REPUBLIC OF THE PHILIPPINES
COURT OF TAX APPEALS
QUEZON CITY

HAWAIIAN-PHILIPPINE COMPANY,
Petitioner,

- versus - **C.T.A. CASE NO. 4951**

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Promulgated:
JAN 16 1996

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D E C I S I O N

This is a petition for review from a decision of respondent Commissioner denying petitioner's protest against a disputed assessment for deficiency income taxes for the taxable years 1986 and 1987. The facts are as stated in the opinion of the Court.

Petitioner is a domestic corporation engaged in the business of sugar milling. Sometime in 1981, petitioner entered into a Management Agreement with Jardine Davies, Inc. (JDI) whereby Jardine Davies was appointed to manage the entire business and operations of petitioner, in exchange for which JDI was paid management fees amounting to ₱2,500,000 per annum or five per centum (5%) of the gross receipts of petitioner during the year, whichever is higher.

It appears that on July 13, 1988, respondent Commissioner of Internal Revenue, through Regional

Director Beethoven L. Rualo, Revenue District Office No. 56 stationed at Bacolod City, issued Letter of Authority Ass. # 06B-56-6-000332-86 and 06B-56-6-000341-87, directing Revenue Enforcement Officers Prudencio Arabejo and Virgie S. Virata to examine the books of account of petitioner to determine its liability, if any, for unpaid internal revenue taxes for 1987 and prior years (Exh. 1).

After examining petitioner's records, the two Revenue Officers submitted a memorandum (Exh. 2) addressed to Revenue District Officer Rualo, detailing their findings. In brief, the two revenue officers recommended that petitioner be assessed for deficiency income taxes for the years 1986 and 1987 totalling ₱12,703,764.00. The recommendation was based on the finding of said revenue officers that the management fees paid by petitioner to JDI during the taxable years in question, and which petitioner claimed as deduction from its gross income for the same period, were not ordinary and necessary expenses and should therefore be disallowed. In due course, the memorandum of the two revenue officers was indorsed to respondent Commissioner. In an "Indorsement" dated December 15, 1989 (Exh. AB), respondent Commissioner concluded that the disallowance of the management fees paid by petitioner to JDI "cannot be legally sustained" since the same were both "ordinary and necessary" expenses. However, on April 24, 1990, petitioner received a Letter of Demand No. FAN-1-86-90-00132930, together with Assessment Notices Nos. FAN-1-86-90-001329 and FAN-1-87-90-001130 from respondent, assessing petitioner for alleged deficiency income taxes, inclusive of interests and penalties, for the taxable years 1986 and 1987. The amounts assessed against petitioner were ₱5,345,054.00 and ₱7,358,710.00 for the years 1986 and 1987, respectively, or a total of ₱12,703,764.00 (Exhs. 3 and 3-A).

In a letter, dated April 26, 1990, addressed to respondent (Exh. AC), petitioner protested the twin assessments. However, on December 20, 1992 (Exh. 5), respondent denied with finality petitioner's protest on the ground that the management fees paid by it to JDI were in fact non-deductible dividends subject to tax. Hence this petition.

It appears that during the pendency of this petition, respondent issued a warrant of distraint and levy against petitioner's properties (Exh. 6). Petitioner requested respondent to recall the warrant, and offered its various machineries as collateral for its tax liabilities. However, the record does not show what action was taken by respondent in respect of such offer.

The sole question brought before Us is whether respondent Commissioner correctly disallowed the deduction of the management fees paid by petitioner to JDI from its gross income on the ground that such management fees are, in truth, disguised dividends subject to tax.

In concluding that the management fees in question were in reality disguised dividends subject to tax, respondent Commissioner reasoned that the separate juridical personalities of petitioner and JDI should be disregarded since petitioner is a mere alter ego or business conduit of JDI. It then pointed to the following factors attending the relationship between petitioner and JDI:

> "(a) Jardine Davies, Inc., your parent company, owns 87.83% of your capital stock; (b) the management contract was signed by Messrs. Mesa and Vorster, and it is a fact that Mr. Vorster, President of Jardine Davies, Inc. is also a member of your Board of Directors; (c) there is no clear evidence that the management services allegedly rendered are necessary as it appears that in your business locale, there are other sugar centrals like First Milling Marketing Co. and Victorias Milling, Inc. that can maintain viable operations without hiring managers; (d) that as to stockholdings, it is only the shares of stock of Jardine Davies, Inc. that are listed in the stock exchange and open to the public whereas in your case, you are not an open or public corporation as you are fully controlled by the said parent corporation.

