REPUBLIC OF THE PHILIPPINES
COURT OF TAX APPEALS
QUEZON CITY

KATUPARAN REALTY CORPORATION,
Petitioner,

- versus - C.T.A. CASE NO. 4373

THE COMMISSIONER OF INTERNAL REVENUE,
Respondent.

2/4/93

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D E C I S I O N

Sought to be reviewed by appeal in this case is the decision of respondent Commissioner of Internal Revenue, dated May 10, 1989, holding petitioner liable for deficiency income tax and expanded withholding tax for the year 1982 in the sums of P413,127.78 and P853.36, respectively.

Briefly, the following are the facts:

For the year ended December 31, 1982, petitioner, a domestic corporation, filed its annual (corporate) income tax return reporting therein a gross income of P2,309,100.00[1] and a net tax due of P39,316.00, which (latter amount) was arrived at after its total claimed deductions had

[1] Said gross income, as shown in schedule 4 of petitioner's income tax return (Exh. "D", pp. 121-122, CTA rec.), refers to "leases and rents" and, as testified to by petitioner's treasurer (witness), consisted entirely of rental income. (TSN, Aug. 14, 1990 hearing, pp. 69-70, CTA rec.)

been subtracted from its gross income and its total quarterly payments and withholding tax on rental had been taken into account. (See Exh. "D", pp. 121-122, CTA rec. & p. 22, BIR rec.).

On March 22, 1988, based upon an investigation/audit report of a revenue examiner recommending that petitioner's claimed deduction of interest expense paid to IBM, Philippines, Inc. (IBM for short) in the sum of P366,000.00 be disallowed on the ground that petitioner and IBM are related taxpayers (p. 67, BIR rec.), *respondent issued against petitioner an assessment for deficiency income tax in the sum of P413,127.78 and deficiency expanded withholding tax in the amount of P8,771.28 for the year 1982, computed as follows:*

1982

Deficiency Income Tax

Net Income per-investigation	P 935,044.00
Add: Disallowance Interest expense paid to IBM Phils. not deductible (Int. between related taxpayer)	366,000.00
Net Income per review	P1,301,044.00
Tax due thereon	575,469.80
Less: Tax paid	317,269.00
Deficiency Income tax	P 258,204.88
20% interest from 4-16-81 to 4-15-88	154,922.88
Total Amount Due and Collectible	P 413,127.78

Deficiency Expanded Withholding Tax

Appraisal fees paid to Asian Appriasal, Inc.	P 4,378.00	
5% thereof		218.90
Cash dividends paid	P 41,500.00	4,150.00
Total		P4,368.90
25% surcharge		1,092.15
14% interest from 2-1-88 to 4-1-88		3,160.15
Compromise penalty		150.00
Total amount Due and Collectible		P8,771.20

(Pp. 68, 69, 70, 71, 72 & 73, BIR rec.)

In a letter dated April 26, 1988, petitioner protested, with extensive arguments, the assessment for deficiency income tax and expanded withholding tax for lack of factual and legal basis. (Pp. 79-84 BIR rec.; also par. 13, Petition, p. 4, CTA rec.)

In a letter/reply dated May 10, 1989, respondent denied petitioner's protest against the deficiency income tax assessment, contending that petitioner and IBM are related taxpayers as defined in Section 30(b)(3) [then Section 31(b)(3)] of the Tax Code, and that petitioner was a personal holding company. However, as regards the deficiency expanded withholding tax, respondent reduced the amount to only P853.36, computed as follows:

5% basic tax --------------	P218.90
25% surcharge --------------	54.72
14% interest from 2-1-83 to 3-1-89 ---------	529.74
Compromise -----------------	50.00
	P853.36

(See pp. 111-112, BIR rec.)

Consequently, on June 28, 1989, petitioner filed its appeal with this Court.

