REPUBLIC OF THE PHILIPPINES
COURT OF TAX APPEALS
QUEZON CITY

EL PORVENIR RUBBER PRODUCTS, INC.,
Petitioner,

July 26, 1969

versus

CTA CASE NOS. 1702 & 1705

MISAEL VERA, as Commissioner of Internal Revenue,
Respondent.

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

DECISION

These two cases, which were consolidated because they involve the same parties and similar questions, are appeals from decisions of respondent Commissioner of Internal Revenue assessing petitioner El Porvenir Rubber Products, Inc., the sums of ₱461.10, ₱207.68, ₱37,879.18 and ₱12,369.64 as deficiency income taxes and interest for the years 1956, 1957, 1958 and 1961, respectively.

Petitioner, a domestic corporation organized under the laws of the Philippines, is engaged in the manufacture of rubber shoes. It is a close family corporation, all its shares of stock being owned by the surviving spouse and children of the late Tomas Geronimo. As of December 31, 1958, its authorized capital stock was ₱2,000,000.00, divided into 20,000 shares at ₱100.00 per share, of which

92

₱1,299,600.00 had been paid. The seven children of the late Tomas Geronimo, namely, Carlos Geronimo, Antonio Geronimo, Vicente Geronimo, Angela G. Fores, Leonarda G. Limjuco, Consuelo G. Garcia, and Pacita G. Coronel owned 1,852 shares of stock each, while the widow, Florentina Vda. de Geronimo owned only 32 shares.

According to its income tax returns filed for the years 1956, 1957, 1958 and 1961, petitioner had gross incomes of ₱484,676.14, ₱581,368.55, ₱757,940.56 and ₱723,544.70, respectively, and net incomes in the amounts of ₱97,565.84, ₱88,026.42, ₱125,730.42 and ₱34,342.45. After an investigation of petitioner's income tax returns, respondent assessed on October 30, 1961 deficiency income taxes amounting to ₱3,366.78, ₱2,434.03 and ₱36,-774.53 for 1956, 1957 and 1958, respectively, inclusive of the ½% monthly interest from June 20, 1959 to June 20, 1962. He also assessed petitioner on April 1, 1965 the sum of ₱12,369.64 as deficiency income tax for 1961, inclusive of the ½% monthly interest for the period from April 16, 1962 to April 1, 1965. These deficiency assessments resulted from the disallowance of the claimed deductions for depreciation of machineries and use of rubber tire materials for the years 1966, 1957 and 1958; bonuses of officers for 1958; and representation allowances and bad debts for the years 1958 and 1961, itemized as follows:

	1956	1957	1958	1961
Bonus of directors-stockholders			₱48,000	
Representation allowances			45,500	₱24,000
Bad debts			17,909.43	23,747.45
Depreciation of rubber tire machineries	₱9,778.53	₱9,778.53	9,778.53	
Rubber tire materials intended for tax-exempt tire industry	₱1,447.60	880.00	3,243.60	

On November 11, 1961 and July 28, 1965 petitioner requested the reconsideration of the aforesaid assessments of October 30, 1961 and April 1, 1965, respectively. After reinvestigation, respondent denied the claimed deductions of bonuses for 1958; representation allowances and bad debts for the years 1958 and 1961; and costs of rubber tire materials intended for the tax-exempt rubber tire industry for 1956 to 1958, but allowed the claimed deduction for depreciation of rubber tire machineries. Consequently, respondent issued on September 30, 1965 a modified deficiency income tax assessment for ₱461.10, ₱207.68 and ₱37,879.18 for 1956, 1957 and 1958, respectively, inclusive of the ½% monthly interest. However, respondent totally denied on October 4, 1965 the request for reconsideration of the assessment of April 1, 1965 on the grounds that the bad debts claimed for 1961 in the sum of ₱23,747.45 were not proven to be worthless and the four officers of petitioner, namely, Leonarda G. Limjuco, secretary; Consuelo G. Garcia, assistant secretary; Florentina L. Vda. de Geronimo, treasurer; and Pacita G. Coronel, assistant treasurer, were not entitled to representation expenses.

