UNITED EQUIPMENT &
SUPPLY COMPANY,
Petitioner,

versus

C.T.A. CASE NO. 1795

COMMISSIONER OF
INTERNAL REVENUE,
Respondent.

Oct 30/71

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D E C I S I O N

Appeal from a decision of respondent Commissioner of Internal Revenue holding petitioner United Equipment & Supply Company liable in the amounts of ₱10,864.26 and ₱3,291.02 as additional tax on unreasonable accumulation of surplus for the years 1957 and 1958, respectively, levied and imposed under Section 25 of the National Internal Revenue Code.

Section 25(a) of the Revenue Code, with certain exceptions not herein applicable, levies an additional tax upon a corporation formed or availed of for the purpose of preventing the imposition of the income tax upon its shareholders or the shareholders of any other corporation through the medium of permitting earnings or profits to accumulate instead of being divided or distributed; and Section 25(c) provides that the fact that earnings or profits of a corporation are permitted to accumulate beyond the reasonable needs of the business is determinative of the purpose to avoid the tax upon the shareholders, unless the corporation shall prove to the contrary by a clear preponderance of the evidence. (See Destilerias Ayala, Inc. v. Commissioner of Internal Revenue, C.T.A. Case No. 1664, Dec. 27, 1969, cert. denied in G.R. No. L-31700, March 3, 1970.) Consequently, the decision in this case depends upon whether the finding by respondent that petitioner accumulated earnings beyond the reasonable needs of the business finds support in the evidence.

The facts of the case are not disputed and may be briefly stated as follows:

Petitioner is a domestic corporation engaged in the business of selling automotive spare parts and accessories since 1946. On January 16, 1963 respondent made an assessment against petitioner in the amount of ₱14,155.28 allegedly representing income tax deficiency for the years 1957 and 1958, computed as follows:

ACR-1596-62/57

Net income per return	₱46,035.62
Less: Tax due thereon per Section 24 of the Tax Code. .	9,207.00
Net income per investigation. . . .	₱36,828.62
Tax due thereon	₱ 9,207.00
Add: ½% monthly interest from 6-20-59 to 6-20-62	1,657.26
TOTAL AMOUNT DUE & COLLECTIBLE . .	₱10,864.26

ACR-1679-62/58

Net income per return	₱ 13,943.90
Less: Tax due thereon per Section 24 of the Tax Code. .	2,789.00
Net income per investigation. . .	₱ 11,154.90
Tax due thereon	₱ 2,789.00
Add: ½% monthly interest from 6-20-59 to 6-20-62. . . .	502.02
TOTAL AMOUNT DUE & COLLECTIBLE. .	₱ 3,291.02

On March 7, 1963 petitioner requested withdrawal of the assessment for the reason that it had paid all its income tax liabilities for 1957 and 1958, and to consider the matter closed. In reply thereto, respondent wrote petitioner a letter dated May 14, 1963, clarifying that the aforesaid amounts represent surtax liabilities for 1957 and 1958 under Section 25 of the National Internal Revenue Code (instead of Section 24 as stated in the assessment) on the ground that the petitioner had prevented the imposition of the income tax upon its shareholders through the medium of permitting its gains and profits for the said years to accumulate beyond the reasonable needs of the business instead of being divided and distributed.

Insisting that it is not also liable for the said surtax under Section 25 of the Code, petitioner, on June 6, 1963, requested reinvestigation of the case and the withdrawal of the assessment. In consideration of the approval of its request for reinvestigation, petitioner executed on July 26, 1965 a waiver, up to December 31, 1969, of its right to the defense of prescription under the statute of limitations provided in Sections 331 and 332 of the National Internal Revenue Code. Accordingly, a reinvestigation of the case was conducted. On July 28, 1966, however, respondent denied petitioner's request for withdrawal of the assessment and reiterated the demand for the payment of the surtax liability. Copy of the said denial was received by petitioner on August 6, 1966. From this decision, petitioner appealed to this Court.

The issues raised by the parties are as follows:

> 1. Whether or not petitioner had unreasonably accumulated profits or surplus during the years 1957 and 1958 and, therefore, subject to the additional tax of 25% imposed under Section 25 of the National Internal Revenue Code; and
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> 2. Whether or not the right of respondent to assess the amount of ₱10,864.26 as alleged accumulated earnings tax for 1957 has already prescribed.

