fib

REPUBLIC OF THE PHILIPPINES
COURT OF TAX APPEALS
QUEZON CITY

PFIZER, INC.,
Petitioner,

- versus - C.T.A. CASE NO. 3604

THE COMMISSIONER OF
INTERNAL REVENUE,
Respondent.
x - - - - - - - - - x

6/3/88

D E C I S I O N

In this petition for review, petitioner Pfizer, Inc., assails the decision of respondent Commissioner of Internal Revenue dated September 21, 1982 denying petitioner's request for cancellation of the assessment in the amounts of P245,552.08 and P55,137.65 as deficiency income tax for the fiscal year ended November 30, 1974, and withholding tax at source for the year 1974, respectively.

For the material facts, petitioner alleges and respondent admits that:

1. Petitioner is a corporation duly organized and existing under and by virtue of the laws of the

ssu

Philippines with principal office address at 6th Floor, Araza Building, Paseo de Roxas, Makati, Metro Manila;

2. Respondent is the duly appointed Commissioner of Internal Revenue who holds office at the Bureau of Internal Revenue Building, Diliman, Quezon City, where he may be served with summons;

3. In a letter dated May 30, 1979 which petitioner received on August 29, 1979, respondent assessed and demanded from petitioner a total amount of P300,689.73 as alleged deficiency income and withholding taxes for the year ending November 30, 1974 computed as follows:

FY Ended November 30, 1974
Income Tax

Net income per return		- P8,460,875.24
Add: Unallowable deductions:		
1. Research and dev. exps.	- P300,199.71	
2. Other marketing exps.	- P 82,926.42	
3. Overpriced portion of purchases	- P110,940.94	- P 494,067.07
Net income per investigation		- P8,954,942.31
Income tax due thereon		- P3,124,230.00
Income tax already paid		- P2,951,306.00
Balance		- P 172,924.00

Add: 14% int. p.a. fr. 3/16/75 - 3/16/78	-	P 72,628.08
TOTAL AMOUNT DUE AND COLLECTIBLE	-	P 245,552.08

1 9 7 4

Withholding Tax at Source

Informal dividend - Pfizer Corporation (Hongkong)	-	P 110,940.94
35% withholding tax at source due thereon	-	P 38,829.33
Add: 14% int. p.a. fr. 1/26/75 - 1/26/78	-	P 16,308.32
TOTAL AMOUNT DUE AND COLLECTIBLE	-	P 55,137.65

4. In a letter dated October 24, 1979 which respondent received on October 29, 1979, petitioner protested the assessment;

5. In a letter dated September 21, 1982 which petitioner received on February 25, 1983 respondent denied petitioner's protest and reiterated his demand for the payment of the deficiency assessment in the amount of P300,689.73;

6. In assessing petitioner for deficiency income tax for the year in question, respondent disallowed the following:

(a) Research and development expenses P300,199.71

(b) Marketing expenses P 82,926.42

(c) Overpriced portion of purchases P110,940.94

Averring that the disallowance of the items described in paragraph 6 above has no factual and legal basis petitioner appealed to this Court.

In its petition for review, petitioner assigned as errors, and issues, the following:

1. Respondent in assessing petitioner for alleged deficiency income tax for the year in question erred in disallowing the following:

(a)	Research and development expenses	P300,199.71
(b)	Marketing expenses	82,926.42
(c)	Overpriced portion of tetracycline	110,940.94

2. Respondent in assessing petitioner for deficiency withholding tax for the year in question erred in treating the overpriced portion of tetracycline as informal distribution of dividends to Pfizer Corporation, a corporation organized and existing under the laws of the State of New York, U.S.A. (Pfizer New York).

Research and Development Expenses - P300,199.71

In disallowing the claimed deduction of research and development expenses of P300,199.71, respondent explained in his decision appealed from (Exh. 7, pp. 190-191, BIR records) that "It is the stand of this Office that since your client (petitioner herein) is manufacturing and selling drugs under established patent, processes or formulas that have already been developed by its parent company, Pfizer Corporation, New York, U.S.A., research and development costs, as well as other marketing expenses, can no longer be claimed by your client as deductible expenses." This is supported by the findings of the revenue examiner assigned to investigate this case in his first indorsement dated November 13, 1978 (Exh. 2, pp. 102-105, BIR records) to the effect that the drugs exported by petitioner have already been so chemically composed and perfected for outright consumption without the necessity of further trials, experimenting and testing. Against this backdrop, it would seem unusual therefore for petitioner to have provided for research and development expenses as its business operations do not apparently require research, experiment and development of a product, formula or improvement of an already existing drug.