From these decisions, petitioner appealed to this Court contending, among other things, that respondent's right to assess the deficiency income taxes for the years 1956, 1957 and 1958 had already prescribed.

In view of the failure of petitioner to pursue in his memorandum and reply memorandum its contention on the alleged prescription of respondent's right to assess, we take it that the prescription issue has been abandoned by it. Hence, we find it unnecessary to consider this question.

The only issue in these cases is whether or not the disallowance by respondent of the deductions in question is in accordance with law. We will discuss the disallowed deductions in the following order: (1) bonuses of directors-stockholders for 1958; (2) representation allowances for 1958 and 1961; (3) bad debts for 1958 and 1961; and (4) costs of rubber tire materials intended for the tax-exempt rubber tire industry of petitioner for 1955, 1957 and 1958.

<u>Bonuses of directors in the sum of ₱48,000 for 1958</u>.

The amount of ₱48,000 represents the bonuses given to all the eight directors-stockholders of petitioner at ₱6,000 each. In disallowing these bonuses, respondent contends that they are not in fact compensation for personal services actually rendered but merely disguised distributions of profits. He based his thesis on the following propositions: (a) no dividend was declared by petitioner in the year 1958 notwithstanding that it had a net income of ₱125,730.42 and an accumulated surplus of ₱366,562.98; (b) petitioner is a close family corporation; (c) there was a disparity between the bonuses of petitioner's directors and its employees; (d) there was no proof of the quality, extent and nature of the services of the recipients; and (e) the bonuses are not ordinary and necessary expenses within the meaning of Section 30(a)(1) of the National Internal Revenue Code.

The justification for the giving of the bonuses in 1958 was explained by petitioner as follows:

> ". . . that while the Board of Directors meet at least once a week, sometimes twice a week, they were not paid per diems for all these meetings (p. 13, t.s.n.), the reason being that Mrs. Geronimo the mother of the board members, objected thereto because as per diems they become recurring expenses when they do not know whether or not the company will make a profit. So at the end of the year, they decided to give bonuses of ₱6,000.00 to the members of the Board because the company realized a profit of over ₱100,000.00 (testimony of Parial, p. 14, t.s.n.; testimony of Antonio Geronimo, p. 126, t.s.n.). In other words the amount was not intended as per diems. The estimated per diem was only used as a measure in the determination of the bonus to be paid." (Petitioner's Memorandum, p. 11.)

It is well-settled that to be deductible from gross income, the bonus must in fact be compensation for personal services actually rendered and, when added to salaries, it must be reasonable when measured by the amount and quality of the services performed with relation to the business of the particular taxpayer. (Kuenzle & Streiff, Inc., v. Collector of Internal Revenue, G.R. Nos. L-12010 & L-12113, October 20, 1959; Aguinaldo Industries Corporation v. Commissioner of Internal Revenue, C.T.A. No. 1636, June 29, 1968; see also Mertens'

Law of Federal Income Taxation, Vol. 4, Sec. 25.44, p. 395.) In the instant cases, the records show that the recipients of the bonuses in question actually rendered service to the company. And the records also show the nature, quality and extent of the services rendered by the board of directors or its individual members, either as directors, executive officers or department managers of the corporation.

Carlos Geronimo, who was the president and general manager of the corporation in 1958, worked full time daily from 8:00 A.M. to 5:00 P.M. As general manager, he enforced the policies laid down by the board of directors, saw to it that the business ran smoothly, and that the manufactured shoes were distributed or sold throughout the country. Antonio Geronimo was sales manager and member of the board of directors in 1958. Aside from assigning salesmen to their respective territories, he was in charge of the approval or disapproval of orders coming from customers. In 1961, he was elected general manager and performed the duties thereof.

