AMERICAN MAIL LINE,
Petitioner,

- versus -

C.T.A. CASE NO. 2596

THE COMMISSIONER OF
INTERNAL REVENUE,
Respondent.

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D E C I S I O N

Petitioner American Mail Line appeals to this Court from a decision dated February 28, 1974 of respondent Commissioner of Internal Revenue on disputed assessments for deficiency income tax for the years 1967 and 1968 in the amounts of ₱89,059.32 and ₱3,793.45, respectively.

Petitioner, as averred in the petition for review and admitted in the answer, is a foreign corporation organized under the laws of Delaware, U.S.A., but engaged in business in the Philippines in water transportation. It is represented in the Philippines by its shipping agent, Everett Steamship Corporation of 290 Atlanta Street, Port Area, Manila.

For income tax purposes, a foreign corporation engaged in trade or business in the Philippines is subject to income tax on income derived from sources within the Philippines. (Section 24(b)(2), Tax Code of 1939 then in force.) Section 152 of the Income Tax Regulations

(Revenue Regulations No. 2) provides that:

> "The taxable income from sources within the Philippines includes that derived in full from sources within the Philippines and that portion of the income which is derived partly from sources within and partly without the Philippines which is allocated or apportioned to sources within the Philippines."

Section 37(e) of the same Tax Code treats gains, profits or income from transportation or other services rendered partly within and partly without the Philippines as derived partly from sources within and partly from sources without the Philippines. It provides further:

> "In the case of gross income derived from sources partly within and partly without the Philippines, the net income may first be computed by deducting the expenses, losses or other deductions apportioned or allocated thereto and a ratable part of any expenses, losses or other deductions which cannot be allocated to some items or class of gross income; and the portion of such net income attributable to sources within the Philippines may be determined by processes or formulas of general apportionment prescribed by the Secretary of Finance." (Emphasis supplied)

It seems clear therefore that the net income derived from sources partly within and partly without the Philippines is arrived at by: (1) first deducting the expenses, losses or other deductions apportioned or allocated thereto; and (2) the expenses, losses and other deductions under the formula of general apportionment prescribed by the Secretary (now Minister) of Finance.

In the implementation of the foregoing provision of the Revenue Code, Section 163 of the Income Tax Regulations provides:

> "The returns of foreign steamship companies whose vessels touch ports of the Philippines should include as gross income, the total receipts of all outgoing business whether freight or passengers. With the gross income thus ascertained, the ratio existing between it and the gross income from all parts, both within and without the Philippines of all vessels, whether touching ports of the Philippines or not, should be determined as the basis upon which allowable deductions may be computed, the principle being that allowable deductions shall be computed upon a basis which recognizes that the income arising and accruing from business done if any from this country shall bear its share, and no more, or expense, incident to the earning or creation of such income, in the ratio that the gross income arising in and from this country bears to the entire gross income arising from business done both within and without this country. In other words, the net income of a foreign steamship company doing business in or from this country is ascertained for the purpose of the income tax, by deducting from the gross receipts from outgoing business such a portion of the aggregate expenses, losses, etc., as such receipts bear to the aggregate receipts from all ports of all vessels, including in each case income of a nonshipping character but incidental, to the shipping business such as dividends from investments, interest on deposits, etc. x x x."

On the basis of Section 37(e) of the Revenue Code quoted above, the expenses, losses or other deductions directly allocable to the Philippine operations should first be deducted and the net income attributable to sources within the Philippines shall then be determined in accordance with the formula of general apportionment prescribed in Section 163 of the Income Tax Regulations.

The deficiency income tax assessment of ₱89,059.32 for the year 1967 was arrived at by respondent as follows:

World Income		$37,372,095.00	
Less: Misc. other income		20,555.00	
		$37,351,540.00	@3.90 = ₱145,669,884.60
World Expense		$33,351,392.00	
Less: Prov. for pension .	$1,436,399.		
Misc. other exp. ...	62,591.		
U.S. Fed. Tax	1,136,718.00	2,635,708.00	
		$30,715,684.00	@3.90 = ₱119,791,167.60

P.I. Income-Gross	₱ 4,245,263.10
Less: Allocable expenses:	
$\frac{₱4,245,263.10}{₱145,669,884.60}$ x ₱119,791,169.60 ..	₱ 3,503,110.45
Net P.I. Income	₱ 742,152.65

