REPUBLIC OF THE PHILIPPINES
COURT OF TAX APPEALS
QUEZON CITY

CYANAMID PHILIPPINES, INC.,
Petitioner,

- versus -

C.T.A. CASE NO. 4250

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

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D E C I S I O N

This is an appeal by petitioner, Cyanamid Philippines, Inc., from a decision of respondent Commissioner of Internal Revenue imposing a 25% surtax assessment for undue accumulation of profits beyond the reasonable business needs of petitioner for the taxable year 1981 involving the amount of P3,774,867.50, inclusive of interest.

Section 25(a) of the National Revenue Code (NIRC) 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 its gains and profits to accumulate instead of being divided or distributed.

On the other hand, Section 25(c) NIRC 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 on shareholders unless the corporation shall prove the contrary by a clear preponderance of evidence.

Petitioner Cyanamid Philippines, Inc. is a wholly-owned subsidiary of American Cyanamid Company, a corporation organized and existing under and by virtue of the laws of the State of Maine, U.S.A. It is engaged in the manufacture of pharmaceutical products and chemicals, wholesaler of imported finished goods, importer and an indentor. (p. 171, BIR Rec., and admitted in "Memorandum for Respondent", CTA Records p. 138).

On January 30, 1985 after respondent's examiner conducted an examination of petitioner's books of accounts and other accounting records, respondent Commissioner of Internal Revenue issued assessment notices both numbered 32-05048-001889-81 to petitioner demanding payments of P119,817.00 as deficiency income tax for 1981 and P3,774,867.50 as 25% surtax for improper accumulation of earnings for the taxable year 1981 computed as follows:

Net Retained Earnings-beg.		P15,280,587.00
Add: Net profit during the year	P14,705,370.00	
Less: Income Tax paid	5,164,444.00	
Amount subject under Sec. 25	P 9,540,926.00	
	x 25%	
Tax due thereon	P 2,385,232.00	
Add: Interest from 4/16/82-2/16/85	1,389,635.00	
TAX DUE AND COLLECTIBLE	P 3,774,867.00	

On March 7, 1985, petitioner protested said tax assessments. Respondent denied said protest on October 20, 1987. Hence, this appeal.

During the pendency of the case, however, both parties agreed to compromise the 1981 deficiency income tax assessment of P119,817.00. Petitioner paid the amount of P26,577.00 as compromise settlement.

The remaining issue is whether or not petitioner is liable for the 25% accumulated earnings tax in the tax year 1981.

The pertinent provisions of Section 25 NIRC, the law under which respondent assessed the corresponding 25% tax for unreasonable accumulation of surplus for the fiscal year 1981, reads as follows:

> "SEC. 25. <u>Additional tax on corporations improperly accumulating profits or surplus.</u> - (a) Imposition of Tax - If any corporation except banks, insurance companies, or personal holding companies, whether domestic or foreign, is formed or availed of for the purpose of preventing the imposition of tax upon its shareholders or members or the shareholders or members of another

> corporation, through the medium of permitting its gains and profits to accumulate instead of being divided or distributed, there is levied and assessed against such corporation, for each taxable year, a tax equal to twenty-five per centum of the undistributed portion of its accumulated profits or surplus which shall be in addition to the tax imposed by Section 24, and shall be computed, collected and paid in the same manner and subject to the same provisions of law, including penalties, as that tax."
>
> xxx xxx xxx
>
> "(c) Evidence determinative of purpose. - the fact that the 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 its shareholders or members unless the corporation, by clear preponderance of the evidence, shall prove the contrary."

A prerequisite to the imposition of the tax is that the corporation be formed or availed of for the purpose of avoiding income tax on its shareholders, or on the shareholders of any other corporation by permitting the earnings and profits of the corporation to accumulate instead of dividing them among or distributing them to the shareholders. If the failure to pay dividends is due to some other cause, such as the use of the undistributed earnings and profits for the reasonable needs of the business, such purpose does not fall within the interdiction of the statute. (Mertens, Law of Federal Income Taxation, Vol. 7, Chapter 39, p. 44, See also Sec. 21, **Revenue Regulations No. 2; Manila Wine Merchants, Inc. v. Commissioner of Internal Revenue**, No. L-26145, February 20, 1984, 127 SCRA 483).

In as much as "purpose" involves a state of mind or intent, it is always necessary to look at the surrounding circumstances and the attendant facts on a case by case basis to determine whether the non-distribution of earnings and profits was to permit the shareholders to avoid income tax or if such was for some legitimate purpose, such as, its use for the reasonable needs of the business. In this regard, although the testimony of the taxpayer, officers and stockholders is entitled to some weight, generally, the issue is to be resolved in the light of the surrounding circumstances, including the interests of those in control of their actual conduct. (**Mertens, Law of Federal Income Taxation**, Vol. 7, Chapter 39, p. 45).

Respondent submits the following findings and analysis allegedly determinative of petitioner's accumulation of profits or earnings for the taxable year involved as being beyond the needs of its business: (Examiner's Memorandum; Exh. 2-A, pp. 169 BIR Records.)

