REPUBLIC OF THE PHILIPPINES
COURT OF TAX APPEALS
QUEZON CITY

LMG CHEMICALS CORPORATION
formerly CHEMPHIL-LMG, INC.,
Petitioner,

- versus -

C.T.A. CASE NO. 5300

THE COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Promulgated:
FEB 02 1999

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DECISION

This is an appeal from the denial of the Commissioner of Internal Revenue of the protest filed by the Petitioner, disputing the assessment demanding the payment of deficiency income tax, deficiency withholding tax and deficiency sales tax for the year 1982 in the total amount of P2,114,911.87. The assessment arose from disallowed deductions of marketing and management support services, under withholding of taxes on the management fees, and subjecting the sales of by-products to 10% sales tax.

Petitioner is a private corporation duly registered with the Securities and Exchange Commission (SEC) and is engaged in the manufacture and sale of fertilizers, sulfuric acid, and other chemical and industrial products.

It appears on the records that Petitioner and Chemical Industries of the Philippines, Inc. (CIP, for brevity) entered into a management agreement whereby the latter shall collect management fees in consideration for rendering assistance in the planning, efficient conduct and general management of the business and affairs of Petitioner LMG Chemicals, Inc. (LMG) as an investment and management company. There was also a separate operating agreement between them whereby CIP shall be entitled to reimbursement for all actual costs incurred by it in the rendition of management services to LMG based on certain reasonable allocation factors (Exhs. H, H-1 to H-3, I, I-1 to I-3).

On April 15, 1983, Petitioner filed its income tax return for the taxable year ended December 31, 1982 (Exhs. D-1 to D-4). Petitioner claimed as deduction from its income the marketing and management support services charged by and paid to CIP per aforesaid management agreement. Petitioner likewise computed its withholding tax on the management fees of CIP at 3% of 15%, claiming that the latter is an independent contractor per Revenue Regulations No. 13-78, as amended by Revenue Regulations No. 6-79; and did not also subject its sales of by-products to 10% sales tax.

On December 28, 1987, Petitioner received an Assessment Notice No. FAS-1B-82-87-00 dated December 16,

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1982 (Exh. A), assessing Petitioner for alleged deficiency income tax, expanded withholding and sales taxes, as well as increments amounting to ₱2,[illegible] computed as follows:

1982-Deficiency Income Tax

Net income per return		₱13,064,803.00
Add: Unallowable deduction/additional income:		
Marketing & management support services charged by Chemphil	₱ 637,900.00	
Management fees-not subjected to EWT (5%)	1,985,712.47	₱ 2,623,612.47
Net taxable per investigation		₱15,688,415.47
Income tax due thereon		₱ 7,049,787.00
Less: Amount due per return		5,869,161.00
Deficiency income tax		₱ 1,180,626.00
Add: 20% int. fr. 4-16-83 to 4-16-86 (maximum)		708,375.60
TOTAL AMOUNT DUE AND COLLECTIBLE		₱ 1,889,001.60

1982-Deficiency Expanded Withholding Tax

Management fees	₱ 2,182,101.67
5% Withholding tax due thereon	109,105.08
Less: Amount paid per return	9,819.46
Deficiency tax:	₱ 99,285.62
Add: 25% surcharge	24,821.40
14% int. fr. 2-1-83 to 12-31-85	40,541.62
20% int. fr. 1-1-86 to 12-18-87	38,983.50
TOTAL AMOUNT DUE AND COLLECTIBLE	₱ 203,632.14

1982-Deficiency Sales Tax

Sales-by product	₱ 89,080.92
10% sales tax due thereon	8,908.08
Less: Amount paid	---
Deficiency tax	8,908.08
Add: 25% surcharge	2,227.02
Sub-total	₱ 11,135.10
Add: 20% int. fr. 2-21-83 to 12-18-87	10,743.03
TOTAL AMOUNT DUE AND COLLECTIBLE	₱ 22,278.13

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On January 7, 1988, Petitioner filed a position paper protesting the aforesaid assessment. (Annex D of the Petition for Review, CTA records pp. 28, 29) Notwithstanding Petitioner's letter of protest and its subsequent letters reiterating such protest, Respondent denied Petitioner's pleas. The last and final denial was received by Petitioner on November 2, 1995 dated May 26, 1995. (Exh. 4, CTA records p. 7)

Respondent disallowed the deductions made by the Petitioner from its income the marketing and management support services charged by and paid to CIP because of alleged absence of evidence to show that the amount was actually incurred by CIP. Respondent also disallowed a withholding tax rate of 3% of 15% of the gross payment of management fees in the amount of ₱2,182,101.67 charged by and paid to CIP, or in the equivalent amount of ₱9,819.46 (Exh. E). Instead, Respondent assessed the Petitioner five percent (5%) of the management fees, or in the equivalent amount of ₱109,105.08. Hence, as assessed, there was a deficiency withheld tax in the amount of ₱99,285.62. Correspondingly, a surcharge of 25% on the deficiency withheld tax and penalties on the aggregate amount in varying percentages was imposed.