Mrs. Angela Fores was vice president and member of the board of directors in 1958 and credit manager in 1961. As vice president, she took the place of the president when he was absent and as credit manager, she supervised the approval or disapproval of purchase orders received by salesmen from all over the Philippines. Vicente Geronimo was the purchasing agent and advertising manager from 1945 until his death in 1967. He was also a member of the board. As purchasing agent, he was in charge of the acquisition of all materials needed by the company, and, as advertising manager, he attended to all the advertising needs and problems of petitioner.

Mrs. Leonarda G. Limjuco was the secretary of the corporation. She was also a member of the board. As secretary, she went around the different departments of the company to see that the laborers, numbering about 500, worked normally as they should. And Mrs. Consuelo G. Garcia, who was also a member of the board and assistant secretary, helped her performed these functions. Mrs. Florentina Geronimo was the treasurer of the corporation. As such, she signed all checks, and was in charge of all disbursements of petitioner. Her assistant in 1958 was Mrs. Pacita G. Coronel, who worked daily from 8:00 A.M. to 4:30 P.M. The salesmen of the company submitted their provisional receipts, together with their remittances to the assistant treasurer, who issued official receipts in lieu of the provisional receipts. She checked and signed an average of 750 to 1000 receipts a month.

While in fixing the bonuses of the officers the ownership of the stocks revealing the enterprise to be a close corporation may be considered, the findings show that it was not the vital consideration thereof. The evidence presented sufficiently demonstrates that bonuses were deserved by management.

A comparison of petitioner's gross and net income for the years 1956, 1957 and 1958 readily shows quite a sharp rise in the gross and net income of the company in 1958. Petitioner's gross income for 1956 and 1957 were ₱484,676.14 and ₱581,368.55 respectively and its net incomes were ₱97,565.84 and ₱88,026.42 respectively. In 1958 its gross and net income sharply rose to ₱757,940.56 and ₱125,730.42 respectively. This net income is actually ₱174,474.02 with the disallowance of the representation expenses and the rubber materials. This accomplishment well reflects the volume and quality of the services rendered by management and to our mind is a sufficient justification for a bonus. Success in the kind of industry the company is engaged in requires a combination of dedication and good judgment and not mere luck. And more, the bonus does not appear to be unusual or extravagant in the light of the capital of the company, the gross and net income for 1958 as compared to previous years, the steady progress of the company up to that year under the same management and the fixed salaries of the officers.) The total of the bonuses may be more than the per diems the recipients could have reasonably received but one should not lose sight of the fact that per diems and bonuses do not have the same foundation and the accepted measure of one cannot be applied to the other.

Respondent makes much of the fact that in 1956 the company declared cash dividends amounting to ₱99,980 although the income was only ₱97,565.98; and in 1957 it declared cash dividends of ₱100,000 and stock dividends of 200,000 although the net income was only ₱88,026.42; but in 1958 the company did not declare any dividend, cash or stock, although its net income was ₱125,730.42 and its accumulated surplus rose up to ₱366,572.98, but instead granted bonuses in the total sum of ₱48,000. These circumstances could be of significance but whatever significance they may have must yield to the fact that the company earnings for 1958 show that management deserved a bonus in that year and that the amount of the bonus does not appear to be exhorbitant nor unreasonable but rather commensurate with the amount and quality of the services performed with relation to the bonuses of the company. The final test after all is the reasonableness of the bonus. The accumulated surplus of ₱366,572.98 does not necessarily vitiate the character of the grant of the bonus considering that the respondent does not question the propriety of such accumulation under Section 25 of the Revenue Code.

<u>Representation allowances of ₱45,500 and ₱24,000 for the years 1958 and 1961</u>.