Whether the accumulated reserves exceeded the reasonable needs of the business cannot be determined from a consideration of a single factor. It is necessary to consider and view all the facts and circumstances in the light of the conditions prevailing at the time the surplus profits were accumulated. As stated by this Court in the cases of

Manila Wine Merchants, Inc. v. Commissioner of Internal Revenue, C.T.A. Case No. 1415, Feb. 28, 1969 and Destilerias Ayala, Inc. v. Commissioner of Internal Revenue, supra, the touchstone of liability for said tax is the purpose or intent behind the accumulation of profits and earnings which is the avoidance of the payment of income tax by the shareholders or members. As a practical matter, liability for the tax under Section 25 of the Code hinges on whether the corporation has accumulated earnings in excess of the reasonable needs of the business. The question of unreasonable or reasonable accumulation of profits or surplus is one of fact. The word "reasonable" is a relative term. What would be reasonable in one situation or for one business, might be clearly unreasonable in another.

The factors and circumstances which respondent considered in reaching his conclusion are set out concisely and clearly in his detailed findings of fact as contained in the memorandum of counsel for the Government dated September 8, 1971 (pp. 81-92, C.T.A. records), as follows:

> The petitioner was incorporated in 1947 with 100 shares subscribed and paid up at ₱1,000.00 per share. On December 29, 1955, a resolution was approved by its Board of Directors (Exhibit 5, pp. 12-14, BIR rec.) transferring the sum of ₱300,000.00 out of its ₱500,000.00 surplus to capital stock account, thus increasing the initial value per share to ₱6,000.00.

> The balance of ₱200,000.00 of its surplus (₱500,000.00 minus ₱300,000.00) was in the same resolution transferred by the Board to reserve account for the acquisition of lease improvements. No cash dividends were declared by the corporation since its incorporation in 1947 up to the years under review (p. 37, t.s.n., Hearing December 3, 1970). Its balance sheet (Exhibit 4, p. 6 BIR rec.) reflected petitioner's strong financial position as of December 31, 1957 and December 31, 1958. As of December 31, 1957, it had assets amounting to ₱1,100,363.18 (Exhibit 4-B) and liabilities of ₱165,257.95 (Exhibit 4-3); and as of December 31, 1958, its assets amounted to ₱965,-050.25 (Exhibit 4-A) and ₱17,045.67 (Exhibit 4-C) as liabilities for the same period.
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> The assessment for unreasonable accumulations of surplus, as shown in respondent's letter of demand, dated January 16, 1963 (Exhibit 9, pp. 75-76 BIR rec.), were based on petitioner's yearly profits realized in 1957 and 1958 after deducting the taxes due thereon under Section 24 of the Tax Code. Thus, for 1957, the surtax was imposed on the ₱36,828.62, profit realized during said year, and for 1958, the surtax was computed on the ₱11,194.90 profit.
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> The fact that those profits were not distributed among its shareholders is not disputed. Such being the case, such profits are presumed _prima facie_ to have been accumulated to avoid the taxes payable by the corporation's stockholders and, consequently, such profits are taxable under Section 25 of the National Internal Revenue Code. . .

Since the finding by respondent that petitioner accumulated earnings and profits beyond the reasonable needs of the business finds support in the evidence, the next question therefore is whether petitioner has sustained the burden which Section 25(c) places upon it to overcome - the presumption that it was availed of for the prohibited purpose. Such presumption arises by virtue of the finding that petitioner accumulated profits beyond the reasonable needs of its business. As earlier stated in this decision, under Section 25(c), the fact that earnings or profits of a corporation are permitted to accumulate beyond the reasonable needs of the business is determinative of the purpose to avoid the tax upon shareholders, unless the corporation shall prove to the contrary by a clear preponderance of the evidence. The law therefore imposes upon petitioner the duty to negate such a purpose by a clear preponderance of the evidence. //

Petitioner seeks to justify the accumulation of surplus profits on the ground that it had definite plans of acquiring leasehold rights and improvements on the premises it was occupying. But, as has already been stated above, while as early as December 29, 1955 a resolution was approved by petitioner's Board of Directors authorizing the transfer of ₱200,000.00 from the surplus account of the corporation to the reserve account for the acquisition of said leasehold rights and improvements, the amount was never spent for the purpose intended but the same was reverted to surplus sometime in 1962 or 1963 and recapitalized. (See pp. 22-23, t.s.n.) Considering the lapse of time from 1955 when the resolution was adopted to 1963 when the amount set aside was reverted to the surplus account without the plan having been put into effect, the retention of surplus profits became unreasonable and improper. Mere contemplated additions or repairs do not justify accumulation of surplus where the improvements have not actually been made. (Perry & Co., Inc. v. Commissioner of Internal Revenue, 120 F. 2d 123.) Profits may only be accumulated for the reasonable needs of the business, and implicit in this is the further requirement of a reasonable time. There had to be an immediate need for the funds in order to justify the retention of earnings. (Manila Wine Merchants, Inc. v. Commissioner of Internal Revenue, supra; Distelerias Ayala, Inc. v. Commissioner of Internal Revenue, supra.)