The ISSUES for resolution are as follows:

1. Whether or not petitioner's deduction of the amount of P366,000.00 representing interest expense paid to IBM Philippines, Inc. should be allowed; and

2. Whether or not petitioner is liable for deficiency expanded withholding tax on the appraisal fees paid to Asian Appraisal, Inc. in the amount of P853.36.

1. As regards the first issue, respondent maintains that, in computing net income, no deduction shall be allowed in regard to interest payments made between related corporations pursuant to Section 30(b)(3),[2] then Section 31(b)(3), of the National Internal Revenue Code. He contends that IBM Philippines, Inc. owned, directly or indirectly, 99% of the shares of stock of petitioner Katuparan Realty Corporation. Hence, IBM Philippines Inc. and Katuparan are related corporations which would qualify the later as a personal holding company. In support of his position, respondent cites the "certification" of

[2] Section 30 (b)(3) of the National Internal Revenue Code cited by respondent is the later provision. For the year involved (1982), it should be the previous law, Sec. 31(b)(3) of Tax Code, as amended.

the assistant corporate secretary of petitioner (herein below quoted) and avers that the rule of attribution will not apply to "IBM Philippines Plan Trust Fund" because it is not a regular corporation registered with the Securities and Exchange Commission but just a mere Trust Fund Account.

> "The following were the stockholders of record standing on the books of said corporation as of December 31, 1982, with their respective holdings:

Stockholder	No. of Shares	of Shares Issued and outstanding
IBM Phils., Inc.	11,243	29%
IBM Phils., Retirement Plan Trust Fund, c/o Far East Bank & Trust Co., Account No. 41-13-00083-3	3,750	10%
IBM Phils., Retirement Plan Trust Fund, c/o Far East Bank & Trust Co. Account No. 41-13-00087-5	22,500	60%
Mr. Roberto R. Romulo	1	NIL
Atty. Ricardo J. Romulo	1	NIL
Mr. Cecilio C. Amoranto	1	NIL
Atty. Corazon Buenconsejo	1	NIL
Mr. Virgilio L Pena	1	NIL
	37,498	100%

> (Pp. 38-39, BIR rec.; see also Exh. "F", 135 CTA rec.; also TSN, Oct. 5, 1990, pp. 7-8.)

Further, respondent claims that the interest payment to IBM Philippines does not qualify as a business expense because the same was incurred by virtue of a promissory note assumed by petitioner and not on account of a loan transaction executed between petitioner and IBM Philippines Inc.

Conversely, petitioner claims that IBM Philippines, Inc. and Katuparan Realty Corporation are not related taxpayers as defined in Section 31(b)(3), now Section 30(b)(3), of the National Internal Revenue Code because not more than fifty (50) percent of the outstanding stock of each was owned, directly or indirectly, by or for the same individual. (In other words, no individual owned more than 50% of the stock of each of IBM and Katuparan). It maintains that only 29% of its outstanding capital stock was owned by IBM Philippines, Inc. The (other) 70% owned by "IBM Philippines Retirement Plan Trust Fund" cannot be attributed to IBM Philippines itself since, allegedly, all the benefits under the retirement plan are payable to IBM employees, and that IBM does not derive any benefit from the fund nor does it execise control over the same since it is managed by an independent trustee, the Far East Bank And Trust Company.

Likewise, petitioner claims that it cannot be considered as a personal holding company as defined in Section 64 of the National Internal Revenue Code because it does not meet the gross income *requirement and stock ownership requirement under subparagraph (a)(1) and (2) thereof, both of which requirement must be satisfied with respect to each taxable year. Citing Section 65 of the Tax Code which defines what constitutes "personal holding company income", in relation to said Section 64(a)(1) of the same code, petitioner argues that it does not satisfy the gross income requirement of a personal holding company because its gross income consisted entirely of income from rent which, under Section 65(g) of the Tax Code, cannot be considered as personal holding company income inasmuch as it constitutes more than 50% of its gross income for the taxable year.*

Moreover, contrary to respondent's postulation, petitioner asserts that said interest expense is an ordinary and necessary expense incurred in the pursuit of its real estate business.