The officers of the corporation and the amounts given to each as representation allowances for 1958 and 1961 are as follows:

<u>Recipients</u>	<u>1958</u>	<u>1961</u>
Carlos Geronimo	₱6,000.00	
Vicente Geronimo	5,500.00	
Antonio Geronimo	6,000.00	
Angela Fores	5,500.00	
Leonarda Limjuco	5,500.00	₱6,000.00
Pacita G. Coronel	5,500.00	6,000.00
Consuelo Garcia	5,500.00	6,000.00
Florentina L. Vda. de Geronimo	6,000.00	6,000.00

Explaining the reason for giving these representation allowances, petitioner states:

"In or about the month of September 1958, when cost of living was noticed to be going up, the members of the Board of Directors complained that they were spending too much in behalf of corporation (p. 12, t.s.n.) by way of representation expenses out of their own pockets.

"The manager, in particular, had to entertain foreign visitors, particularly those from whom they are buying materials and dealers of their shoes not only in the Philippines but also abroad (pp. 102, 113, 129, t.s.n.). So by resolution of the Board (Exhibit 7) each of the members of the Board was authorized to draw representation allowance of ₱500.00 a month, beginning from January 1, 1958, subject to the condition that these amounts were to be included in their individual income tax returns and it is up to them to substantiate the expenditure thereof in their individual returns (testimony of Parial, p. 12, t.s.n.; testimony of Antonio Geronimo, p. 102, t.s.n.; and testimony of Carlos Geronimo, p. 125, t.s.n.). In the case of women dealers, the women members of the Board of Directors are the one's who entertain them in their own homes (p. 137, t.s.n.)." (Petitioner's Memorandum, p. 8.)

Invoking the decision of the Supreme Court in the cases of Collector of Internal Revenue v. Goodrich International Rubber Co. (G.R. No. L-22265, Dec. 22, 1967) respondent disallowed these deductions from petitioner's income tax returns because the representation expenses were not properly supported by receipts. The pertinent portion of said decision reads as follows:

> "The claim for deduction thereof is based upon receipts issued, not by the entities in which the alleged expenses had been incurred, but by the officers of Goodrich who allegedly paid them.
>
> "The claim must be rejected. If the expenses had really been incurred, receipts or chits would have been issued by the entities to which the payments had been made, and it would have been easy for Goodrich or its officers to produce such receipts. Those issued by said officers merely attest to their claim that they had incurred and paid said expenses. They do not establish payment of said alleged expenses to the entities in which the same are said to have been incurred. The Court of Tax Appeals erred, therefore, in allowing the deduction thereof."

In the present cases petitioner did not present receipts to support the contested representation expenses. If, as ruled by the Supreme Court, a claim for representation expense deduction based upon receipts issued by the officers who allegedly paid them must be rejected, there is more reason to reject the present claim of petitioner which is not even evidenced by any receipt.

We note that in its memorandum petitioner refers to these representation expenses as "additional compensations just like salaries and bonuses for which they (officers) need not make an accounting to Petitioner." This assertion is gratuitous and we deem it unnecessary to pass upon the deductibility of these items as additional compensation. The evidence shows that petitioner labeled these items as representation allowances or expenses when they were given to its officers. For purposes of income tax deduction, which is precisely the question involved in these cases, it treated them in its income tax returns for 1958 and 1961 as representation expenses, separate and distinct from salaries and bonuses. And in the statement of the ultimate facts in its petitions for review filed with this Court, which constitute its cause of action, petitioner described and designated these items interchangeably as representation allowances and representation expenses, again different and apart from salaries and bonuses. (Pars. VI & VII, Petition for Review, CTA Case No. 1702; Pars. IV & V, Petition for Review, CTA Case No. 1705.)

Bad debts of ₱17,909.43 and ₱23,747.45 for the years 1958 and 1961.

