REPUBLIC OF THE PHILIPPINES
Court of Tax Appeals
QUEZON CITY

SECOND DIVISION

KEPCO ILIJAN CORPORATION, Petitioner,	**C.T.A. AC NO. 30**
	Members:
- versus -	**CASTAÑEDA, JR.,** *Chairperson* **UY,** *and* **PALANCA-ENRIQUEZ,** *JJ.*
THE CITY OF MAKATI, Respondent.	**Promulgated:** SEP 0 5 2008 4:00 p.m.

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DECISION

UY, J.:

Before this Court is a Petition for Review filed on May 4, 2007 pursuant to Rule 8, Section 4(a) of the Revised Rules of the Court of Tax Appeals, seeking the reversal of the Decision dated November 24, 2006, and the Order dated March 22, 2007, both rendered by Branch 143 of the Regional Trial Court of the City of Makati in Civil Case No. 05-437, entitled "Kepco Ilijan Corporation vs. The City of Makati" dismissing the appeal filed in said case, and denying the motion for reconsideration of said dismissal, respectively.

THE FACTS

As culled from the records of the case, the facts are as follows:

Petitioner, Kepco Ilijan Corporation, is a domestic corporation duly organized and existing under and by virtue of the laws of the Republic of the Philippines, with principal place of business at the 18th Floor Citibank Tower, 8741 Paseo de Roxas, Salcedo Village, Makati City. On the other hand, respondent City of Makati, is being sued in its capacity as the local government unit which classified petitioner as a "contractor" for purposes of local business tax.

On November 5, 1997, petitioner entered into an Energy Conversion Agreement (ECA) with the National Power Corporation (NAPOCOR), whereby the latter shall build, operate and maintain the 1200 MW Ilijan Natural Gas Power Plant.[1]

On February 18, 2004, petitioner was issued a Mayor's Permit by respondent classifying it as "SEO" or special contractor for local business tax purposes. Petitioner then requested that its classification be changed from "contractor" to that of a "manufacturer" since its classification as a "contractor" is allegedly not in accordance with the definition of said word under existing laws and relevant Department of Finance circulars. Due to the fact however that it was still under Income Tax Holiday (ITH) then, and as a consequence of which, no tax collection or assessment could then be imposed by the respondent up to February 28, 2004, petitioner still sought to have its classification reconsidered through a series of written communications and appropriate meetings with officers of the respondent. Upon the expiration of its ITH, petitioner requested for a computation of its local business taxes normally due on January 2005 from the respondent.

[1] Decision, Civil Case No. 05-437; Docket, p 20.

On January 18, 2005, respondent issued the requested computation classifying petitioner as a "contractor" and not a "manufacturer" and assessed petitioner for the amount of P3,358,711.75, representing its local business tax. Despite its objections, petitioner paid the said assessment; but subsequently filed its protest on March 18, 2005. On April 14, 2005, the City of Makati issued its Resolution denying petitioner's protest.

In view of the said denial, petitioner filed its Appeal with Branch 143 of the Regional Trial Court of the City of Makati on May 18, 2005, in accordance with Section 195 of the Local Government Code (LGC) of 1991.[2] Petitioner submits that the nature of its business activity is more of a "manufacturer" rather than a "contractor" as defined under the Makati City Tax Code and Local Finance Circular No. 3-95. It averred that the process of converting natural gas into electricity is more of the role of a "manufacturer" rather than a "contractor"; and that it was not even a "sub-contractor" under the current definition as provided under the Department of Finance (DOF) Circular 3-95.

Dispensing with the need to present any documentary or testimonial evidence, the Court *a quo* issued the Order dated August 22, 2005 requiring the parties to submit their respective memorandum there being no factual issues involved in said case.[3]

On November 24, 2006, the assailed Decision dismissing petitioner's appeal for lack of merit was rendered. The lower court found that petitioner was properly classified as a "contractor" and not as a "manufacturer", pursuant to Section 131(h) of the LGC of 1991; that the terms enumerated in

[2] Appeal, Kepco Ilijan Corporation vs. City of Makati, Civil Case No. 05-437; Docket, pp. 26-35.
[3] Docket, p. 36.

petitioner's Articles of Incorporation which is to "build, operate, maintain and manage a power plant", are services embodied under the definition of a "contractor" – which includes persons whose activity consists essentially of sale of all kinds of services for a fee; that there was insufficiency of evidence to support petitioner's claim that it should fall under the classification of "manufacturer". Thus, the presumption of the correctness of the assessment made by the City of Makati was applied by the lower court.