We agree with petitioner.

The law in focus refers to Section 31(b)(3), now Sec. 30(b)(3), of the National Internal Revenue Code and Section 64 (now repealed), in relation to Section 65(g), of the same code which pertinently provide as follows:

> Section 31. <u>Items not deductible</u>–
> (a) General Rule.– In computing net income no deduction shall in any case be allowed in respect of–

xxx xxx xxx

(b) Losses from sales or exchanges of property. In computing net income no deduction shall in any case be allowed in respect of losses from sale or exchanges of property directly or indirectly –

xxx xxx xxx

(3) Except in the case of distributions in liquidation, between two corporations more than fifty per centum in value of the outstanding stock of each of which is owned directly or indirectly, by or for the same individual, if either one of such corporations, with respect to the taxable year of the corporation preceding the date of the sale or exchange was under the law applicable to such taxable year, a personal holding company or a foreign personal holding company; (Underlining supplied.)

Sec. 64. – Definition of personal holding company. – (a) General Rule. – For the purposes of this Title, the term "personal holding company" means any corporation, as defined in Section 20 if

(1) Gross income requirement.– At least eighty per centum of its gross income for taxable year is personal holding income as defined in Section 65, but if the corporation is a personal holding company with respect to any taxable year beginning after December thirty-first, nineteen hundred and thirty-eight, then, for each subsequent taxable year, the minimum percentage shall be seventy per centum in lieu of eighty, and it shall continue to be considered as a personal holding company until in a taxable year, during the whole of the last half of which, the stock ownership required by paragraph (2) does not exist, or until the expiration of three consecutive taxable years in each of which less than seventy per centum of the gross income is personal holding company income; and

> (2) Stock ownership requirement. - At any time during the last half of the taxable year more than fifty per centum in value of its outstanding stock is owned, directly or indirectly, by or for not more than five individuals.
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> Section 65. Personal holding company income - For the purposes of this title, the term "personal holding company income" means the portion of the gross income which consists of:
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> xxx xxx xxx xxx
>
> (g) Rents. - Rents, unless consisting fifty per centum or more of the gross income. For the purposes of this sub-section, the term "rents" means compensation however designated, for the use of, or right to use property, and the interest on debts owed to the corporation, to the extent such debts represent the price for which real property held primarily for sale to customers in the ordinary course of its trade or business was sold or exchanged by the corporation, but does not include amounts constituting personal holding company income under sub-section (f). (Underlining supplied)

Explicitly, Section 31(b)(3) of the Tax Code requires that in order for two corporations to be considered related taxpayers, more than fifty (50) percent of the outstanding stock of each must be owned, directly or indirectly, by or for the same individual. In the case at bar, it has been sufficiently established that for the taxable year in question, IBM Philippines Inc. owned only 29% of the outstanding capital stock of petitioner Katuparan Realty Corporation. The "IBM Retirement

Plan Trust Fund" owned 70% of Katuparan's capital stock, while the directors owned 1%. (See Exh. "F", supra; also TSN, Oct. 5, 1990 hearing, pp. 7-8). *However, the owneship of 70% of petitioner's outstanding capital stock by the "IBM Retirement Plan Trust Fund" does not make IBM Philippines Inc. the owner/holder of such 70% stocks of Katuparan. (As petitioner claims, such 70% stockholding of the IBM Retirement Plan Trust Fund cannot be attributed to IBM Philippines.) The reason is that all the benefits under the plan are payable exclusively to the employees of IBM and that IBM does not exercise control over the retirement trust fund since the same is managed by an independent trustee, Far East Bank and Trust Company. This was testified to by petitioner's treasurer, Mr. Cecilio C. Amoranto, during the hearing.* (See TSN, Aug. 14, 1990, pp. 30-31; TSN, Sept. 12, 1990, pp. 7-8 and pp. 15-16).

