REPUBLIC OF THE PHILIPPINES
COURT OF TAX APPEALS
QUEZON CITY

DESTILERIAS AYALA, INC.,
Petitioner,

- versus -

C.T.A. CASE NO. 1664

THE COMMISSIONER OF
INTERNAL REVENUE,
Respondent.

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

Dec. 27/67

D E C I S I O N

Section 25(a) of the National Internal Revenue Code, with certain exceptions not herein applicable, imposes an additional tax upon a corporation formed or availed of for the purpose of preventing the imposition of the tax upon its shareholders or the shareholders of any other corporation through the medium of permitting earnings or profits to accumulate instead of being divided or distributed; and Section 25(c) provides that the fact that 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 shareholders, unless the corporation shall prove to the contrary by a clear preponderance of the evidence. Under this law, respondent Commissioner of Internal Revenue assessed additional tax against and demanded from the Destilerias Ayala, Inc. for the year 1957 the amount of ₱36,576.46, inclusive of the ½% monthly interest from June 20, 1959 to May 20, 1961.

Petitioner is a domestic corporation duly organized in 1924 for the principal purpose of engaging in the manufacture, buying and selling of all kinds of alcoholic beverages. It was engaged in that business for which it was primarily incorporated up to 1944. During the battle for the liberation of the City of Manila in 1945, its factory was completely destroyed.

After the destruction of the taxpayer's distillery in 1945, it was not reactivated or rehabilitated, and in 1949, its only business was that of leasing real estate property. It held a privilege tax receipt as real estate dealer, and its income was principally derived from the rentals of its office building at Echague, Manila.

On September 2, 1950, the founder and controlling stockholder of the taxpayer, Don Carlos Palanca, died. He left a will which was duly probated and the special administrator first appointed was the Philippine Trust Company. It was subsequently replaced by former Justice Roman Ozaeta in 1954, who, ultimately, was appointed executor of the estate in 1956 upon the probate of the last will and testament of the deceased. He was later elected president of petitioner, and in 1957, the taxable year in question, he was still its president.

For the year 1957, petitioner filed its income tax return with a net income of ₱30,752.00 and on which an income tax of ₱6,151.00 was paid. During 1957, the controlling stockholder of petitioner was the estate of Don Carlos Palanca which owned 99% of its capital stock. The stockholders of record for that year were as follows:

Estate of Carlos Palanca -	₱349,000.00
Carlos Palanca, Jr. -----	2,200.00
Rosa Gonzales Vda. de Palanca ---------------	900.00
Antonio G. Palanca ------	100.00
Macario G. Palanca ------	100.00
George M. Tilbury -------	100.00
Total Paid-up	₱352,000.00

Upon investigation, respondent found that petitioner had an accumulation of surplus beyond its reasonable needs in the amount of ₱131,215.57 for the year 1957. Accordingly, the tax of 25% imposed by Section 25 of the National Internal Revenue Code was assessed against the taxpayer, details of which are as follows:

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Surplus unreasonably accumulated -------------------	₱131,215.57
Tax due thereon (25%) -------	₱ 32,804.00
Add: ½% monthly interest from 6/20/59 to 5/20/61 ---	3,772.46
TOTAL AMOUNT DUE & COLLECTIBLE ----------------	₱ 36,576.46

The taxpayer protested the said assessment in its letters of June 13, 1961 and July 12, 1961. Upon denial of the protest by respondent, it appealed to this Court.

The pivotal and decisive issue in this case is whether the taxpayer accumulated earnings and profits in the year involved beyond the reasonable needs of its business, and if so, whether it has sustained the burden which Section 25(c) of the Revenue Code places upon it to overcome - the presumption that it was availed of for the purpose of preventing the imposition of the income tax upon its shareholders. And if this Court should find that the petitioner was availed of for the prohibited purpose, as a corollary thereto, whether or not the additional tax should be computed on the basis of the total accumulated profits over the years or on the basis only of the undistributed adjusted net income for the year in question.

