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PARACALE GUMAUS CONSOLIDATED
MINING COMPANY,
Petitioner,

- versus -

C.T.A. CASE NO. 351

Jan. 31, 1959

JOSE ARAÑAS, Collector of
Internal Revenue, Manila,
Respondent.

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D E C I S I O N

This is an appeal from the decision of the Collector (now Commissioner) of Internal Revenue dated January 15, 1957, assessing against and demanding from the petitioner the amounts of ₱1,894.00, ₱10,147.00 and ₱4,477.00, representing deficiency income taxes for the years 1952, 1953 and 1954, respectively. These deficiency assessments were issued as a result of the disallowance of certain deductions claimed by the petitioner in its income tax returns filed for the years under review.

The facts that have been established or stipulated upon are summarized hereunder. The petitioner, Paracale Gumaus Consolidated Mining Company, is a corporation duly organized and existing under the laws of the Philippines and is engaged in the mining industry. Before World War II, the petitioner was operating its mining concessions, but during the war, its machineries and equipment were destroyed and its mines abandoned. After the liberation of the Philippines, the petitioner started to rehabilitate its mines with a view to resuming its normal operations.

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During the years under review, i.e., 1952, 1953, and 1954, the activities that went on "in petitioner's mines consisted of cleaning the tunnels, retimbering the underground property, erecting buildings, putting up the mill machineries, equipment and properties and testing ores preparatory to full-scale operation." (Par. 5, stipulation of facts.) It was only on January 3, 1956, that the petitioner commenced more or less full-scale operation and production.

During these same years, the gross income of the petitioner consisted of:

<u>For the year 1952</u>:

(1) Interest from Hongkong & Shanghai Bank	₱ 4,471.57
(2) Dividends received from San Miguel Brewery (25% of ₱48,000)	12,000.00
(3) Sales of supplies	113.18

<u>For the year 1953</u>:

(1) Interest from Hongkong & Shanghai Bank	350.68
(2) Dividends from San Miguel Brewery (25% of ₱16,856)	4,214.00
(3) Profit on sale of 14,400 shares of San Miguel Brewery	56,478.96

<u>For the year 1954</u>:

(1) Interest from Demonstration Gold Mine Ltd.	30,154.20

(Par. 6, Stipulation of Facts.)

Out of its expenses for each year, it appears that the petitioner capitalized a portion thereof and treated the other part as current expenditures. The items or portion of items allocated as current expenses were thus claimed as deductions from its gross income for income tax purposes. However only the following items of deductions were allowed by the respondent:

For the year 1952:

(1) 1/2 salaries and wages	₱4,150.00
(2) 2/3 legal and secretarial fees	900.00
(3) All transfer agent fees	1,200.00
(4) 1/4 traveling expenses	148.18
(5) 1/2 stationery and supplies	338.43
(6) 1/2 postage and telegram	203.10

For the year 1953:

(1) 1/2 postage and telegram	218.17
(2) 1/3 traveling	578.71
(3) 1/2 salaries and wages	4,200.00
(4) 1/3 medical	259.62
(5) 1/2 stationeries and supplies	322.32
(6) 2/3 legal and secretarial fees	1,367.00
(7) All transfer agent fees	1,200.00
(8) 1/3 real estate taxes	456.41
(9) 1/2 audit fees	175.00
(10) 1/2 director's fees	625.00

For the year 1954:

(1) 1/3 postage and telegrams	158.45

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(2)	1/4 traveling expenses	₱ 1,012.96
(3)	1/5 salaries and wages	1,320.00
(4)	1/5 medical expenses	449.24
(5)	1/3 office supplies	137.17
(6)	1/2 legal and secretarial fees	1,169.75
(7)	All transfer agent fees	1,200.00
(8)	1/3 real estate taxes	456.54
(9)	1/2 audit fees	125.00
(10)	1/2 director's fees	750.00
(11)	1/4 office expenses	993.77

(See pars. 3, 4 and 5, Stipulation of Facts.)