Neither may petitioner be considered a personal holding company under Section 64 of the Tax Code cited herefore. A corporation will be considered a personal holding company only if it meets the gross income requirement and stock ownership requirement. To meet the gross income requirement, either of the following percentages of the gross income of the corporation for the taxable year, viz:

(a) Eighty percent (80%) or more; or

(b) Seventy (70%) or more if the corporation had been classified as a personal holding company for any taxable year beginning after December 31, 1938.

must be "personal holding company income" as defined under Section 65 of ~~the~~ the Tax Code. And a "personal holding company income", as defined in Section 65, subparagraph (g), means portion of the gross income which consists of xxx "Rents, unless constituting fifty per centum or more of the gross income."

> Section 65. Personal holding company income - For the purposes of this title, the term "personal holding company income" means the portion of the gross income which consists of:
>
> xxx xxx xxx xxx
>
> (g) Rents. - Rents, unless consisting fifty per centum or more of the gross income. xxx." (Underlining supplied, supra.)

Verily, in the case at bar, it is not disputed that the gross income of petitioner for the year in question consisted entirely of rental income and, therefore, is much more than the limit required by law (which should be less than 50% of gross income) to qualify as personal holding company income. The treasurer of petitioner testified on the nature and *extent of petitioner's income for the year involved during the hearing on August 4, 1990, thus:*

(DIRECT EXAMINATION)

Q. During the year in question, 1982, as Treasurer of Katuparan Realty, were there any other income received by Katuparan Realty aside from rental payments made by IBM Philippines.?

A. No, its only the rental income from IBM Philippines that has been received by Katuparan.

xxx xxx xxx

Q. Mr. Witness, on Section B of page 1 of this document, under the column income, the figure stated is P2,309,100.00 across the word Schedule 4; and on page 2 of the same documents, schedule 4 refers to income from leases and rents, particularly stated here the income from IBM Philippines, Incorparated. For the record, Mr, Witness, will you confirm to this Honorable Court, that aside from the income stated here in the form of rental income, there is no other income derived by petitioner Katuparan Realty Corporation for the year ending December 31, 1982?

A. I confirmed that there is no other income by Katuparan for the year 1982 except from IBM Philippines (See T.S.N. hearing of August 14, 1990, pages 69 to 70, C.T.A. hearing of August 14, 1990, pages 69 to 70, C.T.A. records; Likewise see Exhibit "D" page 121, C.T.A. rec.)

Thus, indeed, petitioner has not meet the gross income requirement under Section 64(a)(1) in relation to Section 65(g) of the National Internal

Revenue Code, and therefore cannot be considered a personal holding company.

Likewise, petitioner does not meet the stock ownership requirement of a personal holding company under Section 64(a)(2) of the Tax Code because of the requirement that more than 50% of its outstanding capital stock must be owned by not more than five (5) individuals. As stated earlier, IBM Philippines Inc. owned only 29% of the stock of petitioner (Katuparan), while the 70% is owned by the "IBM Retirement Plan Trust Fund". The latter stock ownership, however, is to be attributed only to the IBM employees who are the beneficiaries of the Trust Fund and not to IBM Philippines. Under Section 224 of Income Tax Revenue Regulations No. 2, implementing Section 66(a) of the Tax Code, "in determining the ownership of stock for any of the purposes set forth in the preceding section (referring to stock ownership determination for personal holding company purposes), stock owned, directly or indirectly, by or for a corporation, partnerhip, estate, or trust shall be considered as being owned proportionately by its shareholders, partners or beneficiaries." In other words, the 70% stock ownership of IBM Retirement Trust Fund is, in effect, proportionately owned by the beneficiaries of the Fund. A fortiori, under this *concept, no five (5) individuals own more than 50% of the capital stock of petitioner.*

