Republic of the Philippines
COURT OF TAX APPEALS
Quezon City

A. SORIANO CORPORATION,
Petitioner,

- versus -

C.T.A. Case No. 4803

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Promulgated:
JUL 01 1997

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DECISION

This is a petition seeking for the cancellation of an alleged deficiency income tax assessment for 1985 issued by the respondent against the petitioner in the total amount of P9,746,864.00.

The antecedent facts of the case are as follows.

Petitioner is a domestic corporation duly organized and existing under and by virtue of the laws of the Philippines. As a corporation, it derives its income from managing other corporations affiliated with it, and from earnings from investments and rental of its property.

On April 20, 1989, petitioner received a 1985 deficiency income tax assessment and a demand letter both dated April 15, 1989 (Exhs "A" and "B") in the amount of P9,746,864.00 computed as follows:

Gross Compensation/Net Income per Return			P 7,515,277.00
Add:	Disallowances:		
	Accounts written-off	P12,027,749.00	
	Interest expenses	5,377,364.00	17,405,113.00
Net/Gross Compensation income			
	after investigation		P24,920,390.00
Tax due thereon			P 8,712,137.00
Balance of Tax Due			P 8,712,137.00
Deduct:	Tax Paid		2,620,347.00
Deficiency Tax Due			P 6,091,790.00
Add:	Interest from (maximum) 60%		3,655,074.00
Total amount due			P 9,746,864.00

On May 19, 1989, petitioner filed its protest letter (Exh. "C") against the deficiency income tax assessment arguing that the said assessment was illegal, arbitrary and unjustified. Petitioner maintains that the deduction of bad debts written-off and interest expense from their 1985 gross income is valid and legal based on the provisions of the Tax Code.

On April 13, 1992, respondent, without acting on the protest letter, served a Warrant of Distraint and/or Levy (Exh. "D"); and a Warrant of Garnishment (Exh. "E") against the petitioner. This in effect constituted her final decision impliedly denying petitioner's protest. Hence, this brought about the filing of the petition for review on May 13, 1992.

The only dispute or issue involved in this case is whether or not the disallowance by the respondent of the following deductions are legal and justified.

a) Bad debts or accounts written-off; and
b) Interest expense.

Petitioner claims that the bad debts written-off are allowed as deductible expense under Section 30(e)(1) of the Tax Code since the accounts were connected with the petitioner's trade or business; and that the written-off bad debts were actually ascertained to be worthless, the debtor-companies having suspended their business operations in 1985 as a result of financial difficulties. Thus, rendering petitioner's diligent efforts to collect said debts futile, petitioner was constrained to charge them off within the said taxable year (par. 6(A), Petition for Review, p. 2, CTA rec.).

Respondent, on the other hand, in support of her disallowance of the accounts written-off, presented the testimony of Revenue Examiner Nelson Boongaling, who testified as follows (TSN, April 20, 1995, pp. 34-35):

> "Q. Per your verification of the records of this case which you said was forwarded to your office, did you see any documents indicating that there were collection letters sent by the taxpayer of this case to its various debtors?
>
> A. When I recommended for the final assessment, there is nothing in the record that would determine that there is a collection letter by the taxpayer.
>
> Q. From that you arrived at a conclusion that there was no earnest or diligent effort exerted by the taxpayer in this case to collect the alleged accounts receivable written off?
>
> A. Yes."