However, a perusal of the detailed expense account of this item (Exh. E, p. 45, BIR records) shows that of the total expenditure of P300,199.71 only the amount of P111,459.00 representing clinical and investigational expense, as pointed out by petitioner itself, would fall under research and development cost. (p. 146, CTA records.) The other expenses consisting basically of administration and supervision; scientific and technical; accounting, clerical and secretarial; other payroll; special compensation; social security taxes; compensation insurance; group insurance; repair and maintenance supplies; manufacturing supplies; electricity; accounting and other professional services; postage; telephone, telegraph and cable; traveling, moving and entertaining expense; memberships, dues and subscriptions; building, office and sanitary services; stationery and office supplies; equipment purchased, rented or serviced; company meetings; corporate expense and miscellaneous items; general insurance; taxes; rent of premises; depreciation and amortization; are admittedly allowable deductions. Since these items are clearly and unequivocally ordinary and necessary expenses in carrying on petitioner's business the amount of P188,740.71 is therefore a deductible expense under Section 30(a) of the Tax Code.

On the clinical and investigational expense of P111,459.00, testimonial evidence to this effect presented by petitioner reveals that:

> Testimony of Dioscorro Tatad, financial manager of petitioner:
>
> x x x x x x x x x
>
> Q. In line 41, you have here "Clinical and Investigation Expense", and opposite to that you have the figure "P111,459.00". Can you explain?
>
> A. Well, these clinical and investigation expenses, these are expenses incurred by the pharmaceutical division in conducting tests of the products in the market, and this includes cost of the product itself that are being given to the doctors, hospitals and other clinician for them to test the product to their patients. And these doctors are required to submit a report to the medical director on their findings on the product as to its efficacy and the result of their tests whether

> these are good or whatever reactions are being encountered by the doctors in conducting the test."
>
> (TSN, December 14, 1984, pp. 8-9, 11)

Dr. Antonio Perlas, vice president for medical affairs, likewise described the petitioner's activities as follows:

> Q. Please explain what activities does this clinical trial consist of?
>
> A. We have different kinds of clinical trials.
>
> The first one is the registration trial. The purpose of the registration trial is to test the medicine among Filipinos for safety and efficacy as required by the Ministry of Health. After that we also have some clinical trials. We conduct to help promote the product of the company. We usually ask physicians to conduct clinical trials to demonstrate to Filipinos the drugs we have to market are effective and safe.
>
> x x x x x x x x x

Because of differences of living conditions, climate, physique, diets, habits, reactions, background and others, it cannot be said with certainty that drugs and medicines manufactured in the United States for Americans are just as safe and effective for Filipinos living in the Philippines. These drugs and medicines had to be clinically tried and investigated. Thus as stated by Mr. Ramon Tan of petitioner company (Exh. 3, pp. 54-60, BIR records), the research and development expense involved particularly:

- liaison with leading medical associations group and practitioners so that new products can be tried locally;

- prepare clinical investigation to d termine the local experience and reactions to the new products;

- secure feedback information on the efficacy and safety of medical products so that better treatment dosage of drugs can be established;

- maintain file on current developments relating to the drug industry;

Since these clinical trials and investigations, as shown above, were aimed at discovering of new knowledge with the hope that such knowledge would be useful in developing or improving the safety and efficacy of petitioner's products which invariably brought benefits which lasted for more than one year or even years, the amount of P111,459.00 of the P300,199.71, as petitioner's counsel himself admitted, should therefore be capitalized.

<u>Other Marketing Expenses - P82,926.42</u>

These expenses "consist of outlays paid to research agencies for exploratory study, research study, in-depth interviews, medical surveys, execution test and comments of special groups of medical personnel on specific or particular drugs such as the new drug minipress, combantrin, contramine, visine, fasigyn, cafiel and geopen conducted for the basic purpose of further improving the quality and efficiency of the mentioned drugs" (Exh. 2, p. 104, BIR records.)