Besides the foregoing findings that the interest expense in question does not fall within the prohibited and disallowable deduction under Section 31(b)(3), now Section 30(b)(3), of the Tax Code, said expense, more importantly, constitutes an ordinary and necessary expense incurred by petitioner in carrying on its trade or business, and thus is deductible under Section 30(a)(1), now Section 29(a)(1) & (b)(1) of the Tax Code. Undisputably, petitioner is engaged in real estate business, and the liability for payment of interest in this case arose from an indebtedness incurred by it in the acquisition of the property from which it derived the rental income subject to tax. Again, as testified by its treasurer, petitioner became the debtor of IBM Philippines for the payment of interest when it assumed the obligation on a promissory note of Lexicon Realty Corporation in favor of IBM Philipppines, Inc. (Exh. "C" & "C-1", p. 120, CTA rec.) *after the purchase of the (real) property from Lexicon by petitioner.* (See Exh. "A", Deed of Assignment, p. 103, CTA rec.; and Exh. "B", Deed of Sale with Assumption of Mortgage and Assumption of Contract of Lease) *Hereunder are the* *pertinent portions of the testimony of petitioner's witness (treasurer) on the matter:*

(ON DIRECT EXAMINATION)

xxx xxx xxx

Q. How did IBM Philippines at that time divest itself of the land and building it owned?

A. Because of the urgency of the situation at that time, IBM Philippines sold the land and building to Lexicon Corporation which in turn sold the land and building to Katuparan Realty Corporation.

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Q. Can you tell the Honorable Court briefly the terms and conditions by which that transfer from Lexicon Corporation to Katuparan Realty Corporation was effected?

A. Documents were executed. These are the Deed of Sale and Deed of Assignment between Lexicon and Katuparan.

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Q. Mr. Witness, I refer you back to Exhibit "A" for the petitioner, the Deed of Assignment. Particularly, I refer you to the last paragraph on page 1 of the same document, the recitals regarding the Deed of Assignment. The last paragraph which states and I quote:

> Whereas, Assignee executed on September 20, 1972 a promissory note in the amount of P3,081,752.54 in favor of IBM Philippines, Incorporated (IBM).

xxx xxx xxx

Q. Can you describe to the Honorable Court what the promissory note mentioned here is all about?

A. The promissory note covers the balance of the principal due to IBM Philippines when the land and building was sold.

Q. When the Deed of Assignment and the Deed of Sale earlier marked as Exhibits "A" and "B" for the petitioner were executed, what happened to the obligation covered by this promissory note?

A. Katuparan assumed the obligation as part of the promissory note or transfer of the Deed of Assignment.

Q. So after the execution of the Deed of Assignment and the Deed of Sale, you now became the person obligated under that promissory note?

A. Katuparan is the person obligated on that note.

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(TSN, August 14, 1990, pp. 9-20)

Surely, contrary to respondent's postulation, the fact that the subject interest expense was incurred by reason of a promissory note assumed by petitioner and not because of a loan transaction between it and IBM Philippines, does not render said expense unrelated to petitioner's business and thus not deductible. In real estate business, the act of securing loans such as assumption of obligations, assignments of rights, etc. (direct or indirect) is ordinary and normal. In fact, transactions of such nature are even necessary, *appropriate and helpful in order that one's real estate business may expand and become more profitable.*

2. With respect to the second and last issue, i.e., the legality of the deficiency expanded withholding tax, it appears that no dispute ensues between the parties on the fact that the 5% withholding tax (of P218.90) is due on the appraisal fee (of P4,378.00) paid to Asian Appraisal, Inc. The controversy lies in the computation of the interest on deficiency and the imposition of the compromise penalty.

