

BASILAN ESTATES, INC., PETITIONER, VS. THE COMMISSIONER OF INTERNAL REVENUE AND THE COURT OF TAX APPEALS, RESPONDENTS.

G.R. No. L-22492. September 05, 1967

Ponente: BENGZON, J.P., J.

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BENGZON, J.P., J.:

A Philippine corporation engaged in coconut industry, Basilan Estates, Inc. with principal offices in Basilan City, filed on March 24, 1954 its income tax returns for 1953 and paid an income tax of P8,028. On February 26, 1959, the Commissioner of Internal Revenue, per examiner's report of February 19, 1959, assessed Basilan Estates, Inc., a deficiency income tax of P3,912 for 1953 and P86,876.85 as 25% surtax on unreasonably accumulated pro-fits as of 1953 pursuant to Section 25 of the Tax Code. On non-payment of the assessed amount, a warrant of distraint and levy was issued but the same was not executed because Basilan Estates, Inc. succeeded in getting tile Deputy Commissioner of Internal Revenue to order the Di-rector of the district in Zamboanga City to hold execu-tion and maintain constructive embargo instead. Because of its refusal to waive the period of prescription, the corporation's request for reinvestigation was not given due course, and on December 2, 1960, notice was served the corporation that the warrant of distraint and levy would be executed.

On December 20, 1960, Basilan Estates, Inc. filed be-fore the Court of Tax Appeals a petition for review of the Commissioner's assessment, alleging prescription of the period for assessment and collection; error in disallowing claimed depreciations, travelling and miscellaneous expenses; and error in finding the existence of unreasonably accumulated profits and the imposition of 25% surtax there-on. On October 31, 1963, the Court of Tax Appeals found that there was no prescription and affirmed the deficien-cy assessment in toto.

On February 21, 1964, the case was appealed to Us by the taxpayer, upon the following issues:

1. Has the Commissioner's right to collect deficien-cy income tax prescribed?
2. Was the disallowance of items claimed as deducti-ble proper?
3. Have there been unreasonably accumulated profits? If so, should the 25% surtax be imposed on the balance of the entire surplus from 1947-1953, or only for 1953?
4. Is the petitioner exempt from the penalty tax un-der Republic Act 1823 amending Section 25 of the Tax Code?

PRESCRIPTION

There is no dispute that the assessment of the defi-ciency tax was made on February 26, 1959; but the petiti-ner claims that it never received notice of such assess-ment or if it did, it received the notice beyond the five-year prescriptive period. To show prescription, the an-notation on the notice (Exhibit 10 No. 52 ACR, p. 54-A of the BIR records) "No accompanying letter 11[25]" is ad-vanced as indicative of the fact that receipt of the no-tice was after March 24, 1959, the, last date of the five-year period within which to assess deficiency tax, since the

original returns were filed on March 24, 1954.

Although the evidence is not clear on this point, We cannot accept this interpretation of the petitioner, considering the presence of circumstances that lead Us to presume regularity in the performance of official functions. The notice of assessment shows the assessment to have been made on February 26, 1959, well within the five-year period. On the right side of the notice is also stamped "Feb. 26, 1959" - denoting the date of release, according to Bureau of Internal Revenue practice. The Commissioner himself in his letter (Exh. H, p. 84 of BIR records) answering petitioner's request to lift the war-rant of distraint and levy, asserts that notice had been sent to petitioner. In the letter of the Regional Director forwarding the case to the Chief of the Investigation Division which the latter received on, March 10, 1959 (p. 71 of the BIR records), notice of assessment was said to have been sent to petitioner. Subsequently, the Chief of the Investigation Division indorsed on March 18, 1959 (p. 24 of the BIR records) the case to the Chief of the Law Division. There it was alleged that notice was already sent to petitioner on February 26, 1959. These circumstances pointing to official performance of duty must necessarily avail over petitioner's contrary interpretation. Besides, even granting that notice had been received by the petitioner late, as alleged, under Section 331 of the Tax Code requiring five years within which to assess deficiency taxes, the assessment is deemed made when notice to his effect is released, mailed or sent by the Collector to the taxpayer and it is not required that the notice be received by the taxpayer within the aforementioned five-year period.[1]

ASSESSMENT

The questioned assessment is as follows:

Net Income per return ----- P40,142.90

Add: Overcalled

Depreciation P10,500.49

Mis. Expenses

disallowed -- 6,759.17

Officer's traveling

expenses disallowed 2,300.40 19,560.06

Net Income per Investi-

gation----- P59,702.96

20% tax on P59,702.96 ----- 11,940.00

Less: Tax already assessed ----- 8,028.00

Deficiency income tax ----- P 3,912.00

Add: Additional tax of

25% on P347,507.01----- 86,876.75

Tax Due & Collectible --- P90,788.75

The Commissioner disallowed:

