Commissioner of Internal Revenue v. General Foods: How Ordinary is Ordinary?

*Divina Gracia P. dela Cerna**

I. INTRODUCTION 348
II. FACTS OF THE CASE 351
III. LEGAL HISTORY ON ORDINARY AND CAPITAL EXPENSES 352
IV. THE INSTANT CASE. 357
V. ANALYSIS 359
A. On the Issue of Reasonableness of the Amount Incurred
B. On the Issue of Benefits Extending Beyond the Period of One Year
VI. CONCLUSION 365

I. INTRODUCTION

It is a basic principle in taxation that "deductions from gross income are matters of legislative grace,"[1] and the amounts claimed as such must therefore clearly come within the language of the applicable law to be deductible.[2]

The National Internal Revenue Code,[3] (NIRC) the applicable law, has provided for items of allowable deductions,[4] and included therein are business expenses.[5] The NIRC further provides that business expenses are comprised of reasonable allowances for salaries, wages, and other forms of compensation for personal services actually rendered;[6] travel expenses;[7] rentals;[8] entertainment, amusement and recreation expenses.[9] The use of the term "include" signifies that this enumeration is not exclusive. In fact, other items that fall under the category of *business expense* have been provided under rules and regulations issued by the Commissioner of Internal Revenue (CIR).[10]

Relevant to this, Philippine tax laws have consistently provided that all ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business shall be allowed as deductions for income tax purposes.[11] On this basis, jurisprudence has accordingly held that the statutory test of deductibility of business expenses requires that the same must be (1) ordinary and necessary; (2) paid or incurred within the taxable year; and (3) paid or incurred in carrying on a trade or business.[12]

The application of this statutory test, however, does not prove to be easy, especially when it comes to the interpretation of the terms *ordinary* and *necessary*. Indeed, numerous cases involving disagreements as to the meanings of these terms have been raised before the courts for resolution, relating to either questions of law and/or questions of fact.[13]

---

* '06 J.D., cand. Member, Board of Editors, *Ateneo Law Journal*. The author would like to acknowledge the research assistance of Mr. Adan T. Delamide and editing assistance of Ms. Rosalyn Rayco.

Cite as 49 ATENEO L.J. 348 (2004).

1. Gutierrez v. Collector of Internal Revenue, 14 SCRA 33, 43 (1965).
2. Aguinaldo Industries Corporation v. Commissioner of Internal Revenue, 112 SCRA 136, 142 (1982).
3. The National Internal Revenue Code of the Philippines, Presidential Decree No. 1158, as amended up to Republic Act No. 8424 (1997). [NATIONAL INTERNAL REVENUE CODE].
4. *Id.*, Title II, Chap. VII.
5. *Id.*, § 34 (A).
6. *Id.*, § 34 (A) (1) (a) (i).
7. *Id.*, § 34 (A) (1) (a) (ii).
8. *Id.*, § 34 (A) (1) (a) (iii).
9. *Id.*, § 34 (A) (1) (a) (iv).
10. Bureau of Internal Revenue, Revenue Regulations 2, Feb. 10, 1940.
11. The current provision is found in § 34(A)(1)(a) of the NATIONAL INTERNAL REVENUE CODE which provides:

    > (a) *In General.* - There shall be allowed as deduction from gross income all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on or which are directly attributable to, the development, management, operation and/or conduct of the trade, business or exercise of a profession...

12. Collector of Internal Revenue v. Philippine Education Co., Inc., 99 Phil. 319, 320 (1956).
13. Collector of Internal Revenue v. Philippine Education Co., Inc., 99 Phil. 319 (1956); Kuenzle & Streiff, Inc. v. Collector of Internal Revenue, 106 Phil. 355 (1959); Visayan Cebu Terminal Co., Inc. v. Collector of Internal Revenue, 108 Phil. 320 (1960); Zamora v. Collector of Internal Revenue, 8 SCRA 163 (1963); Gutierrez v. Collector of Internal Revenue, 14 SCRA 33 (1965); C. M. Hoskins & Co., Inc. v. Commissioner of Internal Revenue, 30 SCRA 435 (1969); Atlas Consolidated Mining & Development Corporation v. Commissioner of Internal Revenue, 102 SCRA 246 (1981); Aguinaldo Industries Corporation v. Commissioner of Internal Revenue, 112 SCRA 136 (1982); Commissioner of Internal Revenue v. Algue, Inc., 158 SCRA 9 (1988);

A closely related concept which is also worth noting when it comes to the discussion of ordinary expenditures is that of *capital expenditures*. *Ordinary expenses* and *capital expenditures* are closely related concepts as both, essentially, involve spending. Their basic difference, however, is the length of time over which their benefits extend, or what is often termed as "useful life." An *ordinary expense* has a useful life of one year or less,[14] whereas a *capital expenditure* has a useful life extending beyond one year.[15]