> "A. That the corporation, while declaring stock and cash dividends in 1980, did not or failed to declare any during the year under review, permitting the accumulation of profits instead of being divided or distributed to taxable shareholders; "
>
> "B. The financial position of the company as of November 30, 1981: Assets were P52,316,680.00 while liabilities amounted to P22,212,063.00 or a ratio of 2.5 to 1;"
>
> "C. That the corporation had considerable liquid funds consisting of Cash, Receivables, Inventories and even its sales for the period would adequately provide the normal needs of the business."

Petitioner contends that it did not declare dividends for the year 1981 in order to use the accumulated earnings as working capital reserve to meet its "reasonable business needs". The law permits a stock corporation to set aside a portion of its retained earnigs for specified purposes.[1] In the case at bar, however, petitioner's purpose for accumulating its earnings does not fall within the ambit of any of these specified purposes.

1 Sec. 43 par. 2 Corporation Code of the Philippines - Stock corporations are prohibited from retaining surplus profits in excess of one hundred (100%) of their paid-in capital stock, except: (1) when justified by definite corporation expansion projects or programs approved by the board of directors or; (2) when the corporation is prohibited under any loan agreement with any financial institution or creditor, whether local or foreign, from declaring dividends without its/his consent, and such consent has not yet been secured; or; (3) when it can be clearly shown that such retentions is necessary under special circumstances obtaining in the corporation, such as when there is need for special reserve for probable contingencies.(n)

More compelling is the finding that there was no need for petitioner to set aside a portion of its retained earnings as working capital reserve as it claims since it had considerable liquid funds. A thorough review of petitioner's financial statement (particularly the Balance Sheet, p. 127, BIR Records) reveals that the coporation had considerable liquid funds consisting of cash, accounts receivable, inventory and even its sales for the period is adequate to meet the normal needs of the business. This can be determined by computing the current asset to liability ratio of the company:

$$\text{current ratio} = \frac{\text{current assets}}{\text{current liabilities}} = \frac{P47,052,535.00}{P21,275,544.00} = \underline{2.21 : 1}$$

The significance of this ratio is to serve as a primary test of a company's solvency to meet current obligations from current assets as a going concern or a measure of adequacy of working capital.

Petitioner in this case failed to prove the immediacy of its need for the accumulation of earnings, hence the accumulation was not for the reasonable needs of the business and thus, the surtax should then apply. (**The Manila Wine Merchants, Inc., vs. The Commissioner of Internal Revenue**, GR. No. L-26145, February 20, 1984, 127 SCRA 483).

We further reject petitioner's argument that "the accumulated earnings tax does not apply to a publicly-held corporation" citing American jurisprudence to support its position. The reference finds no application in the case at bar because under Section 25 of the NIRC, as amended by Section 5 of P.D. No. 1379 (dated September 17, 1980), the exceptions to the accumulated earnings tax are expressly enumerated, to wit: Bank, non-bank financial intermediaries, corporations organized primarily, and authorized by the Central Bank of the Philippines to hold shares of stock of banks, insurance companies, or personal holding companies, whether domestic or foreign. The law on the matter is clear and specific. Hence, there is no need to resort to applicable cases decided by the American Federal Courts for guidance and enlightenment as to whether the provision of Section 25 of the NIRC should apply to petitioner.

Equally clear and specific are the provisions of E.O. 41 particularly with respect to its effectivity and coverage. It appears that petitioner availed of the tax amnesty under E.O. 41 under File No. 32A-F-000455-41B as certified and confirmed by respondent through its Tax Amnesty Implementation Office on October 6, 1987.

The availment of the tax amnesty under E.O. 41 as amended is sufficient basis, in appropriate cases, for the cancellation of the assessment issued after August 21, 1986 (Revenue Memorandum Order No. 4-87). Said availment does not result in cancellation of assessments issued before August 21, 1986 as petitioner seeks to do in the case at bar. Therefore, the assessments in this case, issued on January 30, 1985 despite petitioner's availment of the tax amnesty under E.O. 41 as amended, still subsist.

Based on the foregoing, we find the petitioner liable for the payment of the aforementioned 25% surtax on undue accumulation of surplus in the amount of P3,774,867.50 inclusive of interest. Petitioner was unable to prove its non-liability by a clear preponderance of evidence.

WHEREFORE petitioner Cyanamid Philippines, Inc., is ordered to pay respondent Commissioner of

Internal Revenue the sum of P3,774,867.50 representing 25% surtax on improper accumulation of profits for 1981, plus 10% surcharge and 20% annual interest from January 30, 1985 to January 30, 1987.

Costs against petitioner.

SO ORDERED.

Quezon City, Metro Manila, August 6, 1991.

CONSTANTE C. ROAQUIN
Associate Judge

WE CONCUR:

ALEX Z. REYES
Presiding Judge

ERNESTO D. ACOSTA
Associate Judge

C E R T I F I C A T I O N

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, Article VIII of the Constitution.

ALEX Z. REYES
Presiding Judge
Court of Tax Appeals