Overclaimed depreciation ----- P10,500.49

Miscellaneous expenses ----- 6,759.17

Officers travelling expenses ---- 2,300.40

DEDUCTIONS

A. Depreciation. - Basilan Estates, Inc. claimed deductions for the depreciation of its assets up to 1949 on the basis of their acquisition cost. As of January 1, 1950 it changed the depreciable value of said assets by increasing it to conform with the increase in cost for their replacement. Accordingly, from 1950 to 1953 it deducted from gross income the value of depreciation computed on the reappraised value.

In 1953, the year involved in this case, taxpayer claimed the following depreciation deduction:

Reappraised assets----- P47,342.53

New assets consisting

of hospital building

and equipment----- 3,910.45

Total depreciation----- P 51,252.98

Upon investigation and examination of taxpayer's books and papers, the Commissioner of Internal Revenue found that the reappraised assets depreciated in 1953 were the same ones upon which depreciation was claimed in 1952. And for the year 1952, the Commissioner had already determined, with taxpayer's concurrence, the depreciation allowable on said assets to be P36,842.04, computed on their acquisition cost at rates fixed by the taxpayer. Hence, the Commissioner pegged the deductible depreciation for 1953 on the same old assets at P36,842.04 and disallowed the excess thereof in the amount of P10,500.49.

The question for resolution therefore is whether depreciation shall be determined on the acquisition cost or on the reappraised value of the assets.

Depreciation is the gradual diminution in the useful value of tangible property resulting from wear and tear and normal obsolescence. The term is also applied to amortization of the value of intangible assets, the use of which in the trade or business is definitely limited in duration.[2] Depreciation commences with the acquisition of the property and its owner is not bound to see his property gradually waste, without making provision out of earnings for its replacement. It is entitled to see that from earnings the value of the property invested is kept unimpaired, so that at the end of any given term of the years, the original investment remains as it was in the beginning. It is not only the right of a company to make such a provision, but it is its duty to its bond and stockholder and, in the case of a public serviced corporation, at least, its plain duty to the public.[3] Accordingly, the law permits the taxpayer to recover gradually his capital investment in wasting assets free from income tax.[4] Precisely, Section 30(f) (1) which states:

(1) In general. - A reasonable allowance for deterioration of property arising out of its use or employment in the business or trade, or out of its not being used: Provided, That when the allowance authorized under this subsection shall equal the capital invested by the taxpayer $x \times x$, no further allowance shall be made. $x \times x$ "

allows a deduction from gross income for depreciation but limits the recovery to the capital invested in the asset being depreciated.

The income tax law does not authorize the depreciation of an asset beyond its acquisition cost. Hence, a deduction over and above such cost cannot be claimed and allowed. The reason is that deductions from gross

income are privileges[5] not matters of right.[6] They are not created by implication but upon clear expression in the law.[7]

Moreover, the recovery, free of income tax, of an amount more than the invested capital in an asset will transgress the underlying purpose of a depreciation allowance. For then what the taxpayer would recover will be, not only the acquisition cost, but also some profit. Recovery in due time thru depreciation of investment made is the philosophy behind depreciation allowance; the idea of profit on the investment made has never been the under-lying reason for the allowance of a deduction for depreciation.

Accordingly, the claim for depreciation beyond P36,842.04 or in the amount of P10,500.49 has no justification in the law. The determination, therefore, of the Commissioner of Internal Revenue disallowing said amount, affirmed by the Court of Tax Appeals, is sustained.

B. Expenses. - The next item involves disallowed expenses incurred in 1953, broken as follows:

Miscellaneous expenses----- P6,759.17

Officer's traveling ex-

penses ----- 2,300.40

Total ----- P9,059.57

These were disallowed on the ground that the nature of these expenses could not be satisfactorily explained nor could the same be supported by appropriate papers.