The case of *Commissioner of Internal Revenue v. General Foods (Phils.), Inc.*[16] involved the issue of deductibility of advertising expenses. For income tax purposes, advertising expense is considered as an allowable deduction,[17] and the guidelines in determining its deductibility have been provided for in a memorandum issued by the CIR[18] which states that, as a general rule, the company or business concerned shall decide the kind and size of advertising and/or promotional expense that will be expended to promote its product or image, subject, however, to the requirement that the said expense must be properly substantiated by receipts, and the corresponding withholding taxes due thereon must have been actually withheld by the taxpayer.[19]

However, determining the deductibility of advertising expenses has proven to be rather tricky, because, "by its nature, the effect of advertising is usually not limited to the year in which it is done, but has a useful life somewhat indefinite in the future."[20] Thus, there arises a difficulty in characterizing whether the advertising expense is an ordinary or capital expenditure. Furthermore, the amount of advertising expenses may differ radically from year to year, and across different industries, this being a function of management prerogative, as well as being dependent upon the aggressiveness or strategy of management in the promotion of its products.

Esso Standard Eastern, Inc. v. Commissioner of Internal Revenue, 175 SCRA 149 (1989).

14. JAYNE GODFREY, ET.AL., ACCOUNTING THEORY 568 (3d ed. 1997).

15. JERRY M. ROSENBERG, DICTIONARY OF BUSINESS AND MANAGEMENT 56-57 (1993).

16. Commissioner of Internal Revenue v. General Foods (Phils.), Inc., 401 SCRA 545 (2003).

17. Revenue Regulations No. 2, § 65 (Feb. 10, 1940).

18. Revenue Audit Memorandum Order No. 1-87 (April 23, 1987).

19. *Id.*, § 4.

20. E.H. Sheldon & Co. v. Commissioner of Internal Revenue, 214 F.2d 655, 659 (1954).

The case of *General Foods*[21] dealt with these issues and has laid down certain principles enunciated for the first time in Philippine jurisprudence.

II. FACTS OF THE CASE

In filing its income tax return for the fiscal year ending 28 February 1995, General Foods (Phils.), Inc. (General Foods) claimed as deduction advertising expenses amounting to 9,461,246 pesos. The Commissioner of Internal Revenue (CIR) disallowed fifty percent (50%) thereof, on the ground that the said expense was in the nature of a *capital expenditure*, and accordingly should be amortized over a two-year period.

On appeal to the Court of Tax Appeals (CTA), the CTA dismissed the petition and upheld the CIR. The CTA held that the pertinent expense was unreasonable and actually partook of the nature of a *capital outlay*. Hence, despite the fact that said expense was paid or incurred within the taxable year in carrying on the business and was in fact necessary, it failed to meet the requirement that an expense, to be deductible, should also be *ordinary*.[22]

Upon elevation to the Court of Appeals (CA), the dismissal by the CTA was, set aside, primarily on the ground that the said expense did not appear to be disproportionate to the gross sales worth 124,711,969 pesos; and secondarily, for failure to sufficiently establish that the item claimed was excessive.[23]

The Supreme Court, however, reversed the CA's decision. Reaffirming the findings of the CTA, Court disallowed fifty percent (50%) of the advertising expense, basically on two grounds. *First*, it found that the same was unreasonable for being inordinately large,[24] since it constituted almost one-half of General Foods' claim for marketing expenses[25] and was double the amount of general and administrative expenses.[26] *Second*, the expense was incurred in order to protect the corporation's brand franchise, which the

21. General Foods (Phils.), Inc. v. Commissioner of Internal Revenue, C.T.A. Case No. 4386 (Feb. 8, 1994).

22. *Id.* (emphasis supplied).

23. General Foods (Phils.), Inc. v. Commissioner of Internal Revenue, CA-G.R. SP No. 33553 (June 13, 2000).

24. Commissioner of Internal Revenue v. General Foods (Phils.), Inc., 401 SCRA 545, 552 (2003).

25. *Id.* at 551.

26. *Id.* at 552.

Court held to be analogous to the maintenance of goodwill, hence a *capital expenditure*.[27]

III. LEGAL HISTORY ON ORDINARY AND CAPITAL EXPENSES

A. *Philippine Jurisprudence*

In *Visayan Cebu Terminal Co., Inc. v. Collector of Internal Revenue*,[28] the Petitioner tried to claim representation expenses amounting to 75,856 pesos as a deduction from gross income. For failure to substantiate the same, the Commissioner disallowed such deduction. On appeal, the CTA disallowed a full deduction of the amount claimed and instead fixed the amount deductible at 10,000 pesos only. As the amount was considerably lower than that originally claimed, Petitioner appealed to the Supreme Court and insisted on a full deduction. However, the Supreme Court, finding the said amount to be fair, upheld the amount of 10,000 pesos as fixed by the CTA.