> "Finally, your protest is devoid of any proof to justify the inordinate amounts claimed by you as management fees so as to show the nature of the services rendered, the person rendering those services, the extent thereof and in general, such evidence that would establish a proportionate connection between the amounts claimed by you as management expenses and the quality and quantity of the services supposedly rendered."

We are not persuaded by respondent's arguments.

A careful and more circumspect perusal of the records of this case shows that respondent Commissioner erred in disregarding the separate juridical personalities of petitioner and its parent company JDI. It is an elementary and fundamental principle of corporation law that a corporation is an entity separate and distinct from its stockholders and from other corporations to which it may be connected. It is only when the notion of legal entity is used to defeat public convenience, justify wrong, protect fraud, or defend crime, the law will regard the corporation as an association of persons or in the case of two corporations merge them into one. (Koppel [Phil.], Inc. vs. Yatco, 7 Phil 496, *citing* 1 Fletcher Cyclopedia of Corporation, Perm. Ed., pp. 135-136; United States vs. Milwaukee Refrigeration Transit Co., 142 Fed., 247, 255 per Sanborn, J.) Otherwise stated, when the corporation is the "mere alter ego or business conduit of a person, it may be disregarded." (Koppel [Phil.], Inc. vs. Yatco, *supra*.)

We do not believe that there is sufficient evidence on record to show that petitioner is the mere alter ego of JDI or vice versa, nor that the separate juridical personalities of the two corporations was used to defraud the government and avoid the payment of taxes. It has been held that the intention to minimize taxes, when used in the context of fraud, must be proved to exist by clear and convincing evidence amounting to more than mere preponderance, and cannot be justified by a mere speculation. This is because fraud is never lightly to be presumed. Fraud is never imputed and courts never sustain findings of fraud upon circumstances which, at the most, create only suspicion (*Yutivo Sons Hardware Co. vs. Court of Tax Appeals, 1 SCRA 160 [1961]*).

Neither are We convinced that under the circumstances, the mere payment by petitioner to JDI of the management fees in question was purposely resorted to in order to evade the payment of taxes. The record shows that the rendition by JDI of management services to petitioner was in accordance with, and pursuant to, a concededly valid and subsisting management agreement between the two entities. Under said agreement, JDI undertook to provide various services to petitioner, including the following:

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"A. **General Management**

1. To take charge of the management and operations of the business of the COMPANY (referring to petitioner) subject to the supervision and control of the President and Board of Directors of the COMPANY;

2. To be responsible for the marketing/selling of such products or by-products manufactured by the COMPANY;

3. Upon receipt of written advice from the COMPANY, to make the necessary purchase/importation of such merchandise, materials, supplies and equipment, for and on behalf of the COMPANY;

4. To negotiate for and on behalf of the COMPANY, milling and/or cane purchase contracts with existing and prospective sugar cane planters;

5. To be responsible for the installation and audit of information systems but not the development of specific computer programs which shall be separately charged/billed to the COMPANY;

6. Generally, to exercise such other managerial powers as may be conferred and to perform such other services or duties necessary or appropriate to be performed for and on behalf of the COMPANY in the transaction and control of its business.

"B. **Finance and Investments**

1. To invest the funds of the COMPANY in worthy securities, money market and loan investments;

2. To ascertain that all documents concerning any form of investment are prepared and finalized and held by the COMPANY for safekeeping;

3. To manage the plan company funds such that the COMPANY will always have sufficient funds to meet all the required disbursements;

4. To supervise and control company accounts;

5. To appoint a competent internal auditor and make sure that books of the COMPANY are audited by such auditor at such intervals/periods as may be necessary it being understood that the cost of such audit shall be for the account of the COMPANY.

"C. Tax, Legal and Corporate

1. To supervise and cause to be kept full and complete corporate records of the COMPANY and provide full corporate secretarial and transfer services;

2. To provide legal and tax services, including scheduling of payment of appropriate taxes and preparation of related returns as may be required by existing government regulations.

3. To monitor complete compliance with all regulatory requirements.

"D. Labor and Corporate Relations Services

1. To provide advice and assistance on labor relations and other personnel matters.

It cannot be gainsaid that the foregoing services are not necessary, nay even essential, for the conduct of petitioner's business. This being the case, any expenses incurred by petitioner in procuring such services must, of necessity, also be classified as necessary business expenses.

