of the taxpayer's annual accounting period in accordance with the method of accounting regularly employed in keeping the books of such taxpayer. So the net income should have been computed in accordance with the method of accounting employed in keeping the books. So the method used was financing, so I thought that the method should have been used also for taxation purposes must be financing method.

xxx xxx xxx

Q. Then in your opinion and your decision in conducting the examination, Madam Witness, how does this affect your procedure which you have adopted in the examination?

A. Of course, this has some so-called persuasive effect although the main reason actually why I adopted this installment sale method is because of the fact that for accounting purposes the method used was the so-called financing method and as I explained before, under the financing method, the entire amount of the receivable is being recorded in the year of the execution of the contract. And this is very similar to the installment sale method.

We find that the lease agreements in question are genuine leases and not installment sales contrary to the theory of respondent.

This issue has already been settled by the Court of Appeals in a case involving the same parties entitled **Commissioner of Internal Revenue vs. Makati Leasing and Finance Corp., et. al.** (now known as BPI Leasing Corporation), CA-GR SP No. 23578, November 25, 1992 which affirmed this Court's decision in the Case entitled **Makati Leasing and Finance Corporation vs. Commissioner of Internal Revenue,** CTA Case No. 3354, October 25,1990. The Court of Appeals junked the theory that these lease agreements are in reality installment sales when it ruled, thus:

> After due consideration and evaluation of the facts and the applicable statutory provisions, We have found no sufficiently valid and convincing reasons warranting reversal or modification of the appealed judgment.
>
> Firstly, the appellee was duly licensed to do business under R.A. No. 5980 and was inter alia engaged in the leasing of various types of equipments during the taxable year mentioned in the assessment. Conformably with the intent of the contracting parties, MLFC's agreements were all prepared in the form of lease contracts which spelled out the appellee's equipment being leased, the lease period and the rentals to be paid by the lessees. The basic features of a lease are concededly present.
>
> Secondly, the additional income for year 1975 was arrived at simply by concluding that the leases were practically "sales on installments" from the adoption by appellee on the "financing method" of reporting/recording rental income instead of the so-called "operating method" generally used in the leasing business. Evidently, the revenue examiner gave decisive weight to the fact that

> under the "financing method" the "gross rentals receivable... are recorded at the time the lease contract is booked" (e.g., in a lease for a term of 5 years, the rentals accruing and payable during that period are reported immediately upon execution of the contract as receivables -- similarly, We take it, to the method used in installment sales). Such approach ignored the basic features of a lease of equipment that would distinguish it from an installment sale.

With regard to the contention of the respondent that there are provisions in these lease agreements that would point out to the fact that these are in reality contracts of sale, the aforementioned decision has this to say:

> Appellant has argued that the appellee's lease agreements included "extraordinary terms" such as; section 10, granting the lease an "option" to acquire the leased equipment by paying the stipulated "loss value", section 11, requiring the lessee to pay the insurance premiums due on the leased equipment; and section 12, with respect to the payment by the lessee of taxes incident to the lease, to support the conclusion that such leases were in substance installment sales.
>
> It would suffice to say that these, in Our view, are peripheral aspects that would not obliterate or destroy the essential nature of the lease agreements between appellee and its contracting parties. In the purchase of real property, for instance, it is now a practice for the owner-seller to ask the buyer to pay the capital gains tax due, but, it cannot be seriously contended that the transaction is no longer that of sale. The same is true with respect to the payment of insurance premiums by a lessee of real property, if he is willing to assume that burden as part of the agreement. Those items in effect are added costs incident to the sale/lease. As to section 10, as pointed out by the appellee in its answer, the "option" pertains to the owner-lessor and not to the lessee.

> Such provisions, We may add, fall well within the contracting parties' freedom to agree on stipulations or terms as may be deemed convenient, so long as they are not contrary to law, morals, good customs, public order or policy (Article 1306, Civil Code). These can hardly affect the principal purpose and/or intent of the parties in the execution of the contract.

The variance in the methods used by petitioner in recording the lease transactions and computing percentage and income taxes was approved by the respondent himself in a letter, dated January 19, 1976, (Exhibit "F") in response to petitioner's request (Exhibit "E") to use the financing method in recording its lease transactions in its books of accounts and retaining the use of the operating method in the computation of its income and percentage taxes. This letter approval is quoted, thus:

> Gentlemen:
>
> This has reference to your letter of March 4, 1975 requesting for permission to change your accounting method in recording leasing transactions from the "operating method" of accounting for leases to the "financing" method.
>
> In reply thereto, I have the honor to inform you that after verification conducted by this Office, this Office has decided to grant your aforesaid request on the condition that it shall take effect beginning the taxable year 1976.
>
> Very truly yours,
>
> CONRADO P. DIAZ
> Deputy Commissioner of Internal Revenue
> (Exhibit "F")

The second issue which presents to Us a question of whether or not non-negotiable promissory notes issued by the petitioner shall be considered as certificates of indebtedness subject to documentary stamp tax is rendered moot and academic as the assessments on the documentary stamp tax liability of the petitioner for the years 1977 and 1978 are covered by the compromise agreement entered into between BPI Leasing Corporation and the then Commissioner of Internal Revenue, Mr. Jose U. Ong, dated July 6, 1990 (Exhibit "H"). This fact was admitted by respondent's witness, Mr. Lilian Hefti in her testimony given on September 28, 1993, thus:

CROSS EXAMINATION BY ATTY. PADILLA

Q. Examiner Hefti, let us start with the simple ones. On the business tax, you assessed deficiency documentary taxes, right?

A. Yes.

Q. And your theory was that these non-negotiable promissory notes should be taxed as investment securities?

A. Yes.

Q. But you are aware of course that the Commissioner compromised these?

A. Yes, I am aware of that.

Q. You are aware also that the taxpayer entered into a compromise settlement?

A. Yes.

Q. So there is not more assessment?

A. Yes, as far as documentary stamp tax is concerned.

Q. So that finishes the business tax aspect of the case.

A. As a matter of fact it is not only this company that entered into a compromise with respect to this issue. I think this is an industrial problem, so the entire industry entered into a compromise.

Q. Including the banks?

A. Including the banks.

(Underscoring supplied)

WHEREFORE, the decision of the respondent Commissioner of Internal Revenue assessing petitioner BPI Leasing Corporation for deficiency income tax and documentary stamp tax for the years 1977 and 1978 is hereby reversed, without pronouncement as to costs.

SO ORDERED.

RAMON O. DE VEYRA
Associate Judge

WE CONCUR:

ERNESTO D. ACOSTA
Presiding Judge

MANUEL K. GRUBA
Associate Judge

CERTIFICATION

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

ERNESTO D. ACOSTA
Presiding Judge
Court of Tax Appeals