Felix Gulfin, petitioner's accountant, explained the P6,759.17 as actual expenses credited to the account of the president of the corporation incurred in the interest of the corporation during the president's trip to Manila (pp. 33-34 of TSN of Dec. 5, 1962); he stated that the P2,300.40 was the president's travelling expenses to and from Manila; as to the vouchers and receipts of these, he said the same were made but got burned during the Basi-lan fire on March 30, 1962 (p. 40 of same TSN). Petitioner further argues that when it sent its records to Manila in February, 1959 the papers in support of these miscellaneous and travelling expenses were not included for the reason that by February 9, 1959, when the Bureau of Internal Revenue decided to investigate, petitioner had no more obligation to keep the same since five years had lapsed from the time these expenses were incurred (p. 41 of same TSN). On this ground the petitioner may be sustained for under Section 337 of the Tax Code, receipts and papers supporting such expenses need be kept by the taxpayer for a period of five years from the last entry. At the time of the investigation, said five years had lapsed. Taxpayer's stand on this issue is therefore sustained.

UNREASONABLY ACCUMULATED PROFITS

Section 25 of the Tax Code which imposes a surtax on profits unreasonably accumulated, provides:

"SEC. 25. Additional tax on corporation improperly accumulating profits or surplus - (a) Imposition of tax. - If any corporation, except banks, insurance companies, or personal holding companies, whether domestic or foreign, is formed or availed of for the purpose of preventing, the imposition of the tax upon its shareholders or members or the shareholders or members of another corporation, through the medium of permitting its gains and profits to accumulate instead of being divided or distributed, there is levied and assessed against such corporation, for each taxable year, a tax equal to twenty-five per centum of the undistributed portion of its accumulated profits or surplus which shall be in addition to the tax imposed by section twenty-four, and shall be computed, collected and paid in the same manner and subject to the same provisions of law, including penalties, as that tax."

The Commissioner found that in violation of the above-quoted section, petitioner had unreasonably accumulated profits as of 1953 in the amount of P347,507.01, based on the following circumstances (Examiner's Report pp. 62-68 of BIR records):

1. Strong financial position of the petitioner as of December 31, 1953. Assets were P388,617.00 while the liabilities amounted to only P61,117.31 or a ratio of 6:1.
2. As of 1953, the corporation had considerable capital adequate to meet the reasonable needs of the business amounting to P327,499.69 (assets less liabilities).
3. The P200,000 reserved for electrification of drier and mechanization and the P50,000 reserved for malaria control were reverted to its surplus in 1953.
4. Withdrawal of shareholders of large sums of money as personal loans.
5. Investment of undistributed earnings in assets having no proximate connection with the business - as hospital building and equipment worth P59,794.72.
6. In 1953, with an increase of surplus amounting to P677,232.01, the capital stock was increased to 500,000 although there was no need for such increase.

Petitioner tried to show that in considering the surplus, the examiner did not take into account the possible expenses for cultivation, labor, fertilization, drainage, irrigation, repair, etc. (pp. 235-237 of TSN of Dec. 7, 1962). As aptly answered by the examiner himself, however, they were already included as part of the working capital (pp. 237-238 of TSN of Dec. 7, 1962).

In the unreasonable accumulation of P347,507.01 are included P200,000 for electrification of driers and mechanization and P50,000 for malaria control which were reserved way back in 1948 (p. 67 of the BIR records) but reverted to the general fund only in 1953. If there were any plans for these amounts to be used in further expansion through projects, it did not appear in the records as was properly indicated in 1948 when such amounts were reserved. Thus, while in 1948 it was already clear that the money was intended to go to future projects, in 1953 upon reversion to the general fund, no such intention was shown. Such reversion therefore gave occasion for the Government to consider the same for tax purposes. The P250,000 reverted to the general fund was sought to be explained as later used elsewhere: "part of it in the Hilano Industries, Inc. in building the factory site and buildings to house technical men x x x part of it was spent in the facilities for the waterworks system and for industrialization of the coconut industry" (p. 117 of TSN of Dec. 6, 1962). This is not sufficient explanation. Persuasive jurisprudence on the matter such as those in the United States from where our tax law was derived,[8] has it that: "In order to determine whether profits were accumulated for the reasonable needs, of the business or, to avoid the surtax upon shareholder the controlling intention of the taxpayer is that which is manifested at 'the time of the accumulation, not subsequently declared intentions which are merely the products of afterthought.[9] The reversion here was made because the reserved amount was not enough for the projects intended, without any intent to channel the same to some particular future projects in mind.