COMPUTATION OF TAX

Net income per investigation	₱742,152.65
Amount of income subject to tax .	742,152.65
Income tax due thereon	214,646.00
Income tax already paid	139,172.00
Balance	₱ 75,474.00
Add: ½% mo. int. fr. 4/16/68 to 4/16/71	13,585.32
TOTAL AMOUNT DUE AND COLLECTIBLE.	₱ 89,059.32

In computing the allocable expenses to petitioner's Philippine gross income, respondent deducted from petitioner's world expenses its contributions to pension plan and miscellaneous other expenses in the amounts of US$1,436,399 and US$62,591, respectively. Since respondent did not include petitioner's contributions to pension plan and miscellaneous other expenses as part of world expenses in computing the allocable expenses to its Philippine gross income, it follows that said items were not part of the allocable expenses which were deducted from petitioner's Philippine gross income to arrive at the net Philippine income subject to tax.

On the other hand, it is petitioner's position that its contribution to pension plan and miscellaneous other expenses in the amounts of US$1,436,399 and US$62,591, respectively, should be included as part of its world expenses for purposes of computing the expenses allocable to its Philippine gross income considering that said expenses constitute deductible business expenses under Section 30(j) and 30(a)(1) of the Tax Code then in force and can not definitely be allocated to some items or class of gross income in accordance with Section 163 of the Income Tax Regulations quoted above.

Parenthetically, it should be stated that petitioner conceded that the U.S. Federal income tax of US$1,136,718 should not form part of petitioner's world expenses for purposes of determining the expenses allocable to its Philippine gross income. (Par. 8, petition; admitted, par. 1, answer.)

The first issue, therefore, as raised by petitioner is whether or not the disallowance of the contributions to pension plan and miscellaneous other expenses as part of petitioner's world expenses for purposes of computing the expenses allocable to Philippine gross income of petitioner was proper.

Contributions to Pension Plan

As explained in the duly certified and authenticated statements of Mr. R.J. Cowan dated May 17, 1974 (pp. 252-262, particularly page 255, BIR records), treasurer of petitioner, contrary to the impression of respondent's revenue examiner that the contributions to pension plans are mere provisions for pension or retirement, the pension plans for which deductions have been claimed are approved and qualified under the U.S. Internal Revenue Code. Amounts are paid to irrevocable trusts created by the collective bargaining units with labor unions representing both seagoing and shoreside employees. Benefits as outlined in the plans are determined by State and Federal licensed actuaries to provide pensions at normal retirement date. The trust is administered by trustees appointed by the Pacific Maritime Association (representative of the shipping companies) and the unions with one neutral person appointed by the foregoing trustees.

The plans covering offshore personnel are noncontributory on their part. The plan serving shoreside personnel requires employee contributions equal to 3 3/4% his monthly compensation in excess of 1/12th of the annual amount of compensation subject to United States social security tax. Petitioner contributes the amount necessary after employee contributions to provide for benefits as outlined in the plan and to fund the full current cost at all times. No portion of the trust corpus or income can revert to any person other than the employee. As a requisite to approval by the U.S. Internal Revenue Service, it must be demonstrated that each plan does not discriminate as to contributions or benefits in favor of officers or other highly compensated employees. (p. 255, BIR records.)

It seems clear therefore that since both plans covering petitioner's seagoing and shoreside personnel have been approved by the U.S. Internal Revenue Service as qualified pension plans and have allowed the deductions of its actual contributions to the funds for the year in question, petitioner's contributions to pension plan in the amount of US$1,436,399 for 1967 should properly form part of its expenses subject to allocation.

