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REPUBLIC OF THE PHILIPPINES
COURT OF TAX APPEALS
MANILA

KUENZLE & STREIFF, INC.,
Petitioner,

- versus -

April 28, 1961

C.T.A.
CASE NO. 551

THE COMMISSIONER OF
INTERNAL REVENUE,
Respondent.

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

D E C I S I O N

The respondent assessed against the petitioner the sums of ₱40,455.00, ₱16,648.00 and ₱16,228.00 as deficiency income tax for the years 1953, 1954 and 1955, respectively. Petitioner sought a reconsideration of the assessment, but since respondent imposed certain conditions before granting a hearing which were not acceptable to petitioner, the latter instituted the present appeal to review respondent's decision. However, before the case could be set for trial, respondent sought to collect the tax by distraint and levy. Petitioner filed an urgent petition to restrain respondent from collecting the tax pending final determination of the case. The petition was withdrawn when respondent agreed to suspend collection upon the filing of a surety bond to guarantee payment of the tax, plus the corresponding surcharge and interest.

The deficiency income tax in question was brought about by the disallowance of a portion of the bonuses and additional compensation given by petitioner to its ranking officers and claimed by it as deduction from its gross income during the years under review.

For the year 1953, petitioner reported a loss of ₱2,085.84. Its books show that it paid its ranking officers bonuses in the total sum of ₱33,360 and an additional remuneration aggregating ₱175,140.00. The latter amount was taken from the general reserve (profits earned in prior years) to enable petitioner to pay the additional compensation or bonus. Respondent disallowed the deduction of the entire ₱175,140.00 as additional compensation, resulting in a net taxable income of petitioner in the sum of ₱173,054.16. For the year 1954, petitioner reported a loss of ₱4,953.91. The bonus paid in that year to its ranking officers amounted to ₱103,900.00. Respondent disallowed the deduction of a portion of the bonus in the amount of ₱61,193.33 (not ₱88,193.33), resulting in a net taxable income of petitioner in the sum of ₱56,239.42 (not ₱83,239.42). For the year 1955, it reported a loss of ₱9,246.07. The bonus paid in that year amounted to ₱105,800.00. Respondent disallowed the deduction of a portion of the bonus in the sum of ₱90,385.00, resulting in a net taxable income in the amount of ₱81,138.93.

Petitioner raised two issues in its petition for review, viz: (1) that the right of the Government to assess the deficiency income tax in question has already prescribed, pursuant to Section 51(d) of the National Internal Revenue Code[1]; and (2) that it was error for res-

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[1] Repealed by Rep. Act No. 2343.

pondent to have disallowed the deduction of the bonuses and additional compensation in question.

The first issue has apparently been abandoned in view of the numerous decisions holding that Section 51(d) of the Revenue Code, before its repeal, was not a limitation upon assessment and collection of income tax by judicial action. The law applicable is Sections 331 and 332 of the same Code. (See Estifania R. Pirovano v. Commissioner of Int. Rev., C.T.A. 524, Sept. 29, 1960, and cases cited therein.) Therefore, the sole issue left for our consideration is the legality of the disallowance of the aforementioned bonuses and additional compensation.

In the decision of respondent, the disallowance of a portion of the bonuses and additional compensation was premised on his finding that the payment of such bonuses and additional compensation was in effect a distribution of surplus or earnings, in other words, an indirect distribution of dividends. In this appeal, respondent apparently admits that the payment of the disallowed bonuses and additional compensation was not an indirect distribution of dividends. He contends, however, "that such extra-remunerations and bonuses should not be allowed as deductions from the petitioner's gross incomes for the years in question for the reason that they are excessive and are not necessary and reasonable as contemplated under section 30(a)(1) of the Tax Code." (Page 3, Memorandum for Respondent, June 16, 1960.)

Section 30(a)(1) of the Revenue Code allows the deduction from gross income of 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." There is no question that the bonuses and additional compensation in question were paid for services actually rendered. The only question is whether or not they are reasonable.