The other ground relied upon by petitioner in justifying the accumulation of surplus is its alleged need for larger working capital: (1) to increase the inventories of spare parts; (2) to cover the requirements for the manufacture of motor vehicles spare parts; and (3) for the operating expenses for manufacture. While these factors would normally be considered as reasonable grounds for accumulating profits, petitioner failed to present sufficient evidence in support of said allegations. It simply relied on the testimony of its own witness who made the observation that there was very little cash in the coffers of the corporation in 1957 as well as in 1958 (pp. 17-18, t.s.n.) without presenting documentary evidence to bolster the same. Apart from being unsubstantiated, it is belied by the figures reflected in petitioner's Statement of Income and Balance Sheet. (Exhs. 3 & 4.) As of December 31, 1957, petitioner's total capital amounted to ₱735,-105.23; and as of December 31, 1958, ₱748,004.58. Its statement of income showed that it had an operating expense of only ₱133,131.29 for 1957; and ₱131,163.05 for 1958. Its merchandise in transit was valued at ₱6,699.57 for 1958. These figures clearly indicate that petitioner was in a strong financial position and had sufficient funds to meet the anticipated needs adverted to above. Moreover, petitioner's cash on hand and in the bank amounted to ₱95,026.50 for 1957; and ₱62,627.78 for 1958, while its net income amounted to ₱36,828.62 for 1957; and ₱11,154.90 for 1958. We see no reason, therefore, for the retention of current earnings for larger working capital.

//In determining whether the taxpayer for a certain year accumulated profits beyond the reasonable needs of its business, we must consider not only the undistributed earnings or profits for that year, but the surplus, if any, already accumulated, the assets of the company and their liquidity, the expenditures necessary to be made to meet its financial obligations and to carry on its successful operation. (Manila Wine Merchants, Inc. v. Commissioner of Internal Revenue, supra; see also, Southland Industries, Inc., T.C. Memo, Docket No. 3387, Oct. 31, 1946.) The financial history of petitioner shows that it had accumulated profits from 1952 to 1958 and no distribution of such profits was ever made to its stockholders. At the beginning of the years 1952, 1953, 1954, 1955, 1956, 1957 and 1958 petitioner had accrued surplus balances in the respective amounts as follows: ₱341,938.74, ₱436,210.55, ₱462,122.57, ₱550,009.31, ₱53,896.82, ₱98,276.61 and ₱135,105.23. And at the close of its operations in 1957 and 1958, it had a total aggregate net accumulated undistributed incomes of ₱135,106.23 and ₱145,515.68, which sums included the amounts of ₱36,828.62 and ₱11,154.90, the accumulated profits under question (Exh. 6). The current assets of petitioner in the years 1957 and 1958 are in the respective amounts of ₱1,100,161.18 and ₱964,849.25. Its current assets included cash on hand and in bank in the amounts of ₱95,026.50 and ₱62,627.78 and accounts receivables in the total amounts of ₱8,340.54 and ₱30,213.35 (Exhs. F & b).

Considering the aforesaid accumulated surplus earnings in prior years; assets, including cash on hand and in bank and accounts receivables; and the expenditures necessary to meet financial obligations, we see no need for petitioner to accumulate its net earnings or profits in the years under question. Current assets compared to current liabilities in 1957 and 1958 in the amounts of ₱165,257.95 and ₱17,045.67 far exceed current liabilities. There was a favorable ratio of current assets to operating expenses and/or current liabilities. The setting of petitioner in its own particular business presented a bright picture and the results of its operations clearly showed its strong financial position at the time.