Section 30(e)(1) of the 1985 Tax Code, as amended, provides:

> "**Sec. 30.** ***Deductions from gross income.*** - In computing net income there shall be allowed as deductions. -
>
> x x x
>
> **(e)** ***Bad Debts:***
>
> **(1)** ***In general.*** - Debts due to the taxpayer actually ascertained to be worthless and charged off within the taxable year except those not connected with profession, trade or business and those sustained in a transaction entered into between parties mentioned under subsection (b) of Section 31 of the Code." (underscoring supplied)

This provision was implemented by Section 102 of Revenue Regulations No. 2 (Income Tax Regulations), dated February 10, 1940, which provides:

> **"SEC. 102.** ***Bad debts.*** - Where all the surrounding and attending circumstances indicate that a debt is worthless, and the debt is charged off on the books of the taxpayer within the year the same may be allowed as a deduction in computing net income. There should accompany the return a statement showing the propriety of any deduction claimed for bad debts. Before a taxpayer may charge off and deduct a debt, he must ascertain and be able to demonstrate, with a reasonable degree of certainty, the uncollectibility of the debt. Any amount subsequently received on account of a bad debt previously charged off and allowed as a deduction for income tax purposes, must be included in gross income for the taxable year in which received. In determining whether a debt is worthless the Commissioner of Internal Revenue will consider all pertinent evidence, including the value of the collateral, if any, securing the debt and the financial condition of the debtor.
>
> Where the surrounding circumstances indicate that a debt is worthless and uncollectible and that legal action to enforce payment would in all probability not result in the satisfaction of execution on a judgment, a showing of those facts will be sufficient evidence of the worthlessness of the debt for the purpose of deduction. Bankruptcy is generally an indication of the worthlessness of at least a part of an unsecured and unpreferred debt. Actual determination of worthlessness in bankruptcy is sometimes possible before and at other times only when a settlement in bankruptcy shall have been had. Where a taxpayer ascertained a debt to be worthless and charged it off in one year, the mere fact that bankruptcy proceedings instituted against the debtor are terminated in a later year, confirming the conclusion that the debt is worthless, will not authorize shifting the deduction to such later year. If a taxpayer computes his income upon the basis of valuing his notes or accounts receivable at their fair market value when received, which may be less than their face value, the amount deductible for bad debts in any case is limited to such original valuation." (Underscoring supplied.)

The requisites for deductibility of bad debts are:

(1) There must be an existing indebtedness;

(2) The debt must be ascertained to be worthless as when the debtor is insolvent;

(3) It must be actually charged-off within the taxable year; and

(4) The debt must be connected with one's profession, trade or business **(BPI Securities Corporation vs. Commissioner of Internal Revenue, CTA Case No. 4954, October 25, 1995).**

In the case of **Collector of Internal Revenue vs. Goodrich International Rubber Co., L-22265, December 22, 1967, 21 SCRA 1336,** the Supreme Court held:

> "Our statute permits the deduction of debts `actually ascertained to be worthless within the taxable year,' obviously to prevent arbitrary action by the taxpayer, to unduly avoid tax liability.
>
> The requirement of ascertainment of worthlessness requires proof of two facts: (1) that the taxpayer did in fact ascertain the debt to be worthless, in the year for which the deduction is sought; and (2) that, in so doing, he acted in good faith.
>
> Good faith on the part of the taxpayer is not enough. He must show, also, that he had reasonably investigated the relevant facts and had drawn a reasonable inference from the information thus obtained by him. xxx."

This Court has likewise adopted some safeguards before a bad debt expense can be deducted. Thus, in the case of **Philippine Refining Company vs. Commissioner of Internal Revenue, CTA Case No. 4408, February 3, 1993 (Court of Appeals Entry of Judgment on July 30, 1993),** We ruled that:

> "The creditor must be able to demonstrate that the debt is not only uncollectible but also appears uncollectible at any time in the future. So, where the recovery is merely doubtful, deduction will not be allowed. The following steps should be followed:
>
> 1. sending of statements of accounts;
> 2. sending of collection letters;
> 3. giving the account to a lawyer for collection; and
> 4. filing a collection case in court."

