CYANAMID PHILIPPINES, INC., PETITIONER, VS. THE COURT OF APPEALS, THE COURT OF TAX APPEALS AND COMMISSIONER OF INTERNAL REVENUE, RESPONDENTS.

G.R. No. 108067. January 20, 2000

Ponente: QUISUMBING, J.

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QUISUMBING, J.:

Petitioner disputes the decision[1] of the Court of Appeals which affirmed the decision[2] of the Court of Tax Appeals, ordering petitioner to pay respondent Commissioner of Internal Revenue the amount of three million, seven hundred seventy-four thousand, eight hundred sixty seven pesos and fifty centavos (P3,774,867.50) as 25% surtax on improper accumulation of profits for 1981, plus 10% surcharge and 20% annual interest from January 30, 1985 to January 30, 1987, under Sec. 25 of the National Internal Revenue Code.

The Court of Tax Appeals made the following factual findings:

Petitioner, Cyanamid Philippines, Inc., a corporation organized under Philippine laws, is a wholly owned subsidiary of American Cyanamid Co. based in Maine, USA. It is engaged in the manufacture of pharmaceutical products and chemicals, a wholesaler of imported finished goods, and an importer/indentor.

On February 7, 1985, the CIR sent an assessment letter to petitioner and demanded the payment of deficiency income tax of one hundred nineteen thousand eight hundred seventeen (P119,817.00) pesos for taxable year 1981, as follows:

> "Net income disclosed by the return as audited
>
> 14,575,210.00
>
> Add: Discrepancies:
>
> Professional fees/yr 17018 262,877.00
>
> Per investigation 110,399.37
>
> Total Adjustment .....
>
> 152,477.00
>
> Net income per Investigation .....
>
> 14,727,687.00

Less: Personal and additional exemptions .....

_____

Amount subject to tax .....

14,727,687.00

Income tax due thereon ... 25% Surtax 2,385,231.50

3,237,495.00

Less: Amount already assessed .....

5,161,788.00

BALANCE .....

75,709.00

___ monthly interest from.....1,389,636.00

44,108.00

_____ .....

_____

Compromise penalties .....

_____

TOTAL AMOUNT DUE 3,774,867.50

119,817.00"[3]

On March 4, 1985, petitioner protested the assessments particularly, (1) the 25% Surtax Assessment of P3,774,867.50; (2) 1981 Deficiency Income Assessment of P119,817.00; and 1981 Deficiency Percentage Assessment of P8,846.72.[4] Petitioner, through its external accountant, Sycip, Gorres, Velayo & Co., claimed, among others, that the surtax for the undue accumulation of earnings was not proper because the said profits were retained to increase petitioner's working capital and it would be used for reasonable business needs of the company. Petitioner contended that it availed of the tax amnesty under Executive Order No. 41, hence enjoyed amnesty from civil and criminal prosecution granted by the law.

On October 20, 1987, the CIR in a letter addressed to SGV & Co., refused to allow the cancellation of the assessment notices and rendered its resolution, as follows:

> "It appears that your client availed of Executive Order No. 41 under File No. 32A-F-000455-41B as certified and confirmed by our Tax Amnesty Implementation Office on October 6, 1987.
>
> In reply thereto, I have the honor to inform you that the availment of the tax amnesty under Executive Order No. 41, as amended is sufficient basis, in appropriate cases, for the cancellation of the assessment issued after August 21, 1986. (Revenue Memorandum Order No. 4-87) Said availment does not, therefore, result in cancellation of assessments issued before August 21, 1986, as in the instant case. In other words, the assessments in this case issued on January 30, 1985 despite your client's availment of the tax amnesty under Executive Order No. 41, as amended still subsist.
>
> Such being the case, you are therefore, requested to urge your client to pay this Office the aforementioned

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> deficiency income tax and surtax on undue accumulation of surplus in the respective amounts of P119,817.00 and P3,774,867.50 inclusive of interest thereon for the year 1981, within thirty (30) days from receipt hereof, otherwise this office will be constrained to enforce collection thereof thru summary remedies prescribed by law.
>
> This constitutes the final decision of this Office on this matter."[5]

Petitioner appealed to the Court of Tax Appeals. During the pendency of the case, however, both parties agreed to compromise the 1981 deficiency income tax assessment of P119,817.00. Petitioner paid a reduced amount --twenty-six thousand, five hundred seventy-seven pesos (P26,577.00) -- as compromise settlement. However, the surtax on improperly accumulated profits remained unresolved.