The basis of Respondent in disallowing the withholding tax rate of 3% of 15% of the gross payment was that the said tax rate was applicable only to independent contractors per Revenue Regulations No. 13-78, as amended by Revenue Regulations No. 6-79.

In her denial, dated September 28, 1994 (attachment of Annex F, Petition for Review, CTA records pp. 39, 40), Respondent took the position that CIP allegedly rendered management services only to its sister companies which includes Petitioner, and does not offer the same services to other companies; and as such, CIP can only be categorized as a "management and technical consultant" under Section 1 (b) of Rev. Regs. No. 13-78, as amended, instead of Section 1(e)(2)(i) under the same revenue regulation. With regard to deficiency sales tax on by-products, Respondent claims that there was no sufficient basis to alter their findings why these main products (Alkylbenzene) and by-products (light alkylate and heavy alkylate) should not be subjected to sales tax, considering that the by-products were also being sold as separate products to sister companies to which income was earned and for which no sales tax was paid.

Respondent remained firm in her position so Petitioner was constrained to file a petition for review before this Court on December 1, 1995. Petitioner reiterates its position and prays for the reversal of Respondent's decision denying its protest thereby absolving it from the payment of the aforesaid disputed assessment. Petitioner further submits that Respondent's right to collect such taxes have already been barred by prescription.

The issues to be resolved in this case are the following:

1. Whether or not the right of Respondent to collect has already prescribed, and if the answer is in the negative;

2. Whether or not the marketing and management support services charged by and paid to CIP by the Petitioner is deductible as allowable expense;

3. What is the proper withholding tax rate on management fees?

4. Whether or not the sales of by-products derived from the principal product produced or manufactured by the Petitioner is also subject to 10% sales tax.

The question of prescription is deemed a primary issue and must first be resolved so that this Court can determine whether or not the other issues presented deserve consideration.

Petitioner contends that Respondent can no longer collect the aforesaid disputed assessment considering that the action has already prescribed. In its petition for review, Petitioner elaborated on the issue of prescription by stating that the assessment in question was issued on December 18, 1987, so based on the law then in force, the assessment was well within the five-year period. Petitioner then proposed the argument that Respondent had five (5) years from the issuance of the assessment, that was on December 18, 1987 to collect the deficiency taxes, hence the period to collect was up to December 18, 1992. However, Petitioner claims that Respondent failed to make any move regarding the disputed assessment despite the fact that they have not executed any agreement in writing to extend the time for collection, thus, resulting in the prescription of the right to collect the disputed deficiency taxes.

Respondent, on the other hand, refutes the allegation by stating that since the prescriptive period for collection was interrupted when the Petitioner requested for a reinvestigation or reconsideration of the assessment, the protested assessment has not yet prescribed.

We find Petitioner's contentions with regard to prescription devoid of merit.

Records show that Petitioner received the assessment notice pertaining to the year 1982 on December 28, 1987. On January 7, 1988, Petitioner presented a position paper in an effort to convince Respondent to re-evaluate his position with regard to its tax deficiencies subject of the assessment. Respondent, however refused to re-evaluate and proceeded to issue a demand letter asking for the payment of the Petitioner's tax deficiencies. A protest letter was soon filed by Petitioner on August 3, 1989 disputing the correctness of the 1982 assessment and at the same time requesting for a reinvestigation of their case. On September 28, 1994, Respondent denied this protest to which Petitioner again requested for a reconsideration in a letter filed on April 12, 1995 where it raised the issue of prescription for the first time. Finally, Respondent issued his final decision denying all the requests of Petitioner and demanding the payment of deficiency income taxes. This final decision was received by Petitioner on November 2, 1995 which led Petitioner to file a Petition for Review with this Court on December 1, 1995.