With respect to the bad debt deductions in the amounts of ₱17,909.43 and ₱23,747.45 for the years 1958 and 1961, respectively, petitioner claims that where the accounts receivables from customers, who were small retailers scattered throughout the Philippines with no collaterals, were found to be difficult to collect, its collection agents reported the matter in writing to the company and recommended that collection cases be referred to petitioner's retained lawyer for action. Collection letters were then sent to the debtors by the counsel but the majority of them were returned unclaimed because most of the debtors were no longer residing in their original residences. Some did not bother to answer. In view of these circumstances, the lawyer advised petitioner to write off the debts. But notwithstanding this advice of counsel, steps were still taken subsequently by petitioner to re-verify the financial status of the debtors. The reports made by petitioner's agents on the re-verification showed that the debtors had either "disappeared," "refused to pay," or were "bunkrupt." Considering that the amounts involved in these accounts are small, mostly ranging from ₱5.00 to ₱350.00, and that the debtors were scattered in the different parts of the country, petitioner was justified in believing that the unsuccessful efforts exerted to collect the same sufficed to warrant their being written off. Indeed, it would have been "foolish to spend good money after bad." (Collector of Internal Revenue v. Goodrich International Rubber Co., supra.)

The bad debts in the amounts of ₱17,909.43 and ₱23,747.45 should be allowed as deductions from gross income for the years 1958 and 1961, respectively.

Rubber tire materials in the amounts of ₱1,447.60, ₱880.00 and ₱3,243.60 for the years 1956, 1957 and 1958.

Petitioner was granted tax exemption as a new and necessary industry in the manufacture of automobile and truck tires under Republic Acts Nos. 35 and 901. It appears in the testimony of Cayetano Parial and Antonio Geronimo, assistant general manager and sales manager, respectively, of petitioner, that for the years 1956, 1957 and 1958, it deducted from its gross income the sums of ₱1,447.60, ₱880.00 and ₱3,243.60, respectively, representing the cost of raw materials for its new and necessary industry of manufacturing tires. These raw materials, consisting of raw cotton materials, steel, rubber tires, and others, were intended to be used in its tax-exempt tire manufacturing industry. When the company's tax-exempt industry was however abandoned, petitioner deducted the cost of these raw materials from the gross income realized from its non-exempt shoe manufacturing industry on the ground that such raw materials were used allegedly in the manufacture of rubber shoes.

Respondent contends that the alleged use of these raw materials in the manufacture of petitioner's rubber shoe products is without factual basis. He invites the attention of this Court to the following facts:

(1) On June 22, 1957 petitioner wrote a letter to the Secretary of Finance stating, among other things:

> "In connection with your requirements to submit annual reports on our operation of tire manufacturing for the year 1956, we have the honor to inform you that we have not been able to manufacture automobile tires during the year. This is due to our problem of getting the required dollar quota allocations for the importation of essential raw materials and machines. We have already set aside sufficient funds for the purchase of such materials and machines needed by our industry, and negotiations for their procurement is being undertaken now." (P. 118, BIR rec., CTA Case No. 1702.)

(2) Again on March 8, 1958 a letter of similar tenor was sent by petitioner to the Secretary of Finance. It stated, among others:

> "We were not able to import the additional machines and materials due to strict government restrictions in the allocation of foreign exchange for machinery and raw materials. . ." (P. 115, BIR rec., CTA Case No. 1702.)

(3) And on March 10, 1959 another letter was forwarded by petitioner to the Secretary of Finance. It informed the Secretary "that our tire plant is still not in operation due to lack of some additional machineries and raw materials particularly raw rubber." (Exh. J, p. 112, BIR

rec., CTA Case No. 1702.)

It seems clear therefore, as respondent claims, that petitioner could not have used in the manufacture of shoes in 1956 and 1957 tire raw materials that it did not have. At that time "negotiations for their procurement" were still being undertaken. The same is true with respect to the year 1958, because petitioner's tire plant was not in operation yet due to lack of additional machineries and raw materials particularly raw rubber. In this connection, petitioner's board chairman and former president and general manager in 1958 testified before the Court that of the raw materials needed for manufacturing rubber tires, only raw rubber can be used for making rubber shoes (p. 128, t.s.n.). In the main, the testimony alone of petitioner's two witnesses unsupported by any document is not enough proof that raw materials intended for manufacturing tires were actually used in the manufacture of rubber shoes during the years in question, considering petitioner's letters mentioned above. It behooves petitioner to adduce better evidence since the claim is contested and respondent has the presumption of correctness in his favor. It is of course possible that the materials in question has actually been used but they did not come from the tax-exempt tire manufacturing materials since there were no such materials existing.