The applicable principles of law are clear and in the end the decision in this case must rest upon its own peculiar facts and circumstances. As this Court explained in C.T.A. Case No. 1415, Manila Wine Merchants, Inc., vs. Commissioner of Internal Revenue, February 28, 1966, the accumulated earnings tax under Section 25 of the Tax Code is a tax on obnoxious hoarding as distinguished from harmless accumulation. If the corporation is availed of for the purpose of avoiding the income tax on its stockholders by permitting its gains and profits to accumulate instead of being divided or distributed among its shareholders, then the accumulated earnings tax applies to the corporation. The touchstone of liability is the purpose behind the accumulation of the surplus or profits and not the consequences of the accumulation. (Sauk Investment Co. 34 B.T.A. 732; Law of Federal Income Taxation, Mertens, Vol. 7, p. 347.) As a practical matter, liability for the tax under Section 25 of the Tax Code hinges on whether the corporation has accumulated the earnings in excess of the reasonable needs of the business. The question of unreasonable or reasonable accumulation of profits or surplus is one of fact. The word "reasonable" is a relative term. What would be reasonable in one situation or for one business, might be clearly unreasonable in another. (William C. de Mille Productions, Inc., 30 B.T.A. 826; Wilkerson Daily Corp. Ltd., 42 B.T.A. 1266, aff'd 125 F [2d] 998 (CCA 9th, 1942); Law of Federal Income Taxation, Mertens, Vol. 7, p. 360; Manila Wine Merchants, Inc., vs. Commissioner of Internal Revenue, supra.)

Respondent's findings that the accumulation of the 1957 surplus profits was in excess of the reasonable needs of the business were based on the financial statements of the petitioner which disclosed a net worth of ₱483,715.57 and undistributed surplus of ₱131,215.57 as of December 31, 1957. (Exh. 1, pp. 4-7, BIR rec.) Although petitioner had sufficient cash on hand and in banks, no dividends were ever declared whether in cash or in stocks since 1947. On the other hand, huge loans in cash were granted to certain individuals in the aggregate sum of ₱128,558.90 including accrued interest. The corporation had a Notes Receivable account consisting of a Savings Account and Current Account with the Bank of America. The Current Account was open for withdrawals by recipients of loans for their personal disposition. Interest on loans at 6% per annum was allowed to accumulate and was added to the aforesaid Notes Receivable account. There was no apparent attempt to repay the loans. Instead, additional loans were granted during succeeding years - ₱20,000.00 in 1958; ₱20,500.00 in 1959 and ₱2,000.00 as of February 2, 1960. (Exh. 2, pp. 21-23, BIR rec.) Respondent also found that no expansion of the business was undertaken and there were no outstanding obligations of the corporation then existing to warrant accumulation of surplus. (Exhs. 1 and 2, pp. 4-7, 21-23, BIR rec.; Respondent's memorandum, pp. 1-2.)

All of these facts and circumstances tend to support the contention of respondent that petitioner was availed of for the purpose of preventing the imposition of the income tax upon its shareholders. In addition to these, we have, for all practical purposes, a one-man corporation. The estate of Don Carlos Palanca owned all but one per cent of the capital stock of the corporation. It would have received 99% of all earnings so distributed as dividends. If the earnings for 1957 had been distributed to the stockholders, its share alone would have amounted to ₱30,445.45. Furthermore, the taxpayer's cumulative surplus at the end of 1957 is so large that there is no reason for the retention of the current earnings to finance the reasonable needs of the business. Petitioner had already retained earnings of ₱106,613.59 during the previous years, and a net income of ₱30,752.98 for the year 1957 or a retention of earnings in the total amount of ₱131,215.57. In determining whether the taxpayer for a certain year accumulated profits beyond the reasonable needs of its business, we must consider not only the undistributed earnings or profits for that year, but the surplus, if any, already accumulated, the assets of the company and their liquidity, the expenditures necessary to be made to meet its financial obligations and to carry on its successful operations. (Southland Industries, Inc., T.C. Memo, Docket No. 3387, Oct. 31, 1946; Manila Wine Merchants, Inc., vs. Commissioner of Internal Revenue, C.T.A. Case No. 1415, Feb. 28, 1966.) The assets of petitioner and their liquidity, and the enviable financial status of the taxpayer of having no apparent outstanding obligations to meet, have already been discussed in the preceding paragraph.