The facts narrated above show that Petitioner had asked Respondent for several reinvestigations/re-evaluation of the findings of the revenue examiner with respect to its 1982 tax deficiencies. As a result, the protest was never finally denied until November 2, 1995 where Respondent categorically declared the finality of the decision. Under the law, particularly Section 320 of the 1982 Tax Code, the taxpayer's requests for reinvestigation have the effect of suspending the running of the statute of limitation to assess and collect as seen from the following statements:

> **SEC. 320.** ***Suspension of running of statute.*** — The running of the statute of limitations provided in Section 318 and 319 on the making of assessment and the beginning of distraint or levy or a proceeding in court for collection, in respect of any deficiency, shall be suspended for the period during which the Commissioner of Internal Revenue is prohibited from making the assessment or beginning

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> distraint or levy or a proceeding in court, and for sixty days thereafter; when the taxpayer requests for a re-investigation which is granted by the Commissioner; when the taxpayer cannot be located in the address given by him in the return filed upon which a tax is being assessed or collected: *Provided*, That if the taxpayer informs the Commissioner of Internal Revenue of any change in address, the statute will not be suspended; when the warrant of distraint and levy is duly served upon the taxpayer, his authorized representative, or a member of his household with sufficient discretion, and no property could be located; and when the taxpayer is out of the Philippines. (Underscoring supplied)

It is clear that Respondent's right to collect Petitioner's 1982 tax deficiencies has not yet prescribed due to the latter's repeated requests for reinvestigation which have the effect of suspending the prescriptive period. It is for this reason that we will now proceed to discuss the merits of the assessment.

For purposes of clarity, we shall discuss the three kinds of taxes involved in the assessment individually.

SALES TAX DEFICIENCY

The sales tax deficiency arose from Respondent's theory that the sales of the by-product of alkylbenzene (which is the main product being manufactured by Petitioner) should have been subject to the sales tax. During the taxable year 1982, the revenue examiners discovered that Petitioner did not pay sales taxes on the sale of these by-products thus a computation of the

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deficiency resulted in the amount of P22,278.13 pertaining to sales tax liabilities for said year.

Petitioner gave a rather vague explanation in an effort to refute the findings of the revenue examiners with respect to the sales tax deficiencies. Petitioner declared that light and heavy alkylate are by-products of the main product alkylbenzene and these are used by them for the heating system in their manufacturing plant. Due to their utilization of these by-products, lower operating costs resulted, thereby increasing its gross income and consequentially, increasing the taxes paid to the government.

An analysis of the records of this case provided us with a different perspective in deciding the issue of sales tax deficiency of Petitioner.

Records reveal that the Board of Industries granted Petitioner a 100% exemption privilege pursuant to the provisions of Section 8(a) of Republic Act No. 5186. The effectivity of this tax exempt privilege was extended up to 1982. The exemption in payment of sales tax was even acknowledged by the revenue examiner in his working paper (found on page 87, BIR records). We find the particular exemption significant because We believe that if Petitioner was exempt from paying sales taxes on their main product (alkylbenzene) then We see no reason why it should not also be exempt from the payment of sales taxes

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on its by-products. Furthermore, the records do not show that Petitioner engaged in any other activity that will warrant the withdrawal of its tax exemption privilege.

In this light, the sales tax deficiency for 1982 should be cancelled due to a lack of legal basis.

INCOME TAX DEFICIENCY

There are two items of deductions disallowed giving rise to the income tax deficiency assessment in the amount of ₱1,889,001.60. One is the amount of ₱637,900.00 representing disallowed deductions pertaining to marketing and management support services charged by and paid to Chemical Industries of the Philippines (CIP). The other item involves the amount of ₱1,985,712.47 disallowed as a deduction allegedly representing management fees paid to CIP which was not subjected to the expanded withholding tax.

a) The amount of ₱637,900.00

Respondent maintains that the amount of ₱637,900.00 representing the portion of shared expenses of petitioner and CIP corresponding to marketing and management support services was never proven to have been actually incurred due to lack of receipts and invoices to substantiate the same.

We have reviewed the records of this case and We find that Petitioner has satisfactorily proven that the managing company (CIP) actually incurred expenses and correctly billed the Petitioner the amount of ₱637,900.00. Although Petitioner failed to present the receipts corresponding to said amount, it was able to present secondary evidence such as Journal Voucher No. 5112, dated December 31, 1982, which contained a summary of all expenses incurred by CIP in the management of the affiliates and other managed companies (Exhibit "M"). Said voucher revealed the breakdown of expenses incurred by CIP and allocated among the managed companies. The amount of ₱637,898.33 was mentioned in said Exhibit "M" corresponding to the shares of LMG Chemicals Inc.. Furthermore, the amount of ₱637,900.00 was stipulated in the reimbursement agreement between LMG Chemicals and CIP (see Exhibit "H-3").