More revealing, however, is the fact that, as admitted by respondent, the management fees were reflected in JDI's own books of account as Income and not as a liability reserve, which would have otherwise been the case if said fees were intended to be subsequently distributed directly to JDI's stockholders as dividends.

The case of Yutivo Sons Hardware Co v. Court of Tax Appeals (supra) relied on by respondent weakens, rather than strengthens, respondent's case. In that case, the Supreme Court based its conclusion that Southern Motors (SM) was a mere alter ego or business conduit of Yutivo Sons Hardware Co. in its finding, among others, that the management fees paid by SM to Yutivo were reflected in the latter's books as a liability reserve rather than as income. Thus:

> "Proceeding to another aspect of the relation of the parties, the management fees due from SM to Yutivo were taken up as expenses of SM and credited to the account of Yutivo. If it were to be assumed that the two organizations are separate juridical entities, the corresponding receipts or receivables should have been treated as income on the part of Yutivo. But such management fees were recorded as "Reserve for Bonus" and were therefore a liability reserve and not an income account. This reserve for bonus were subsequently distributed directly to and credited in favor of the employees and directors of Yutivo, thereby clearly showing that the management fees were paid directly to Yutivo officers and employees." (*underscoring supplied*)

The situation is different in the case at bar. As already stated, the management fees paid by petitioner to JDI were reflected as expenses in petitioner's books and were correspondingly treated as income in JDI's books. This is clearly indicative of the fact that there was no commingling of the separate juridical personalities of petitioner and JDI, contrary to respondent's findings.

It should likewise be noted at this point that in his Indorsement dated December 15, 1989, then Commissioner Jose U. Ong concluded that the management fees paid by petitioner to JDI were "ordinary and necessary" business expenses and as such, may be allowed as deductions from petitioner's gross income. Thus:

> "In the instant case, it appears that the disallowed management fee expenses in question are both ordinary and necessary. Ordinary and necessary in the sense that the same connote payments which, <u>although not normal in relation to the business of the taxpayer, can be considered proper for the purpose of realizing profit or appropriate or helpful in the development of the taxpayer's business</u> considering that the taxpayer is based in Silay City, Negros Occidental, hence, by opting to have its affairs managed by its parent company who has a substantial interest in it in terms of investment, <u>it is able not only to save on the cost of maintaining an office in Metro Manila and in other cost incident to its business but at the same time avail of the benefits arising from the various services being provided by its parent company</u> as a consequence of the aforementioned management agreement the consideration of which <u>can be considered as fair under the circumstances</u>.
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> "In view thereof, it is believed that the disallowance of the management fee expenses being claimed by the taxpayer for the years 1986 and 1987 cannot be legally sustained." (*underscoring supplied*)

It bears emphasis that the foregoing conclusion of then Commissioner Ong was based on exactly the same set of facts which were used as basis for his subsequent yet contradictory decision denying petitioner's protest of the disputed assessments. Thus, while concluding in the first instance that the management fees paid by petitioner to JDI were "fair under the circumstances" considering the benefits derived by petitioner from the management agreement, respondent subsequently and without the benefit of any new evidence being adduced reversed himself and concluded that such fees were "inordinate" and "disproportionate" to the services rendered by JDI. We find this unjustified flip-flopping totally untenable.

Finally, We find petitioner's contention that the separate corporate personalities of petitioner and JDI should be disregarded simply on the basis of the fact that the former is a subsidiary of latter as being fraught with dangerous consequences. If respondent were to be upheld, it would be tantamount to saying that no parent company can ever manage its subsidiary since this would in each and every case be a ground for disregarding the otherwise separate juridical personalities of the two entities. We are not prepared to sanction such a theory.

WHEREFORE, judgment is hereby rendered **REVERSING** and **SETTING** aside the decision of respondent Commissioner of Internal Revenue dated December 15, 1992 denying petitioner's protest. The warrant of distraint and levy issued by respondent against petitioner's properties is hereby LIFTED, and respondent Commissioner is hereby DIRECTED to release any collateral petitioner may have submitted to guarantee the payment of its tax liabilities under the disputed assessments. No pronouncement as to costs.

SO ORDERED.

MANUEL K. GRUBA
Associate Judge

WE CONCUR:

ERNESTO D. ACOSTA
Presiding Judge

RAMON O. DE VEYRA
Associate Judge

CERTIFICATION

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.

ERNESTO D. ACOSTA
Presiding Judge
Court of Tax Appeals