Petitioner's Motion for Reconsideration filed on December 27, 2006[4] was likewise denied for lack of merit in the Order dated March 22, 2007.[5] The lower court maintained its stand on classifying petitioner as a "contractor" as it undeniably provides services to NAPOCOR for a fee. It further held that as shown by evidence, the service petitioner rendered was to operate the power station principally for NAPOCOR; which included all the necessary commissioning and testing of the power station, guarantee tests, and conversion of fuel to electricity; while NAPOCOR, in turn, was required to reimburse the generator for the natural gas used and paid for during the other tests of the power station prior to the completion date.

Dissatisfied, petitioner filed the instant Petition for Review on May 4, 2007.[6] Respondent filed its Comment on June 15, 2007,[7] arguing that the lower court did not err or commit grave abuse of discretion amounting to lack of or in excess of its jurisdiction when it classified petitioner as a "contractor" and not as a "manufacturer" for the settlement of its local taxes. A Reply was

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[4] Docket, pp. 37-45.
[5] Docket, pp. 17-19.
[6] Docket, pp. 1-15.
[7] Docket, pp. 48-55.

filed by petitioner on June 27, 2007[8] maintaining its stand that it should be classified as a "manufacturer" based on prevailing jurisprudence on the matter.

On July 16, 2007, petitioner filed a "Motion for Consolidation" of the instant case with the case entitled **Kepco Philippines Corporation vs. The City of Makati**, docketed as C.T.A. AC No. 23 also assigned to the Second Division of this Court.[9] However, in the Resolution dated October 19, 2007,[10] this Court denied said motion on the ground that a Decision has already been rendered in the aforementioned case on August 24, 2007 and considered the instant case submitted for decision considering that both parties have already filed their respective Memorandum.

Hence, this Decision.

THE ISSUES

The sole issue for this Court's consideration is whether or not petitioner, in the process of selling electricity, is a "contractor" or a "manufacturer", as defined under the Local Government Code and Makati City Tax Code.

PETITIONER'S ARGUMENTS

Petitioner assigns two errors allegedly committed by the Court *a quo,* to wit: (I) that the Honorable Court allegedly erred and committed grave abuse of discretion amounting to lack of jurisdiction when it classified the petitioner as a contractor and not as a manufacturer, without taking into consideration the nature of its business activity; and (II) that in the absence of a trial on the

[8] Docket, pp. 56-61.
[9] Docket, pp. 64-66.
[10] Docket, p. 91.

merits, the Honorable Court erred when it ruled that petitioner failed to present sufficient evidence to prove it is a manufacturer.

According to petitioner, for purposes of taxation, jurisprudence has already laid down the guidelines as to how to determine whether an entity is a manufacturer or contractor. In the case of **Concrete Aggregates Inc. vs. Court of Tax Appeals**,[11] a "manufacturer" is implied as follows:

> "As aptly pointed out by the Solicitor General, petitioner's raw materials are processed under a prescribed formula and thereby changed by means of machinery into a finished product, altering their quality, transforming them into marketable state or preparing them for any of the specific uses of industry. Thus, the raw materials become a distinct class of merchandise or 'finished products for the purpose of their sales or distribution to others and not for his own use or consumption.' Evidently, without the above process, the raw materials or aggregates could not, in their original form, perform the uses of the finished product.
>
> In a case involving the making of ready-mixed concrete, it was held that concrete is a product resulting from a combination of sand or gravel or broken bits of limestones with water and cement, a combination which requires the use of skill and most generally of machinery. Concrete in forms designed for use and supplied to others for buildings, bridges and other structures is a distinct article of commerce and the making of them would be manufacturing by the corporation doing so."

Further, in the case of **Bermejo vs. CIR**[12], the Supreme Court held that:

> "The process is a chemical or physical process altering the exterior texture and inner substance of the firewood in such manner as to prepare it for special uses to which firewood may not be dedicated. Wherefore, in making charcoal for the market, plaintiff became a manufacturer within the meaning of the law."

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[11] G.R. No. 55793, May 18, 1990.
[12] 87 Phil. 96 (1950).