Petitioner argues that since it has P560,717.44 as its expenses for the year 1953, a surplus of P347,507.01 is not unreasonably accumulated. As rightly contended by the Government, there is no need to have such a large amount at the beginning of the following year because during the year, current assets are converted into cash and with the income realized from the business as the year goes, these expenses may well be taken care of (pp. 238 of TSN of Dec. 7, 1962). Thus, it is erroneous to say that the taxpayer is entitled to retain enough liquid net assets in amounts approximately equal to current operating needs for the year to cover "cost of goods sold and operating expenses" for "it excludes proper consideration of funds generated by the collection of notes receivable as trade

accounts during the course of the year." [10] In fact, just because the total accumulations are less than 70% of the annual operating expenses of the year, it does not mean that the accumulations are reasonable as a matter of law." [11]

Petitioner tried to show that investments were made with Basilan Coconut Producers Cooperative Association and Basilan Hospital (pp. 103-105 of TSN of Dec. 6, 1962) totaling P59,794.72 as of December 31, 1953. This shows all the more the unreasonable accumulation. As of December 31, 1953 already P59,794.72 was spent - yet as of that date there was still a surplus of P347,507.01.

Petitioner question why the examiner covered the period from 1948-1953 when the taxable year on review was 1953. The surplus of P347,507.01 was taken by the examiner from the balance sheet of petitioner for 1953. To check the figure arrived at, the examiner traced the accumulation process from 1947 until 1953, and petitioner's figure stood out to be correct. There was no error in the process applied, for previous accumulations should be considered in determining unreasonable accumulation for the year concerned. "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." [12]

Another factor that stands but to show unreasonable accumulation is the fact that large amounts were withdrawn by or advanced to the stockholders. For the year 1953 alone these totaled P197,229.26. Yet the surplus of P347,507.01 was left as of December 31, 1953. We find unacceptable petitioner's explanation that these were advances made in furtherance of the business purposes of the petitioner. As correctly held by the Court of Tax Appeals, while certain expenses of the corporation were credited against these amounts, the unspent balance was retained by the stockholders without refunding them to petitioner at the end of each year. These advances were in fact indirect loans to the stockholders indicating the unreasonable accumulation of surplus beyond the needs of the business.

ALLEGED EXEMPTION

Petitioner wishes to avail of the exempting proviso in Sec. 25 of the Internal Revenue Code as amended by R.A. 1823, approved June 22, 1957, whereby accumulated profits or surplus if invested in any dollar-producing or dollar-earning industry or in the purchase of bonds issued by the Central Bank, may not be subject to the 25% tax. We have but to point out that the unreasonable accumulations was in 1953. The exemption was by virtue of Republic Act 1823 which amended Sec. 25 only June 22, 1957 - more than three years after the period covered by the assessment.

In resume, Basilan Estates, Inc. is liable for the payment of deficiency income tax and surtax for the year 1953 in the amount of P88,977.42, computed as follows:

Net Income per return -----	P40,142.90
Add: Overclaimed depreciation -----	10,500.49
Net income per finding -----	P50,643.39
20 % tax on P50,643.39 -----	P10,128.67
Less: Tax already assessed --	8,028.00

Deficiency income tax ----- P2,100.67

Add: 25% surtax on

P347,507.01 ----- 86,876.75

Total tax due and

collectible ----- P88,977.42

WHEREFORE, the judgment appealed from is modified to the extent that petitioner is allowed its deductions for travelling and miscellaneous expenses, but affirmed insofar as the petitioner is liable for P2,100.67 as deficiency income tax for 1953 and P86,876.75 as 25% sur-tax on the unreasonably accumulated profit of P347,507.01. No costs.

SO ORDERED.

Concepcion, C.J., Reyes, Dizon, Makalintal, Zaldivar, Sanchez, Castro, Angeles, and Fernando, JJ., concur.`

[1] Collector of Internal Revenue v. Bautista, G.R. Nos. L-12250 & L--12259, May 27, 1959.

[2] Jose Arañas, Annotations and Jurisprudence on the National Internal Revenue Code, as Amended Second Ed., Vol. I, p. 263.

[3] Knoxville v. Knoxville Water Co., 212 U.S. 1, 53 L. ed. 371.

[4] Detroit Edison Co. v. Commissioner, 131 F (2d) 619 (CCA 6th, 1942), Aff'd 319 U.S. 98, 87 L. ed. 12860 63 S.Ct. 902.

[5] Palmer v. State Commission of Revenue & Taxation, 156 Kan. 690, 135 P 2d 899.

[6] Southern Weaving Co. v. Query, 206 SC 307, 34 SE 2d 51.

[7] See Gutierrez v. Collector of Internal Revenue, G.R. No. L-19537, May 20, 1965.

[8] Collector of Internal Revenue v. Binalbagan Estate, Inc., G.R. No. L-12752, Jan. 30, 1965.

[9] Jacob Mertens, Jr., The Law of Federal Income Taxation, Vol. 7, Cumulative Supplement, p. 213.

[10] Ibid., p. 229.

[11] Ibid., p. 222.

[12] Ibid., 202.

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