Petitioner claimed that CIR's assessment representing the 25% surtax on its accumulated earnings for the year 1981 had no legal basis for the following reasons: (a) petitioner accumulated its earnings and profits for reasonable business requirements to meet working capital needs and retirement of indebtedness; (b) petitioner is a wholly owned subsidiary of American Cyanamid Company, a corporation organized under the laws of the State of Maine, in the United States of America, whose shares of stock are listed and traded in New York Stock Exchange. This being the case, no individual shareholder of petitioner could have evaded or prevented the imposition of individual income taxes by petitioner's accumulation of earnings and profits, instead of distribution of the same.

In denying the petition, the Court of Tax Appeals made the following pronouncements:

> "Petitioner contends that it did not declare dividends for the year 1981 in order to use the accumulated earnings as working capital reserve to meet its "reasonable business needs". The law permits a stock corporation to set aside a portion of its retained earnings for specified purposes (citing Section 43, paragraph 2 of the Corporation Code of the Philippines). In the case at bar, however, petitioner's purpose for accumulating its earnings does not fall within the ambit of any of these specified purposes.
>
> More compelling is the finding that there was no need for petitioner to set aside a portion of its retained earnings as working capital reserve as it claims since it had considerable liquid funds. A thorough review of petitioner's financial statement (particularly the Balance Sheet, p. 127, BIR Records) reveals that the corporation had considerable liquid funds consisting of cash accounts receivable, inventory and even its sales for the period is adequate to meet the normal needs of the business. This can be determined by computing the current asset to liability ratio of the company:
>
> current ratio = current assets / current liabilities
>
> = P 47,052,535.00 / P21,275,544.00
>
> = 2.21: 1
>
> The significance of this ratio is to serve as a primary test of a company's solvency to meet current obligations from current assets as a going concern or a measure of adequacy of working capital.

x x x

> We further reject petitioner's argument that "the accumulated earnings tax does not apply to a publicly-held corporation" citing American jurisprudence to support its position. The reference finds no application in the case at bar because under Section 25 of the NIRC as amended by Section 5 of P.D. No. 1379 [1739] (dated September 17, 1980), the exceptions to the accumulated earnings tax are expressly enumerated, to wit: Bank, non-bank financial intermediaries, corporations organized primarily, and authorized by the Central Bank of the Philippines to hold shares of stock of banks, insurance companies, or personal holding companies, whether domestic or foreign. The law on the matter is clear and specific. Hence, there is no need to resort to applicable cases decided by the American Federal Courts for guidance and enlightenment as to whether the provision of

> Section 25 of the NIRC should apply to petitioner.
>
> Equally clear and specific are the provisions of E.O. 41 particularly with respect to its effectivity and coverage...
>
> ... Said availment does not result in cancellation of assessments issued before August 21, 1986 as petitioner seeks to do in the case at bar. Therefore, the assessments in this case, issued on January 30, 1985 despite petitioner's availment of the tax amnesty under E.O. 41 as amended, still subsist."

x x x

> WHEREFORE, petitioner Cyanamid Philippines, Inc., is ordered to pay respondent Commissioner of Internal Revenue the sum of P3,774,867.50 representing 25% surtax on improper accumulation of profits for 1981, plus 10% surcharge and 20% annual interest from January 30, 1985 to January 30, 1987."[6]

Petitioner appealed the Court of Tax Appeal's decision to the Court of Appeals. Affirming the CTA decision, the appellate court said:

> "In reviewing the instant petition and the arguments raised herein, We find no compelling reason to reverse the findings of the respondent Court. The respondent Court's decision is supported by evidence, such as petitioner corporation's financial statement and balance sheets (p. 127, BIR Records). On the other hand the petitioner corporation could only come up with an alternative formula lifted from a decision rendered by a foreign court (Bardahl Mfg. Corp. vs. Commissioner, 24 T.C.M. [CCH] 1030). Applying said formula to its particular financial position, the petitioner corporation attempts to justify its accumulated surplus earnings. To Our mind, the petitioner corporation's alternative formula cannot overturn the persuasive findings and conclusion of the respondent Court based, as it is, on the applicable laws and jurisprudence, as well as standards in the computation of taxes and penalties practiced in this jurisdiction.
>
> WHEREFORE, in view of the foregoing, the instant petition is hereby DISMISSED and the decision of the Court of Tax Appeals dated August 6, 1992 in C.T.A. Case No. 4250 is AFFIRMED in toto."[7]