While petitioner's witness testified:

> Q. How about the other marketing expense which was disallowed, can you explain the nature of this expense?
>
> A. Well, these are expenses being paid to advertising companies to conduct tests also in the market, especially when there are new products to be marketed by the marketing division. Before they decide to launch a product, they have to conduct tests whether these products are adaptable here, so they engage the services of these advertising companies to do the job.
>
> (TSN, December 14, 1984, pp. 12-13)

petitioner's Exhibit "F" (p. 42-43, BIR records) shows that such expenses were paid to research organizations/companies primarily for in-depth interviews on certain drugs, introduction of new drugs, research service for exploratory studies on drugs, medical surveys, concept and package research, drug artwork, execution tests for bringing about significant improvements of the quality and efficacy of petitioner's products. Since these marketing expenses are in the nature of search or critical investigation in bringing about a significant improvement to petitioner's products, the beneficial effects of which would extend to future periods, the amount of P82,926.42 representing such expenses should therefore be capitalized.

Overpriced Portion of Purchases

It appears that for the fiscal period of 1974, petitioner purchased from Pfizer, Hongkong, as noted by respondent's examiner, 741,683 kilograms of tetracycline at a total price of P323,811.74. Respondent's examiner also discovered that for the same year, Pfizer, Hongkong also sold to Warner Chilcott 800 kilograms of tetracycline at a total price of P229,400.80. Comparing these sales, respondent's examiner surmised that the overpriced portion of purchases in the sum of P110,940.94 from Pfizer, Hongkong in 1974 (p. 98, BIR records) is a built-in amount in petitioner's pricing system with Pfizer, Hongkong, acting as the medium whereby informal dividends were remitted, to the extent of the excess, to the parent company, Pfizer Corporation of New York.

There is entirely no factual basis for the allegation that Pfizér, Hongkong, is acting as a medium through which dividends were channeled to petitioner's parent company, Pfizer Corporation of New York. Pfizer, Hongkong, was never a stockholder of petitioner during the period in question. (t.s.n., December 14, 1984, p. 16.) As a matter of fact, it was Pfizer Corporation of New York, a corporation organized under the laws of the State of New York, U.S.A., which was the stockholder of petitioner. (Exh. "J", p. 68, CTA records.) An assessment fixes and determines the tax liability of a taxpayer. Hence, the assessment must be based on actual facts. It should not be based on mere presumption or assumption no matter how reasonable or logical said presumption may be.

(Collector of Internal Revenue vs. Benipayo, 4 SCRA 182.)

At any rate, the records show that for the year 1974 involved in this case, petitioner purchased from different suppliers tetracycline at unit costs ranging from $32.80 to $35.43 per kilogram. The recorded unit cost of tetracycline purchased from Pfizer, Hongkong, is $33.00 which is clearly within the range. It seems evident, therefore, that there is no question that petitioner purchased the product at arm's length or at its fair market value. (p. 179, BIR records.)

Withholding Tax

This assessment of P55,137.63 as withholding tax at source for 1974 was based on respondent's view that the overpriced portion of tetracycline constituted informal distribution of dividends by petitioner to Pfizer, Hongkong. Having reached the conclusion that there could be no such informal dividend, this assessment cannot be sustained.

Conclusion

In the light of the above, petitioner's deficiency income tax for the fiscal year ended November 30, 1974 is therefore computed as follows:

Fiscal Year Ended November 30, 1974
Income Tax

Net income per return		- P8,460,875.24
Add: Unallowable deductions		
1. Research and development expenses	- P111,459.00	
2. Other marketing expenses	- 82,926.42	194,385.42
Net income per investigation		- P8,655,260.66
Income tax due thereon		- P3,019,341.00
Income tax already paid		- 2,951,306.00
Balance		- P 68,035.00
Add 14% int. p.a. from 3/16/75 to 3/16/78		- 28,574.70
TOTAL AMOUNT DUE AND COLLECTIBLE		- P 96,609.70

Accordingly, petitioner Pfizer, Inc. is ordered to pay to respondent Commissioner of Internal Revenue the amount of P96,609.70 as deficiency income tax for the fiscal year ended November 30, 1974, plus surcharges and interest incident to delinquency pursuant to Section 51(e) of the applicable National Internal Revenue Code, as amended.

WHEREFORE, the decision appealed from is modified as indicated in the above opinion of the Court. With costs.

SO ORDERED.

Quezon City, Metro Manila, June 3, 1988.

AMANTE FILLER
Presiding Judge

I CONCUR:

(on official leave)
CONSTANTE C. ROAQUIN
Associate Judge

ALEX Z. REYES
Associate Judge

C E R T I F I C A T I O N

I hereby certify that this decision was reached after due consultation among the members of the Court of Tax Appeals in accordance with Section 13, Article VIII of the Constitution.

AMANTE FILLER
Presiding Judge
Court of Tax Appeals