In passing upon the issue, the Supreme Court agreed with the CTA's ratiocination that to be deductible, business expenses must be *ordinary* and *necessary*, paid or incurred in carrying on any trade or business, and that the same must also meet the further test of *reasonableness* in amount, such test "being inherent in the phrase *ordinary* and *necessary*."[29] However, since the *Visayan Cebu Terminal* case mainly dealt with the failure of the Petitioner to substantiate the claimed deduction as ordinary and necessary, the Court no longer passed upon the *reasonableness* of the amount in question. Nonetheless, it is apparent from this decision that the Court regards *reasonableness* of the amount as a consideration for deductibility, although the guidelines for the determination of what is *reasonable* were not laid down.

The case of *Zamora v. Collector of Internal Revenue*[30] involved a dispute over the deductibility of promotional expenses incurred by Petitioner, specifically travel expenses abroad to observe the management in modern hotels. Of the total amount claimed as deduction, only half was allowed by the CIR due to Petitioner's failure to substantiate the said expense. In the course of proving its authenticity and deductibility to the extent of the entire amount, it was found by the Court that the alleged promotional expense was spent for a combined medical and business trip.

27. *Id.*

28. Visayan Cebu Terminal Co., Inc. v. CIR, 108 Phil. 320 (1960).

29. *Id.* at 323 (emphasis supplied).

30. Zamora v. Collector of Internal Revenue, 8 SCRA 163 (1963).

The Court then held that "not all of [petitioner's] expenses came under the category of ordinary and necessary expenses [since] part thereof constituted her personal expenses."[31] Citing the case of *Visayan Cebu Terminal*, the Court reiterated the requirement that a business expense, to be deductible, must also meet the further test of *reasonableness* in terms of its amount.[32] However, such requirement was no longer expounded on by the Court since the amount in controversy was immediately adjudged to be outside the category of *ordinary* and *necessary* for having been incurred for the taxpayer's personal benefit.

In *Atlas Consolidated Mining and Development Corporation v. Commissioner of Internal Revenue*,[33] petitioner claimed as deduction the full amount of 25,523.14 pesos for expenses that it incurred for a selling campaign which was intended to promote the sale of additional capital stock. At the onset, it is important to note that the expense incurred in this case was intended to facilitate the sale of capital stock. The Commissioner characterized the said expense as a *capital expenditure*, thus disallowing it as a deduction. On appeal, the CTA ruled in favor of the Commissioner and reasoned that since the amount was effectively spent for the acquisition of additional capital, it was, thus, a *capital expenditure*. The Supreme Court effectively agreed with the reasoning of the CTA.

Acknowledging that there is, at present, no adequate or satisfactory definition of the terms *ordinary* and *necessary* as used in the federal tax laws and as interpreted in several decisions in the United States, the Court laid down certain principles to be considered in adjudicating conflicting claims. First, "an expense will be considered *necessary* where the expenditure is appropriate and helpful in the development of the taxpayer's business."[34] Second, an expense is "*ordinary* when it connotes a payment which is normal in relation to the business of the taxpayer and the surrounding circumstances. [However,] [t]he term *ordinary* does not require that the payments be habitual or normal in the sense that the same taxpayer will have to make

31. The author would like to point out, however, that the ground that the expense inured to the taxpayer's personal benefit may serve more properly as basis for holding that the expense was not incurred in carrying on the trade or business, hence disallowable. Nonetheless, this case is being cited since the Court reiterated herein the requirement that an expense, to be deductible, must also comply with the requirement of reasonableness.

32. *Zamora*, 8 SCRA at 168.

33. Atlas Consolidated Mining and Development Corporation v. Commissioner of Internal Revenue, 102 SCRA 246 (1981).

34. *Id.* at 254 (citing 4 JACOB MERTENS, JR., THE LAW OF FEDERAL INCOME TAXATION 315 (1978)).

them often; the payment may be unique or non-recurring to the particular taxpayer affected."[35]

Based on these principles, the Court held that the amount claimed was correctly disallowed as a deduction since such expenses may rightfully be classified as expenses for the recapitalization and reorganization of the corporation,[36] the cost of obtaining stock subscription,[37] promotion expenses,[38] and commission or fees paid for the sale of stock organization,[39] which are, in fact, *capital expenditures*.

Furthermore, the Court took into account the fact that the expense was incurred in order to create a favorable image of the corporation with the end-goal of maintaining the public's – as well as its stockholders' – patronage. Since efforts to establish reputation are akin to acquisition of capital assets, the expenses related thereto were adjudged to be not ordinary business expenses but *capital expenditures*.[40]

B. *American Jurisprudence*

A reading of the cases show, that in ruling on the deductibility of business expenses, the Courts have relied heavily on American jurisprudence. This is largely owing to the fact that the NIRC was patterned after the U.S. Tax Code. Hence, a study of the pertinent jurisprudence of the said jurisdiction is necessary.

In *Colonial Ice Cream Co. v. Commissioner of Internal Revenue*,[41] after the organization of the corporation and prior to the commencement of its primary business of ice cream manufacturing, petitioner began an advertising campaign in order to create a market for its product. The amount spent

35. *Id.* (citing 4 JACOB MERTENS, JR., THE LAW OF FEDERAL INCOME TAXATION 316 (1978)) (emphasis supplied).