Hence, petitioner now comes before us and assigns as sole issue:

> WHETHER THE RESPONDENT COURT ERRED IN HOLDING THAT THE PETITIONER IS LIABLE FOR THE ACCUMULATED EARNINGS TAX FOR THE YEAR 1981.[8]

Section 25[9] of the old National Internal Revenue Code of 1977 states:

> "Sec. 25. Additional tax on corporation improperly accumulating profits or surplus
>
> "(a) Imposition of tax. -- If any corporation 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.
>
> "(b) Prima facie evidence. -- The fact that any corporation is mere holding company shall be prima facie evidence of a purpose to avoid the tax upon its shareholders or members. Similar presumption will lie in the case of an investment company where at any time during the taxable year more than fifty per centum in value of its outstanding stock is owned, directly or indirectly, by one person.
>
> "(c) Evidence determinative of purpose. -- The fact that the earnings or profits of a corporation are permitted to accumulate beyond the reasonable needs of the business shall be determinative of the purpose to avoid the tax

> upon its shareholders or members unless the corporation, by clear preponderance of evidence, shall prove the contrary.
>
> "(d) Exception -- The provisions of this sections shall not apply to banks, non-bank financial intermediaries, corporation organized primarily, and authorized by the Central Bank of the Philippines to hold shares of stock of banks, insurance companies, whether domestic or foreign.

The provision discouraged tax avoidance through corporate surplus accumulation. When corporations do not declare dividends, income taxes are not paid on the undeclared dividends received by the shareholders. The tax on improper accumulation of surplus is essentially a penalty tax designed to compel corporations to distribute earnings so that the said earnings by shareholders could, in turn, be taxed.

Relying on decisions of the American Federal Courts, petitioner stresses that the accumulated earnings tax does not apply to Cyanamid, a wholly owned subsidiary of a publicly owned company.[10] Specifically, petitioner cites Golconda Mining Corp. vs. Commissioner, 507 F.2d 594, whereby the U.S. Ninth Circuit Court of Appeals had taken the position that the accumulated earnings tax could only apply to a closely held corporation.

A review of American taxation history on accumulated earnings tax will show that the application of the accumulated earnings tax to publicly held corporations has been problematic. Initially, the Tax Court and the Court of Claims held that the accumulated earnings tax applies to publicly held corporations. Then, the Ninth Circuit Court of Appeals ruled in Golconda that the accumulated earnings tax could only apply to closely held corporations. Despite Golconda, the Internal Revenue Service asserted that the tax could be imposed on widely held corporations including those not controlled by a few shareholders or groups of shareholders. The Service indicated it would not follow the Ninth Circuit regarding publicly held corporations.[11] In 1984, American legislation nullified the Ninth Circuit's Golconda ruling and made it clear that the accumulated earnings tax is not limited to closely held corporations.[12] Clearly, Golconda is no longer a reliable precedent.

The amendatory provision of Section 25 of the 1977 NIRC, which was PD 1739, enumerated the corporations exempt from the imposition of improperly accumulated tax: (a) banks; (b) non-bank financial intermediaries; (c) insurance companies; and (d) corporations organized primarily and authorized by the Central Bank of the Philippines to hold shares of stocks of banks. Petitioner does not fall among those exempt classes. Besides, the rule on enumeration is that the express mention of one person, thing, act, or consequence is construed to exclude all others.[13] Laws granting exemption from tax are construed strictissimi juris against the taxpayer and liberally in favor of the taxing power.[14] Taxation is the rule and exemption is the exception.[15] The burden of proof rests upon the party claiming exemption to prove that it is, in fact, covered by the exemption so claimed,[16] a burden which petitioner here has failed to discharge.