<u>Miscellaneous Other Expenses</u>

The miscellaneous other expenses in the amount of US$62,521 was disallowed by respondent's revenue examiner because of petitioner's failure to submit a breakdown thereof in order to determine whether or not the whole amount or part thereof should form part of worldwide expenses for purposes of allocation. (pp. 33-34, t.s.n. dated October 14, 1982.) As stated in the supplemental contesting memorandum dated May 14, 1973 of petitioner (Exh. E, pp. 85-88, p. 87), the said item is broken down as follows:

Amortization of Debt Discount and Expense	$ 5,354
Mortgage Insurance and Mortgage Trust Fees	50,322
Other Miscellaneous Expenses	6,915
Total	$62,591

Since bonds are in the nature of indebtedness, there is no doubt that the portion of the debt discount and expense in the amount of US$5,354 which was amortized in 1967 should form part of petitioner's expenses for purposes of ascertaining the expenses allocable to its Philippine income. This is allowed by Section 57(3)(a) of the Income Tax Regulations which provides that "if bonds are issued by a corporation at a discount, the net amount of such discount is deductible and should be prorated or amortized over the life of the bonds." It has been ruled that debt discount and expenses or obligations incurred by a taxpayer in connection with a bond issue which are not discharged until payment of the bonds at maturity may properly be accrued or amortized over the period of the life of the bonds and allowed as annual deduction from gross income. (See Lincoln Mortgage and Title Guaranty Co. vs. Commissioner, 79 F 2d 585, 16 AFTR 833; Helvering vs. Union Pacific R. Co., 55 S.Ct. 165; 293 U.S. 282; 14 AFTR 705.)

The same holds true with respect to the amount of US$50,322 which represents payments made for mortgage insurance and mortgage trustee's fees in connection with petitioner's business. As indicated in Note 4 of petitioner's audited financial statements (p. 31, BIR records), its mortgage bonds are insured by the U.S. Federal Government. Since the mortgage insurance premiums on these bonds were paid by petitioner, and the mortgages securing the bonds were administered in trust and the trustee was paid for administration services, the aforesaid amount representing payments for mortgage insurance and mortgage trustee fees constitutes deductible business expenses under Section 30(a)(1) of the Tax Code. It should therefore form part of petitioner's world expenses subject to allocation in accordance with Section 163 of the Income Tax Regulations.

And this rule likewise applies to the other miscellaneous expense of US$6,915, broken down as follows:

a)	Collecting Commissions on Hull claims against London Underwriters	US$ 878
b)	Loss on Sale of Stock	791
c)	Loss on Scrap Sale of vessel supplies	3,295
d)	Other miscellaneous expenses	1,951
	T o t a l	US$6,915

As provided by the last part of Section 163 of the Income Tax Regulations, the net income of a foreign steamship company doing business in or from this country is ascertained for the purpose of the income tax, by deducting from the gross receipts from outgoing business such a portion of the aggregate expenses, losses, etc., as such receipts bear to the aggregate receipts from all ports of all vessels, including in each case income of a non-shipping character but incidental to the shipping business such as dividends from investments, interests or deposits, etc.

This brings us to the question of whether or not the agency fees and commissions, income from terminal and stevedore operations, interest income, dividend income, and miscellaneous other income should be excluded from the world gross income of petitioner for purposes of computing the allocable deduction.

In computing the deductions allocable to petitioner's Philippine income, its world gross income included the following items of income:

Gross receipts from world vessel operations	US$28,090,956
Operating Differential Subsidy	6,086,061
Agency Fees and Commissions	370,941
Income from terminal and stevedore operations	2,255,584
Interest Income	471,571
Dividend Income	76,427
Miscellaneous Other Income	20,555
T o t a l	US$37,372,095

In accordance with the formula of general apportionment prescribed in Section 163 of the Income Tax Regulations, petitioner claims that the following items should be excluded from its world gross income as they have been derived in full from sources without the Philippines:

a)	Agency Fees and Commissions	US$ 370,941
b)	Income from Terminal and Stevedore Operations	2,255,584
c)	Interest Income	471,571
d)	Dividend Income	76,427
e)	Miscellaneous Other Income	20,555
	Total	US$3,195,078

From the certified and authenticated statements of Mr. R.J. Cowan dated May 17, 1974 (pp. 255-262, particularly pp. 258-259, BIR records), treasurer of petitioner, the aforesaid items of income appear to have been derived in full from sources outside the Philippines. They should therefore be excluded from petitioner's world gross income because of the formula of general apportionment prescribed in Section 163 of the Income Tax Regulations. These items are classified as follows:

1. Agency fees and commissions were all earned by petitioner's U.S. head office and were for services performed outside the Philippines. (See Section 37(c)(3), NIRC.)