36. *Id.* at 255 (citing Missouri Kansas Pipe Line v. Commissioner of Internal Revenue, 148 F. 2d 460 (1945); Skenandos Rayon Corp. v. Commissioner of Internal Revenue, 122 F.2d 268, cert. denied, 314 U. S. 6961 (1941)).

37. *Id.* (citing Simmons Co. v. Commissioner of Internal Revenue, 8 B.T.A. 631 (1927)).

38. *Id.* (citing Beneficial Industrial Loan Corp. v. Handy, 92 F.2d 74 (1937)).

39. *Id.* (citing Protective Finance Corp. v. Commissioner of Internal Revenue, 23 B.T.A. 308 (1931)).

40. *Id.* at 256 (citing Welch v. Helvering, 290 U.S. 111 (1933)) (emphasis supplied).

41. Colonial Ice Cream Co. v. Commissioner of Internal Revenue, 7 B.T.A. 154 (1927).

thereon was charged to "organization and development expense" and was consequently treated by petitioner as a deferred expense,[42] to be amortized over a period of three years. It must be borne in mind that in this case, the advertising expense was incurred *prior* to the commencement of business operations. Here, petitioner was seeking to *create* a market for its product even before the product was actually introduced to the public.

During the second year of amortization, the pertinent expense was disallowed by the Commissioner, hence resulting in a dispute over whether or not the expense may be treated as a *capital expenditure*, thereby warranting amortization beyond one year. Petitioner anchored its contention that the expense was a *capital expenditure* mainly on the ground that the amount spent for the purpose was "abnormally large because of the fact that it was seeking to establish a market for its product and that it should be permitted to take deductions over a series of years for this abnormal and unusual expense in order that the subsequent years which received the benefit of the advertising might bear their proportionate part of the cost thereof."[43]

The Court held that some part of a campaign cost or promotion system may be of permanent significance which warrants treating it as a *capital expenditure*, rather than a deductible expense. This was true with respect to the expense in question. However, for failure of petitioner to substantiate with evidence the portions which should rightfully be allocated between capital and expense, the Court sustained the Commissioner's disallowance of the amortization for the second year.

In *Welch v. Helvering*,[44] petitioner was the Corporate Secretary of the corporation E.L. Welch Company. After the corporation was adjudged bankrupt and subsequently discharged from its debts, Petitioner tried to re-establish his relations with former customers of the corporation; and in an attempt to solidify his individual credit and standing, he paid the debts of the corporation as far as he was able to. Subsequently, petitioner claimed the said payments as deductions from his own income. The Commissioner disallowed the claim, stating that the payments were not ordinary and necessary business expenses, but were in the nature of *capital expenditures*. The Commissioner's position was sustained by the Board of Tax Appeals, the Court of Appeals, and the Supreme Court.

In pronouncing the said amount as a *capital expenditure*, the U.S. Supreme Court stated that the amounts expended were actually intended to

42. An asset that has been created through the payment of cash by an entity before it will obtain benefits from that payment. (JERRY M. ROSENBERG, DICTIONARY OF BUSINESS AND MANAGEMENT 97 (1993)).

43. *Colonial Ice Cream*, 7 B.T.A. at 156 (emphasis supplied).

44. Welch v. Helvering, 290 U.S. 111 (1933).

establish petitioner's good reputation. *Reputation* is akin to a capital asset, similar to the goodwill[45] of an old partnership.[46] Hence, expenses intended for the establishment of good reputation are to be treated as *capital expenditures*.

In *E.H. Sheldon & Co. v. Commissioner of Internal Revenue*,[47] petitioner-corporation was engaged in the design, manufacture, and installation of laboratory equipment. To promote its products, it advertised in trade and professional magazines, mailed circulars to certain groups, and printed and distributed catalogs from time to time. It was expected that petitioner would continue to make sales of some of the products shown in the catalogs over long periods of time, while other products shown in the catalogs might become obsolete within a relatively short time. Subsequently, petitioner claimed the catalog expense as a deduction from its income. However, the same was disallowed by the Commissioner on the ground that the cost of the catalogs was recoverable only through amortization over a period of useful life of five years, commencing on the date of publication. In other words, the Commissioner was of the opinion that the claimed expenses were *capital expenditures*.

On appeal to the Tax Court, petitioner contended that the catalog expenses "were advertising expenses or substantially the equivalent of advertising expenses," [48] hence, deductible as an *ordinary expense*. Nonetheless, the Tax Court agreed with the Commissioner's findings that the expenses were *capital expenditures* because the catalogs had a useful life extending beyond one year. Further, the Tax Court held that, "if a taxpayer purchased an asset having a useful life of several years and uses it to advertise its products over that span of time, the cost of which is not deductible as an expense of the first year."[49]

Upon appeal, this decision was reversed by the Court of Appeals.[50] To support its decision, the court pointed out that by its nature, the effect of

45. Goodwill has an indeterminate life. (2 CONRADO T. VALIX & JOSE F. PERALTA, FINANCIAL ACCOUNTING 204 (1997)).

46. *Welch*, 290 U.S. at 115.