Having found the evidence pertaining to the expense of ₱637,900.00 to be sufficient, the deduction for said amount should be allowed.

b) The amount of ₱1,985,713.47

Respondent disallowed the above amount as a deduction from gross income because it allegedly represents management fees paid to CIP which were never subjected to the expanded withholding tax. Respondent based his conclusion on Section 30(e) of the 1982 Tax Code which provides that any expense subject to expanded withholding tax should only be allowed as a deduction from gross income if the corresponding income tax is withheld by the payor.

Petitioner apparently did not understand how Respondent came up with the disallowed amount of P1,985,712.47 so that its first reaction was to deny having deducted said amount from its gross income by way of management fees.

A closer scrutiny of the records show that the amount of P1,985,712.47 was due to Respondent's theory that the management fees paid by Petitioner to CIP should have been subjected to 5% income tax instead of only the amount of 3% of 15% as what Petitioner had done. Shown hereunder is how Respondent computed the amount of P1,985,712.47.

Total management fees paid	P2,182,101.67
EWT paid by Petitioner (P2,182,101.67 x 15% x 3%)	P 9,819.46
Divided by 5%, the correct EWT rate per Respondent	5 %
Corresponding allowable management fees	P 196,389.20
Less management fees paid	2,182,101.67
Disallowed management fees	P1,985,712.47

Again, We find for and in favor of the Petitioner and consider the deduction of the amount of P1,985,712.47 to be proper under the circumstances.

While We agree with Respondent that Petitioner should have subjected the management fees paid to CIP to the tax rate of 5% income tax for reasons that will be discussed in the latter part of this decision, We also believe that Petitioner should be allowed to deduct the amount of P1,985,712.47 from its gross income primarily because Respondent has already assessed Petitioner of deficiency expanded withholding tax (EWT) on management fees based on his theory that it should have paid 5% instead of 3% of 15% EWT as will be explained on the issue of deficiency expanded withholding tax. Furthermore, Petitioner already complied with the requirement of deducting expanded withholding tax on these management fees, thus allowing said fees to be deducted as an expense. As mentioned earlier, the tax code allows an expense to be deducted from gross income only if the corresponding EWT is paid on said expense. It was clearly shown that Petitioner was in good faith when it deducted the rate of 3% of 15% EWT from the management fees instead of 5%, hence there is no reason why said management fees should not be allowed as a deduction.

DEFICIENCY EXPANDED WITHHOLDING TAX (EWT)

This issue is intertwined with the above discussion pertaining to the rate of EWT to be imposed on the management fees paid by Petitioner to CIP. Whether or not it should be subjected to 5% or to 3% of 15% EWT is a question that should still be answered.

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Respondent maintains that the management fees paid by Petitioner to CIP should be subject to the 5% EWT because CIP can be categorized only as a management and technical consultant and as such falls under the provision of Section 1(b) of Revenue Regulations No. 13-78 in relation to Section 1(a)(5) of the same Revenue Regulations. The conclusion of Respondent was based on his observation that CIP rendered management services only to its sister companies and does not offer the same services to other companies.

On the other hand, Petitioner asserts that CIP is not merely a management and technical consultant but is an independent contractor performing management services, thus the applicable provision is Section 1(e)(2)(1) of the same Revenue Regulation No. 13-78, as amended by Revenue Regulations No. 6-79, where the proper EWT rate is 3% of 15% and not 5%, as claimed by Respondent.

To better understand the arguments of both parties, We quote certain portions of Section 1(e) of Revenue Regulations No. 13-78 as amended by Revenue Regulations No. 6-79, (for Petitioner) and Section 1(b) (for Respondent) of the same Revenue Regulations.

> "**Section 1. *Income payments subject to withholding tax and rates prescribed therein.* -**
>
> x x x
>
> "(e) *Amounts paid to certain contractors.* - On fifteen per cent (15%) of gross payment to the following contractors, whether

individual or corporate - three per centum (3%).

x x x

"(2) *Other Contractors.* -

x x x

"(i) *Management and consultancy agencies.*"

x x x

"**Section 1.** ***Income payments subject to withholding tax and rates prescribed therein.*** -

x x x

"(b) *Professional fees, talent fees, etc., paid to taxable juridical persons.* - On the gross professional, promotional, talent fees or other remunerations enumerated in the preceding subparagraph paid to taxable juridical persons - five per centum (5%)."