In the case at bar, petitioner has written-off the following bad debts accounts:

1.	Industrial Textile Manufacturing Corp. of the Philippines (ITEMCOP)	P 4,868,318.00
2.	ANSCOR Transports & Terminal, Inc. (ATTI)	4,321,192.00
3.	Herald Publications	2,838,241.00
	TOTAL BAD DEBTS WRITTEN-OFF	P12,027,751.00

Petitioner maintains that these three (3) companies have suspended its operations in 1985 as a result of financial difficulties. And after diligent efforts have been exerted to collect the said amounts, such as the issuance of demand letters, the collection thereof remains to be futile. Thus, petitioner considered them to be worthless. In its effort to convince this Court, petitioner has offered the following documentary evidence to prove the existence of a valid debt and that the same has been written-off in 1985 when it was ascertained that the debt could not be collected:

1. Promissory Notes issued by the debtors to prove the existence of a valid and subsisting obligations of these debtors to the petitioner (Exhs. "F", "K" and "O");

2. Statement of Accounts issued by petitioner demanding collection from the debtors;

3. Minutes of the Special Meeting of the Board of Directors of the debtor companies: Herald Publications, Inc. (Exh. "J") and ITEMCOP (Exh. "S") stating the cessation of operations and/or the dissolution due to insolvency and the suspension of operations, respectively;

4. Financial Statements as of December 1984 and 1985 (Exhs. "I", "R", and "AA-3") of these debtors were also presented by the petitioner to prove that they continue to sustain losses in their business operations and that their assets are insufficient to pay all their creditors; and

5. Petitioner's Resolution (Exh. "T") to show that the bad debts were actually written-off in 1985 and were reflected in its 1985 Income Tax Return as a deduction from its gross income amounting to P12,027,749.00.

On this issue, We rule in favor of the respondent.

Petitioner inadvertently assumed that the foregoing documentary evidence would fully substantiate its claim that the debts have become worthless. It completely overlooked the fact that mere Statements of Account; Minutes of Special Meetings of the Board of Directors of the distressed corporations; the debtor's Financial Statements showing continued losses would only prove that the collection of the said debts are doubtful but not as to its unworthiness.

In addition, earnest effort exerted by the petitioner to collect from the debtors is a vital requirement for deductibility of bad debts. In the instant case, petitioner did not show sufficient proof that it exerted earnest efforts to collect said debts. It did not give the said accounts to a lawyer for the filing of a collection suit considering the huge amounts involved. As a matter of fact, in the Minutes of Special Meeting of the Board of Directors of ITEMCOP, it was stated that "the company's (ITEMCOP) machineries and equipment have a sound value of about P50M which, together with the value of its land and buildings, would be sufficient to meet the company's liabilities" (p. 137, CTA rec.). But despite knowledge thereof, petitioner did not file a claim to enforce collection in order to be given priority among other creditors in case of liquidation of the said corporation. Thus, the evidence presented is not convincing enough to sustain the deduction of bad debts in 1985.

We now go on to the issue of disallowance of interest expense.

Petitioner claims that interest expense is allowed as a deductible item from gross income under Section 30(b) of the Tax Code. It also maintains that the said interest expense was paid on indebtedness in connection with the petitioner's trade or business. The interest expense was incurred during the taxable year (1985). The indebtedness was not incurred or continued to purchase or carry obligation the interest upon which is exempt from taxation as income.

Respondent relied on petitioner's 1985 Income Tax Return showing the interest expense was higher than its interest income earned (Exh. "2-C"). This prompted her to conclude that the interest falls within the purview of the so-called "back-to-back interest scheme" or in simple terms, the interest used to earn income subject to final tax should not be deducted from income subject to the normal corporate rate of tax. Thus, respondent arrived at the following computation of disallowed interest expenses (Exh. "3-C"):

Interest income subject to final withholding tax	P11,606,085.50
Dividends income subjected to final withholding tax	15,725,799.00
Gain on sale of investments	13,102,669.50
Total (Final taxed income)	P40,434,553.00

$$\frac{\text{Final taxed income}}{\text{Gross Income}} \times \text{Interest Expense} =$$

$$\frac{\text{P 40,434,553.00}}{\text{P164,659,783.00}} \times \text{P21,898,370.00} = \underline{\text{P 5,377,363.70}}$$

Respondent disallowed that expense corresponding to the proportion of income subject ~~to~~ final tax from the gross income for the year 1985. Since the income has been subject to final tax, the expense related thereto should not be allowed as a deduction from the gross income subject to the normal corporate income tax rate.