The contention that the accumulated net incomes for 1957 and 1958 are very small in amounts and can easily be wiped out by uncollected accounts receivables is untenable. Petitioner seems to imply that the accumulated earnings for those years in the amounts of ₱36,838.62 and ₱11,154.90 are only the means available to meet its financial needs and to carry on its business to a successful operation. This is far from the truth because the sources from which funds are taken for business operations are not only from profits but from accumulated earnings of prior years and the current assets of the business. In fact, a business need not have a large amount of cash at the beginning of the year to cover its operating expenses since this can be taken care of by the conversion of the current assets into cash, by the realization of income in the regular course of trade or business and by the funds generated by the collection of accounts or notes receivables. (Basilan Estate, Inc. v. Commissioner of Internal Revenue, G.R. No. L-22492, Sept. 5, 1967, 21 SCRA 17.)

In addition, we have in this case, for all practical purposes, a one-man corporation. As of 1948, petitioner was controlled by the American International Commercial Company, a non-resident foreign corporation of Havana, Cuba, owning 95% of the authorized and subscribed capital stock of petitioner consisting of 100 shares. The remaining five shares were owned by individual stockholders owning one share each. This circumstance is not without significance because if the earnings of petitioner for 1957 and 1958 had been distributed, American International Commercial Company would receive 95% thereof which would doubtless be taxable to the controlling corporate stockholder.

Mention is made by petitioner of the dismissal by this Court of C.T.A. Case No. 1269, between the same parties herein and allegedly involving the same question although pertaining to a different taxable year, as an indication of the impropriety of respondent's assessment. It appears, however, that in C.T.A. Case No. 1269 the 1954 income tax liability of petitioner, subject matter of the appeal, was amicably settled by the parties. Upon motion of petitioner, to which no objection was interposed by respondent, this Court dismissed the appeal in its resolution dated March 27, 1968 without going into the merits of the case. Consequently, the settlement of the former case (C.T.A. Case No. 1269) has absolutely no bearing on the instant case.

In the light of the above, we agree with respondent that the accumulation of the 1957 and 1958 surplus of petitioner was in excess of the reasonable needs of its business. And petitioner having failed to overcome by a clear preponderance of the evidence the statutory presumption that it was availed of for the purpose of preventing the imposition of the income tax upon its shareholders, the imposition upon petitioner of the additional tax provided in Section 25 of the National Internal Revenue Code is proper.

In resisting the assessment amounting to ₱10,864.26 as accumulated earnings tax for 1957, petitioner also invoked the defense of prescription against the right of respondent to assess the said tax. It is contended that since its income tax return for 1957 was filed in 1958, and with the clarification by respondent in his letter dated May 14, 1963 that the amount sought to be collected was petitioner's surtax liability under Section 25 rather than a deficiency corporate income tax under Section 24 of the National Internal Revenue Code, the assessment has already prescribed under Section 331 of the same Code.

Section 331 of the Revenue Code provides:

> SEC. 331. Period of limitation upon assessment and collection.— Except as provided in the succeeding section, internal-revenue taxes shall be assessed within five years after the return was filed, and no proceeding in court without assessment for the collection of such taxes shall be begun after the expiration of such period. For the purposes of this section a return filed before the last day prescribed by law for the filing thereof shall be considered as filed on such last day: Provided, That this limitation shall not apply to cases already investigated prior to the approval of this Code.

Obviously, Section 331 applies to assessment of national internal revenue taxes which require the filing of returns. A return, the filing of which is necessary to start the running of the five-year period for making an assessment, must be one which is required for the particular tax. Consequently, it has been held that the filing of an income tax return does not start the running of the statute of limitation for assessment of the sales tax. (Butuan Sawmill, Inc. v. Court of Tax Appeals, G.R. No. L-20601, Feb. 28, 1966, 16 SCRA 277.)

Although petitioner filed an income tax return, no return was filed covering its surplus profits which were improperly accumulated. In fact, no return could have been filed, and the law could not possibly require, for obvious reasons, the filing of a return covering unreasonable accumulation of corporate surplus profits. A tax imposed upon unreasonable accumulation of surplus is in the nature of a penalty. (Helvering v. National Grocery Co., 304 U.S. 282.) It would not be proper for the law to compel a corporation to report improper accumulation of surplus. Accordingly, Section 331 limiting the right to assess internal revenue taxes within five years from the date the return was filed or was due does not apply.