Petitioner likewise submits that in the case of **Oriental Kapok Industries vs. CIR**[13], it was held that:

> "Where the taxpayer buys unhusked kapok, removes the skin, airs and feeds it into a machine called 'separator' thus, altering the exterior texture or form of the raw, unhusked kapok pods and also the quality of the kapok fiber itself, reducing it to marketable shape or preparing it for any of the uses of the industry, the taxpayer is a manufacturer as defined by the Tax Code."

According to petitioner, the raw materials used by petitioner are either the natural gas sourced from the Malampaya fields located in the area of the Province of Palawan or the diesel fuel purchased by petitioner from NAPOCOR. These raw materials are then converted into electricity by using the combined cycle generating equipment located at the Ilijan Power Plant. Once the natural gas is converted into electricity, the petitioner will sell the same to NAPOCOR, to the energy spot market trading, and to other customers or traders.

Petitioner avers that while natural gas and diesel fuel are sources of energy, it is also without doubt that, in its original state, these raw materials cannot provide electricity or energy. It is at this stage that petitioner, through the use of its turbine generator equipment and applying specific engineering methods, converts the potential energy found in natural gas into actual energy and thereafter produces a commodity commonly known as electricity. Accordingly, this is the very essence of petitioner's business.

Moreover, petitioner argues that the terms "build, operate, maintain and manage" are mere incidental activities to the true nature of petitioner's

[13] G.R. No. L-17837, January 31, 1963.

business. Petitioner, for it to sell the electricity it generates, has to perform such activities in order to convert natural gas to energy. Apart from the fact that petitioner did not secure a contractor's license which is required under the Contractor's Licensing Law, it did not build, operate or manage any other power plant in the Philippines. According to petitioner, if it was indeed its intention to be a "contractor", it would not have limited itself to operating only one power plant. Petitioner maintains that that these activities are not the basis of its income.

The basic distinction between a "manufacturer" and a "contractor", therefore, should allegedly be based on the end-product of the business and how this is achieved. A "manufacturer" sells a commodity, while a "contractor" sells service. Devoid of any technical details, natural gas is a raw material which enables petitioner to produce and convert them into electricity. Without the process of alteration which petitioner undertakes, any type of raw material alone cannot be used as electricity or transformed into energy. The operation and maintenance of the plant is merely an incident to its main line of business activity – that is to sell electricity. Thus, petitioner submits that its local business tax classification should be as a "manufacturer", based on the type of business it is engaged in.

Furthermore, petitioner asserts that the Electric Power Industry Reform Act (EPIRA) of 2001[14] has recognized that generation companies are more of a "manufacturer" than a "contractor". This is considering that Section 31 of the EPIRA has now mandated generation companies to sell their electricity to the spot market (WESM) and eventually to qualified end-users upon the

[14] Republic Act No. 9136.

implementation of the open-access scheme. In other words, the WESM allows the suppliers and buyers to trade electricity as a commodity. Hence, the significance of the establishment of the WESM is that our laws recognize the sale by generation companies of their manufactured electricity as a commodity and not just any type of service.

Finally, petitioner claims that when the lower court dispensed with the presentation of evidence by petitioner, it invariably prejudiced the right of petitioner to effectively prove that, by the very nature of its business activity, it is a "manufacturer".

RESPONDENT'S ARGUMENTS

Respondent, for its part, maintains that the lower court did not commit any grave abuse of discretion when it classified petitioner as a "contractor" and not as a "manufacturer". Respondent avers that there could not have been grave abuse of discretion in this case considering that the decisions have been supported by citations of law and jurisprudence decided by the Highest Tribunal. A reading of the Decision and Order rendered by the lower court discloses that the said court examined clearly the evidence presented and the details and matters raised by the parties. In fact, the findings of the lower court are fully supported by facts and evidence presented by petitioner itself.

Likewise, respondent points out that Section 131(h) of the LGC of 1991 expressly defines a "contractor" as "includes persons, natural or juridical, not subject to professional tax under Section 139 of this Code, whose activity consists essentially of the sale of all kinds of services for a fee, regardless of whether or not the performance of the service calls for the exercise or use of the physical or mental faculties of such contractor of his employees."