On the other hand, the respondent disallowed the following deductions claimed by the petitioner, to wit:

For the year 1952:

(1)	Mine General Overhead - 1/4 of ₱29,565.40	₱ 7,391.35
(2)	General expenses - 1/2 of ₱4,164.96	2,082.48

For the year 1953:

(1)	Assessments	14,727.84
(2)	Mine General Overhead - 1/3 of ₱32,790.69	10,930.23
(3)	General expenses - 1/2 of ₱4,544.06	2,272.03
(4)	Maintenance and Repair - auto equipment - 1/3 of ₱4,907.79	1,635.93
(5)	Maintenance and Repair - machinery equipment - 1/3 of ₱49,212.70	16,404.23
(6)	Workmen's Compensation - 1/3 of ₱2,995.20	998.40
(7)	Assay fees - 1/4 of ₱5,584.81	1,396.12

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(8) Depreciation - 1/4 of total depreciation of ₱9,483.36	₱ 2,370.84

For the year 1954:

(1) Mine General Overhead - 1/5 of ₱52,189.65	10,437.93
(2) General expenses - 1/3 of ₱6,551.85	2,183.95
(3) Repairs and Maintenance - auto equipment - 1/4 of ₱9,454.71	2,363.68
(4) Repairs and Maintenance - machinery equipment - 1/4 of ₱36,647.16	9,161.79
(5) Depreciation - 1/4 of ₱10,023.64	2,505.91
(6) Road Maintenance - 1/4 of ₱3,126.64	781.59
(7) Road right of way - 1/4 of ₱652.90	163.23
(8) Haulage - 1/4 of ₱3,100.00 ..	775.00

(See par. 1, Stipulation of Facts.)

The respondent accordingly assessed the petitioner deficiency income tax for the years 1952, 1953 and 1954 in the amount of ₱1,894.00, ₱10,147.00 and ₱4,477.00, respectively, which is now the subject of review.

No issue has been raised with regard to those expenditures which the petitioner had capitalized. Neither is there a question as to the items or portions of items which were incurred by the petitioner and allowed by the respondent. The only issue therefore is limited to the disallowed items, the question being whether or not the respondent Commissioner of Internal Revenue properly disallowed the aforementioned items claimed as deductions from the petitioner's gross income for the years in question.

Under the Income Tax Law, a taxpayer is allowed to deduct from gross income -

"Expenses— 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 personal services actually rendered; x x x " (Section 30 (a) (1), Tax Code; underscoring added.)

However, it is also provided that in computing net income, no deduction shall in any case be allowed in respect of -

"(2) Any amount paid out for new buildings or for permanent improvements, or betterments made to increase the value of any property or estate;

"(3) Any amount expended in restoring property or in making good the exhaustion thereof for which an allowance is or has been made;" (Sec. 31, Tax Code; underscoring supplied.)

The pertinent portions of Revenue Regulations No. 2 which implements the foregoing statutory provisions, state as follows:

"Sec. 65. Business expenses - Business expenses deductible from gross income include the ordinary and necessary expenditures directly connected with or pertaining to the taxpayer's trade or business. The cost of goods purchased for resale, with proper adjustment for opening and closing inventories, is deducted from gross sales in computing gross income. Among the items included in business expenses are management expenses, commissions, labor, supplies, incidental repairs, operating expenses of transportation equipment used in the trade or business, traveling expenses while away from home solely in the pursuit of a trade or business, advertising and other selling expenses, together with insurance premiums against fire, storm, theft, accident, or other similar losses in the case of a business, and rental for the use of business property. A taxpayer is entitled to deduct the necessary expenses paid in carrying on his business from his gross income from whatever source."

"Sec. 68. Repairs - The cost of incidental repairs which neither materially add to the value of the property nor appreciably prolong its life, but keep it in an ordinarily

> efficient operating condition, may be deducted as expense, provided the plant or property account is not increased by the amount of such expenditure. Repairs in the nature of replacements, to the extent that they arrest deterioration and appreciably prolong the life of the property should be charged against the depreciation reserve if such account is kept."

> "Sec. 120. Capital expenditures - No deduction from gross income may be made for any amounts paid out for new buildings or for permanent improvements or betterments made to increase the value of the taxpayer's property, or for any amounts expended, in restoring property or in making good the exhaustion thereof for which an allowance for depreciation or depletion or other allowance is or has been made. x x x"

In applying the foregoing statutory rules and interpretative regulations to the instant case, the issue narrows down to the question as to whether the expenses incurred by the petitioner constitute "ordinary and necessary expenses" allowable as deduction under said Section 30 (a) or are in the nature of "capital expenditures" and therefore non-deductible under said Section 31 (a). ISSUE

In the application of the foregoing statutory rules and implementing regulations, it must be noted that when the expenditures cover business expenses and capital items, the burden is upon the taxpayer to show the basis under which a proper segregation is to be made. In the event the taxpayer fails to meet such burden, the entire expenditure must necessarily be disallowed as a deduction.