47. E.H. Sheldon & Co. v. Commissioner of Internal Revenue, 214 F.2d 655 (Court of Appeals, 1954).

48. E.H. Sheldon & Co. v. Commissioner of Internal Revenue, 19 T.C. 481, 485 (1952).

49. *Id.* (citing Alling & Cory Co. v. Commissioner of Internal Revenue, 7 B.T.A. 574 (1927); Liberty Insurance Bank v. Commissioner of Internal Revenue, 14 B.T.A. 1428 (1929), reversed for other reasons 59 F.2d 320) (emphasis supplied).

50. No further appeal was taken thereon.

advertising is usually not limited to the year in which it is done, but has a useful life somewhat indefinite in the future.[51] However, the fact that an expenditure produces something that has a useful life which extends beyond the taxable year is clearly not the controlling test.[52] The Court further stated that even though advertising expense is heavily incurred in a certain year with resulting benefits over future years, it is nevertheless a deductible expense for the year in which it is incurred.[53] Also, the Court reiterated the rule that such an expense cannot be capitalized, absent sufficient evidence showing, with reasonable certainty, the benefits accruing to future years from the expenditure.[54] Here, the Court clearly laid down the principle that in the determination of deductibility, the analysis should not be limited to a mere determination of the useful life.

IV. THE INSTANT CASE

In *General Foods*, there was no controversy on whether (1) the advertising expense was incurred or paid during the year; (2) incurred in carrying on with the business; and (3) necessary. The only question, which called for the Court's resolution, was the issue on whether the said expense was *ordinary*, and thus may be claimed in full as deduction from gross income.

In laying down the criteria in determining whether an expense is *ordinary*, the Court adopted the position of the Commissioner, which was, in turn, culled from American jurisprudence that to be considered *ordinary*, two criteria must be met. First, the amount must be *reasonable*; and second, it must *not* be a capital outlay to create goodwill.

On the requirement of *reasonableness*, the Supreme Court elaborated on the matter by acknowledging that there is, as yet, no clear-cut criteria in determining the *reasonableness* of an advertising expense. Thus, its deductibility depended "on a number of factors such as, but not limited to,

51. *E.H. Sheldon & Co.*, 214 F.2d at 659 (1954).

52. *Id.* (citing J. H. Collingwood v. Commissioner of Internal Revenue, 20 T.C. 937 (1953); Perkins Bros. Co. v. Commissioner of Internal Revenue, 78 F.2d 152 (1935); Marsh Fork Coal Co. v. Lucas, 42 F.2d 83 (1930); New Pittsburgh Coal Co. v. United States, 200 F.2d 146 (1952)).

53. *Id.* (citing Appeal of Northwestern Yeast Co., 5 B.T.A. 232 (1926); Colonial Ice Cream Co. v. Commissioner of Internal Revenue, 7 B.T.A. 154 (1927); F. E. Booth Co. v. Commissioner of Internal Revenue 21 B.T.A. 148 (1930); A. Finkenberg's Sons, Inc. v. Commissioner of Internal Revenue, 17 T.C. 973, 982, 983 (1951); Consolidated Apparel Co. v. Commissioner of Internal Revenue, 17 T.C. 1570, 1582 (1952); Richmond Hosiery Mills v. Commissioner of Internal Revenue, 29 F.2d 262 (1928)).

54. *Id.*

the type and size of [the] business in which the taxpayer is engaged; the volume and amount of its net earnings; the nature of the expenditure itself; the intention of the taxpayer and the general economic conditions."[55]

In holding that the amount of 9,461,246 pesos failed to meet the criteria of reasonableness, the Supreme Court anchored such a finding mainly on the ground that the said expense was "inordinately large."[56] The inordinate largeness of the amount was attributed solely to the fact that the said amount comprised more than one-half of respondent's total claim for marketing expenses, and was double the amount of general and administrative expenses. No discussion of the other factors, as enumerated above, was made.

It must be noted, however, that in his Separate Opinion in the CTA ruling of this case, Judge Ernesto D. Acosta pointed out that the corporation's expenses generated sales in the amount of 137,183,166 pesos.[57] The CA took this fact into account and, in reversing the decision of the CTA, the CA stated that it did not find the amount of claimed advertising expenses to appear disproportionate *vis-à-vis* the amount of sales generated thereby.

In reversing the CA's decision, the Supreme Court did not dwell on this particular matter. Rather, the Court focused on the CA's ruling that there was insufficient evidence to support the CTA's finding that the amount was excessive. The Court held that the CA's decision was erroneous because the burden of proving the validity of the claimed deductions actually rests upon the taxpayer. The Supreme Court categorically stated that the respondent failed to discharge this burden.

