Republic of the Philippines
SUPREME COURT
Manila

EN BANC

G.R. Nos. L-12010 and L-12113 October 20, 1959

KUENZLE & STREIFF, INC., petitioner,
vs.
THE COLLECTOR OF INTERNAL REVENUE, respondents.

Angel S. Gamboa for petitioner.
Office of the Solicitor General Ambrosio Padilla, Assistant Solicitor General Jose P. Alejandro and Special Attorney Librada del Rosario-Natividad for respondent.

BAUTISTA ANGELO, *J.*:

This is a petition for review of a decision of the Court of Tax Appeals, as later modified, declaring petitioner liable for the total sum of P33,187.00 as deficiency income tax due for the years 1950, 1951 and 1952.

Petitioner is a domestic corporation engaged in the importation of textiles, hardware, sundries, chemicals, pharmaceuticals, lumbers, groceries, wines and liquor; in insurance and lumber; and in some exports. In the income tax returns for the years 1950, 1951 and 1952 it filed with respondent, petitioner deducted from its gross income certain items representing salaries, directors' fees and bonuses of its non-resident president and vice-president; bonuses of its resident officers and employees; and interests on earned but unpaid salaries and bonuses of its officers and employees. The income tax computed in accordance with these returns was duly paid by petitioner.

On July 2, 1953, after disallowing the deductions of the items representing director's fees, salaries and bonuses of petitioner's non-resident president and vice-president; the bonus participation of certain resident officers and employees; and the interests on earned but unpaid salaries and bonuses, respondent assessed and demanded from petitioner the payment of deficiency income taxes in the sums of P26,370.00, P53,865.00 and P44,112.00 for the years 1950, 1951 and 1952, respectively. Petitioner requested for the re-examination of this assessment, and June 8, 1955, respondent modified the same by allowing as deductible all items comprising directors' fees and salaries of the non-resident president and vice-president, but disallowing the bonuses insofar as they exceed the salaries of the recipients, as well as the interests on earned but unpaid salaries and bonuses. Hence, for the years 1950, 1951 and 1952, respondent made a new assessment and demanded from petitioner as deficiency income taxes the amounts of P10,147.00, P26,783.00 and P20,481.00, respectively. Petitioner having taken the case on appeal to the Court of Tax Appeals, the latter modified the assessment of respondent as stated in the early part of this decision.

From this decision both parties have appealed, petitioner from that portion which holds that the measure of the reasonableness of the bonuses paid to its non-resident president and vice-president should be applied to the bonuses given to resident officers and employees in determining their deductibility and so only so much of said bonuses as applied to the latter should be allowed as deduction, and respondent from that portion of the decision which allows the deduction of so much of the bonuses which is in excess of the yearly salaries paid to the respective recipients thereof.

The law involved here is Section 30 (a)(1) and (b)(1) of the National Internal Revenue Code, the pertinent provisions of which we quote:

> SEC. 30. *Deductions from gross income*. — In computing net income there shall be allowed as deductions —
>
> (a) Expenses:
>
> (1) In general. — All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered;
>
> (b) Interest:
>
> (1) In general. — The amount of interest paid within the taxable year on indebtedness, except on indebtedness incurred or continued to purchase or carry obligations the interest upon which is exempt from taxation as income under this Title.

It would appear that all ordinary and necessary expenses paid or incurred in carrying on a trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered, may be allowed as deductions in computing the taxable income during the year. It likewise appears that the amount of interests paid within the taxable year on any indebtedness may also be deducted from the gross income. Here it is admitted that the bonuses paid to the officers and employees of petitioner, whether resident or non-resident, were paid to them as additional compensation for personal services actually rendered and as such can be considered as ordinary and necessary expenses incurred in the business within the meaning of the law, the only question in dispute being how much of said bonuses may be considered reasonable in order that it may be allowed as deduction.

It should be noted that petitioner gave to its non-resident president and vice president for the years 1950 and 1951 bonuses equal to 133-1/2% of their annual salaries and bonuses equal to 125-2/3% for the year 1952, whereas with regard to its resident officers and employees it gave them much more on the alleged reason that they deserved them because of their valuable contribution to the business of the corporation which has made it possible for it to realize huge profits during the aforesaid years. And the Court of Tax Appeals ruled that while the bonuses given to the non-resident officers are reasonable considering their yearly salaries and the services actually rendered by them, the bonuses given to the resident officers and employees are, however, quite excessive, the court saying on this point that "there is no special reason for granting greater bonuses to such lower ranking officers than those given to Messrs. Kuenzle and Streiff." Petitioner now disputes this ruling insofar as the resident officers and employees are concerned contending that the same is not in accordance with the usual pattern to be followed in determining the reasonableness of a given compensation because it ignores the nature, extent and quality of the services actually rendered by its resident officers and employees.

It is a general rule that "Bonuses to employees made in good faith and as additional compensation for the services actually rendered by the employees are deductible, provided such payments, when added to the stipulated salaries, do not exceed a reasonable compensation for the services rendered" (4 Mertens, Law of Federal Income Taxation, Sec. 25.50, p. 410). The condition precedents to the deduction of bonuses to employees are: (1) the payment of the bonuses is in fact compensation; (2) it must be for personal services actually rendered; and (3) the bonuses, when added to the salaries, are reasonable when measured by the amount and quality of the services performed with relation to the business of the particular taxpayer" (*Idem*, Sec. 25.44, p. 395). Here it is

admitted that the bonuses are in fact compensation and were paid for services actually rendered. The only question is whether the payment of said bonuses is *reasonable*.