Respondent adds that, on the other hand, Section 131(o) of the same Code defines a "manufacturer" as "includes every person who, by physical or chemical process, alters the exterior texture or form or inner substance of any raw material or manufactured or partially manufactured product in such manner as to prepare it for special use or uses to which it could not have been put in its original condition, or who by any such process, alters the quality of any such raw material or manufactured or partially manufactured products so as to reduce it to marketable shape or prepare it for any of the use of industry, or who by any such process, combines any such raw material or manufactured or partially manufactured products with other materials or products of the same or of different kinds and in such manner that the finished products or such process or manufacture can be put to a special use or uses to which such raw material or manufactured or partially manufactured products in their original condition could not have been put, and who in addition, alters such raw material or manufactured or partially manufactured products, or combines the same to produce such finished products for the purpose of their sale or distribution to others and not for his own use or consumption."

From the foregoing definitions then, it is allegedly clear that herein petitioner is a "contractor" and not a "manufacturer", contrary to what petitioner asserts. Accordingly, petitioner is covered under Section 131(h) of the LGC of 1991 and is liable to pay the assessed taxes.

THE COURT'S RULING

In order for this Court to determine the true nature of petitioner's business activity, the Court will first look into the nature of the conversion of fuel into electricity; whether such act of converting the natural gas or the diesel fuel, through the use of its turbine generator equipment and applying specific engineering methods, into electricity is sufficient to classify petitioner as a "manufacturer".

Petitioner does not dispute the fact that the primary purpose for its incorporation is to build, operate, maintain and manage the 1200 MW Combined-Cycle Ilijan Power Plant for the conversion of fuel into electricity; and that it was established for the sole purpose of operating a power station principally for NAPOCOR which includes all necessary commissioning and testing of the power station and operate it in a manner that will allow tests, for conversion of fuel into electricity for NAPOCOR.

As found by the lower court, which factual findings this Court will not disturb in the absence of proof that the same are erroneously made, petitioner operates the power station principally for NAPOCOR, and in return, NAPOCOR is required to reimburse herein petitioner for the natural gas used and paid for during the other tests of the power station prior to the completion date; and that all electricity supplied whether before or after the completion date, would be owned by NAPOCOR.

In other words, NAPOCOR is obligated to supply and shoulder the cost of the fuel requirements of the power plant used by petitioner in converting the natural gas or diesel fuel into electricity. NAPOCOR then pays the "fees" for the conversion of such fuel. As defined under Black's Law Dictionary, a "fee" is a recompense for an official or professional service or a charge or emolument or compensation for a particular act or service. It is a fixed charge or perquisite charged as recompense for labor; reward, compensation, or wage given to a person for performance of services or something done or to be done.[15]

There is thus no argument that these activities of petitioner come in the form of services. In the process of performing these services, the question that arises is whether petitioner, in the course of performing said services, does it as a "contractor" or as a "manufacturer"?

For a clearer understanding of what is a contractor and a manufacturer, We look into the definitions thereof as provided in Sections 131 (h) and (o) of the LGC of 1991,[16] to wit:

> "SEC. 131. *Definition of Terms.* –When used in this Title, the term:
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> x x x x x
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> (h) **'Contractor' includes persons, natural or juridical**, not subject to professional tax under Section 139 of this Code, **whose activity consists essentially of the sale of all kinds of services for a fee, regardless of whether or not the performance of the service calls for the exercise or use of the physical or mental faculties of such contractor or his employees**.
>
> As used in this Section, the term 'contractor' shall include general engineering, general building, and specialty contractors as defined under applicable laws; filling, demolition and salvage works contractors; proprietors or operators of mine drilling apparatus; proprietors or operators of dockyards; persons engaged in the installation of water system, and gas or electric light, heat or power; proprietors or operators of smelting plants; engraving, plating and plastic lamination establishments; proprietors or operators of establishments for repairing, repainting, upholstering, washing or greasing of vehicles, heavy

[15] Black's Law Dictionary, 6th Edition, p. 614.
[16] Republic Act No. 7160.