As to the other requirement that the expense must *not be a capital outlay* to create goodwill, the Supreme Court, before determining whether respondent's advertising expense met this criterion, stated that advertising is of two kinds: that which stimulates *current* sale of merchandise or use of services; and that which is designed to stimulate *future* sale of merchandise or use of services. The second type was said to involve "expenditures incurred, in whole or in part, to create or maintain some form of goodwill for the taxpayer's trade or business or for the industry or profession of which the taxpayer is a member."[58] The Supreme Court then held that the advertising expense incurred herein was intended to protect respondent's brand

55. Commissioner of Internal Revenue v. General Foods (Phils.), Inc., 401 SCRA 545, 551 (2003).

56. *Id.* at 552.

57. General Foods (Phils.), Inc. v. Commissioner of Internal Revenue, C.T.A. Case No. 4386 (Feb. 8, 1994).

58. *General Foods*, 401 SCRA at 552.

franchise, and went on to say "that the protection of brand franchise is analogous to the maintenance of goodwill or title to one's property."[59] Accordingly, the same may be categorized as a *capital expenditure*, which should be amortized over a reasonable period of time.[60]

In addition, the Supreme Court stated that respondent's venture to protect its brand franchise amounted to an effort to establish a reputation. Citing as basis the *Helvering* case, [the Court] ruled that the same was akin to the acquisition of a capital asset and hence, a capital expenditure.[61]

Having failed, therefore, to meet the two criteria laid down for an expense to be considered ordinary, the Supreme Court held that the advertising expense incurred by respondent was a *capital expenditure* that should be amortized over a period more than one year. Accordingly, it sustained the CIR's allocation of the said expense over a period of two years.

V. ANALYSIS

A. *On the Issue of Reasonableness of the Amount Incurred*

As mentioned earlier, the Court enumerated certain factors upon which the deductibility of an expense depends: "the type and size of business in which the taxpayer is engaged; the volume and amount of its net earnings; the nature of the expenditure itself; the intention of the taxpayer and the general economic conditions."[62] However, the Court categorically stated that this is not an exclusive list. These factors may fall into broader categories, such as external and internal factors; or under broader accounting concepts, as revenues and expenses.

It is important to note, however, that when the Court held the amount claimed to be inordinately large, its conclusion with respect to the size of the expenditure was based solely on the fact that the said amount comprised more than one-half of respondent's total claim for marketing expenses, and was double the amount of general and administrative expenses. Apparently, the Court was satisfied with an evaluation of the expense claimed as against other expenses, thereby limiting itself within a single category.

But as stated previously, the decision of the CTA was accompanied with a rather strong dissent by Judge Acosta, who pointed out that the

59. *Id.*

60. *Id.* (citing Colonial Ice Cream Co. v. Commissioner of Internal Revenue, 7 B.T.A. 154 (1927)) (emphasis supplied).

61. *Id.* at 552-53.

62. *Id.* at 551.

corporation generated *sales* amounting to 137,183,166 pesos. Compared against this sales figure, the *advertising expense* claimed is merely seven percent (7%). It is also important to note that the Dissent was supported by the decision of the CA. The fact, therefore, that the case was marked with conflicting views coming from both the CTA and the CA, should have apprised the Court to look into this conflict and resolve the same. Despite this, there is no showing that the Court took the same into account. Consequently, one cannot determine how, and to what extent, such consideration by the Court would have made an impact on the decision.

Furthermore, the Court held that it found "the subject expense for the advertisement of a single product to be inordinately large. Therefore, even if it is *necessary*, it cannot be considered an *ordinary* expense deductible under Section 29 (a)(1)(A)[63] of the NIRC."[64]

Judging from the manner by which the Court enunciated such a holding, it appears that with regard to the *size* of the expenditure, the fact that an expense is *inordinately large* automatically places it outside the realm of *ordinary*. This is in contrast to the pronouncement under American jurisprudence which states that "abnormally large expenditures for advertising are *usually* to be spread over the period of years during which the benefits of the expenditures are received."[65] Clearly then, the Court made a rather sweeping statement. This is buttressed by the fact that, U.S. courts have held that even if the taxpayer's advertising expenses in other years were much less than in the taxable year, it does not render the expense nondeductible.[66]

To further support its finding of *unreasonableness* of amount, the Court cited the case of *Colonial Ice Cream*. However, this case is not on all fours with the instant case. On one hand, *Colonial Ice Cream* involved advertising expenses intended to *create* a market[67] for a product *prior* to its introduction to the consuming public. On the other hand, the instant case dealt with

63. § 29(a)(1)(A) is now §34(A)(1)(a) of the National Internal Revenue Code.

64. *General Foods*, 401 SCRA at 552 (emphasis supplied).

65. 4 JACOB MERTENS, JR., THE LAW OF FEDERAL INCOME TAXATION 193 (1979) (citing Colonial Ice Cream Co. v. Commissioner of Internal Revenue, 7 B.T.A. 154 (1927); Cf. F.E. Booth Co. v. Commissioner of Internal Revenue, 21 B.T.A. 148 (1930)) (emphasis supplied).

