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REPUBLIC OF THE PHILIPPINES
COURT OF TAX APPEALS
MANILA

November 8, 1964

C. M. HOSKINS & CO., INC.
Petitioner

versus

G.T.A. CASE NO. 1383

THE COMMISSIONER OF
INTERNAL REVENUE,
Respondent.

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

D E C I S I O N

This is an appeal from a decision of the respondent, holding the petitioner liable for the payment of the sum of ₱33,103.72 representing deficiency income tax for the fiscal year ending September 30, 1957.

It appears that petitioner, a corporation duly organized and existing under the laws of the Philippines, with head office at 252 Escolta, Manila, is engaged in real estate brokerage business, and at times, serves as managing agents in the supervision and direction of the subdivision, development, sale, and administration of real properties of other persons.

On November 26, 1957, petitioner filed its income tax return for the fiscal year ending September 30, 1957, showing a net income of ₱92,540.25, and a tax liability due thereon of ₱18,508.00. (Exh. "A," pp. 17-18, CTA rec.; Exh. "1," p. 16, BIR rec.), which was paid in two equal installments of ₱9,254.00. (Exhibits "B" and "B-1," pp. 19-20, CTA rec.)

After an examination of this return, respondent, on June 20, 1962, determined against petitioner an income tax deficiency in the sum of ₱28,054.00, plus the sum of ₱5,049.72, representing interests, or a total of ₱33,103.72. The breakdown of this deficiency assessment is as follows:

Net income per return	₱ 92,540.25
Add: Unallowable deductions and additional income:	
(1) Supervision Fees to Mr. C. M. Hoskins	99,077.91
(2) Appraisal Fees Earned	743.75
(3) Travelling Expense	225.00
(4) Amortization of leasehold improvements	2,278.17
Net income as per investigation	₱194,865.08
Amount subject to tax . . .	₱194,865.08
Tax due thereon	46,562.00
Less: Amount already assessed	18,508.00
Balance	28,054.00
Add: ½% monthly interest from 6-20-59 to 6-20-62	5,049.72
TOTAL AMOUNT DUE & COLLECTIBLE	₱ 33,103.72

(Exhibit "C," & "7," pp. 24-26, BIR rec.)

The above itemized deficiency assessment was disputed by the petitioner, thru its accountants, Stewart, Cunanan & Co., in a letter dated July 30, 1962 (Exhs. "O" and "9," pp. 33-37, BIR rec.) requesting its withdrawal and cancellation, which request was denied by the respondent, in a letter dated February 18, 1963, for lack of legal and factual basis (Exhs. "P" and "10," p. 63, BIR rec.).

The petitioner, again thru its accountants, in a letter dated March 11, 1963 (Exhs. "Q" and "11," pp. 64-65, BIR rec.), requested reconsideration of the letter dated February 18, 1963, and/or reinvestigation of the case. This request was likewise denied by the respondent in his letter dated March 25, 1963 (Exhs. "U" and "12," p. 66, BIR rec.). Hence, on April 29, 1963, the present petition for review was filed.

The only issue raised in this case is whether or not the disallowance of the deductions made by the petitioner in its income tax return for the fiscal year ending September 30, 1957 (Exh. "A"), as itemized in the above stated breakdown of the deficiency assessment (Exhs. "C" and "7,"), is justified.

We shall proceed to dispose of this issue, by discussing individually each disputed item.

<u>Supervision Fees to Mr. C. M. Hoskins</u> - <u>₱99,077.91</u>.- The amount of ₱99,077.91 represents 50% of the supervision fees earned by petitioner-

company from the Realty Investments, Inc. and Paradise Farms, Inc., which was paid to Mr. C. M. Hoskins in pursuance of the policy of sharing its commissions with its agent, officer or employee who earned the income for the company. It was disallowed by the respondent on the ground that it is not an ordinary and necessary expense, and it should be treated as a distribution of earnings and profits of the petitioner. Respondent justifies the disallowance of the deduction in the light of the provisions of Section 70 (1) and (3) of Revenue Regulations No. 2, which implements Section 30 (a) (1) of the National Internal Revenue Code. Said Section 30 (a) (1) provides:

> "Sec. 30. Deductions from gross income. - In computing net income there shall be allowed as deductions—
>
> "(a) Expenses:
>
> "(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; traveling expenses while away from home in the pursuit of a trade or business; and rentals or other payments required to be made as a condition to the continued use or possession, for the purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity."

(The above quoted provision of the Tax Code has repeatedly been the apple of discord of income tax cases involving deductions, for what may be an ordinary and necessary expense of business in a certain case, and therefore is deductible, may not be so in another. The difficulty in determining what is ordinary and necessary arises in part from the complexities inherent in many business transactions involving mixed considerations, and to some extent from attempts of certain taxpayers in applying inappropriate labels to payments made, in calling them <u>salary</u> or <u>compensation</u>, although in fact they are distributions of dividends or profits.)