> "Where an expenditure covers both repairs deductible as business expenses and capital items, it is incumbent on the taxpayer to make a proper segregation; otherwise the entire expenditure will be disallowed as a deduction." (Mertens, Law of Federal Income Taxation, Vol. IV, Sec. 25.30, p. 373.)

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We shall now proceed to consider the items claimed as deductions by the petitioner. A review of the expenditures given above will show that the allocation of current expenditures, was made on a more or less arbitrary manner. The segregation was based allegedly on estimates, but the same was without a fixed or reasonable basis. In fact, it may be observed that the apportionment of the same kind of expense in one year varies in the succeeding year or years without any explanation of such change or changes by the petitioner. Let us cite a few examples. "Mine General Overhead" was so apportioned that for 1952, 1/4 thereof was treated as current expenditure, whereas, for 1953, the fraction was increased to 1/3 but for 1954, reduced to 1/5. Respecting the "Maintenance and Repair" account for auto equipment and machinery equipment, 1/3 thereof was treated as current expenditure for 1953, whereas, only 1/4 was allocated for 1954. The "General Expense" was allocated to current expenditure in the following proportion: 1952 and 1953 - 1/2 thereof and 1954 - 1/3 thereof, the rest being capitalized. In all these cases, however, the apportionment has been based on estimates which have not been supported by substantial and reasonable grounds.

On the other hand, the item of "Assessment" is claimed as deduction in its entirety for the year 1953. We take it that these were incurred in the character of "works and improvements" required by Sections 81, 82 and 83 of the Mining Law (Commonwealth Act No. 137). In such a case, the payments appear to be more of capital expenditures than ordinary business expenses and must consequently be capitalized under Section 31 (a) of the Tax Code. Likewise, the "Assay Fees" were allegedly incurred in 1953 to cover costs of the checking of the samples and of building up of petitioner's mines. The circumstances indicate that they were in the character of development expenses, preparatory to the operation of the mines and may not be claimed as ordinary and necessary expenses.

On the whole, we note that except for the broad statements of the petitioner's witnesses as regards the expenses incurred, there has been no showing that the apportioned expenditures claimed as deductions were actually spent by it as "ordinary and necessary expenses for carrying on the trade or business" of the petitioner, especially considering that it was not yet engaged in the ordinary or normal mining operations.

It should be especially remembered that during the years under review, the only "activities going on in petitioner's mines consisted of cleaning the tunnels, retimbering the underground property, erecting buildings, putting up the mill machineries, equipment, maintaining these mill machineries, equipment and properties, and testing ores preparatory to full scale operations" (par. 5, stipulation of facts). It follows that the bulk of the expenses incurred by the petitioner were for the aforesaid purposes, which were in the character of development expenses preparatory to the engaging in the normal operations. Unless the taxpayer herein can reasonably point out which expenses or portion thereof were ordinary business expenses, the expenditures must have to be deemed capital outlays.

It is a rule well-recognized that -

> "if an expenditure is made to attain an intended output, it is properly chargeable to capital as a cost of development; if the expenditure is made to maintain an output, it is properly chargeable to operating expense." (Guanacevi Mining Co. vs. Commissioner of Internal Revenue, 127 F 2d 49, 51, citing Marsh Fork Coal Co. vs. Lucas, 4 Cir., 42 F 2d 83, 85, 86, and Enterprise Coal Co. vs. Philipps, D.C. Pa., 12 F Supp. 49, 50, 51 affirmed 3 Cir., 84 F 2d. 565.)

Considering that the finding of the respondent -- that the payments in question were capital outlays -- is presumed to be correct and the taxpayer has the burden of proving it to be erroneous (Welch v. Helvering, 1933, 290 U.S. 11, 78 L. Ed. 212), and it appearing that the petitioner has failed to show that the expenditures disallowed were in the nature of an ordinary and necessary expenses rather than as capital outlays, we are constrained to hold that the disallowances were properly made.

WHEREFORE, finding no error in the decision appealed from, the same is hereby affirmed and the petitioner is ordered to pay the sums of ₱1,894.00, ₱10,147.00 and ₱4,477.00 as deficiency income tax for 1952, 1953 and 1954, respectively, plus 5% surcharge and interest at 1% per month from February 15, 1957. With costs against the petitioner.

SO ORDERED.

Manila, January 31, 1959.

MARIANO NABLE
Presiding Judge

WE CONCUR:

AUGUSTO M. LUCIANO
Associate Judge

ROMAN M. UMALI
Associate Judge