66. *Id.*

67. A market is the set of actual and potential buyers of a product (PHILIP KOTLER AND GARY ARMSTRONG, PRINCIPLES OF MARKETING 9 (1999). Actual buyers, therefore, comprise the current or existing market, and potential buyers, the future or prospective market.

advertising expense aimed at countering, among others, "the *slackening* demand for consumer products."[68] Implicitly, in the instant case, there is already an existing market for the product.[69] Whether this difference in the surrounding circumstance constitutes a material consideration, sufficient to warrant different treatment, was not clarified by the Court.

B. *On the Issue of Benefits Extending Beyond the Period of One Year*

1. Creation of Goodwill

The Court first laid down the principle that there are two kinds of advertising: those that stimulate *current* sale of merchandise or use of services, and those that are designed to stimulate *future* sale of merchandise or use of services. Elaborating on the second kind, the Court said that such involves "expenditures incurred, in whole or in part, to create or maintain some form of goodwill for the taxpayer's trade or business or for the industry or profession of which the taxpayer is a member."[70]

From there, the Court proceeded to hold that the advertising expense incurred in the instant case was intended to protect respondent's brand franchise, and that the same is analogous to the maintenance of goodwill or title to one's property.[71] Working on this premise, the Court ruled that the same may therefore be categorized as a *capital expenditure* which should be amortized over a reasonable period of time.[72]

Following the reasoning of the Court, it is evident that its conclusion, that the amount spent partook of the nature of a *capital expenditure*, was principally hinged on its belief that the expense was basically intended to create some form of goodwill. As basis for this holding, the Court adopted the CIR's contention, which in turn was grounded on principles enunciated in American jurisprudence.[73]

68. Commissioner of Internal Revenue v. General Foods (Phils.), Inc., 401 SCRA 545, at 549 (emphasis supplied).

69. Marketing has a two-fold goal: to attract new customers and to keep current customers (PHILIP KOTLER AND GARY ARMSTRONG, PRINCIPLES OF MARKETING 3 (1999).

70. *General Foods*, 401 SCRA at 552.

71. *Id.*

72. *Id.* (citing Colonial Ice Cream Co. v. Commissioner of Internal Revenue, 7 B.T.A. 154 (1927)).

73. *Id.* at 551.

However, a wider reading of American jurisprudential pronouncements regarding the matter would reveal that the Court's adoption of these principles is rather hasty and not well grounded, for U.S. Courts have likewise acknowledged that:

> [o]ne factor in determining whether the expenditure should be capitalized or deducted in the year of payment is the purpose of such expenditure and whether the taxpayer was looking more to future than present sales and whether in fact the expenditure produces immediate rather than prospective benefits. If the expenditures constitute a part of a continued plan of advertising in order to keep constantly before the public the product which the taxpayer is manufacturing, the expenses should ordinarily be deducted in the year of payment *notwithstanding that there may be involved some element of resulting goodwill.*[74]

Added to this, it is already established under American jurisprudence that *goodwill advertising* designed to keep the taxpayer's name before the public is a deductible business expense, subject only to the condition that the expenditures are related to the patronage the taxpayer might reasonably expect in the future.[75]

Based on the foregoing, it becomes clear that the fact alone that advertising expenses have resulted in the creation of some form of goodwill does not necessarily qualify the said expense as a capital expenditure. Instead, the essence of its deductibility springs from the purpose borne in mind by the taxpayer in incurring the expense, the immediacy of the benefits to be derived therefrom, and its place relative to the taxpayer's strategy in marketing its product. Why the Court failed to consider these pronouncements is not clear from its decision.

2. Establishment of Reputation

Another justification advanced by the Court for its decision was its finding that respondent incurred the expense in order to protect its brand franchise, and which, according to the Court, amounted to an effort to establish a reputation. Citing as basis the *Helvering* case, the Court stated that the same was akin to the acquisition of a capital asset and hence, a *capital expenditure.*[76]

It is important to note, however, that the Court in the instant case did not elaborate on the relevant facts surrounding the protection of respondent's brand franchise. It merely stated that in the letter protest submitted by the respondent to the CIR, the former admitted that the

74. MERTENS, *supra* note 65, at 193 (emphasis supplied).

75. *Id.* at 194 (emphasis supplied).

76. *General Foods*, 401 SCRA at 552-53 (emphasis supplied).

advertising expense was incurred in order to protect respondent corporation's brand franchise.[77] There was no justification as to whether or not a reliance on *Helvering* is in order. It must be recalled that the circumstances surrounding *Helvering* were rather peculiar, and an outright adoption of the principles enunciated therein, without discussing the propriety of such adoption, would be rather hasty.