2. Income from terminal and stevedore operations was generated by a separate department of petitioner within the company which handled cargo solely in the Pacific Northwest area for its own vessels and those of other U.S. flag ship operators. All such services were rendered outside the Philippines and are foreign source income. (See Section 37(c)(3), NIRC.)

3. Interest income was earned primarily on securities of the U.S. Government. Any interest not earned on U.S. Government securities is earned on investments in the obligations of U.S. entities and none is earned within the Philippines. (See Section 37(c)(1), NIRC.)
4. Dividends were received from the Bank of California, San Francisco, U.S.A.; Pacific Far East Lines, San Francisco, U.S.A.; and Common Stock Trust, all foreign entities. The Common Stock Trust item is the income from the investment of funds by petitioner in the common stocks of other U.S. companies through a trust fund under joint control with the U.S. Maritime Administration. The trust is administered by a U.S. bank. All dividends were earned without the Philippines. (See Section 37(c)(3), NIRC.)
5. Miscellaneous income consists of gain on purchase of mortgage bonds, gain on sale of corporate securities and miscellaneous nominal individual amounts. All items of miscellaneous income were derived from U.S. sources and none within the Philippines. As a matter of fact, for the purpose of computing the allocable deductions to petitioner's Philippine income,

respondent excluded this item from petitioner's world income. (Exh. "3", p. 50, BIR records.)

Settled is the rule that agency fees, commissions and other shipping income from agency services for other steamship lines in its several offices in the United States; interest income earned from government securities and time deposits in the United States; income realized from the gains on sales of fixed assets in the United States; proceeds of insurance taken on the life of key officers in the United States and refund of Federal Income tax were derived in full from sources outside the Philippines. Under the provisions of Section 37 of the Tax Code, as implemented by Section 158 of the Income Tax Regulations, the income mentioned above should not be included in the gross income of a non-resident foreign shipping company, like petitoner herein, for the purpose of determining its Philippine income under Section 163 of the Income Tax Regulations because, if an item of income emanated actually from sources within or without the Philippines under the provisions of Section 37(a) and (c) of the Tax Code, then Section 37(e) and Section 163 of the Income Tax Regulations above-mentioned will no longer apply as the said income are not subject to allocation or apportionment to sources within or without the Philippines. (Pacific Transport Lines, Inc. vs. Commissioner of Internal Revenue, CTA Case No. 1039, April 29, 1981, certiorari denied in G.R. No. L-57306, March 8, 1982; See also Daiichi Chuo Kisen Kaisha vs. Commissioner of Internal Revenue, CTA Case No. 1277, May 31, 1969; United States Lines Company vs. Commissioner of Internal Revenue, CTA Case No. 1305, June 28, 1973; Ginn & Company vs. Commissioner of Internal Revenue, CTA Case No. 674, May 21, 1962; Holland East Asia Lines vs. Collector of Internal Revenue, CTA Case No. 383, August 5, 1958.)

Since the aforesaid items of income were derived in full from sources outside the Philippines, they should therefore be excluded from petitioner's world gross income because the formula of general apportionment prescribed in Section 163 of Revenue Regulations No. 2 does not apply.

Respondent, however, argues that the phrase "world gross income" denotes not only gross income realized within the Philippines but also includes other incomes from all sources "including in each case income of a nonshipping character but incidental to the shipping business such as dividends from investments, interest on deposits." (Sec. 163, Rev. Regs. No. 2.) Again, respondent seems to have lost sight of the division by the law of income of taxpayers into three distinct classes (Sec. 152, Rev. Regs. No. 2; Sec. 37, Revenue Code), which is specially significant to petitioner herein as a foreign corporation deriving income from sources within the Philippines. As already shown above, under Section 37(e) of the Revenue Code, only items of gross income coming under the third classification, i.e., income from sources partly within and partly without the Philippines, should be allocated or apportioned to sources within or without the Philippines in accordance with Section 163 of Revenue Regulations No. 2. Consequently, where an item of income is directly classified as income which is derived in full from sources within the Philippines or income which is derived in full from sources without the Philippines under the provisions of Section 37(a) or (c) of the Tax Code, in relation to Section 152 of Revenue Regulations No. 2, then Section 37(e) of the same Code, as well as the provisions of Section 163 of Revenue Regulations No. 2, cannot apply. (Daiichi Chuo Kisen Kaisha vs. Commissioner of Internal Revenue, <u>supra</u>.)