equipment, vulcanizing, recapping and battery charging; proprietors or operators of furniture shops and establishments for planing or surfacing and recutting of lumber, and sawmills under contract to saw, or cut logs belonging to others; proprietors or operators of dry-cleaning or dyeing establishments, steam laundries and laundries using washing machines; proprietors or owners of shops for the repair of any kind of mechanical and electrical devices, instruments, apparatus, or furniture and shoe repairing by machine or any mechanical contrivance; proprietors or operators of establishments or lots for parking purposes; proprietors or operators of tailor shops, dress shops, milliners and hatters, beauty parlors, barbershops, massage clinics, sauna, Turkish and Swedish baths, slenderizing and building saloons and similar establishments; photographic studios; funeral parlors; proprietors or operators of hotels, motels and lodging houses; proprietors or operators of arrastre and stevedoring, warehousing, or forwarding establishments; master plumbers; smiths, and house or sign painters; printers, bookbinders, lithographers; publishers except those engaged in the publication or printing of any newspaper, magazine, review or bulletin which appears at regular intervals with fixed prices for subscription and sale and which is not devoted principally to the publication of advertisements; business agents, private detective or watchman agencies, commercial and immigration brokers, and cinematographic film owners, lessors and distributors." *(Emphasis Ours)*

x x x x x

"(o) **'Manufacturer'** includes every person who, by physical or chemical process, alters the exterior texture or form or inner substance of any raw material or manufactured or partially manufactured product in such manner as to prepare it for special use or uses to which it could not have been put in its original condition, or who by any such process alters the quality of any raw material or manufactured or partially manufactured products so as to reduce it to marketable shape or prepare it for any of the use of the industry, or who by any such process, combines any such raw materials or manufactured or partially manufactured products with other materials or products of the same or of different kinds and in such manner that the finished products of such process or manufacture can be put to a special use or uses to which such raw material or manufactured or partially manufactured products in their original condition could not have been put, and who in addition, alters such raw material or manufactured or partially manufactured products, or combines the same to produce such finished products for the purpose of their sale or distribution to others and not for his own use or consumption."

Based on the foregoing definition, petitioner's act of converting the natural gas or diesel fuel into electricity definitely falls under Section 131(h) of the LGC of 1991. The Court finds petitioner's assertion, that it is a "manufacturer" mainly because of the alleged alteration of the fuel through processing, to be self-serving. If indeed petitioner is a "manufacturer" as it argues it to be, considerations as regards the supplier of raw materials/fuels needed to generate electricity, and ownership of the electricity thus generated by the power plant for transmission, and sale to end-users should be taken into account. It is quite unusual that NAPOCOR supplies the fuel needed by petitioner to generate fuel, as well as, receives all the electricity generated, and still conclude that petitioner is a "manufacturer". The fact that petitioner merely operates, maintains, and manages the power plant for the conversion of fuel supplied by NAPOCOR for the eventual transmission of electricity only to NAPOCOR show that the same all come in the nature of the rendition of service for a fee. All these lead to the conclusion that petitioner is a "contractor" as defined under the LGC of 1991.

On the same vein, the Court finds no merit in petitioner's argument that the Electric Power Industry Reform Act of 2001 has recognized that generation companies are more of a "manufacturer" than a "contractor". It may be that Section 31 of the EPIRA has now mandated generation companies to sell their electricity to the spot market (WESM) and eventually to qualified end-users upon the implementation of the open-access scheme; such act does not necessarily assume that the WESM allows the suppliers and buyers to trade electricity as a commodity. As earlier discussed, petitioner renders "service" by operating, maintaining, and managing the power plant for the conversion of fuel supplied by NAPOCOR for the eventual transmission of electricity only to NAPOCOR. Hence, this Court affirms the ruling of the lower court that petitioner is a "contractor" rather than a "manufacturer".

WHEREFORE, finding no reversible error in the assailed Decision and Order dated November 24, 2006 and March 22, 2007, respectively, rendered by Branch 143 of the Regional Trial Court of Makati City in Civil Case No. 05-437, the instant Petition for Review is hereby **DISMISSED** for lack of merit. Accordingly, said assailed Decision and Order are hereby **AFFIRMED**.

SO ORDERED.

ERLINDA P. UY
Associate Justice

WE CONCUR:

JUANITO C. CASTAÑEDA, JR.
Associate Justice

OLGA PALANCA-ENRIQUEZ
Associate Justice

ATTESTATION

I attest that the conclusions in the above Decision were reached in consultation before the case was assigned to the writer of the opinion of the Court's Division.

JUANITO C. CASTAÑEDA, JR.
Associate Justice
Chairperson

CERTIFICATION

Pursuant to Article VIII, Section 13 of the Constitution, and the Division Chairperson's Attestation, it is hereby certified that the conclusions in the above Decision were reached in consultation before the case was assigned to the writer of the opinion of the Court.

ERNESTO D. ACOSTA
Presiding Justice