



**TAX LAW FOR BUSINESS**  
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## **Taxation of advances to affiliates**

There used to be a time when instructional memos and cash and journals vouchers were just tools used by entrepreneurs and corporate officers in the usual conduct of their business activities. With the recent decision of the Supreme Court, however, the way these business implements are viewed and used may soon change.

In that decision, a corporation gave large amounts of cash advances to its affiliates in order to extend financial assistance to them for their operational and capital expenditures. These advances were evidenced with instructional memos and the cash disbursements with cash and journal vouchers.

As a result, the Bureau of Internal Revenue (BIR) issued the corporation a formal notice of demand to pay deficiency- income and documentary-stamp taxes (DST), plus interest and compromise penalties covered by assessment notices previously issued the corporation. The assessments were issued supposedly for the "arm's length" interest rate and DST imposable on the advances extended by the corporation to its affiliates.

Due to the BIR's failure to resolve the corporation's request for reconsideration/protest, the corporation elevated the case to the Court of Tax Appeals (CTA). The CTA ruled that the BIR was justified in assessing undeclared interest on the advances made to its affiliates pursuant to the commissioner's authority under Tax Code (1993 NIRC) to distribute and allocate income or deductions between and among related parties if it is determined that such distribution or allocation is necessary in order to prevent evasion of taxes or to clearly reflect the income of these related corporations. However, with regard to the corporation's DST liability, the CTA opined that the documents evidencing the cash advances of the company to affiliates cannot be considered as loan agreements that are subject to DST.

Dissatisfied with the CTA's decision, both the corporation and the BIR filed separate petitions for review before the Court of Appeals (CA). The CA upheld the position of the corporation, reversing in effect the decision of the CTA, requiring the corporation to pay deficiency income tax on allegedly undeclared interest income. On the other hand, the CA dismissed the petition of the BIR for lack of merit, thus, the BIR filed a petition for review on certiorari with the Supreme Court (SC).

The SC, after reviewing the case, ruled that the assessment notices issued by the BIR for deficiency DST due on the instructional letters, as well as on the journal and cash vouchers evidencing the advances the corporation extended to its affiliates are valid. In addition, the SC upheld the cancellation of the Notices issued for deficiency income assessed on the "arm's-length" interest from the advances.

The SC, in maintaining the validity of the BIR's assessment for deficiency DST on the instructional letters, and cash and journal vouchers cites Revenue Regulation 9-94. This regulation defines loan agreements as a contract in writing where one of the parties delivers to money or other consumable thing, upon the condition that the same amount of the same kind and quality shall be paid. The term shall include credit facilities, which may be evidenced by credit memo, advice or drawings. In addition, the regulation provides that in cases where no formal agreements or promissory notes have been executed to cover credit facilities, the DST shall be based on the amount of drawings or availment of the facilities which may be evidenced by credit/debit memo, advice or drawings by any form of check or withdrawal slip. Applying these provisions, the SC ruled that the instructional letters, as well as the journal and cash vouchers evidencing the advances that the corporation extended to its affiliates qualify as loan agreements upon which DST may be imposed.

On the issue of the deficiency income assessed on the "arm's-length" interest from the amount the corporation advanced to its affiliates as evidenced by the instructional letters and the journal and cash vouchers, the SC ruled that the broad parameters granted to the BIR commissioner relative to the commissioner's power to distribute, apportion and allocate gross income and deductions do not include the power to impute "theoretical interests" to related party transactions. In addition, the Civil Code provides that no interest shall be due unless it has been expressly stipulated in writing. Considering that taxes are burdens imposed on citizens, the same are not to be presumed beyond what the applicable statute expressly and clearly declares.

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