In the former case of petitioner involving the same question, the tests for determining the reasonableness of the payment of bonuses and additional compensation for services actually rendered have been laid down, and we quote:

> "It is a general rule that 'Bonuses to employees made in good faith and as additional compensation for the services actually rendered by the employees are deductible, provided such payments, when added to the stipulated salaries, do not exceed a reasonable compensation for the services rendered' (4 Mertens, Law of Federal Income Taxation, Sec. 25.50, p. 410). The condition precedents to the deduction of bonuses to employees are: (1) the payment of the bonuses is in fact compensation; (2) it must be for personal services actually rendered; and (3) the bonuses, when added to the salaries, are 'reasonable x x x when measured by the amount and quality of the services performed with relation to the business of the particular taxpayer' (Idem., Sec. 25.44, p. 395). Here it is admitted that the bonuses are in fact compensation and were paid for services actually rendered. The only question is whether the payment of said bonuses is <u>reasonable</u>."
>
> "There is no fixed test for determining the <u>reasonableness</u> of a given bonus as compensation. This depends upon many factors, one of them being 'the amount and quality of the services performed with relation to the business'. Other tests sug-

gested are: payment must be '<u>made in good faith</u>'; 'the character of the taxpayer's business, <u>the volume and amount of its net earnings</u>, its locality, the type and extent of the services rendered, the salary policy of the corporation'; 'the size of the particular business'; 'the employees' qualifications and contributions to the business venture'; and 'general economic conditions' (4 Mertens, Law of Federal Income Taxation, Secs. 25.44, 25.49, 25.50, 25.51, pp. 407-412). However, 'in determining whether the particular salary or compensation payment is reasonable, the situation must be considered as a whole. Ordinarily, no ssingle factor is decisive. x x x it is important to keep in mind that it seldom happens that the application of one test can give a satisfactory answer, and that ordinarily it is the interplay of several factors, properly weighted for the particular case, which must furnish the final answer (Idem.)." (Kuenzle & Streiff v. Coll. of Int. Rev., G. R. Nos. L-12010 & L-12113, Oct. 20, 1959.)

One of the tests for determining the reasonableness of the bonuses and additional compensation is "the character of the taxpayer's business, the volume and amount of its net earnings." In the former case of petitioner, C.T.A. No. 169, Dec. 29, 1956, affirmed in G. R. Nos. L-12010 & L-12113, Oct. 20, 1959, involving the taxable years 1950, 1951 and 1952, this Court allowed bonuses and additional compensation in amounts bigger than what were allowed by respondent in view, among others, of the huge profits earned by petitioner during those years. The payment of such bonuses still left petitioner with substantial net profits available for distribution as dividends to its stockholders. In the instant case, petitioner paid out bonuses and additional compensation in amounts beyond its net earnings. In fact, in 1953, it had to withdraw the sum of ₱175,140.00 from its reserve, accumulated from its prior years' earnings, to be able to pay the additional compensation. We do not think that the payment of bonuses and extra compensation, in addition to the regular salaries of employees and officers of a corporation in business, in amounts beyond its net earnings constitutes an ordinary and necessary expense. Neither may it be considered reasonable within the meaning of Section 30(a)(1) of the Revenue Code.

For the year 1953, respondent allowed the deduction of bonuses amounting to ₱33,360.00 and disallowed the additional compensation of ₱175,140.00, leaving petitioner with a net taxable income of ₱173,054.16, instead of a loss of ₱2,085.84. For 1954, respondent allowed the deduction of ₱42,706.67 and disallowed the sum of ₱61,193.33, leaving petitioner with a net taxable income of ₱56,239.42, instead of a loss of ₱4,953.91. And for 1955, respondent allowed the deduction of ₱15,415.00 and disallowed the sum of ₱90,385.00, leaving petitioner with a net taxable income of ₱81,138.93, instead of a loss of ₱9,246.07. There is nothing of record indicating that the determination of respondent is unreasonable or unjust.

Respondent admits that in regard to the assessment for 1954 a mistake was committed in the computation of the deficiency tax due. The correct amount is ₱11,248.00, instead of ₱16,648.00. (See par. 17, Petition for Review; par. 10, Answer.)

FOR THE FOREGOING CONSIDERATIONS, the decision appealed from is hereby affirmed with respect to the deficiency assessment for the years 1953 and 1955. As regards the deficiency assessment for the year 1954, the same is hereby modified in the sense that the amount due from petitioner is ₱11,248.00, instead of ₱16,648.00. Accordingly, petitioner is ordered to pay within thirty days from the date this decision becomes final the sums of ₱40,455.00 and ₱16,228.00, plus 5% surcharge and 1% monthly interest from October 1, 1957 until paid. It is likewise ordered to pay the sum of ₱11,248.00 within the same period, and, if not so paid, there shall be added thereto 5% surcharge and 1% monthly interest from the date of delinquency to the date of payment. With costs against petitioner.

SO ORDERED.

Manila, April 28, 1961.

ROMAN M. UMALI
Associate Judge

I CONCUR:

MARIANO NABLE
Presiding Judge

Associate Judge AUGUSTO M. LUCIANO did not take part.