Another point raised by the petitioner in objecting to the assessment, is that increase of working capital by a corporation justifies accumulating income. Petitioner asserts that respondent court erred in concluding that Cyanamid need not infuse additional working capital reserve because it had considerable liquid funds based on the 2.21:1 ratio of current assets to current liabilities. Petitioner relies on the so-called "Bardahl" formula, which allowed retention, as working capital reserve, sufficient amounts of liquid assets to carry the company through one operating cycle. The "Bardahl"[17] formula was developed to measure corporate liquidity. The formula requires an examination of whether the taxpayer has sufficient liquid assets to pay all of its current liabilities and any extraordinary expenses reasonably anticipated, plus enough to operate the business during one operating cycle. Operating cycle is the period of time it takes to convert cash into raw materials, raw materials into inventory, and inventory into sales, including the time it takes to collect payment for the sales.[18]

Using this formula, petitioner contends, Cyanamid needed at least P33,763,624.00 pesos as working capital. As of

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1981, its liquid asset was only P25,776,991.00. Thus, petitioner asserts that Cyanamid had a working capital deficit of P7,986,633.00.[19] Therefore, the P9,540,926.00 accumulated income as of 1981 may be validly accumulated to increase the petitioner's working capital for the succeeding year.

We note, however, that the companies where the "Bardahl" formula was applied, had operating cycles much shorter than that of petitioner. In Atlas Tool Co., Inc. vs. CIR,[20] the company's operating cycle was only 3.33 months or 27.75% of the year. In Cataphote Corp. of Mississippi vs. United States,[21] the corporation's operating cycle was only 56.87 days, or 15.58% of the year. In the case of Cyanamid, the operating cycle was 288.35 days, or 78.55% of a year, reflecting that petitioner will need sufficient liquid funds, of at least three quarters of the year, to cover the operating costs of the business. There are variations in the application of the "Bardahl" formula, such as average operating cycle or peak operating cycle. In times when there is no recurrence of a business cycle, the working capital needs cannot be predicted with accuracy. As stressed by American authorities, although the "Bardahl" formula is well-established and routinely applied by the courts, it is not a precise rule. It is used only for administrative convenience.[22] Petitioner's application of the "Bardahl" formula merely creates a false illusion of exactitude.

Other formulas are also used, e.g. the ratio of current assets to current liabilities and the adoption of the industry standard.[23] The ratio of current assets to current liabilities is used to determine the sufficiency of working capital. Ideally, the working capital should equal the current liabilities and there must be 2 units of current assets for every unit of current liability, hence the so-called "2 to 1" rule.[24]

As of 1981 the working capital of Cyanamid was P25,776,991.00, or more than twice its current liabilities. That current ratio of Cyanamid, therefore, projects adequacy in working capital. Said working capital was expected to increase further when more funds were generated from the succeeding year's sales. Available income covered expenses or indebtedness for that year, and there appeared no reason to expect an impending 'working capital deficit' which could have necessitated an increase in working capital, as rationalized by petitioner.

In Basilan Estates, Inc. vs. Commissioner of Internal Revenue,[25] we held that:

> "...[T]here 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. [citation omitted]. 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."[26]

If the CIR determined that the corporation avoided the tax on shareholders by permitting earnings or profits to accumulate, and the taxpayer contested such a determination, the burden of proving the determination wrong, together with the corresponding burden of first going forward with evidence, is on the taxpayer. This applies even if the corporation is not a mere holding or investment company and does not have an unreasonable accumulation of earnings or profits.[27]

In order to determine whether profits are accumulated for the reasonable needs of the business to avoid the surtax upon shareholders, it must be shown that the controlling intention of the taxpayer is manifested at the time of accumulation, not intentions declared subsequently, which are mere afterthoughts.[28] Furthermore, the accumulated profits must be used within a reasonable time after the close of the taxable year. In the instant case, petitioner did not establish, by clear and convincing evidence, that such accumulation of profit was for the immediate needs of the business.

In Manila Wine Merchants, Inc. vs. Commissioner of Internal Revenue,[29] we ruled:

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> "To determine the 'reasonable needs' of the business in order to justify an accumulation of earnings, the Courts of the United States have invented the so-called 'Immediacy Test' which construed the words 'reasonable needs of the business' to mean the immediate needs of the business, and it was generally held that if the corporation did not prove an immediate need for the accumulation of the earnings and profits, the accumulation was not for the reasonable needs of the business, and the penalty tax would apply. (Mertens, Law of Federal Income Taxation, Vol. 7, Chapter 39, p. 103).[30]

In the present case, the Tax Court opted to determine the working capital sufficiency by using the ratio between current assets to current liabilities. The working capital needs of a business depend upon the nature of the business, its credit policies, the amount of inventories, the rate of turnover, the amount of accounts receivable, the collection rate, the availability of credit to the business, and similar factors. Petitioner, by adhering to the "Bardahl" formula, failed to impress the tax court with the required definiteness envisioned by the statute. We agree with the tax court that the burden of proof to establish that the profits accumulated were not beyond the reasonable needs of the company, remained on the taxpayer. This Court will not set aside lightly the conclusion reached by the Court of Tax Appeals which, by the very nature of its function, is dedicated exclusively to the consideration of tax problems and has necessarily developed an expertise on the subject, unless there has been an abuse or improvident exercise of authority.[31] Unless rebutted, all presumptions generally are indulged in favor of the correctness of the CIR's assessment against the taxpayer. With petitioner's failure to prove the CIR incorrect, clearly and conclusively, this Court is constrained to uphold the correctness of tax court's ruling as affirmed by the Court of Appeals.