With the above finding that petitioner accumulated its earnings and profits beyond the reasonable needs of its business, the next question is whether the taxpayer met the burden which the statute places upon it to overcome - the presumption that it was availed of for the prohibited purposes. As stated above, Section 25(e) of the National Internal Revenue Code provides that the fact that 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 income tax on shareholders unless the corporation shall prove to the contrary by a clear preponderance of the evidence. The taxpayer must then negate such purpose by a clear preponderance of the evidence.)

Petitioner seeks to justify the accumulation of its surplus on the ground that it was under the control of the executor who had to retain the profits realized over the years in order to preserve the value of the shares of stock for eventual distribution to the heirs of the deceased Don Carlos Palanca. This justification is anchored on the alleged desire of the decedent, expressed in his last will and testament, to the effect that the legatees should continue the liquor business of petitioner. As long as the control of the corporation was vested in the representative of the estate, the taxpayer contends that the corporation could not possibly embark on such a venture to reconstruct its plants destroyed during the war and to reactivate its liquor business.

The fallacy of this justification lies in its assumption that the executor of the deceased and petitioner are one and the same person. Petitioner has apparently overlooked the elementary principle of corporation law that a corporation is an entity separate and distinct from its stockholders and from other corporations. Consequently, the rights and obligations of a corporation are not affected by the death or change of the individual members, but the corporate business continues uninterrupted and unaffected as long as the corporate entity continues. (Tolentino, Commentaries and Jurisprudence on the Commercial Laws of the Philippines, Vol. II, p. 690, citing Fletcher, Vol. I, p. 42.) In other words, as respondent alleges, the death of petitioner's principal stockholder did not put a stop to the exercise of corporate rights and obligations. To say that the executor was prohibited from continuing the business of the deceased is to ignore the basic principle of the corporation law. The business of the taxpayer is not the business of the deceased, because as petitioner itself alleges under paragraph 1 of its petition for review, Destilerias Ayala, Inc., is a corporation duly organized and existing under the laws of the Philippines.

Granting that as the person in whom legal title to 99% of the voting stock of the petitioner-corporation was vested, control of the corporation was for all practical purposes lodged upon the executor, and would be the sole judge to decide whether or not the taxpayer's business should be continued, that alone will not be enough justification for the executor to accumulate profits beyond the reasonable needs of the business without making the petitioner liable for the additional tax under Section 25 of the Revenue Code. Determination of the reasonable needs of the business is, in the first place, a task for the officers and directors of a corporation. (Crawford County Printing and Publishing Co., 17 T.C. 1404; Manila Wine Merchants, Inc., vs. Commissioner of Internal Revenue, supra.) As president of petitioner and controlling stockholder with authority to vote as stockholder upon stock held in his representative capacity (Sec. 37 of the Corporation Law, as amended), the executor had the duty and the responsibility to see to it that petitioner should employ legitimate means to rehabilitate its liquor business. No useful purpose would be served by a detailed discussion of the various and sundry ways, all innately legitimate, by which petitioner could have rehabilitated its liquor business, but if it had to plow its earnings back into the business, it could not with impunity permit its profits to pile up merely because at some future time certain outlays would have to be made. Profits may only be accumulated for the reasonable needs of the business, and implied in this is the further requirement of a reasonable time. There had to be an immediate need for the funds in order to justify the retention of earnings. (Manila Wine Merchants, Inc., vs. Commissioner of Internal Revenue, supra.) The abuse of accumulating earnings until the expansion can be timely undertaken was the genesis of Section 25 of the Revenue Code and its forbears. (Crawford County Printing and Publishing Company vs. Commissioner of Internal Revenue, 17 T.C. 1404.)

To our mind, therefore, the duty of the executor to preserve the assets of the estate, including the controlling block of shares, did not carry with it the authority of permitting petitioner, an entity separate and distinct from the estate of the deceased, of accumulating its profits beyond the reasonable needs of its business without subjecting the taxpayer to the penalty tax under Section 25 of the Revenue Code. If the executor was under obligation of giving affect to the last wishes of the decedent, expressed in his last will and testament, that should have been effected within the limits of the law. The law contemplates that any legitimate business may acquire the means of growth but legitimate means should be employed.