It could be seen from the arguments propounded by the Petitioner that the assumption of CIP of the role of an independent contractor rendering management services is anchored on its allegation that it does not merely offer management services to its sister companies but to various other companies as well. The theory is that if CIP renders management services to the public in general and not only to related companies, it falls outside the category of management and technical consultant but is already in the category of a contractor offering management services where the management fees paid to it are subject to an EWT rate of 3% of 15% pursuant to

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Section 1(e) of Revenue Regulations No. 13-78, as amended by Revenue Regulations No. 6-79, *supra*.

Respondent, on the other hand refutes the claim of Petitioner and offers two observations on the ownership structure of CIP and Petitioner, to wit:

> a) Chemical Industries of the Philippines (CIP) renders management services only to its sister companies and does not offer the same service to other parties, and
>
> b) CIP, LMG Chemicals (Petitioner herein) and Chemphil Manufacturing, Inc., are owned by the same stockholders.

The aforecited observations lead Respondent to conclude that CIP is not an independent contractor but falls under the category of management and technical consultant, where management fees paid to it should be taxed at the rate of 5% EWT.

In this aspect of the assessment of EWT, We find for the Respondent.

CIP which rendered management services to Petitioner, cannot be classified as an independent contractor as claimed by the latter primarily because it failed to dispute the claim of Respondent that it offers management services only to its sister companies. This, plus the fact that the ownership structure of Petitioner and CIP is the same, thus belying the claim of Petitioner that CIP is an "independent" contractor.

Even granting that CIP is an independent contractor, the management fees paid to it are still subject to 5%

EWT, because a perusal of Section 1(e)(2)(1) of Revenue Regulations No. 13-78 as amended by Revenue Regulations No. 6-79 uses the term "contractor" as pertaining to a management and consultancy agency. The legal definition of agency is far different from that of an independent contractor as claimed by Petitioner, thus the management fees really fall outside the tax rate of 3% of 15% because Revenue Memorandum Circular No. 51-79 also uses the term "contractors" as referring to a "management and consultancy agency". If petitioner claims that he is an independent contractor, it cannot now fall under the category of a management and consultancy agency because these two terms have different legal definitions. One cannot claim to be an independent contractor and at the same time fall under the category of a management and consultancy agency.

We therefore conclude that Respondent is correct in classifying CIP as a management and technical consultant as defined under Section 1(b) of Revenue Regulations No. 5-78, therefore subjecting management fees paid to it to a tax rate of 5%.

BIR Ruling No. 182, which dealt on the very same issue, dated October 17, 1983, also declares that payment of professional fees to juridical persons is subject to 5% withholding tax.

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However, due to the failure of Revenue Regulations No. 13-78 or Revenue Regulations No. 6-79 to provide for a clear definition of a "management and consultancy agency", then the penalty, surcharge and interest should not be imposed on the assessed deficiency as Petitioner made an honest mistake in classifying CIP as a management and consultancy agency.

In sum, Petitioner is liable to pay the basic deficiency expanded withholding tax of P99,285.62 computed as follows:

Management fees	P2,182,101.67
Multiply by correct rate	5%
Correct withholding tax	P 109,105.08
Less: amount paid per return	9,819.46
Basic deficiency EWT	P 99,285.62

WHEREFORE, in view of the foregoing, the assessments issued by Respondent for the taxable year 1982 pertaining to deficiency sales tax in the amount of P22,278.13 and deficiency income tax in the total amount of P1,889,001.60 are hereby **CANCELLED** and **WITHDRAWN** for lack of legal bases. However, the assessment for expanded withholding tax in the amount of P99,285.62 is upheld, without imposing the corresponding penalties.

ACCORDINGLY, Petitioner is **ORDERED** to **PAY** the amount of P99,285.62 to Respondent.

SO ORDERED.

RAMON O. DE VEYRA
Associate Judge

WE CONCUR:

ERNESTO D. ACOSTA
Presiding Judge

AMANCIO Q. SABA
Associate Judge

CERTIFICATION

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

ERNESTO D. ACOSTA
Presiding Judge