Neither does Section 332 apply. Said Section provides:

> SEC. 332. <u>Exceptions as to period of limitation of assessment and collection of taxes.</u>—(a) In the case of a false or fraudulent return with intent to evade tax or of a failure to file a return, the tax may be assessed, or a proceeding in court for the collection of such tax may be begun without assessment, at any time within ten years after the discovery of the falsity, fraud, or omission.
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> (b) Where before the expiration of the time prescribed in the preceding section for the assessment of the

> tax, both the Commissioner of Internal Revenue and the taxpayer have consented in writing to its assessment after such time, the tax may be assessed at any time prior to the expiration of the period agreed upon. The period so agreed upon may be extended by subsequent agreements in writing made before the expiration of the period previously agreed upon.
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> (c) Where the assessment of any internal-revenue tax has been made within the period of limitation above-prescribed such tax may be collected by distraint or levy or by a proceeding in court, but only if begun (1) within five years after the assessment of the tax, or (2) prior to the expiration of any period for collection agreed upon in writing by the Commissioner of Internal Revenue and the taxpayer before the expiration of such five-year period. The period so agreed upon may be extended by subsequent agreements in writing made before the expiration of the period previously agreed upon.

It will be noted that Section 332 has reference to national internal revenue taxes which require the filing of returns. This is implied from the provision that the ten-year period for assessment specified therein treats of the filing of a false or fraudulent return or of a failure to file a return. There can be no failure or omission to file a return where no return is required to be filed by law or by regulations. It is, therefore, our opinion that the ten-year period for making an assessment under Section 332 does not apply to internal revenue taxes which do not require the filing of a return.

It is well settled that limitations upon the right of the government to assess and collect taxes will not be presumed in the absence of clear legislation to the contrary. The existence of a time limit beyond which the government may recover unpaid taxes is purely dependent upon some express statutory provision. (51 Am. Jur. 867; 10 Mertens, Law of Federal Income Taxation, Par. 57.02.) It follows that in the absence of express statutory provision, the right of the government to assess unpaid taxes is imprescriptible. Since there is no express statutory provision limiting the right of the Commissioner of Internal Revenue to assess the tax on unreasonable accumulation of surplus provided in Section 25 of the Revenue Code, said tax may be assessed at any time.

We find, however, that a mistake was committed in the process applied by respondent in the assessment of the tax in question. In determining whether accumulations of earnings or profits in a particular year are within the reasonable needs of a corporation, it is necessary to take into account prior accumulations, since accumulations prior to the year involved may have been sufficient to cover the business needs and additional accumulations during the year involved would not reasonably be necessary.

(Basilan Estates, Inc. v. Commissioner of Internal Revenue, _supra_; Destilerias Ayala, Inc. v. Commissioner of Internal Revenue, _supra_.) Respondent covered the period 1957-1958 in his assessment, which are also the taxable years under review, and assessed the 25% surtax upon the accumulation of profits as of the end of each particular year - 1957 and 1958 - instead of the accumulation of earnings outstanding as of the end of the period covered, or as of December 31, 1958. Since previous accumulations should always be considered in determining unreasonable accumulations for the year concerned, the accumulation of profits as of the end of December 31, 1957 should therefore be added to the accumulated earnings at the end of December 31, 1958 to arrive at the accumulation of surplus outstanding as of the end of the period under review. Thus, the 25% surtax assessed for the year 1958 should be based on accumulated surplus in 1957 in the amount of ₱36,828.62 plus the accumulated earnings in 1958 of ₱11,154.90, or a total of ₱47,983.52, since this sum represents the surplus unreasonably accumulated during the period involved in respondent's assessment. With respect to the accumulations prior to 1957, we cannot, however, take them into consideration for purposes of computing the accumulated profits during the period under review because the 25% surtax assessed by respondent on May 14, 1963 is only upon accumulations of profits as of 1957 and 1958. They are not therefore covered by this appeal. Accordingly, the 25% surtax due on the unreasonable accumulation of surplus of petitioner for the years 1957 and 1958 is ₱11,995.88, computed as follows:

Surplus unreasonably accumulated:	
1957	₱ 36,828.62
1958	11,154.90
Total surplus subject to tax under Section 25 of the Revenue Code	₱ 47,983.52
25% surtax due thereon	₱ 11,995.88

WHEREFORE, the decision appealed from is hereby modified. Petitioner is ordered to pay respondent Commissioner of Internal Revenue or his duly authorized collection agent the sum of ₱11,995.88 within thirty (30) days from the date this decision becomes final. Costs against petitioner.

SO ORDERED.

Quezon City, October 30, 1971.

ROMAN M. UMALI
Presiding Judge

WE CONCUR:

ESTANISLAO R. ALVAREZ
Associate Judge

RAMON L. AVANCEÑA
Associate Judge