In the case at bar, it appears in evidence that the petitioner was founded by Mr. C. M. Hoskins in 1937, with a capital stock of 1,000 shares at a par value of ₱1.00 each share; that of these 1,000 shares, Mr. C. M. Hoskins owns 996 shares (the other 4 shares being held by the other four officers of the corporation), which constitute exactly 99.6% of the total authorized capital stock (p. 92, t.s.n.); that during the first four years of its existence, Mr. C. M. Hoskins was the President, but during the taxable period in question, that is, from October 1, 1956 to September 30, 1957, he was the chairman of the Board of Directors and salesman-broker for the company (p. 93, t.s.n.); that as chairman of the Board of Directors, he received a salary of ₱3,750.00 a month, plus a salary bonus of about ₱40,000.00 a year (p. 94, t.s.n.); that he was also a stockholder and officer of the Paradise Farms Inc., and Realty Investments Inc., from which petitioner derived a large portion of its income in the form of supervision fees and commissions earned on sales of lots (pp. 97-99, t.s.n.; Financial Statements, attached to Exhibit "1," p. 11, BIR rec.); that as chairman of the Board of Directors of petitioner, his duties were: "To act as a salesman; as a director, presides over meetings and to get all of the real estate business I could for the company by negotiating sales, purchases, making appraisals, raising funds to finance real estate operations where that was necessary" (p. 96, t.s.n.); that he was familiar with the contract entered into by the petitioner with the Paradise Farms Inc. and the Realty Investments Inc., by the terms of which petitioner was "to program the development, arrange financing, plan the proposed subdivision as outlined in the prospectus of Paradise Farms, Inc., arrange contract for road constructions, with the provision of water supply to all of the lots and in general to serve as managing agents for the Paradise Farms, Inc. and subsequently for the Realty Investments, Inc." (pp. 96-97, t.s.n.)

Considering that, in addition to being chairman of petitioner's Board of Directors, Mr. C. M. Hoskins was also its salesman "to get all the real estate business x x x for the company by negotiating sales, purchase, making appraisals, raising funds to finance real estate operations" for which he received a monthly salary of ₱3,750.00 and an annual salary bonus of ₱40,000.00, we believe that the payment to him of the inordinately large amount of ₱99,077.91, as supervision fees, cannot be accorded the treatment of ordinary and necessary expense within the purview of Section 30(a) (1) of the Tax Code. In view of his ownership over 99.6% of petitioner's capital stock, the additional payment of supervision fees is excessive and bears a close relationship to the recipient's stockholdings. That petitioner has labelled the payment as fee for planning and supervision cannot becloud the eyes of this Court from the stark reality evinced by the evidence of record that it is in fact a distribution of its earnings and profits.

The resolution of the Board of Directors authorizing the payment of this questioned fee to Mr. Hoskins, who is the chairman and dominant stockholder, cannot in any way change the situation. The tremendous power and influence which Mr. Hoskins wields in the formulation and making of decisions and policies of petitioner make irresistible the suspicion that the resolution authorizing the payment as supervision fees (Exhibit "F") was motivated by a desire to circumvent the law under the guise of legitimate payment. The label "supervision fees" given to the payment does not completely hide the true picture revealed by the evidence of record.]

Thus, it has been held:

> "x x x that extraordinary, unusual, and extravagant amounts paid by a corporation to its officers in the guise and form of compensation for their services, but having no substantial relation to the measure of their services and being utterly disproportioned to their value, are not in reality payment for services, and cannot be regarded as 'ordinary and necessary expenses' within the meaning of the section; <u>and that such amounts do not become part of the 'ordinary and necessary expenses' merely because the payments are made in accordance with an agreement between the corporation and its officers.</u> Even if binding upon the parties, such an agreement does not change the character of the purported compensation or constitute it, as against the government, an ordinary and necessary expense." (Botany Worsted Mills vs. U. S. 278 U. S., 292; L. ed. p. 386; underscoring supplied.)

The splitting of commissions earned between the petitioner and its salesmen on the basis of 50-50 sharing arrangement, as embodied in its regulation adopted on June 18, 1946 (Exhibits "N" and "N-1"), is inapplicable to Mr. C. M. Hoskins, for, as heretofore stated, his duties as chairman of the Board of Directors of petitioner, for which he is already well compensated, include the promotion of sales, purchases, making appraisals, raising of funds to finance real estate operations, programming, financing, planning of the proposed subdivision. Said regulation is applicable only to other salesmen and employees of the corporation, not holding the same position and duties as Mr. Hoskins.

The controlling guide to the allowance of the deduction is the kind of transaction out of which the obligation arose and its normalcy in the particular business involved (Deputy v. Dupont, 308 U. S. 488; 84 L. ed. 416; 60 S. Ct. 363 [1942]). And not every expense from which some incidental business advantage may flow is an ordinary and necessary business expense (Barbour Coal Co. v. Comm., 74 F. [2d] 163 [CCA 10th 1934], cert. den. 295 U. S. 731; 79 L. ed. 1680; 55 S. Ct. 643, 1935). For a payment may be highly commendable from an ethical standpoint, or expedient and still not be deductible (White v. Comm. 61 F. [2d.] 726 CCA 9th 1932).