There is no fixed test for determining the *reasonableness* of a given bonus as compensation. This depends upon many factors, one of them being "the amount and the quality of the services performed with relation to the business." Other tests suggested are: payment must be "made in good faith"; "the character of the taxpayer's business, the volume and amount of its net earnings, its locality, the type and extent of the services rendered, the salary policy of the corporation"; "the size of the particular business"; "the employees' qualifications and contributions to the business venture"; and "general economic conditions" (4 Mertens, Law of Federal Income Taxation, Sec. 25.44, 25.49, 25.50, 25.51, pp. 407-412). However, "in determining whether the particular salary or compensation payment is reasonable, the situation must be considered as a whole.

Ordinarily, no single factor is decisive. It is important to keep in mind that it seldom happens that the application of one test can give satisfactory answer, and that ordinarily it is the interplay of several factors, properly weighted for the particular case, which must furnish the final answer" (*Idem*.).

Considering the different tests formulated above, was the trial court justified in holding that the reasonableness of the amount of bonuses given to resident officers and employees should follow the same pattern for determining the reasonableness of the amount of bonuses given to non-resident officers?

Petitioner contends that it is error to apply the same measure of reasonableness to both resident and non-resident officers because the nature, extent and quality of the services performed by each with relation to the business of the corporation widely differ, as can be plainly seen by considering the factors already mentioned above, to wit, the character, size and volume of the business of the taxpayer, the profits made, the volume and amount of its earnings, the salary policy of the taxpayer, the amount and quality of the services performed, the employees qualifications and contributions to the business venture, and the general economic conditions prevailing in the place of business. And elaborating on these factors in connection with the business of petitioner, its counsel made a detailed exposition of the facts and figures showing in a nutshell that through the efficient management, personal effort and valuable contribution rendered by the resident officers and employees, the corporation realized huge profits during the year 1950, 1951 and 1952, which entitle them to the bonuses that were given to them for those years, especially having in mind the after-liberation policy of the corporation of giving salaries at low levels because of the unsettled conditions that prevailed after the war and the imposition of controls on exports and imports and in the uses of foreign exchange without prejudice of making up later for that shortcoming by giving them additional compensation in the form of bonuses if the financial situation of the corporation would warrant. As the General Manager Jung testified, the payments of bonuses were strictly based on the amount of work performed, the nature of responsibility, the years of service, and the cost of living.

While it may be admitted that the resident officers and employees had performed their duty well and rendered efficient service and for that reason were given greater amount of additional compensation in the form of bonuses than what was given to the non-resident officers. The reason for this is that, in the opinion of the management itself of the corporation, said non-resident officers had rendered the same amount of efficient personal service and contribution to deserve equal treatment in compensation and other emoluments with the particularity that their liberation yearly salaries had been much smaller.

Thus, according to counsel for petitioner, the following is the contribution made by said non-resident officers of the corporation: "A.P. Kuenzle and H.A. Streiff, had dedicated abroad, especially in New York City, New York, U.S.A. and Zurich, Switzerland, their full time and attention to the services of Kuenzle & Streiff, Inc.; engaging themselves exclusively in the purchases abroad of the merchandise for the supply of the import business of the Kuenzle & Streiff, Inc., taking care of its orders of the importation of the merchandise and also of their shipments to the said company, making contacts and effecting transactions with the suppliers abroad, and directing, controlling and supervising the business operations and affairs of the company by directives. They have been the policy-makers for the company. All decisions to be made by the company on important matters and anything and everything outside of the routinary have always been determined by them and made only upon their instructions which had been strictly adhered to by the management of the Company. A.P. Kuenzle and H.A. Streiff have been the president and vice president, respectively, of the company for many years before 1950, 1951 and 1952 and during these particular years up to the present." Indeed, the trial court was justified in expressing the view that "there is no special reason for granting greater bonuses to such lower ranking officers than those given to Messrs. Kuenzle and Streiff." We concur in this observation.

The contention of respondent that the trial court erred also in allowing the deduction bonuses in excess of the yearly salaries of their respective recipients predicated upon his own decision that the deductible amount of said bonuses should be *only equal* to their respective yearly salaries cannot also be sustained. This claim cannot be justified considering the factors we have already mentioned that play in the determination of the reasonableness of the bonuses or additional compensation that may be given to an officer or an employee which, if properly considered, warrant the payment of the bonuses in question to the extent allowed by the trial court. This is specially so considering the post-war policy of the corporation in giving salaries at low levels because of the unsettled conditions resulting from war and the imposition of government controls on imports and exports and on the use of foreign exchange which resulted in the diminution of the amount of business and the consequent loss of profits on the part of the corporation. The payment of bonuses in amounts a little more than the yearly salaries received considering the prevailing circumstances is in our opinion reasonable.

As regards the amount of interests disallowed, we also find the ruling of the trial court justified. There is no dispute that these items accrued on unclaimed salaries and bonus participation of shareholders and employees. Under the law, in order that interest may be deductible, it must be paid "on indebtedness" (Section 30, (b)(1) of the National Internal Revenue Code). It is therefore imperative to show that there is an *existing indebtedness* which may be subjected to the payment of interest. Here the items involved are unclaimed salaries and bonus participation which in our opinion cannot constitute indebtedness within the meaning of the law because while they constitute an obligation on the part of the corporation, it is not the latter's fault if they remained unclaimed. It is well settled rule that the term indebtedness is restricted to its usual import which "is the amount which one has contracted to pay the use of borrowed money." Since the corporation had at all times sufficient funds to pay the salaries of its employees, whatever an employee may fail to collect cannot be considered an indebtedness for it is the concern of the employee to collect it in due time. The willingness of the corporation to pay interest thereon cannot be considered a justification to warrant deduction.

Wherefore, the decision appealed from is affirmed, without pronouncement as to costs.

Paras, C.J., Bengzon, Padilla, Montemayor, Labrador, Concepcion, Edencia, Barrera, and Gutierrez David, JJ., concur.