As computed by respondent, the deficiency expanded withholding tax liability of petitioner is P853.36, to wit:

5% basic tax ----------------	P218.90
25% surcharge ----------------	54.72
14% interest from 2-1-83 to 3-1-89 ----------	529.74
Compromise ------------------	50.00
Total	P853.36

On the other hand, petitioner claims that the applicable expanded withholding tax has already been paid under Confirmation Receipt No. B14445087 and Payment Order No. C2880924, both dated April 18, 1988, in the amount of P437.80. (Par. 13, Petition, p. 4, CTA rec. and Annexes "C" and "D", Petition, p. 10, CTA rec.) *Although both in its* *petition for review and memorandum, petitioner does not explain or elaborate on how and why its liability for expanded withholding tax is only P437.80, it, however, appears in a document filed by petitioner with the Bureau of Internal Revenue*[3] *(which now forms part of the BIR records) that petitioner, through counsel, presented the following computation of its tax liability with supporting reason that under the law then applicable, the interest on deficiency should be* ***at 20% per annum computed at the maximum period of three (3) years****, and that the compromise penalty should not be imposed:*

5% basic tax	---------------	P218.90
25% surcharge	---------------	54.73
20% interest (maximum of 3 years)	-----	164.17
Total tax due		P437.80

This Court believes that the correct deficiency expanded withholding tax is the amount of P437.80 which petitioner has determined and not the sum of P853.00 as computed and assessed by respondent. Firstly, the interest on deficiency for the tax year in question (1982) is 20% per annum but not to exceed in any case the maximum period of three (3) years. This is clear from the

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[3]Letter to the Commissioner of Internal Revenue dated June 21, 1989, pp. 149 to 157, BIR record.

provisions of Section 51(d) of the 1977 Tax Code, as amended by P.D. No. 1705, which state:

> Sec. 51. Payment and assessment of income tax. - xxx.
>
> (d) Interest on deficiency. - Interest upon the amount determined as a deficiency shall be assessed at the same time as the deficiency and shall be paid upon notice and demand from the Commissioner and shall be collected as a part of the tax at the rate of twenty per centum per annum from the date prescribed for the payment of tax, (or, if the tax is paid in installment from the date prescribed for the payment of the first installment) to the date the deficiency is assessed; Provided, That the maximum amount that may be collected as interest on the deficiency shall in no case exceed the amount corresponding to a period of three years, the present provisions regarding prescription to the contrary notwithstanding. (Underlining supplied.)

The interest, therefore, cannot be that (without limitation) imposed by respondent. Secondly, the compromise penalty cannot be imposed inasmuch as petitioner has not agreed thereto. A compromise implies agreement and the other party cannot impose it upon the other who disagrees with or rejects it. (See Commissioner of Internal Revenue vs. Abad, G.R. L-19627, June 27, 1968, 23 SCRA 1132)

Indeed, that the correct deficiency expanded withholding tax (in the amount of P437.80) has already been paid in this case, is the logical conclusion. As will be noted, respondent has not impugned the authenticity, materiality and probative value of the documents of payment cited by petitioner, namely: Confirmation Receipt No. B14445087 and Payment Order No. C2880924 dated April 18, 1988 for said amount. (Annexes "C" & "D", Petition, supra; also p. 128, BIR rec.) In fact, saying that "the issue in this case is purely legal", respondent's counsel did not submit evidence anymore but simply submitted this case for decision on the basis of the pleadings and records. (See p. 164, CTA rec.)

ACCORDINGLY, petitioner's appeal is sustained and respondent's decision dated May 10, 1989 holding petitioner liable for deficiency income tax in the total sum of P413,127.78 and deficiency expanded withholding tax of P853.36 for the tax year in question (1982), is reversed and is hereby ordered cancelled.

SO ORDERED.

Quezon City, Metro Manila, February 14, 1993.

ERNESTO D. ACOSTA
Presiding Judge

WE CONCUR:

MANUEL K. GRUBA
Associate Judge

RAMON O. DE VEYRA
Associate Judge

CERTIFICATION

I hereby certify that this decision was reached after due consultation between the members of the Court of Tax Appeals in accordance with Section 13, Article VIII of the Constitution.

ERNESTO D. ACOSTA
Presiding Judge
Court of Tax Appeals