<u>Appraisal Fees Earned: ₱743.75</u> - This amount of ₱743.75 represents fees <u>due from</u> Tuazon & San Pedro, Inc. for petitioner's appraisal report on a real property owned by the partnership. It was reported as an income in the 1955 tax return. However, petitioner finally collected only the amount of ₱500.00 on February 27, 1957, leaving a balance of ₱243.75 which was written off in its return for the fiscal year in question. Instead of disallowing the deduction claim of ₱243.75, respondent admittedly erred in disallowing the whole ₱743.75.

Respondent contends that this amount is not allowable as deduction for the reason that it was not a bad debt, as it was compromised and the debtor, Tuazon & San Pedro, is a solvent partnership. This contention is not well taken.

The agreement to pay the appraisal fees of ₱743.75 is not evidenced by any written instrument. It is only a verbal understanding between petitioner and Mr. San Pedro, which, after the latter's death, was not recognized and honored by the surviving partners; that utmost deligence and effort had been exerted to collect this amount to no avail (Exhibit "R;" p. 43, t.s.n.). Considering the meager amount of ₱243.75; the improbability of success of collection through judicial action because, as already stated, it was not evidenced by any writing; the refusal of the surviving partners to pay ₱743.75; the cost of the suit; and the time element involved in a judicial collection, we believe that petitioner has satisfactorily established the worthlessness of the debt. Hence, the amount of ₱243.75 should be deducted.

Traveling Expense: ₱225.00 - This disallowed deduction item represents transportation and vacation allowance given to petitioner's messenger, Mr. Ulpiano Santos, pursuant to petitioner's policy of giving salaried employees fifteen days vacation outside of Manila. The sum of ₱225.00 was for transportation, lodging, and subsistence. It included the amount of ₱75.00 for pocket money, for which no accounting was required from the recipient-employee (Exhibit "F," p. 3; pp. 17-19, t.s.n.).

There is no question that the above item is deductible as ordinary and necessary business expense, not only from the standpoint of sound business policy, but also from the standpoint of public policy (Sec. 284, Rev. Administrative Code, as amended by Rep. Act 218; Leyte Land Transportation Co. v. Leyte Farmer's and Laborers' Union, 80 Phil., 843; Vol. 4, Mertens, Law of Federal

Income Taxation, Sec. 25.85 citing Joseph Elias & Co., Inc. v. Comm., 46 F. 2nd, 1931).

In a previous case, we held:

> "To our mind it is not unusual for petitioner to grant additional compensation to its officers and employees, as an incentive to efficient service; to send them to the different manufacturing plants of its parent corporation for the purpose of acquainting them with the products they are dealing with; and, to send them abroad for vacations after years of service. Needless to say, these business practices obtain in most corporations whose operations are as world-wide as that of petitioner. And the grant of other compensations, in the form of bonuses, to deserving employees is sanctioned by law (Sec. 30(a)(1) of the Tax Code) and is deductible from gross income (See Alhambra Cigar & Cigarette Manufacturing Co., vs. Collector of Internal Revenue, G. R. No. L-12026, May 29, 1959; Kuenzle & Streiff, Inc. vs. Collector of Internal Revenue, G. R. No. L-12010 & L-12113, October 20, 1959)." (General Electric [P. I.] Inc., v. Comm. of Int. Revenue, CTA Case No. 1117, July 14, 1963)

<u>Amortization of leasehold improvement of ₱2,278.17</u>. - In connection with this item, it appears that, prior to 1955, petitioner made improvements on its leased office building in the amount of ₱12,886.92. It claimed a full deduction in its 1955 tax return. However, respondent allowed the deduction of only 20% thereof on the ground that the total cost of the improvements should be amortized during the life of the lease. This partial allowance resulted in a deficiency

DECISION -
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income tax assessment of ₱2,002.00 (Exhibit "11"), which was duly paid on April 6, 1959, as per O. R. No. 331672 (Exhibit "K"; pp. 170-173, t.s.n.). In this circumstance, we hold that the amount of ₱2,278.77, which is equivalent to 20% of the remaining cost of the leasehold improvements, should be deducted.)

WHEREFORE, premises considered, the decision of the respondent is hereby modified. Petitioner is ordered to pay to the latter or his representative the sum of ₱27,145.00, representing deficiency income tax for the year 1957, plus interest at ½% per month from June 20, 1959 to be computed in accordance with the provisions of Section 51(d) of the National Internal Revenue Code. If the deficiency tax is not paid within thirty (30) days from the date this decision becomes final, petitioner is also ordered to pay surcharge and interest as provided for in Section 51(e) of the Tax Code, without costs.

SO ORDERED.

Quezon City, November 8, 1964.

MARIANO NABLE
Presiding Judge

WE CONCUR:

AUGUSTO M. LUCIANO
Associate Judge

ROMAN M. UMALI
Associate Judge

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