Further, it is to be noted that petitioner had ceased to operate its liquor business since the destruction of its factory in 1945. It only engaged in the business as a real estate dealer deriving its income from the rentals of its office building. (Since the statute imposing surtax on corporations improperly accumulating surplus beyond the reasonable needs of the business in order to avoid the tax on shareholders contemplates the immediate need, need associated with business in hand, in order to avoid imposition of surtax (McCutchin Drilling Co. vs. Commissioner of Internal Revenue, 143 F. 2d 480), petitioner could not, therefore, legitimately accumulate the earnings of its real estate business to acquire means to activate its liquor business because that was not already its business in hand.) It is true that the taxpayer was formed for the purpose of manufacturing, buying and selling all kinds of alcoholic beverages but the records of the case do not show even an attempt on the part of petitioner to reactivate its liquor business. No evidence was presented, oral or documentary, which might indicate a policy or pursuit on the part of petitioner of rehabilitating its business of manufacturing, buying and selling alcoholic beverages. As respondent found in his investigation of this case, no apparent expansion had been undertaken by the corporation which would justify the accumulation of profits beyond the reasonable needs of its business.

Another factor that stands out to show unreasonable accumulation of earnings by petitioner is the fact that loans in substantial amounts were extended to some persons and the interests thereon were not collected but were allowed to accumulate. While only one of the three debtors was a stockholder, such loans tend to prove the lack of necessity of the accumulation of surplus by the corporation (Vol. 7, Mertens, Law of Federal Income Taxation, Sec. 39.34, 1956 ed.), specially in this case where more loans were granted during the succeeding years after 1957. Petitioner claims that the loans were granted to strengthen the financial position of the corporation, but with a business of leasing an office building only; a net worth of ₱483,715.57; an undistributed surplus of ₱131,215.57; and with no outstanding obligations to meet, these loans fully and strongly suggest that such funds were not reasonably needed in its business.

In the light of the above, we agree with the result reached by respondent that the accumulation of the 1957 surplus of petitioner was in excess of the reasonable needs of its business. And the taxpayer having failed to overcome by a clear preponderance of evidence the statutory presumption that it was availed of for the purpose of preventing the imposition of the income tax upon its shareholders, the additional tax provided for under Section 25 of the Revenue Code should be imposed upon it.

Anent the question as to whether or not the additional tax should be computed on the basis of the total accumulated profits over the years or on the basis only of the undistributed adjusted net income for 1957, the tax year in question, we agree with respondent that this is already foreclosed by the decision of the Supreme Court in the case of Basilan Estates, Inc., vs. Commissioner of Internal Revenue, G.R. No. L-22492, Sept. 5, 1967. It was there held that in determining whether accumulations of earnings or profits in a particular year are within the reasonable needs of a corporation, it is necessary to take into account prior accumulations, since accumulations prior to the year involved may have been sufficient to cover the business needs and additional accumulations during the year involved would not be reasonably necessary. In that case, the taxpayer involved questioned the computation of the surtax on the accumulations during the period from 1948 to 1953 when the taxable year under review was only 1953.

The Court held that there was no error in the process applied. Hence, the assessment should be sustained.

Finding no error in the decision appealed from, the same is hereby affirmed. Petitioner, Destilerias Ayala, Inc., is hereby ordered to pay to respondent Commissioner of Internal Revenue, or his duly authorized representatives, the amount of ₱36,576.46 as surtax and ½% monthly interest, plus 5% surcharge and 1% monthly interest from May 20, 1961 until fully paid, provided that the maximum amount that may be collected as interest shall not exceed the amount corresponding to a period of three years, pursuant to Section 51(e) of the National Internal Revenue Code, as amended. With costs against petitioner.

SO ORDERED.

Quezon City, December 27, 1969.

RAMON L. AVANCEÑA
Associate Judge

I CONCUR:

ROMAN M. UMALI
Presiding Judge

Associate Judge ALVAREZ did not take part.