But petitioner has not adduced proof to this effect. The deduction of the cost of or expenses for these raw materials in the amounts of ₱1,447.60, ₱880.00 and ₱3,243.60 for the years 1956, 1957 and 1958, respectively, is not therefore proper.

In sum, the assessments of respondent should be modified in the sense that petitioner is liable for deficiency income taxes and interest for the years 1956, 1957, 1958 and 1961 in the amounts of ₱461.10, ₱207.68, ₱16,103.46 and ₱6,217.20, computed as follows:

1956

Net income per original investigation	₱108,791.97
Deduct: Depreciation - Machineries	9,778.53
Net income per investigation	₱ 99,013.44
Amount subject to tax	₱ 99,013.44
Tax due thereon	₱ 19,803.00
Less: Amount already assessed	19,513.00
B a l a n c e	₱ 390.00
Add: ½% mo. int. from 6/20/59 to 6/20/62	71.10
TOTAL AMOUNT DUE & COLLECTIBLE	₱ 461.10

1957

Net income per original investigation	₱ 98,684.95
Deduct: Depreciation - Machineries	9,778.53
Net income per investigation	₱ 88,906.42
Amount subject to tax	₱ 88,906.42
Tax due thereon	₱ 17,781.28
Less: Amount already assessed	₱ 17,605.00
B a l a n c e	₱ 176.00
Add: ½% mo. int. from 6/20/69 to 6/20/62	31.68
TOTAL AMOUNT DUE & COLLECTIBLE	₱ 207.68

1958

Net income per return		₱125,730.42
Add: Unallowable deductions:		
Representation expenses	₱45,500.00	
Rubber tire materials used in tax-exempt industry	3,243.60	48,743.60
Net income per investigation		₱174,474.02
Amount subject to tax		₱174,474.02
Tax due thereon		₱ 40,853.00
Less: Amount already assessed		27,206.00
B a l a n c e		₱ 13,647.00
Add: ½% mo. int. from 6/20/59 to 6/20/62		2,456.46
TOTAL AMOUNT DUE & COLLECTIBLE		₱ 16,103.46

1961

Net income per return	₱ 34,342.45
Add: Unallowable deductions:	
Representation expenses	24,000.00
Net income per investigation	₱ 58,342.45
Amount subject to tax	₱ 58,342.45
Tax due thereon	₱ 12,835.00
Less: Amount already assessed	7,555.00
B a l a n c e	₱ 5,280.00
Add: ½% mo. int. from 4/16/62 to 4/16/65	937.20
TOTAL AMOUNT DUE & COLLECTIBLE	₱ 6,217.20

WHEREFORE, the decisions appealed from are hereby modified. Petitioner El Porvenir Rubber Products, Inc., is ordered to pay respondent Commissioner of Internal Revenue deficiency income taxes in the amounts of ₱461.10, ₱207.68, ₱16,103.46 and ₱6,217.20 for the years 1956, 1957, 1958 and 1961, respectively, inclusive of the ½% monthly interest pursuant to Section 51(d) of the Revenue Code, as amended by Republic Act No. 2343. If the deficiency taxes are not paid in full within thirty (30) days from the date this decision becomes final and executory, petitioner shall pay a surcharge of five per cent (5%) of the unpaid amount plus interest at the rate of one per cent (1%) a month, computed from the date this decision becomes final until paid, provided that the maximum amount that may be collected as interest shall in no case exceed the amount corresponding to a period of three (3) years. Without pronouncement as to costs.

SO ORDERED.

Quezon City, July 26, 1969.

RAMON L. AVANCEÑA
Associate Judge

I CONCUR:

ROMAN M. UMALI
Presiding Judge