WHEREFORE, the instant petition is DENIED, and the decision of the Court of Appeals, sustaining that of the Court of Tax Appeals, is hereby AFFIRMED. Costs against petitioner.

SO ORDERED.

Bellosillo, (Chairman), Mendoza, Buena, and De Leon, Jr., JJ., concur.

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[1] Rollo, pp. 25-34.

[2] CA Rollo, pp. 19-28.

[3] Records, CA Rollo, p. 24.

[4] Id. at 25.

[5] Id. at 27.

[6] Id. at 24-28.

[7] Rollo, p. 33.

[8] Id. at 9.

[9] The tax on improperly accumulated income tax underwent changes since the time of assessment of herein petitioner, in 1985, until the enactment of the present tax code, the 1997 NIRC. This provision was subsequently repealed by Executive Order No. 37 which took effect on January 1, 1986. The reason for the repeal was explained by the Commissioner of Internal Revenue through Revenue Memorandum Circular No. 26-86 as follows: "The tax on improper accumulation of surplus is essentially a penalty tax designed to compel corporations to distribute corporate earnings so that the said earnings will be taxed to the shareholders. The exemption of dividends from income tax renders the improperly accumulated surplus tax meaningless.

Accordingly, the provisions of the tax on improper accumulation or surplus are repealed and replaced with provisions to govern the taxation of foreign corporation which are lifted from Section 24 (b)." (Annotation, Improper Accumulation of Corporate Surplus or Profit by Severiano S. Tabios, 173 SCRA, pp. 403-408.) However, Section 29 of the New 1997 NIRC provides for the revival of the imposition of improperly accumulated earnings tax. The exemption from this rule now includes publicly held corporation (par. B, 2, Section 29, 1997 NIRC)

[10] A publicly owned corporation was one where the outstanding stock was owned by more than 1,500 persons and not more than 10% of either the total combined voting power, or, the total value of all classes of its outstanding stock was owned at the close of the taxable year, by any one individual, either directly or indirectly, under the provision for attribution of ownership.

[11] 10 Mertens Law of Federal Income Taxation, Chapter 39, Accumulated Earnings Tax, Sec. 39.05.

[12] Ibid.

[13] Commissioner of Customs vs. Court of Tax Appeals, 224 SCRA 665, 669-670 (1993); Centeno vs. Villalon-Pornillos, 236 SCRA 197 (1994)

[14] Commissioner of Internal Revenue vs. Mitsubishi Metal Corporation, 181 SCRA 214, 223-224 (1990)

[15] Ibid.

[16] Ibid.

[17] Bardahl Manufacturing Corp. vs. Commissioner, 24 TCM 1030.

[18] 10 Mertens Law of Federal Income Taxation, Chapter 39, Accumulated Earnings Tax, Sec. 39.133.

[19] Rollo, p. 118.

[20] 614 F2d 860.

[21] 535 F 2d 1225.

[22] 10 Mertens Law of Federal Income Taxation, Chapter 39, Accumulated Earnings Tax, Sec. 39.132.

[23] Id. at Sec. 39.128.

[24] 19 Fletcher Cyclopedia Corporations, Chapter 68, Corporation Practice, Section 9248 (1975)

[25] 21 SCRA 17 (1967)

[26] Id. at 27.

[27] Nolledo and Nolledo, The National Internal Revenue Code of the Philippines, Annotated (1982)

[28] Basilan Estates, Inc. vs. Commissioner of Internal Revenue, 21 SCRA 17, 26 (1967), citing Jacob Mertens, Jr., The Law of Federal Income Taxation, Vol. 7, Cumulative Supplement, p. 213.

[29] 127 SCRA 483 (1984)

[30] Id. at 494.

[31] Commissioner of Internal Revenue vs. Court of Appeals, 271 SCRA 605, 608 (1997)

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