Having reached the result that the income from the terminal and stevedore operations of petitioner should be excluded from its world gross income for purposes of computing the allocable deduction, it follows that the expenses directly allocable thereto in the amount of US$1,979,276 should likewise be excluded from petitioner's world expenses for purposes of computing the allocable expenses.

In the light of the above, petitioner's Philippine income tax liability should be recomputed as follows:

World Gross Income per Return		$37,372,095.00
Less: Agency fees and commissions	$ 370,941	
Income from terminal and stevedore operations	2,255,584	
Interest income	471,571	
Dividend Income	76,427	
Miscellaneous other income	20,555	3,195,078.00
Adjusted World Gross Income		$34,177,017.00
World Expenses per Return		$33,351,392.00
Less: Expenses of terminal and stevedore operations	$1,979,276	
U.S. Federal income tax	1,136,718	3,115,994.00
Adjusted World Expenses		$30,235,398.00
Receipts from cargo loaded at Philippine ports - $1,088,529 Converted to Philippine currency at ₱3.90 to $1		₱ 4,245,263.10
Philippine Allocable Expenses $\frac{\$ 1,088,529}{\$34,177,017} \times \$30,235,398 = \$962,988.36$ converted at ₱3.90 to $1		₱ 3,755,654.60
Receipts from cargo loaded in the Philippines		₱ 4,245,263.10
Less: Philippine allocable expenses		3,755,654.60
Net Income subject to tax		₱ 489,608.50
Income tax due thereon		₱ 138,882.55
Less: Income tax paid per return		130,172.00
Deficiency income tax due		₱ 8,710.55
Interest from April 16, 1967 to April 15, 1970		1,567.90
TOTAL AMOUNT DUE AND COLLECTIBLE		₱ 10,278.45

Anent respondent's special and affirmative defense that the right of petitioner to contest the 1968 deficiency income tax assessment has already prescribed pursuant to Sections 7 and 11 of Republic Act No. 1125, the records show that respondent's decision on the disputed assessment dated February 28, 1974 (Exhibit "H", pp. 185-186, BIR records; Annex "A" to the petition for review, p. 7, CTA records), was received by petitioner on March 13, 1974. Pursuant to Section 11 of Republic Act No. 1125, petitioner has thirty (30) days from March 13, 1974 or up to April 12, 1974 within which to appeal to this Court. However, April 12, 1974 was a legal holiday being Good Friday. As such, petitioner had up to the next business day following April 12, 1974, or up to April 15, 1974 (Monday) within which to file the present petition for review with this Court as was done by petitioner. Accordingly, the instant appeal, which was filed on April 15, 1974, was seasonably brought to this Court as provided by law.

And as to the 1968 deficiency income tax assessment in the amount of ₱3,793.45 on account of the increase of corporate income tax rates mandated by Republic Act No. 5431, contrary to the allegation of respondent that it is an incidental penalty imposed on petitioner for late payment of tax, the increased corporate income tax rates do not apply to petitioner's entire taxable income for the calendar year ended December 31, 1968 because it started before June 20, 1968. (The Manila Times Publishing Company vs. Commissioner of Internal Revenue, CTA Case No. 2263, December 17, 1973, certiorari denied in L-38154, May 10, 1974.) Section 10 of Republic Act No. 5431 clearly provides that the provisions of the Act shall apply to income for taxable years beginning after June 30, 1968.

Accordingly, petitioner American Mail Line is ordered to pay to respondent Commissioner of Internal Revenue the amount of ₱10,278.45 as deficiency income tax for 1967 plus surcharge and interest incident to delinquency pursuant to the provisions of Section 51(e) of the applicable National Internal Revenue Code, as amended.

WHEREFORE, the decision appealed from is hereby modified as indicated in the above opinion of the Court. No costs.

SO ORDERED.

Quezon City, Metro Manila, July 23, 1986.

AMANTE FILLER
Presiding Judge

WE CONCUR:

CONSTANTE C. ROAQUIN
Associate Judge

ALEX Z. REYES
Associate Judge