Furthermore, reaffirming the decision of the CTA, the Court said:

> [i]t has been a long-standing policy and practice of the Court to respect the conclusions of quasi-judicial agencies such as the Court of Tax Appeals, a highly specialized body specifically created for the purpose of reviewing tax cases. The CTA, by the nature of its functions, is dedicated exclusively to the study and consideration of tax problems. It has necessarily developed an expertise on the subject. We extend due consideration to its opinion unless there is an abuse or improvident exercise of authority. Since there is none in the case at bar, the Court adheres to the findings of the CTA.[78]

Pertinently, the Court quoted portions of the decision of the CTA. Part of which states that "efforts to establish reputation are akin to acquisition of capital assets and, therefore, expenses related thereto are not business expenses but capital expenditures."[79] As legal basis for this statement, the CTA cited the *Helvering* and *Atlas Consolidated Mining* case. But as previously discussed, *Helvering* is not in point.

As for *Atlas Consolidated Mining*, it must be recalled that in this case, what was being advertised was the corporation's *capital stock* and not its *products*. This distinction constitutes a material difference. On one hand, capital stock is the amount upon which the company is to conduct its operations,[80] and the sale of capital stock is intended to increase a company's equity or capital. It is the goal of every company to maintain, more so increase through the generation of profits, its equity for as long as the business remains a going concern.[81] On the other hand, a company's products, or more appropriately called inventory, are assets which are held

77. *Id.* at 552.

78. *Id.* at 553.

79. *Id.* at 549.

80. 2 CONRADO T. VALIX, AND JOSE F. PERALTA, FINANCIAL ACCOUNTING 437 (1997).

81. Going concern is defined as the idea that an accounting entity will have a continuing existence for the foreseeable future (JERRY M. ROSENBERG, DICTIONARY OF BUSINESS AND MANAGEMENT 152 (1993)).

for sale in the ordinary course of trade or business.[82] The goal in this respect is to sell the goods as soon as possible, thus, a short-term transaction.

Consequently, advertising for the sale of capital stock is merely incidental to a primary transaction: raising *capital*. Logically, therefore, the cost thereof should be charged against capital stock, which is a capital account, and hence, properly treated as a *capital expenditure*. Whereas, advertising for the sale of one's products is incidental to a different primary transaction: raising *revenue*. In such a situation, each sale is regarded as a separate transaction, which is essentially a short-term transaction. Being short-term in nature, the same should be treated as an *ordinary expense*.

In the instant case, the advertising expense was incurred for the purpose of generating sales,[83] and this matter was clearly pointed out in the dissent of Judge Acosta.[84] Reliance on the *Atlas Consolidated Mining* case was, therefore, imprecise.

It is admitted that both the creation of goodwill and the establishment of reputation produce long-term benefits. With useful lives extending for a period longer than one year, it can be said that it partakes of the nature of a capital outlay. However, American jurisprudence has provided that the fact that an expenditure produces something that has a useful life extending beyond the taxable year is clearly not the controlling test.[85] In fact, there has been an increasing tendency in the United States to allow a deduction in the year the advertising expense was paid or incurred due to the nebulous nature of the future benefits.[86]

A reading of the instant case does not provide one with a clue on whether these principles were taken into account by the Court. Their

82. VALIX AND PERALTA, *supra* note 80, at 425 (emphasis supplied).

83. That revenue and expense should go hand in hand is consistent with the "matching principle" in accounting which requires that "those costs and expenses incurred in earning a revenue should be reported in the same period." (1 CONRADO T. VALIX, AND JOSE F. PERALTA, FINANCIAL ACCOUNTING 37 (1997)).

84. "While the former (referring to the instant case) is for the purpose of generating sales, the latter (referring to the Atlas Consolidated Mining case) was for the purpose of enhancing the image of the company to generate sales of newly issued shares of stocks, obviously to increase its capital and therefore properly classifiable as 'capital expenditure.'" (General Foods (Phils.), Inc. v. Commissioner of Internal Revenue, C.T.A. Case No. 4386 (Feb. 8, 1994)).

85. MERTENS, *supra* note 65, at 193. (citing Colonial Ice Cream Co. v. Commissioner of Internal Revenue, 7 B.T.A. 154 (1927)).

86. *Id.*

impact, therefore, in determining the deductibility of an expense remains, at best, ambiguous.

VI. CONCLUSION

It is a basic precept in constitutional law that the decisions of the courts must state the facts and the law on which they are based.[87] It is not disputed that the Court in *General Foods* stated the facts and the law upon which it based the disallowance of the claimed deduction.

However, the facts considered and the legal bases relied upon were rather limited. Had the Court broadened the scope of its considerations, one of two things could have happened: the Court may have allowed the deduction, or disallowed it just the same. But either way, a broader scope of considerations, as warranted by the circumstances herein, would have made the decision stand on firmer ground, thus further enriching jurisprudence.

Cases are decided not merely for the sake of adjudicating conflicting claims but also for the purpose of laying down precedents. And when it comes to laying down the facts and the law on which a decision is based, there should not be such thing as substantial compliance.

87. PHIL. CONST. art. VIII, § 14.