We disagree with the respondent.

In the case of **Citytrust Investment Philippines, Inc. vs. Commissioner of Internal Revenue, CTA Case No. 4443, January 18, 1994 (Entry of Judgment, March 24, 1994),** this Court held that

> "Classifying interest incomes as non-taxable incomes is a misnomer since income arising from bank deposits, government securities or trust placements are taxed separately under the Tax Code.
>
> Furthermore, income from interest which is considered as passive and fixed income can be realized without the necessity of incurring expenses. In earning interest income, taxpayers need not spend for salaries, wages, commissions, management or professional fees, rental and other utilities, advertising and promotions, depreciation, supplies, and the like. Normally, once the money is invested, there is nothing left for the taxpayers to do. The invested money will surely earn interest income. Consequently, there is no logical basis to allocate expense to this kind of income."

In the similar case of **Sime Darby Philippines, Inc., (Formerly Sime Darby International Tire Co., Inc.) vs. The Commissioner of Internal Revenue, CTA. Case No. 4448, August 8, 1994**, the Court ruled:

> "The respondent claims that since the petitioner also earned income from interests and money market placements, it should allocate a certain part of its operating cost to the generation of such passive income, thus in effect, disallowing a proportionate amount of deductible expenses from the petitioner's income in the manufacture and recapping of tires.
>
> However, the undisputed claim of the petitioner is that no expenses were incurred in the production of its passive income such as income earned in bank deposits. Moreover, these income had already been subjected to a final withholding tax of 20%. By the very nature of a final tax, the income is tax based on its gross amount, without consideration of any deductions or costs that may have been actually been incurred in their production.
>
> We therefore, cannot find any valid reason for the respondent's allocation of deductible expenses to the petitioner's income that has been subject to a final tax. Neither can we find any legal basis for adopting the abovementioned formula in view of the unrefuted testimony of the petitioner's witness that during the examination on its accounting records, all the pertinent journals, ledgers and documents covering both taxable and non-taxable revenues were duly presented to the respondent." **(Affirmed by the Court of Appeals in the case of Commissioner of Internal Revenue vs. Sime Darby Philippines, Inc., et al, CA G.R SP No. 35191, February 28, 1995.)**

Clearly, based on the foregoing decisions, the disallowance of interest expense allocated to income subject to final tax is erroneous for lack of legal and factual basis.

Petitioner's 1985 Deficiency Income Tax liability is therefore computed as follows:

Gross Compensation/Net Income per Return	P 7,515,277.00
Add: Disallowed Accounts written-off	12,027,749.00
Net/Gross Compensation income after investigation	P19,543,026.00
Tax due thereon	P 6,830,059.00
Deduct: Tax Paid	2,620,347.00
Deficiency Tax Due	P 4,209,712.00
Add: Interest from (maximum) 60%	2,525,827.20
Total amount due	P 6,735,539.20

WHEREFORE, in view of all the foregoing, the 1985 Deficiency Income Tax Assessment issued by the respondent against the petitioner is hereby **MODIFIED**. Petitioner is hereby ordered to pay respondent the amount of P6,735,539.20, representing deficiency income tax for the year 1985, plus 25% surcharge and 20% annual interest from April 15, 1989 until fully paid pursuant to Sections 282 and 283 (now 248 and 249, respectively) of the Tax Code, and costs of suit.

SO ORDERED.

RAMON O. DE VEYRA
Associate Judge

WE CONCUR:

ERNESTO D. ACOSTA
Presiding Judge

AMANCIO Q. SAGA
Associate Judge

CERTIFICATION

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

ERNESTO D. ACOSTA
Presiding Judge
Court of Tax Appeals